Ethical Obligations and Decision Making in Accounting Text and Cases 4th edition Mintz Solutions Manual

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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. During the audit, Diane, a member of the group, points out that she identified a deficiency in the client's inventory system that she did not discover during the physical observation of the client's inventory. The deficiency was relatively minor, and perhaps that is why it was not detected at the time. 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 who identified the deficiency and she is the one who should have detected it at the time of the observation. 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. **Discuss these issues from the perspective of Kohlberg's model of moral development. How does this relate to the established norms of the work group as you see it?**

   Diane and the ones who did not want to take the matter to Jessica, the senior, are reasoning at the preconventional levels of avoiding punishment and satisfying one's own needs. They want to avoid having more work to do or receiving a low evaluation from missing a mistake (Diane) or going over the time budget. Barbara and Haley are reasoning at the conventional and, possibly, postconventional levels. They want to be fair to the firm, the client, and the public, and know that they are following audit standards (law and order). It is possible that they are reasoning at level 5, social contract. They fully understand the social contract CPAs undertake to protect the public interest in financial markets. Barbara understands that the deficiency could be more serious than the group of staff auditors understands or that the deficiency could portend other problems. It could also portend problems with internal control deficiencies over financial reporting, which is the most cited deficiency of audit firms by the PCAOB.

   Often groups want to have a clear cut leader or work by majority rule. However, ethics does not go along well with majority rule. If a group decides by majority rule to rob someone, it does not make the theft right or ethical. Barbara should tell Jessica about the deficiency.

2. **Assume you are in Barbara's position. What would you do and why? Consider the following in answering the question:**

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- **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 push-back will be and, then, what would you say next?**

Barbara should explain to the other team members that she feels compelled to go on and tell Jessica. She can say that she understands their concerns and will take all the blame for not finding the deficiency sooner. She also can state that telling Jessica will show their integrity, due diligence, and professional objectivity by not ignoring information that could impact the conclusion of the audit.

Barbara can also solicit the help of Haley who supports Barbara's point of view. There is strength in numbers so going together to talk to Jessica should enhance Barbara's position and its legitimacy in the eyes of Jessica.

Diane and the other team members may still push back against Barbara telling Jessica. Diane and the other team members may feel that they will still be blamed and be assigned even more work to do. They may be fearful of receiving low evaluations.

Barbara should then go talk to Jessica and explain in detail why Jessica or the manager or partner may need to know about the deficiency. Jessica may at first be mad that the deficiency is just coming out as the audit is nearing completion. She may not want to go over the budget, which could affect her promotion to manager. Jessica may play the "loyalty to the team" card or say just ignore it this one time in trying to convince Barbara to let the deficiency go. She may emphasize that it is not material to the audit as well.

If Jessica does not want to listen or does not believe Barbara, Barbara should document her concerns in the workpapers. Will Jessica allow the work papers to go forward with Barbara's concerns? Should Barbara consider going to the manager or the partner? Standard practice is to go to the immediate supervisor, not jump over reporting lines. SOX and Dodd Frank laws are trying to protect whistleblowers and to get financial statement corrections done quickly. Most public accounting firms have a reporting mechanism similar to ethics hotlines in public companies, so that Barbara might employ that mechanism to report the error without going over Jessica's head.

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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 so many requests for the recipe and a local restaurant asked to use it as the house special, that 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.

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.

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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."

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

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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?**

   Michael is using cost-benefit analysis and does not consider the cost of losing the brand's reputation. Gregory by remaining silent is agreeing with Michael. Alex needs to try to estimate the cost of loss of reputation to possibly show that the cost-benefit analysis including the total costs of recall, shut down, cleaning, training and restocking is more than the cost of complying with FDA requirements. For example, the FDA can close production of the dressing and order the plant to be cleaned from top to bottom. In 2015 Blue Bell Ice Cream had to do a total recall of its ice cream, total cleaning of three plants, and keep its products off the shelves for six months; estimated costs of recall, cleaning plants, and training of employees total over $125 million. The challenge for Blue Bell is whether customers will buy the products again.

   An example of heightened corporate responsibility happened at Chipotle restaurants. In October 2015, the restaurant temporarily closed 43 stores in Washington and Oregon after an E. coli outbreak was linked to several of the chain's restaurants in the area. Eight people had been hospitalized but no one had died from the reported cases of infection at the time of writing. Health officials had believed the outbreak was linked to Chipotle's food but hadn't discovered the exact source of contamination.

   Chipotle spokesman Chris Arnold said that customers' safety is the company's biggest concern. "We immediately closed all of our restaurants in the area out of an abundance of caution, even though the vast majority of these restaurants have no reported problems," he said.

   "The safety of our customers and integrity of our food supply has always been our highest priority," Steve Ells, chairman and co-CEO of Chipotle, said in a statement. "We work with a number of very fresh ingredients in order to serve our customers the highest-quality, best-tasting food we can. If there are opportunities to do better, we will push ourselves to find them and enhance our already high standards for food safety. Our deepest sympathies go out to those who have been affected by this situation and it is our greatest priority to ensure the safety of all of the food we serve and maintain our customers' confidence in eating at Chipotle."

2. **What is at stake for the key parties, including those who disagree with you?**

   Alex has his reputation and his salad dressing recipe at stake. He is committed to producing quality products and maintaining the reputation of the company. He is (morally) tied to the reputation of the company he has helped develop and wants the company to continue developing new and zesty dressing. Alex is reasoning at stage 6: He

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knows it is illegal to sell tainted food; he is aware of the social contract that restaurants have with society; he doesn't care about costs and benefits emphasizing instead the rights of the consuming public to be safe and ensured of eating healthy products.

Michael wants the company to stay profitable and successful so the firm can do an IPO; then he can cash out and be wealthy. Michael seems oblivious to the ethical issues, (i.e., ethical blindness) reasoning at stage 2.

Gregory's position is unknown, although silence may be a cover for not wanting to rock the boat and upset either Michael or Alex. If so, he has failed in his leadership role in running the business.

For the company, Alex, Michael, and Gregory, the FDA could shut production down until the plant is sterilized. This would lead to losses from recalls, loss of sales, liabilities if any customers become sick from eating an unsafe product. Even though the company might do all the right things in reaction to the listeria, it doesn't mean it will regain its reputation for trust.

For the FDA and the public, food safety is critical. Food borne diseases are hard to pinpoint and costly to recover from, whether due to sickness, hospitalizations, loss of product and sales, or mistrust of inspections and food supplies. The employees of the company could lose jobs, and the community will lose taxpayers.

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

Alex can use the reputation of the company, the quality of the products, and the mission of company. He can use the ethical reasoning of virtues, deontology, and rule utilitarianism. He can emphasize integrity, transparency, commitment to mission and quality, and citizenship with complying with FDA.

If the company has a code of ethics, he can appeal to those values. For example, Kraft Foods code has ten rules. The 10 rules are: Make food that is safe to eat; market responsibly; treat people fairly; respect the free market; compete fairly; respect the environment; deal honesty with the government; keep honest books and records; never trade on inside information; give Kraft Foods your complete business loyalty.

Alex can use the lever of including the costs of recalls, shut down, cleaning, training and restocking in the cost-benefit analysis. He can also use that an IPO filing would require disclosure of the FDA inspections, which increase the risks that would have to be disclosed in the filing. Those risks could affect the stock price and total value of the IPO.

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?**

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Gregory may reason that he wants to get as much money as possible and get his investment out from the company. In wanting to get out of the company now, Gregory may think that Michael is right to do a cost benefit analysis on meeting FDA inspections. Gregory and Michael are looking at the short-term of keeping expenses low until the IPO is done. They may also be rationalizing that the expenses to meet the FDA requirements and the fines and penalties are immaterial compared to the profits to be made from IPO, and that this is an isolated incident.

The most powerful and persuasive argument needs to be addressed to Gregory. Alex needs to remind Gregory that as partners they started the company together, not to make money but to follow their passion, and make high quality, specialty dressings. Alex needs to remind Gregory of that passion and the goals of starting the company. He also needs to remind Gregory that the company's promise and mission is to provide great-tasting dressing made with the freshest, best, organic products. The reputation of Gregory and Alex will be affected if after an IPO it is discovered that the company cut corners on complying with the FDA, and in the process did not the company's promise and mission. The public's trust in them as managers may be compromised should they decide to open a new business later on.

Alex needs to stand his ground on this issue. He does not want his reputation to be tainted. Alex can threaten to disclose everything to the FDA and state regulatory agencies if he can't change Michael's mind and is unable to convince Gregory of the right thing to do. This issue has high moral intensity for Alex as he is closest to quality issues with the food and has worked hard to develop a reputation for trust.

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Case 2-3 The Tax Return (a GVV case)

Brenda Sells sent the tax return that she prepared for the president of Purple Industries, Inc., Harry Kohn, to Vincent Dim, the manager of the tax department at her accounting firm. Dim asked Sells to come to his office at 9 a.m. on Friday, April 12, 2016. Sells was not sure why Dim wanted to speak to her. The only reason she could come up with was the tax return for Kohn.

"Brenda, come in," Vincent said.

"Thank you, Vincent," Brenda 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 Mr. Kohn?" asked Brenda.

"That's right," answered Vincent.

"Is there a problem?" Brenda asked.

"I just spoke with Kohn. I told him that you want to report his winnings from the lottery. He was incensed."

"Why?" Brenda asked. "You and I both know that the tax law is quite clear on this matter. When a taxpayer wins money by playing the lottery, then that amount must be reported as revenue. The taxpayer can offset lottery gains with lottery losses, if those are supportable. Of course, the losses cannot be higher than the amount of the gains. In the case of Mr. Kohn, the losses exceed the gains, so there is no net tax effect. I don't see the problem."

"You're missing the basic point that the deduction for losses is only available if you itemize deductions," Vincent said. "Kohn is not doing that. He's using the standard deduction."

Brenda realized she had blown it by not knowing that.

Brenda didn't know what to say. Vincent seemed to be telling her the lottery amounts shouldn't be reported. But that was against the law. She asked, "Are you telling me to forget about the lottery amounts on Mr. Kohn's tax return?"

"I want you to go back to your office and think carefully about the situation. Consider that this is a one-time request and we value our staff members who are willing to be flexible in such situations. And, I'll tell you, other staff in the same situation have been loyal to the firm. Let's meet again in my office tomorrow at 9 a.m."

Questions

1. **Analyze the alternatives available to Brenda using Kohlberg's six stages of moral development. Assume that Brenda has no reason to doubt Vincent's veracity with**

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respect to the statement that it is "a one-time request." Should that make a difference in what Brenda decides to do? Why or why not?

Vincent is reasoning at stage 3 trying to keep the client happy first and foremost. Brenda was reasoning at stage 4, following the rules. Brenda should use ethical reasoning, and consider the force of tax laws and regulations on the situation.

An ethical person acts ethically at all times, not just when it is convenient. This may not be a one-time request, the next time will be easier to go along and it may be the start of the slide down the proverbial "ethical slippery slope." The concept of an ethical slippery slope is one that defines behavior when a decision-maker first decides to deceive others by consciously covering up or lying about past behavior. This begins the slide downhill and it becomes more difficult to reverse course because the decision maker is committed to the deceitful action; then since most people don't want others (i.e., superiors) to know about the initial act, wrongful actions over time may be taken to cover up the misdeed. Moreover, the lies may slowly become untangled and the truth emerges. Saying that an incident will be one-time request is a rationalization. Brenda should not fall for that trap as she can't be sure it will be a one-time request. Nevertheless, it is wrong to submit a tax return one knows is fraudulent regardless of the reasons and rationalizations of superiors.

2. **Assume you have decided what your position will be in the meeting with Vincent but are not quite sure how to respond to the reasons and rationalizations provided by him to ignore the lottery losses. How might you counter those arguments? What would be your most powerful and persuasive responses?**

The next morning Brenda was ready for the meeting with Vincent. She has researched the reporting and deduction of gambling wins and losses.

"Vincent, I know about the gambling winnings because there was a W-2 G in his tax documents. I researched the requirements for reportable winnings on a W-2G. Reportable gambling winnings include:

1. The winnings (not reduced by the wager) are $1,200 or more from a bingo game or slot machine,

2. The winnings (reduced by the wager) are $1,500 or more from a keno game,

3. The winnings (reduced by the wager or buy-in) are more than $5,000 from a poker tournament,

4. The winnings (except winnings from bingo, slot machines, keno, and poker tournaments) reduced, at the option of the payer by the wager are:

    a. $600 or more, and

    b. At least 300 times the amount of the wager, or

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5. The winnings are subject to federal income tax withholding.

Withholding on gambling winnings must be done when the winnings reported on the W-2G form are greater than $5,000." Brenda reported.

Vincent replied, "Well, Kohn doesn't want the winnings reported so that is what we will do."

"The IRS is also getting a copy of the W-2G. Leaving the amounts off the tax return will lead to interest and penalties, including tax preparer penalties when it is found," Brenda replied.

"But the IRS is understaffed and the missing amounts will not be discovered."

"I disagree and cannot go along with you. I will not sacrifice my integrity and commitment to professional excellence to lie for a client."

Vincent is using reasons and rationalizations based on keeping clients happy and that it is expected or standard practice; how long would the firm last without clients? The amount Brenda is being asked to exclude from the tax return is immaterial to Mr. Kohn's total income. Vincent is also promising that this will be a one-time request. He encourages Brenda to go along to get along, to show that she is a team member, which will help her when it is time for promotions.

Brenda's most powerful and persuasive argument to Vincent's reasons and rationalizations is the tax rules and reporting, ethics code of the accounting profession, and ethical reasoning including virtues, deontology, and rule utilitarianism. Brenda should remind Vincent that going along with Mr. Kohn may be more than tax evasion and may be tax fraud due to the under-reporting of income. This could hurt Vincent's chances of making partner.

Brenda should use the leverage of the AICPA Code Principles that follows. The umbrella statement in the Code is that the overriding responsibility of CPAs is to exercise sensitive professional and moral judgments in all activities.

3. **Assume that Brenda decides to go along with Vincent and omits the lottery losses and gains. Next year a similar situation arises with winnings from a local poker tournament. Kohn now trusts Brenda and shared with her that he won $4,950 from that event. He tells you to not report it because it was below the $5,000 threshold for the payer to issue a form W-2G. If you were Brenda, and Vincent asked you to do the same thing you did last year regarding omitting the lottery losses and gains, what would you do this second year and why?**

Brenda may be blackmailed by threat of loss of job into going along again and again with Vincent to keep the client happy. Brenda needs to cut her (ethical) losses and stand up for what she believes in. She can admit the mistake of going along the first time but she did

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not compound that mistake with other unethical decisions. She has drawn a line in the sand and needs to stick to her principles.

At this point it should be quite clear to Brenda she needs to leave the accounting firm. The handwriting is on the wall. It is not an ethical place to work.

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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. Daniels was recently asked to prepare a sales budget for the year 2016. He conducted a thorough analysis and came out with projected sales of 250,000 units of product. That represents a 25 percent increase over 2015.

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 hired me."

"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?"

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"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 percent was wrong. I checked my numbers and it should have been 12.5 percent. 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." Cwervo 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, Jose Cwervo, his boss. The meeting ended with Daniels feeling sick to his stomach and guilty for not taking any action.

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NOTES

This case provides a way to discuss with students how to handle errors made on a job. This case is dealing with making a mistake in an estimate, which many accountants often do. Many think that all errors should be covered up. An ethical person or company owns up to mistakes honestly.

Ethical Issues

The ethical issues here are how to handle the situation of having made a mistake in a job; the short term versus the long term consequences; a certainty versus a possibility; the economic loss to company versus possible job loss to self. The values involved are trustworthiness, respect, fairness and caring. Ask students how they would want a doctor or pharmacy to handle a mistake in supplying the wrong medicine to them. Ask students how a professor should handle an error in grading or calculations of grades.

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?**

   Daniels could go along with Pete to cover up the mistake and not say anything to Cwervo. This is using egoism (stage 2 of Kohlberg's model) so Daniels (and Pete) would be assured of keeping his job and saving face, until and unless the mistake is found out.

   Using utilitarianism theory could support not telling Cwervo as then the new hires would be able to keep their jobs, which may be the greatest good for the greatest number. However, if Daniels considers the future loss of jobs and reputation to the company assuming the mistake is found later in the year, then the greatest good for the greatest number would require that Daniels tell Cwervo immediately.

   Daniels could revisit his promise to Pete to go along with the mistake. Wanting to be honest and make sure an error is corrected, if needed, he might consider reporting the mistake to Cwervo, a tips hotline, the Audit Committee, or the external auditors. He should go to Cwervo, first. A challenge in this approach, is whether Daniels should report his conversation with Pete, or not. His loyalty obligation to Pete conflicts with doing the right thing. Recall that loyalty should never be used to mask higher ethical values such as honesty and integrity.

   The approach used by Daniels should consider the Rights Theory that Cwervo has a right to know about the mistake. Daniels could use the Categorical Imperative: Act only in a way that you are willing to have others act in similar situations in similar ways. Surely, Daniels would not want others to cover up their mistakes because it would create a chaotic situation for the company.

2. **Given that you have decided to take some action even though you had agreed not to do so, who would you approach to express your point of view and why?**

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Daniels should tell Cwervo as soon as possible. Cwervo may want to consult with Pete and the CEO. The firm might need to lay off the workers just hired, but it might also be possible to use either the new hires or seasoned personnel to expand another area of the firm in keeping with the strategic plan. This plan has an urgency element for the firm to react and make changes in an honest, transparent manner for all stakeholders.

In the case it is noted that Cwervo likes to get things right and move on. If that is so, hopefully, Daniels would not lose his job for making a mistake, and might be commended for admitting his mistake in a timely manner. As noted in the previous question, Daniel will have to decide whether or how to disclose the conversation with Pete.

3. What is at stake for the key parties?

Daniels could lose his job for owing up to his mistake. Walker could also lose his job or a good friend (Daniels) at work. Pete could lose his reputation (and possibly his job) after hiring workers for production when there was little demand. Pete could also lose his job for being a poor manager. The firm could suffer a loss, in over-producing the tanks, hiring workers, and other expenses from the increased work force. Then the firm could also loss its reputation when hiring and then dumping workers. If Cwervo and other officers appreciate and commend Daniels for bringing the error forward, the firm would gain or reinforce its reputation of an ethical firm, and supportive of employees who uphold the firm's values. Other stakeholders, shareholders, creditors, the public, want transparent and fairly reported financial statements; this group would prefer to know bad news soon rather than a cover-up.

4. What are the main arguments you are likely to encounter in making the strongest case possible?

Daniels is arguing for correcting an error in budgeting with long-term consequences. The corrections affect the new hires, Pete, and the company's image and reputation. Thus, Cwervo, another officer, or the other stakeholders might use the issues of materiality or locus of loyalty to avoid correcting the error. Many stakeholders may think that 12.5 percent is not material or that the end result would not be that material to the bottom line.

The decision Daniels makes should emphasize integrity above all else. There are no valid reasons and rationalizations for deviating from ethical practice. If there were, decisions would be made based on situational ethics.

5. 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?

Daniels should respond to the argument of materiality by noting that most external auditors use 5-to-10 percent, as a rule of thumb, but if it is a high risk area could use less. If the error is expected to be netted against higher revenues and lower costs/expenses for

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other products, were these already included in the budget? How good is that estimate? If the error remains in the budget, what will be done at the end of the year if there is large loss? The error may be immaterial now but could grow larger during the year. The stakeholders may clamor louder to know who made the mistake and why it wasn't corrected sooner at year-end than doing a mid-year correction.

Daniels should counter the locus of loyalty rationalization by questioning who the firm has loyalty to and in what priority. Although it is never good to hire and shortly after lay-off employees, but is loyalty the same to all employees. Does the firm have a greater loyalty to senior employees? Does the firm have a loyalty to all employees to provide secure benefits, especially retirement benefits? Will being loyal to the recent hires come at the expense of senior employees, providing for retirement needs of past and current employees? Does the firm owe any loyalty to investors and creditors? Does the loyalty to recent hires come at the expense of those investors and creditors?

Daniels should address his responses and arguments to Cwervo in the meeting to disclose the error. If Cwervo wants to ignore and cover up the error, Daniels should work his way up the chain of command, to the audit committee and board of directors, if necessary. The disclosure and defense of correcting the error may cost Daniels's job. If it does not cost his job but requires him to go along with the error remaining in the budget and financial reporting, he should consider whether he wants to continue working for the firm.

It would be a good idea for Daniels to commit to writing the various steps he has taken to correct his mistake; who he has spoken to; when; what was their reaction; and what were his thoughts along the way with respect to his ethical evaluations. This will help him down the road, if necessary, to recount his steps clearly and defend himself properly. He can even give a copy of the memo to a trusted advisor who can attest to the fact Daniels' observations occurred at the time they happened and not retrospectively.

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Case 2-6 LinkedIn and Shut Out

The facts of this case are fictional. Any resemblance to real persons, living or dead, is purely coincidental.

Kenny is always looking to make contacts in the business world and enhance his networking experiences. He knows how important it is to drive customers to his sports memorabilia business. He's just a small seller in the Mall of America in Bloomington, Minnesota.

Kenny decided to go on LinkedIn. Within the first few weeks, he received a number of requests that said, "I'd like to add you to my professional network." At first almost all of such requests came from friends and associates he knew quite well. After a while, however, he started to receive similar requests from people he didn't know. He would click on the "view profile" button, but that didn't provide much useful information so he no longer looked at profiles for every request. He simply clicked the "accept" button and the "You are now connected" message appeared.

One day Kenny received the following message with a request to "connect":

"I plan to come to your sports memorabilia store in the future so I thought I'd introduce myself first. I am a financial planner and have helped small business owners like yourself to develop financial plans that provide returns on their investments three times the average rate received for conventional investments. I'm confident I can do the same for you. As a qualified professional, you can trust my services."

Kenny didn't think much about it. It certainly sounded legitimate. Besides, he would meet the financial planner soon and could judge the type of person he was. So, Kenny linked with the planner.

A week later, the financial planner dropped by Kenny's store and provided lots of data to show that he had successfully increased returns for dozens of people. He even had testimonials with him. Kenny agreed to meet with him in his St. Paul office later that week to discuss financial planning.

The meeting took place and Kenny gave the financial planner a check for $30,000, which was most of Kenny's liquid assets. At first the returns looked amazing. Each of the first two quarterly statements he received from the planner indicated that he had already earned $5,000; a total of $10,000 in six months. Three months later Kenny did not receive a statement. He called the planner and the phone had been disconnected. He sent emails but they were returned as not valid. No luck with text messages.

Kenny started to worry whether he ever would see his money – at least the $30,000. He was at a loss what to do. A friend suggested he contact LinkedIn and see if it could help. His online contact led to the following response in an email:

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> As per our agreement with you, we are not liable to you or others for any indirect, incidental, special, consequential, or punitive damages, or any loss of data, opportunities, reputation, profits or revenues, related to the services of LinkedIn. In no event shall the liability of LinkedIn exceed, in the aggregate for all claims against us, an amount that is the lesser of (a) five times the most recent monthly or yearly fee that you paid for a premium service, if any, or (b) $1,000. This limitation of liability is part of the basis of the bargain between you and LinkedIn and shall apply to all claims of liability (e.g., warranty, tort, negligence, contract, law) and even if LinkedIn has been told of the possibility of any such damage, and even if these remedies fail their essential purpose. If disputes arise relating to this Agreement and/or the Services, both parties agree that all of these claims can only be litigated in the federal or state courts of Santa Clara County, California, USA, and we each agree to personal jurisdiction in those courts.

To say Kenny was distraught is an understatement. He felt like he had been shut out. While he did he not understand all the legalese, he knew enough that he would have to hire an attorney if he wanted to pursue the matter.

Questions

1. **How would you characterize Kenny's thought process in the way he responded to requests to connect on LinkedIn?**

   Kenny was thinking that the more connections he had on LinkedIn, the better it was for his business. He was not using any discernment or skepticism in accepting links. He was probably using System 1 (quick, gut-reflex thinking) versus System 2 (slow and reasoned) thinking. System 2 includes reflection on ethical values such as responsibility, fairness, trustworthiness, integrity, and reliability. LinkedIn and other social media sites ask the participants if they accept the "friend" or invitation to be "linked," so the participants have control over their privacy.

2. **Who is to blame for what happened to Kenny and why?**

   Kenny is to blame for not researching an investment firm more carefully with which he was planning to invest $30,000. He should have checked with the Better Business Bureau, the local Chamber of Commerce, his bank, and friends and business associates that might be able to give a personal recommendation. Just because the financial planner requested to meet with Kenny, he was not obligated to meet or invest with him.

   The financial planner is also to blame for being dishonest and running a Ponzi scheme.

   It is hard to see how LinkedIn is to blame. It provides a social platform for individuals to communicate with each other. It does not promise to verify anyone's background, facts, or other details. LinkedIn does promise to protect the users' privacy.

3. **What would you do at this point if you were in Kenny's position and why?**

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Kenny has had a very expensive lesson in trusting someone you just met with savings. The financial planner was not associated or employed by a firm that could have helped protect the customers. Kenny should have investigated the planner fully and been skeptical of the promises made. He should report the theft of his investment to the police and see if it would be worthwhile to hire a private investigator to find the financial planner.

Kenny should reflect on his experience on how he was treated versus how he expected to be treated. Using enlightened egoism, virtues, deontology, and utilitarianism, he should think how he treats his customers to make sure that he treating them in an ethical manner.

Extended Discussion

Here is a story about a legal settlement reached between LinkedIn and users that relates to this case. You may want to discuss with your students.

LinkedIn might have to pay you money for spamming your email contacts

Business Insider by Jillian D'Onfro, October 2, 2015

In 2013, a class-action lawsuit accused LinkedIn of accessing users' email accounts without their permission and unwittingly using their names to send email invitations to people in their address books.

At the time, LinkedIn called many of the accusations false.

The court agreed that LinkedIn members did give the social network permission to use their email contacts to send connection invitations.

But the court found that although LinkedIn members consented to importing their contacts and sending LinkedIn connection requests, they did *not* consent to the two additional "reminder emails" that LinkedIn would send about those requests.

Although LinkedIn still denies any wrongdoing, it has made changes to its product and privacy policy and agreed to pay $13 million to settle the lawsuit. The settlement had not yet been approved at this writing, but LinkedIn and the plaintiffs' lawyers have agreed to it, so unless members of the class object, it'll probably be approved next year.

Assuming the settlement goes through, what does that mean for a LinkedIn user?

LinkedIn users will now see a new disclosure when they send a connection invitation, letting them know that LinkedIn will send two reminder emails to the recipient. By the end of 2015, LinkedIn will also start letting members who are getting reminders stop those reminders from coming by canceling the invitation.

If a user gets the email, they may also be eligible to get some money.

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LinkedIn's $13 million will be distributed pro rata, meaning that the amount each person gets will depends on how many people file claims. But if the number of claims means that the pay-out amounts to less than $10 per person who filed, LinkedIn will have to add on an additional $750,000.

LinkedIn sent Business Insider the following statement:

> LinkedIn recently settled a lawsuit concerning its Add Connections product. In the lawsuit, a number of false accusations were made against LinkedIn. Based on its review of LinkedIn's product, the Court agreed that these allegations were false and found that LinkedIn's members gave permission to share their email contacts with LinkedIn and to send invitations to connect on LinkedIn. Because the Court also suggested that we could be more clear about the fact that we send reminder emails about pending invitations from LinkedIn members, we have made changes to our product and Privacy Policy. Ultimately, we decided to resolve this case so that we can put our focus where it matters most: finding additional ways to improve our members' experiences on LinkedIn. In doing so, we will continue to be guided by our core value — putting our Members First.

http://www.businessinsider.com/linkedin-settles-class-action-lawsuit-2015-10.

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Case 2-5 Gateway Hospital (a GVV case)

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, 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 discuss the matter with Troy. Answer the following questions.

Questions

1. **What are the main arguments you feel Troy will make and reasons and rationalizations you need to address?**

   Troy may want to argue that it is only one night, he has been a long time employee, the amount is not material, everyone else does the same, and that he will cover for Kristen in the future. Kristen will need to be prepared to counter each of those rationalizations. She may also want to explain why she does not want to go against her values of honesty, integrity, responsibility, and trustworthiness. She can also explain in fairness to other employees, the firm cannot pay personal expenses for one employee but not for others.

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2. **What is at stake for the key parties in this situation?**

   The key parties in the case are Troy, his wife, Kristen, Joyce, and the hospital. Troy has his performance reviews and status as a supervisor at stake. He and his wife also have at stake the reimbursement of expenses (in the short-term the expenses may seem high, but in the long-term the amount is immaterial). Kristen as a new employee is in a position of having to lie about the expenses or act as a whistle-blower on Troy. If Kristen chooses to lie for Troy, it may be the start of the slippery slope (the start of continually telling lies to cover up the first lie) and she may be expected to lie more in the future or about larger amounts. If Kristen chooses to act as a whistle-blower she may have trouble fitting in at work and finding work friends. Kristen may wish to take a neutral option of giving the conference schedule to the accounting head so that Troy would have to explain instead of her. Joyce and the hospital have an ethical obligation to apply the firm's policies in a fair manner to all employees. The way in which this matter is handled will say a lot about the culture of Gateway Hospital.

3. **What levers can you use to influence how Troy reacts to your position in this matter?**

   Kristen should appeal to Troy to be honest and fair to all concerned by paying his own personal expenses from the trip. Kristen should emphasize that at this point no harm will likely come to Troy if he steps forward and explains to Joyce that he made a mistake asking for reimbursement for that one day. He wants to correct the record. The sooner he does this, the better. He will also maintain his integrity.

   Kristen should also point out to Troy that his wife and family are depending on him to provide for their well-being. Is the amount of one personal day in Orlando worth possibly losing your job? She also should point out that following policies helps the hospital maintain fairness to all employees. Troy should do the right thing for its own reward and to set an example to his children.

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?**

   Kristen should appeal to Troy not to have the matter to go higher in accounting department or be reported to the president. She should mention that although he is a long time employee that does not entitle him to steal from the hospital by using the company's reimbursement procedures to mask personal expenses. If the amount is immaterial as Troy is stating, then it should not be a hardship for Troy to pay it himself. If the hospital is having employees charging personal expenses as covered travel expenses as a standard practice, then the hospital needs to review its policies and internal controls over travel. Troy may think this is a one-time lie on his expense account, but it could be the start of his ethical slippery slope, e.g., when Troy first decides to deceive others by consciously covering up or lying about past behavior.

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Kristen needs to be prepared to rebut the loyalty argument made by Troy. Pressure from a superior can lead to a decision whether to act in accordance with stage 3 or at a higher level of moral reasoning.

Kristen also should make it clear to Troy he is putting her in a difficult position and stress the unfairness of Troy's actions and his request to go along with reimbursement for the extra day. She could ask Troy how he would feel if their roles were reversed. Would Troy cover for Kristen? If he says "yes," then Kristen should have no hesitation in taking the matter up the chain of command.

This is a situation where Kristen must be true to her values and make sure she voices them as high in the organization as is necessary to make it clear she does not condone what Troy has done. This may mean going to top management to discuss the matter.

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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 2005, and it grew in revenue from $500,000 to $5 million in 10 years. However, the revenues declined to $4.5 million in 2015. 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 2016.

Irv Milton met with Ann Plotkin, the chief accounting officer (CAO), on January 15, 2016, 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 2016 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 percent 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 2016 for investing activities would be limited to the level of those capital expenditures in 2013, 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.

EXHIBIT 1

MILTON MANUFACTURING COMPANY

Summary of Cash Flows
For the Years Ended December 31, 2015 and 2014 (000 omitted)

	December 31, 2015	**December 31, 2014**
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)

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EXHIBIT 1

MILTON MANUFACTURING COMPANY

Summary of Cash Flows
For the Years Ended December 31, 2015 and 2014 (000 omitted)

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

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 2016. 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 2016. 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 2015 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.

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 percent 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 2014. Markowicz argued that he was faced with an

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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 percent. Coupled with the 25 percent increase in price by the company's supplier, Markowicz knew he could save the company $1,500, or 50 percent 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 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 2016 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, 2016.

During the course of an internal audit of the 2016 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."

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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 shook their heads simultaneously, perhaps in gratitude for being saved the additional lecturing. Milton then said he wanted the three of them to brainstorm some alternatives on how best to deal with the Markowicz situation and present the choices to him in one week.

Case Overview

This case deals with a company's efforts to manage its short-term earnings and cash outflows by restricting capital expenditures.

Top managements' decision to restrict capital expenditures created a conflict for Sammie Markowicz, the plant manager at the headquarters location in Long Island City. On the one hand, Markowicz knows that the company expects him to follow company policy. On the other hand, he is very conscious of his primary responsibility to keep the production process operating as efficiently as possible. Markowicz was placed in a difficult position because of the capital expenditure restrictions, especially in light of the previously experienced machine breakdowns. The conflict comes to a head for Markowicz when he learns about the 25% price increase that is announced by the plant's primary supplier for motors used in the production process.

Markowicz' decision to order 1,000 of the motors for the Long Island City plant influences other plant managers to take similar actions. He acted in a way that he thought would be in the best interest of the company even though it violated company policy. He failed to consider the consequences of his action on the stakeholders. At a minimum, Markowicz could have contacted top management with his dilemma and sought a reversal of the policy by emphasizing the more frequent machine break downs and pending price increase. Markowicz was wrong to hide the acquisition of an asset by charging it to expense. This action violates the rights of the stockholders who rely on accurate financial information. Markowicz's action were primarily motivated by self-interest (reasoning at stage 2) and not out of concern for the interests of the stakeholders. An issue that should be dealt with by the company is how and why Markowicz was able to circumvent the interest controls and override the policy.

Some students may argue that Markowicz did the right thing; he saved the company a lot of money; kept the production process flowing; and best served customer needs. All of this is true but Markowicz's ethics were situational and the problem is what if another employee/manager decides in the future to take matters into his own hands, regardless of company policy, and make a decision that may be in his best interests without considering all stakeholder interests. The company has a right to expect its employees to be faithful to its policies and not violate them for some sense of a "greater good." Even though the policy may have been short-sighted, the way to handle it would have been for Markowicz to have an open and honest conversation with all relevant parties before deciding what action he would take. He owed that to top management as a trusted employee.

Questions

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Use the Integrated Ethical Decision-Making Process discussed in the chapter to help you assess the following:

1. **Identify the ethical and professional issues of concern to Beverly Wald as the chief internal auditor and a CPA.**

   The ethical and professional issues for Beverly Wald are the recording, integrity, due care, transparency and fair disclosure of accounting transactions and the resulting financial statements. There could be question of whether the bank would have made the loan if the proper accounting treatment had been reflected in the financial statements. Markowicz convinced the plant accountant to treat the expenditure as an operating expense, not a capital expenditure which was the appropriate accounting. Wald can't let the Cash Flow Statement go forward with this error. A major concern is how Markowicz circumvented internal controls. There seems to have been no checks and balances in the system before Markowicz made the expenditure.

   Wald should be concerned with the policies and internal controls to prevent such circumvention in the future. She should also consider whether the company culture encourages employees to act with integrity, objectivity, and due care. How can the culture be changed? Is it only through policies? She also needs to consider that how this matter is handled will contribute to whether the company's control environment fosters ethical or unethical behavior.

2. **Who are the stakeholders in this case and what are their interests?**

   The stakeholders in this case are Milton, shareholders, Wald, Plotkin, Sugofsky, Markowicz, other plant managers, the plant accountants and other employees. Other stakeholders include Second Bankers Hours & Trust Co., creditors, customers, the communities where the plants are located, and the public. Milton and the shareholders want the company to be profitable and provide a return on their investment. Wald, Plotkin, Sugofsky, Markowicz, other plant managers and employees want a good job at an ethical, sustainable company. Second Bankers Hours & Trust Co. and creditors want their loans to be secured, able to be repaid with interest, and able to rely on financial statements. The customers want a quality product at a competitive price and dependable delivery dates. The communities and the public want a good corporation citizen which provides jobs and pays taxes. Employees want the security of knowing their jobs are secure.

3. **Identify alternative courses of action for Wald, Plotkin, and Sugofsky to present in their meeting with Milton. How might these alternatives affect the stakeholder interests?**

   Wald, Plotkin, and Sugofsky may consider the following alternatives. (1) The company can pretend that management did not know or notice the violation of the policy. This alternative may be a rationalization of act-utilitarianism. The company used the new motors to increase inventory, sales, and obtain borrowed funds. Since everything seems

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to have worked for good, no need to take any other action, or the ends justified the means of breaking policies. The company could counsel Markowicz to not do it again. (2) The company could restate the financial statements. This would be supported by virtue theory. Once the company makes the restatement, it should inform the lender. Further (3) the company could decide to publicly punish Markowicz to temper any future insubordination. The punishment could range from a reprimand to being fired. This alternative would be supported by rule-utilitarianism. Rights Theory would also support this alternative. The company had a right to expect the Markowicz to follow its directives; Markowicz had a duty to meet the company's expectations. The company could fire Sugofsky, who did not listen or negotiate on the issue, in addition to Markowicz. Or the company could privately reprimand Markowicz and publicly let other employees know the importance of doing the right thing and being ethical. In any case, ethical training is called for to make sure this does not happen again and establish better controls as to how to handle such matters.

4. If you were in Milton's place, which of the alternatives would you choose and why?

Being in Milton's place, alternative (2) of restating the financial statements and letting the lender know should be chosen. Further the punishment of Markowicz and Sugofsky should be considered to set an ethical tone in the firm.

Still, the company has to examine its own behavior – unbending policies – and lack of effective communication. Employees should feel comfortable to bring matters to their superiors and able admit to mistakes. In this case, if Markowicz had felt comfortable in explaining the plan to purchase the motors with Sugofsky or other superiors, the firm could have re-considered the policy at least this one time and made plans for the number of motors to be purchased and which plants were to receive the motors. This would be acting with integrity, transparency and would be supported by virtues, deontology, and utilitarianism. In the end, the best thing to do might be give a stern warning to Markowicz (maybe put it in writing and place it in his file) and have staff training to establish clear reporting channels when this kind of thing happens again.

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Case 2-8 Juggyfroot

"I'm sorry, Lucy. That's the way it is," Ricardo said. The client wants it that way.

"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.

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

"Are you kidding? They're the ones who made the decision to go along with Juggyfroot," Ricardo responded.

"I don't care, Ricardo. I expect more from you. I didn't join this firm to compromise my values."

The previous scene took place in the office of Deziloo LLP, a large CPA firm in Beverly Hills, California. Lucy Spheroid is the partner on the engagement of Juggyfroot, a publicly owned global manufacturer of pots and pans and other household items. Ricardo Rikey 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 Rikey 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 2015 by 8 percent. Ricardo knows that without the change, the earnings would have declined by 2 percent and the company's stock price would have taken a hit. However, he is also very aware of his ethical and professional responsibilities.

In the meeting, Ricardo decides to overlook the recommendation by Fred and Ethel. 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 generally accepted accounting principles (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?"

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"What do you mean?"

"You agreed that we could record $1 million as revenue for 2014 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 2015."

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 expect you to be loyal to our interests here as well."

The meeting broke up when Baitz received a confidential phone call. They agreed to continue it first thing in the morning.

Questions

1. **Should Ricardo let what happened last year affect how he approaches the issue of the improper recording of marketable securities when he resumes his discussion with Baitz in the morning? Why or why not?**

   It is tempting to continue going along with unethical actions once we have agreed to overlook unethical acts. Ricardo has already begun the slide down the proverbial ethical slippery slope and it will be difficult to hold the line on the recording of the $2 million in income rather than reclassifying it to stockholder's equity, as desired by Baitz.

   Continuing with a new cover-up means not having to admit past mistakes, which is dishonest, and accelerates the slide down the ethical slippery slope. Ricardo needs to draw a line in the sand or he will always be caving into Baitz's directions of not following GAAP until the fraudulent and misleading financial statements are discovered. The discovery of the misleading financial statements is a matter of when, not if. Many firms seldom revert to honest and fair presentation of financial statements on their own. When Juggyfroot hires a new CEO or CFO in the future, the financial statements may unravel and become public at that time. The tarnish to Desilou LLP's reputation from going along with Baitz could be enough to seriously harm the firm's revenues or even sink the CPA firm.

2. **How would you handle the issue if you were in Ricardo's position? Develop an action plan to get your point of view across. What would you say? What do you expect the objections or push-back will be? How would you convince Baitz of the rightness of your position?**

   Ricardo should tell Baitz immediately he can no longer go along with questionable accounting reclassifications that would lead to misleading financial statements. Although last year he agreed to the acceleration of revenue, that does not mean he will always go

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along with Baitz regardless of the ethical issues. Ricardo should explain he regrets that decision and does not want to compound his error this year.

Ricardo should tell Baitz that he understands that Juggyfroot will put out the audit for bids. Desilou LLP then should note that accounting issues and disagreements with management were the cause for resigning from the audit on the 8-K filed with the SEC.

It is probably not possible to convince Baitz of the rightness of the position; that is why Ricardo needs to go into the meeting with a strong backbone. He needs to have a draft of the 8-K with him to leave with Baitz. There may be a technical review partner to approach that can be used as leverage and even the promise of taking the matter to the outside auditors.

Ricardo has to realize his job may be on the line. However, this is the second time he was asked (expected) to go along with financial wrongdoing and needs to be cognizant of the ethical nature of any action he takes. Rights Theory justifies emphasizing the right of the banks and other stakeholders that might rely on the accuracy of the financial statements. Rule Utilitarianism dictates following the GAAP rules. Only Act Utilitarianism and Egoism would seem to be possible ways to rationalize making the change in classification. Ricardo can counteract such a request be appealing to the long-term perspective of the misstatement becoming public down the line and the additional damage it may do. He needs to emphasize virtue-based decision making over expediency and loyalty to Baitz in giving voice to his values.

Extended Discussion of Ethical Issues

Ricardo is asked by Baitz to classify an investment so that current income will increase; Ricardo refused to go along with the reclassification. The ethical theories are discussed below:

Rights Theory: It is not right to mislead the investors by making it look as though the company is doing better than it really is. Any attempt to intentionally misstate the financial statements violates the categorical imperative.

Justice Theory: Stakeholder interests are not fairly represented because the perceived interests of the management are given priority over the interest of all other stakeholders (investors, creditors, employees, regulators, and the public).

Utilitarian Theory: Rule-utilitarianism: It requires that the correct rule should be followed. Act-utilitarianism: Requires that the act that creates the greatest good for the greatest number of stakeholders should be selected. None of the stakeholders benefit from an action that misstates net income. Even Juggyfroot is potentially harmed because the SEC may impose sanctions on it for false and misleading financial statements.

Virtue Theory: Honesty requires that the statements should be truthful and recognize revenue using generally accepted accounting principles. Objectivity requires that the company should approach its decision about the proper asset classification with fair-mindedness and without

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partiality to one set of stakeholders. Trustworthiness means that the accountants should not violate the investors' faith that the statements are accurate and reliable. Integrity requires that Ricardo should have the moral courage (which he did) to withstand Baitz's pressure, and not to subordinate judgment.

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Case 2-9 Phar-Mor

The Dilemma

The story of Phar-Mor shows how quickly a company that built its earnings on fraudulent transactions can dissolve like an Alka-Seltzer.

One day, Stan Cherelstein, the controller of Phar-Mor, discovered cabinets stuffed with held checks totaling $10 million. Phar-Mor couldn't release the checks to vendors because it did not have enough cash in the bank to cover the amount. Cherelstein wondered what he should do.

Background

Phar-Mor was a chain of discount drugstores, based in Youngstown, Ohio, and founded in 1982 by Michael Monus and David Shapira. In less than 10 years, the company grew from 15 to 310 stores and had 25,000 employees. According to Litigation Release No. 14716 issued by the SEC, Phar-Mor had cumulatively overstated income by $290 million between 1987 and 1991. In 1992, prior to disclosure of the fraud, the company overstated income by an additional $238 million.

The Cast of Characters

Mickey Monus personifies the hard-driving entrepreneur who is bound and determined to make it big whatever the cost. He served as the president and chief operating officer (COO) of Phar-Mor from its inception until a corporate restructuring was announced on July 28, 1992.

David Shapira was the CEO of both Phar-Mor and Giant Eagle, Phar-Mor's parent company and majority stockholder. Giant Eagle also owned Tamco, which was one of Phar-Mor's major suppliers. Shapira left day-to-day operations of Phar-Mor to Monus until the fraud became too large and persistent to ignore.

Patrick Finn was the CFO of Phar-Mor from 1988 to 1992. He brought Monus the bad news that, following a number of years of eroding profits, the company faced millions in losses in 1989.

John Anderson was the accounting manager at Phar-Mor. Hired after completing a college degree in accounting at Youngstown State University, Anderson became a part of the fraud.

Coopers & Lybrand, prior to its merger with Price Waterhouse, were the auditors of Phar-Mor. The firm failed to detect the fraud as it was unfolding.

How It Started

The facts of this case are taken from the SEC filing and a PBS *Frontline* episode called "How to Steal $500 Million." The interpretation of the facts is consistent with reports, but some literary license has been taken to add intrigue to the case.

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Finn approached Monus with the bad news. Monus took out his pen, crossed off the losses, and then wrote in higher numbers to show a profit. Monus couldn't bear the thought of his hot growth company that had been sizzling for five years suddenly flaming out. In the beginning, it was to be a short-term fix to buy time while the company improved efficiency, put the heat on suppliers for lower prices, and turned a profit. Finn believed in Monus's ability to turn things around, so he went along with the fraud. Also, he thought of himself as a team player. Finn prepared the reports, and Monus changed the numbers for four months before turning the task over to Finn. These reports with the false numbers were faxed to Shapira and given to Phar-Mor's board. Basically, the company was lying to its owners.

The fraud occurred by dumping the losses into a "bucket account" and then reallocating the sums to one of the company's hundreds of stores in the form of increases in inventory amounts. Phar-Mor issued fake invoices for merchandise purchases and made phony journal entries to increase inventory and decrease cost of sales. The company overcounted and double-counted merchandise in inventory.

The fraud was helped by the fact that the auditors from Coopers observed inventory in only 4 out of 300 stores, and that allowed the finance department at Phar-Mor to conceal the shortages. Moreover, Coopers informed Phar-Mor in advance which stores they would visit. Phar-Mor executives fully stocked the 4 selected stores but allocated the phony inventory increases to the other 296 stores. Regardless of the accounting tricks, Phar-Mor was heading for collapse and its suppliers threatened to cut off the company for nonpayment of bills.

Stan Cherelstein's Role

Cherelstein, a CPA, was hired to be the controller of Phar-Mor in 1991, long after the fraud had begun. One day, Anderson called Cherelstein into his office and explained that the company had been keeping two sets of books—one that showed the true state of the company with the losses and the other, called the "subledger," that showed the falsified numbers that were presented to the auditors.

Cherelstein and Anderson discussed what to do about the fraud. Cherelstein asked Anderson why he hadn't done something about it. Anderson asked how could he do so? He was the new kid on the block. Besides, Pat (Finn) seemed to be disinterested in confronting Monus.

Cherelstein was not happy about the situation and felt like he had a higher responsibility. He demanded to meet with Monus. Cherelstein did get Monus to agree to repay the company for the losses from Monus's (personal) investment of company funds into the World Basketball League (WBL). But Monus never kept his word. In the beginning, Cherelstein felt compelled to give Monus some time to turn things around through increased efficiencies and by using a device called "exclusivity fees," which vendors paid to get Phar-Mor to stock their products. Over time, Cherelstein became more and more uncomfortable as the suppliers called more and more frequently, demanding payment on their invoices.

Accounting Fraud

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Misappropriation of Assets

The unfortunate reality of the Phar-Mor saga was that it involved not only bogus inventory but also the diversion of company funds to feed Monus's personal habits. One example was the movement of $10 million in company funds to help start the WBL.

False Financial Statements

According to the ruling by the U.S. Court of Appeals that heard Monus's appeal of his conviction on all 109 counts of fraud, the company submitted false financial statements to Pittsburgh National Bank, which increased a revolving credit line for Phar-Mor from $435 million to $600 million in March 1992. It also defrauded Corporate Partners, an investment group that bought $200 million in Phar-Mor stock in June 1991. The list goes on, including the defrauding of Chemical Bank, which served as the placing agent for $155 million in 10-year senior secured notes issued to Phar-Mor; Westinghouse Credit Corporation, which had executed a $50 million loan commitment to Phar-Mor in 1987; and Westminster National Bank, which served as the placing agent for $112 million in Phar-Mor stock sold to various financial institutions in 1991.

Tamco Relationship

The early financial troubles experienced by Phar-Mor in 1988 can be attributed to at least two transactions. The first was that the company provided deep discounts to retailers to stock its stores with product. There was concern early on that the margins were too thin. The second was that its supplier, Tamco, was shipping partial orders to Phar-Mor while billing for full orders. Phar-Mor had no way of knowing this because it was not logging in shipments from Tamco.

After the deficiency was discovered, Giant Eagle agreed to pay Phar-Mor $7 million in 1988 on behalf of Tamco. Phar-Mor later bought Tamco from Giant Eagle in an additional effort to solve the inventory and billing problems. However, the losses just kept on coming.

Back to the Dilemma

Cherelstein looked out the window at the driving rain. He thought about the fact that he didn't start the fraud or engage in the cover-up. Still, he knew about it now and felt compelled to do something. Cherelstein thought about the persistent complaints by vendors that they were not being paid and their threats to cut off shipments to Phar-Mor. Cherelstein knew that, without any product in Phar-Mor stores, the company could not last much longer.

Questions

1. **Evaluate the role of each of the stakeholders in this case from an ethical perspective. How do you assess blame for the Phar-Mor fraud?**

   This case highlights rationalizations used to justify not meeting one's ethical obligations. The rationalization was that all the misrepresentation was short-term so that the company

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could recover losses and make the reported financial statements correct. The short term turned into long term and the losses kept mounting. Monus refused to report losses and had taken company funds for a personal investment in the World Basketball League. Monus failed in his fiduciary duties and acting as an ethical leader with strong values of honesty, integrity, trustworthiness, and responsibility. Shapira also failed in his fiduciary duties and responsibility as CEO to oversee Phar-Mor. Finn, Cherelstein, and Anderson failed to comply with GAAP and adequately disclose accounting treatments and procedures in the financial statements.

The stakeholders of Phar-Mor have a right not to be misled by financial statements making it look as though the company is doing better than it really is. Any attempt to intentionally misstate the financial statements violates the categorical imperative under Rights Theory. From a justice perspective, stakeholder interests are not fairly represented because the perceived interests of the management are given priority over the interest of all other stakeholders. From a utilitarian perspective, Rule-utilitarianism: It requires that the correct rule should be followed. Act-utilitarianism: Requires that the act that creates the greatest good for the greatest number of stakeholders should be selected. None of the stakeholders benefit from an action that misstates net income. Even Phar-Mor was harmed because the SEC imposed sanctions on it for false and misleading financial statements. From a virtue perspective, honesty requires that the statements should be truthful and follow generally accepted accounting principles. Objectivity requires that the company should approach its decision about the proper accounting procedures for investments and inventory with fair-mindedness and without partiality to one set of stakeholders. Trustworthiness means that the accountants should not violate the investors' faith that the statements are accurate and reliable. Due professional care requires that Coopers & Lybrand should have conducted the audit with skepticism and gathered sufficient evidence upon which to base an opinion. They never should have examined such a small percentage of the inventory and even tell the client which stores would be audited. That decision smacks of carelessness and reckless disregard for the true value of the inventory.

The blame for the fraud lies mostly with Monus; he was using company assets for his personal purposes and pressured subordinators to go along with his schemes so that his pride would not be hurt by reporting losses. Finn and Shapira were willing to go along and believe that the situation was short term rather than have to deal with the unpleasantness that reality would cause. Anderson was not a CPA and started at Phar-Mor right out of college; he may have thought the accounting treatments were correct. However, when the firm began keeping two sets of books, he should have realized that something was not right. His personal values should have told him that the company must keep one set of accurate books or he should have found another job. Cherelstein should have done his homework before he accepted the position with Phar-Mor. Once he found out about the fraud and agreed to go along, he became as guilty as Monus. Anderson and Cherelstein knew of the fraud, approached Finn and Monus, but were unsuccessful in correcting the fraud. They didn't take the ultimate step of whistle-blowing as did Cynthia Cooper when she approached the outside auditors to gain leverage with management of WorldCom.

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Professional judgment is exercised with due care, objectivity, and integrity. It seems that Coopers & Lybrand did not demonstrate objectivity and lacked professional skepticism. Coopers & Lybrand contributed to the fraud by not being skeptical enough in its audit of inventory, a violation of due professional care. The advance notification of the store locations allowed Phar-Mor to fully stock those stores to perpetuate the fraud cover-up. Coopers failed to exercise professional judgment in observing inventory at only 1.3% of the stores and following up on the analytical procedures showing that inventory was increasing and cost of sales decreasing as revenues were increasing. Phar-Mor was a discount pharmacy, which meant that retail model was to minimize inventory while using low prices to increase and maximize inventory turn-over. Increasing inventory amounts should have been a red flag to Coopers.

The "exclusivity fees" should have been a red flag for Coopers. A skeptical auditor would have asked what was required in return for the fees; did they have a "shelf life"; and what evidence existed that the company could go back to the vendors over and over again to strong-arm them into paying these fees while earnings were going down.

2. **Assume you are in Stan Cherelstein's position. Evaluate the moral intensity issues in the case. How do these issues relate to Rest's Four-Component Model of Ethical Decision Making? What are the challenges for Cherelstein in that regard?**

   Cherelstein's first step and challenge is moral sensitivity and acknowledgement of the fraud. He understands that the fraud has been going on a long time and that as the fraud unwinds many will be hurt: suppliers who were unpaid; employees who might lose their jobs'; investors who might lose equity; and creditors whose financing might be at risk. The second step would be moral judgment or solutions to solve the ethical dilemma. Solutions might include going to the board of directors and then working with the auditors to restate the financial statements. The third step of moral motivation includes Cherelstein's willingness to place the ethical values ahead of self-interest. Cherelstein has thought through the first three steps since the case states that he knows about the fraud and feels compelled to do something. He is just deciding what that something is. The final step is moral character which requires courage to implement the steps 2 and 3. He needs to schedule a meeting with the board of directors. Cherelstein should voice the importance of the values of integrity, transparency and compilation with GAAP in financial statements. He needs to speak with Shapira directly and go on the record about his concerns. He also needs to consider going to the outside auditors, assuming the board fails to take action. He needs to find a way to voice his values in a positive fashion that might change what has been happening at Phar-Mor.

3. **Assume you decide to confront Monus. How would you counter the likely reasons and rationalizations you will hear from Monus? What levers do you have to influence Monus's behavior?**

   Monus has been using the rationalization of needing more time to fix the problem, locus of loyalty, and one-time request as reasons and rationalizations. However, the fraud is

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beyond a one-time request since it has been going for some time and maybe the entire time during which Phar-Mor was a public company.

Monus must be confronted about using company funds for personal purposes, which is embezzlement. He has violated the law and basic issues of ethics. It wouldn't be even enough if he replaced the money, which would have been unlikely. He needs to understand there are consequences for bad behavior.

Trying to change Monus's behavior may not be possible, so Cherelstein needs to explain that Monus will have the responsibility for his actions either forced on him by the SEC and financial markets, or he can own up to the situation and cut his (ethical) losses. Monus will play the loyalty card but Cherelstein should explain that he has loyalty to Phar-Mor, the accounting profession and code of conduct, but most importantly loyalty to his values of integrity and trustworthiness.

Cherelstein should use the levers of public humiliation due to the fraud, Monus's personal reputation, the bankruptcy and failure of Phar-Mor, possible criminal and civil lawsuits, and what will happen if the auditors discover (and act on) what has been going on with the financial fraud. He should use these levers to try and influence Monus's behavior.

4. **What is the ethical message of Phar-Mor? That is, explain what you think the moral of this story is.**

   The moral of the story is the tone at the top determines practices of a company, that pride should not get in the way of good business and that delaying bad news may only cause more harm. Also, accountants must be true to their values and act in accordance with the ethics of the profession. In other words, it takes a long time in business to build trust but not very long to tear it apart.

Extended Discussion

Case 7-5 discusses exclusivity fees in the context of "financial shenanigans" and instructors may want to introduce students to it in the discussion of Phar-Mor and then assign it in Chapter 7. The following is from a blog posted by Charlie Smith on November 15, 2012.[1]

On July 22, 2010, the SEC charged Dell Inc. with failing to disclose material information to investors and using fraudulent accounting practices to make it falsely appear that the company was consistently meeting Wall Street earning targets and reducing its operating expenses.

Beginning in the 1990s, Intel had a marketing campaign that paid its vendors certain marketing rebates to use their products according to a written contract. These were known as market developing funds (MDF), which by accounting rules Dell could treat these as reductions in operating expenses because these payments offset expenses that Dell incurred in marketing

[1] http://charlielsmith.blogspot.com/2012/11/sec-charges-dell-inc-with-fraud-pwcs.html.

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Intel's products. However, the characteristic of these payments changed in 2001, when Intel began to provide additional rebates to Dell and a few other companies that were outside of the contractual agreements.

Intel Corporation made these large payments to Dell Inc. from 2001 to 2006 to not use chips/processors manufactured by Intel's main rival, AMD. Rather than disclosing these material payments to investors, Dell decided it would be better to incorporate these funds in their component costs without any recognition of their existence. The nondisclosure of these payments caused fraudulent misrepresentation allowing Dell to report increased profitability over these years.

These payments grew significantly over the years making up a rather large part of Dell's operating income. When viewed as a percentage of operating income, these payments started at about 10% in the 2003 fiscal year to about 76% in the first quarter of the 2007 fiscal year.

Dell used these large payments to reduce their operating expenses, allowing them to consistently meet their Wall Street earnings targets. When Dell began using AMD as a secondary supplier of chips in 2006, Intel cut these payments off, which resulted in Dell having to report a decrease in profits. Rather than disclose the loss of the exclusivity payments as the reason for the decrease in profitability, Dell continued to mislead investors. Dell reported to their investors that the reason for the sudden decline in profits was,

These payments were not disclosed to the public, and are actually the focus of five different government antitrust violations. It is believed that Intel was no longer paying Dell and these other companies to reduce their marketing expenses, but rather they were paying them to limit their purchases of AMD products. In Dell's case, Intel was paying them to completely boycott AMD. Dell did not disclose any of these payments, omitting material facts, which greatly mislead investors. Outside the MDF program, these payments amounted to $61 million in the beginning of 2003 and peaked at $720 million in the first quarter of 2007.

Dell separately committed the accounting violations through the conduct of former CFO James Schneider and other former senior accounting executives. The SEC claimed that Dell's senior accounting personnel maintained cookie jar reserves to cover shortfalls in operating results from 2002 to 2005. A cookie jar reserve is an accounting practice in which companies use reserves from good years against losses that could be incurred in bad years.

Dell used an array of cookie jar reserves and manipulated these reserve accounts to manage its financial results. This manipulation of their statements caused Dell's financial performance look better. "Contrary to GAPP, Dell created and maintained excess accruals in multiple reserve accounts, which Dell used to offset the financial statement impact of future expenses." This type of accounting manipulation caused Dell's financial results to be materially misstated, including the reports submitted to the SEC.

FASB Statement of Financial Accounting Standards No. 5 states that a loss accrual should be recognized with a charge to income when a loss is probable and reasonably estimable. The maintenance of reserves for unspecified business risks (known as "cookie jar reserves") is not

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permitted under GAAP. "The impact of Dell's reserve manipulations materially misstated Dell's operating results."

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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.

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."

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

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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. Ebbers was sentenced to 25 years in jail for his offenses.

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. In the end, Vinson was sentenced to five months in prison and five months of house arrest.

Questions

1. **Identify the stakeholders in the WorldCom case and how their interests were affected by the financial fraud.**

   The stakeholders in the WorldCom case are Vinson, Cooper, Sullivan, Ebbers, the owners, other employees, investors, creditors, the accounting firm (Andersen), and the public. Vinson, Sullivan, and Ebbers had criminal trials as a result of their part in the fraud. Copper received praise for being whistleblower but was also subject to retaliation and was shunned by the community. However, most critics came to understand how and why Cooper did what she did and she became a "hero" of sorts because she blew the whistle on the fraud and was willing to accept the consequences of her actions. She received one of Time Magazine's "Persons of the Year award in 2002.

   The owners, investors, and creditors lost their investment. Employees lost their jobs. They had to find to a new employment, most of which involved moving away from Clinton, MS. Andersen suffered a further blow to its fragile reputation. The public lost faith in public accounting and CPAs.

2. **Do you think Betty Vinson was a victim of "motivated blindness"? Are there steps should could have taken to stand up for what she believed? Explain.**

   Betty Vinson's situation at WorldCom: she knew it was wrong to "cook the books" 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

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knew accounting better than herself. Thus, Vinson did not act on her ethical intent and did not display ethical behavior.

One observation about human nature is that we have difficulty seeing our own ethical failures as clearly as we see those of others. Why don't we see how often we betray our own ethical standards? A large part of the answer is that the human decision-making system – like the human visual system – has blind spots. Ethical blind spots often obscure important aspects of an ethical decision. As a result, we don't realize that the decisions we make have ethical implications and we make unethical choices without knowing it. It is no surprise, then, that the great majority of people believe themselves to be more ethical than the average – a statistical impossibility!

Although we have more trouble seeing our own unethical behavior than we do seeing others' unethical behavior, Max H. Bazerman and Ann E. Tenbrunsel, the authors of the book *Blind Spots: Why We Fail to Do What's Right and What to Do about It,* have found that people have a tendency "to overlook the unethical behavior of others when it is not in their best interest to notice the infraction." They call this "motivated blindness."

The principal example the authors give for motivated blindness is auditors who show a strong bias toward the interests of their clients. "Rather than making a conscious decision to favor their clients, the participants assimilated information about the target company in a biased way. … Auditors became more like their clients than they would be if no such motivation existed; as a result, they are unlikely to see the unethical actions and biases in their clients' behavior." Other elements in creating motivated blindness include fear, incentives, organizational loyalty, and organizational culture.

A gap exists between who we think we are and how we actually behave. People need to more clearly understand their own behavior and, in the process, raise themselves up to the ethical standards they already hold. Betty Vinson never bridged this gap perhaps thinking she was "justified" in going along with the fraud because smarter people told her it was OK; perhaps because she didn't want to see what became so obvious to Cynthia Cooper; most likely because she was blinded by her own self-interests and compromised her ethics and reputation in the process.

What about moral blindness? Moral blindness is used to describe someone who can't tell right from wrong, rather than just choosing to ignore doing "the right thing." Since Betty knew that it was wrong to "cook the books" she was not a victim of moral blindness. She was weak in not staying true to her ethical values; she may have felt pressured and did not have a choice except to go along. That is different from moral blindness. She was a victim of ethical dissonance; an ethical person gets caught up with an unethical company thereby creating disconnect between one's values and what the company stands for.

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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Cooper meant that everyone will make some bad decisions at some points. There can be all sorts of reasons and rationalizations why we made the bad decisions: tired, stressed, in a hurry, wanting to be liked, wanting to keep job, needing the job for the family's finances, it is a one-time request, etc. Often we need to consider how we will recover from a bad decision. Do we continue to make bad decisions? Do we learn from our mistakes and start being ethical and moral now? If not now, when?

For the whole of the interview with Cooper, see: http://www.jmu.edu/news/2013/11/14-cooper-demonstrates-power-of-choice-in-business-ethics.shtml.

WorldCom Videos

The convictions: https://www.youtube.com/watch?v=7Oeh2Njux_I.

Cynthia Cooper interview: https://www.youtube.com/watch?v=6yXuNnjnnEA.

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Major Case 2 Royal Ahold N.V. (Ahold)

Summary of Court Ruling

The U.S. Court of Appeals for the Fourth Circuit affirmed the lower court ruling in the case *Public Employees' Retirement Association of Colorado; Generic Trading of Philadelphia, LLC v. Deloitte & Touche, LLP* that Deloitte defendants lacked the necessary scienter to conclude that they knowingly or recklessly perpetrated a fraud on Ahold's investors.

This class action securities fraud lawsuit arose out of improper accounting by Royal Ahold N.V., a Dutch corporation, and U.S. Foodservice, Inc. (USF), a Maryland-based Ahold subsidiary. The misconduct of Ahold and USF was not disputed in this appeal. The main issue is the liability of Ahold's accountants, Deloitte & Touche LLP (Deloitte U.S.) and Deloitte & Touche Accountants (Deloitte Netherlands), for their alleged role in the fraud perpetrated by Ahold and USF. Under the Private Securities Litigation Reform Act of 1995 (PSLRA), plaintiffs must plead facts alleging a "strong inference" that the defendants acted with the required scienter. As explained by the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* a strong inference "must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent."

The Appeals Court found that Deloitte, like the plaintiffs, were victims of Ahold's fraud rather than its enablers. In its decision, the court relied on the PSLRA and the decision in *Tellabs.* Circuit Judge Wilkinson wrote the conclusion for the court. The court ruling will be explained later on.

ERISA Class Action Settlement

Class action lawsuits are common in cases such as Ahold where dozens of separate private class action securities are combined. In this case the Employee Retirement Income Security Act of 1974 (ERISA) actions were filed against Ahold, Deloitte, and other defendants. On June 18, 2003, the Judicial Panel on Multidistrict Litigation transferred these actions to the U.S. District Court for the District of Maryland, *In re Royal Ahold N.V. Securities & ERISA Litigation.* Following the certification of the class action lawsuit, the U.S. District Court in Maryland ruled in favor of the ERISA plaintiffs on November 2, 2006, and awarded them $1.1 billion in the securities fraud case against Royal Ahold.

Summary of Accounting Fraud

Beginning in the 1990s, and continuing until 2003, Ahold and USF perpetrated frauds that led it to overstate its earnings on financial reports significantly:

- Ahold improperly "consolidated" the revenue from a number of joint ventures (JVs) with supermarket operators in Europe and Latin America. That is, for accounting purposes, Ahold treated these JVs as if it fully controlled them—and thus treated all revenue from the ventures as revenue to Ahold—when in fact, Ahold did not have a controlling stake.

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Under Dutch and U.S. GAAP, Ahold should have consolidated only the revenue proportionally to Ahold's stake in the ventures.

- USF falsely reported its income from promotional allowances (PAs). Also known as *vendor rebates,* PAs are payments or discounts that manufacturers and vendors provide to retailers like USF to encourage the retailers to promote the manufacturers' products. To increase its stated income, USF prematurely recognized income from PAs and inflated its reported PA income beyond amounts actually received.
- On February 24, 2003, Ahold announced that its earnings for fiscal years 2001 and 2002 had been overstated by at least $500 million as a result of the fraudulent accounting for promotional allowances at USF, and that Ahold would be restating revenues because it would cease treating the joint ventures as fully consolidated. After this announcement, Ahold common stock trading on the Euronext stock exchange and Ahold American Depositary Receipts[5] trading on the NYSE lost more than 60 percent of their value. Subsequent to the February 2003 announcement, Ahold made further restatements to its earnings totaling $24.8 billion in revenues and approximately $1.1 billion in net income.

Ahold Fraud—Joint Ventures

With respect to the JV fraud, both Deloittes advised Ahold on the consolidation of the joint ventures. Five joint ventures were at issue in this litigation: JMR, formed in August 1992; Bompreço, formed in November 1996; DAIH, formed in January 1998; Paiz-Ahold, formed in December 1999; and ICA, formed in February 2000. Ahold had a 49 percent stake in JMR and a 50 percent share of each of the other ventures at their respective times of formation. Prior to Ahold's entering into the first joint venture, Deloitte Netherlands and Deloitte U.S. gave Ahold advice about revenue consolidation under Dutch and U.S. GAAP. A memo explained that control of a joint venture is required for consolidation of the venture's revenue and discussed what situations are sufficient to demonstrate control. The memo indicated that control could be shown by a majority voting interest, a large minority voting interest under certain circumstances, or a contractual arrangement.

Ahold began consolidating the joint ventures as they were formed. The various JV agreements did not indicate that Ahold controlled the ventures. For example, the JMR joint venture agreement specified that decisions would be made by a board of directors, "deciding unanimously," and that the board would consist of three members appointed by Ahold and four members appointed by JMH, Ahold's partner in the venture. However, Ahold represented to Deloitte Netherlands that it nonetheless possessed the control requisite for consolidation. Deloitte Netherlands initially accepted these representations for the consolidation of JMR and Bompreço. But as consolidation continued, Deloitte became concerned that Ahold lacked the control necessary to consolidate these first two joint ventures.

On August 24, 1998, Deloitte Netherlands partner John van den Dries sent a letter to Michiel Meurs, Ahold's chief financial officer (CFO), advising him that Ahold's representations of control would no longer suffice—that Ahold would need to produce more evidence of control in order to justify continuing consolidation of joint venture revenue under U.S. GAAP, and that without such evidence, a financial restatement would be required. In response to Deloitte Netherlands's requests, Ahold drafted a "control letter" addressed to BompreçoPar S.A., its

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partner in the Bompreço joint venture. The letter stated that the parties agreed that if they were unable to reach a consensus on a particular issue, "Ahold's proposal to solve that issue will in the end be decisive." After reviewing the draft letter, Deloitte Netherlands advised Ahold that if countersigned by the JV partner, the letter would be sufficient evidence to consolidate the venture. The letter was signed by Ahold and BompreçoPar in May 1999. By late 2000, Ahold had obtained similar countersigned control letters for the ICA, DAIH, and Paiz-Ahold joint ventures. Based on these letters and other evidence, Deloitte Netherlands concluded that consolidation was appropriate. However, in October 2002, Deloitte learned of a "side letter" sent to Ahold in May 2000 by one of Ahold's ICA joint venture partners, Canica. The letter stated that Canica did not agree with the interpretation of the shareholder agreement stated in the ICA control letter.

At this point, Deloitte Netherlands and Deloitte U.S. began trying to get Ahold to obtain an amendment to the shareholder agreement in order to justify ongoing consolidation. At a February 14, 2003, meeting, Deloitte Netherlands and Deloitte U.S. told Ahold that Ahold lacked the necessary control for consolidation. On February 22, 2003, Ahold revealed to Deloitte Netherlands side letters contradicting the Bompreço, DAIH, and Paiz-Ahold control letters. Two days later, Ahold announced that it had consolidated its joint ventures improperly and would be restating its revenues.

USF Fraud—Promotional Allowances

Ahold acquired USF in early 2000. Prior to the acquisition, Deloitte U.S. participated in Ahold's due diligence on USF. In a February 2000 memo, Deloitte U.S. noted that USF's internal system for recording promotional allowances received was weak because it heavily relied on vendors' figures, and that the system could "easily result in losses and in frauds." Deloitte U.S. also noted in the memo that USF's use of value-added service providers, special-purpose entities that bought products from vendors and then resold them to USF for a higher price, needed to be evaluated for their "tax and legal implications and associated business risks."

After Ahold's acquisition of USF was finalized, Deloitte U.S. became USF's external auditor. When performing an opening balance sheet audit of USF, Deloitte U.S. discovered that a USF division in Buffalo, New York, had been fraudulently accounting for PA income. This fraud required a restatement of $11 million of PA income. USF also downwardly adjusted its income by $90 million as a result of Deloitte U.S.'s advice that it be less aggressive in its method for recognizing PA income. USF used at interim periods a method known as the "PA recognition rate" to estimate promotional allowance income, in which PAs were estimated as a percentage of USF's total sales. The rate used by USF was 4.58 percent at the time of Ahold's acquisition of USF, but it rose as high as 8.51 percent in 2002. When USF booked final numbers, Deloitte U.S. in its audits tested USF's recognition of PAs by requesting written confirmation of PA amounts from vendors and by performing cash receipt tests. Using this confirmation process, Deloitte U.S. was able to test between 65 and 73 percent of PA receivables in its audits for 2000 and 2001.

Auditing Issues

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Because USF lacked an internal auditing department, in April 2000, Ahold hired Deloitte U.S. to perform internal auditing services at USF. The internal auditors did not report to the Deloitte U.S. external auditors. Instead, they reported initially to Ahold USA's internal audit director and, later, to USF's internal audit director after he was hired. The audit was managed by Jennifer van Cleave under the supervision of Patricia Grubel, a Deloitte U.S. partner. One of the internal audit's objectives was to determine whether USF's tracking of PAs was adequate. In van Cleave's attempt to verify USF's PA numbers, she requested a number of documents from USF management, including vendor contracts. Management refused to produce a number of the requested documents. Several members of management also refused to meet with van Cleave when she asked to conduct exit meetings. Van Cleave was thus unable to complete all the audit's objectives.

In a February 5, 2001, draft report, van Cleave described how management's failure to produce requested documents resulted in her inability to complete some of the goals of the audit. Grubel instructed van Cleave to soften the report's language, and the version submitted to Michael Resnick, director of USF's Internal Audit Department, simply stated that Deloitte U.S. "was unable to obtain supporting documentation for some of the promotional allowance sample items," without more specifically detailing management's failures and lack of cooperation.

In its February 2003 external audit for 2002, Deloitte U.S. discovered through the PA confirmation process that USF had been inflating its recorded PA income. An investigation ensued. Ultimately, USF's former chief marketing officer (CMO), Mark Kaiser, was convicted on all counts of a federal indictment that alleged that he had induced USF's vendors to report PA income amounts and receivable balances falsely to Deloitte U.S., and that he had concealed the existence of written contracts with USF vendors from Deloitte U.S. Two other USF executives pled guilty to federal securities fraud charges; in their plea statements, they admitted that USF lied to and deceived Deloitte U.S., and that they induced vendors to sign false audit confirmation letters that falsely overstated PA payments. In addition, 17 individuals associated with USF vendors pled guilty to various charges and admitted that they signed false audit confirmation letters in order to conceal the PA fraud from Deloitte U.S.

PSLRA: Fraud and Scienter

In passing the PSLRA in 1995, Congress imposed heightened pleading requirements for private securities fraud actions. As a general matter, heightened pleading is not the norm in federal civil procedure. Frequently stated reasons include protecting defendants' reputations from baseless accusations, eliminating unmeritorious suits that are brought only for their nuisance value, discouraging fishing expeditions brought in the slight hope of discovering a fraud, and providing defendants with detailed information in order to enable them to defend effectively against a claim. When "alleging fraud or mistake," plaintiffs "must state with particularity the circumstances constituting fraud or mistake."

The PSLRA imposed a number of requirements designed to discourage private securities actions lacking merit. Among them is the requirement that in a private securities action "in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission . . . , state with

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particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Complaints that do not plead scienter adequately are to be dismissed.

Because the PSLRA did not define "a strong inference," the courts of appeals disagreed on how much factual specificity plaintiffs must plead in private securities actions. The Supreme Court resolved that issue in *Tellabs,* in which the Court prescribed the following analysis for Rule 12(b)(6) motions to dismiss Section 10(b) actions:

- First, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true.
- Second, courts must consider the complaint in its entirety, as well as other sources that courts ordinarily examine, when ruling on Rule 12(b) motions to dismiss. The inquiry, as several Courts of Appeals have recognized, is whether *all* the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.
- Third, in determining whether the pleaded facts give rise to a "strong" inference of scienter, the court must take into account plausible opposing inferences. The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative. The inference of scienter must be more than merely "reasonable" or "permissible"—it must be cogent and compelling, thus strong in light of other explanations.

Legal Reasoning

The "strong inference" requirement and the comparative analysis of inferences still leave unanswered the question of exactly what state of mind satisfies the scienter requirement of a 10b-5 action. In *Ernst & Ernst v. Hochfelder,* the Supreme Court held that a plaintiff must show that the defendant possessed the "intent to deceive, manipulate, or defraud" in an action brought under Rule 10b-5 of the Securities and Exchange Act of 1934. However, the Court never made clear what mental state suffices to meet this requirement. ("We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under Rule 10b-5."). The U.S. Court of Appeals held in *Ottman v. Hanger Orthopedic Group, Inc.,* that "a securities fraud plaintiff may allege scienter by pleading not only intentional misconduct, but also recklessness." The court defined a reckless act as one "so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it" (quoting *Phillips v. LCI Int'l, Inc.*). A showing of mere negligence, however, will not suffice to support a 10(b) claim.

Thus, the court ruled, the question is whether the allegations in the complaint, viewed in their totality and in light of all the evidence in the record, allow us to draw a strong inference, at least as compelling as any opposing inference, that the Deloitte defendants either knowingly or recklessly defrauded investors by issuing false audit opinions in violation of Rule 10b-5(b) or 10b-5(a) and (c). On the other hand, if it found the inference that defendants acted innocently, or even negligently, more compelling than the inference that they acted with the requisite scienter, it must affirm the lower court's ruling. Plaintiffs must show that defendants actually made a misrepresentation or omission in their audit opinions on which investors relied.

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In light of the foregoing standards, the court considered first the JV fraud. The plaintiffs alleged that Deloitte U.S. and Deloitte Netherlands allowed Ahold to consolidate the joint ventures despite knowing, or being reckless with regard to the risk, that Ahold lacked the control required for consolidation. The thrust of their argument was that the control letters and Ahold's oral representations were insufficient evidence of control under Dutch and U.S. GAAP. Thus, they argued, the defendants were complicit in the fraud. According to the plaintiffs, the secret side letters, in which the JV partners contradicted Ahold's interpretations of the JV agreements in the control letters, were irrelevant because the control letters themselves did not amend the JV agreements. The plaintiffs' arguments did not provide a basis for a strong inference that either Deloitte U.S. or Deloitte Netherlands acted knowingly or recklessly in relation to the JV fraud. The most plausible inference that one can draw from the fact that Ahold concealed the side letters from its accountants is that the accountants were uninvolved in the fraud. Ahold produced letters attesting to Ahold's control countersigned by Ahold's partners for the ICA, Bompreço, DAIH, and Paiz-Ahold joint ventures at the Deloitte defendants' request, all the while concealing the side letters from those same defendants. These facts led to a strong inference that the Deloitte defendants were attempting to ensure that Ahold had sufficient control over the joint ventures for consolidation and that Ahold was determined to prevent them from discovering otherwise. With perfect hindsight, one might posit that the defendants should have required stronger evidence of control from Ahold. Indeed, as the district court noted, it may have been negligent for the defendants to accept as the only evidence of control Ahold's repeated representations that it controlled JMR, the one joint venture for which Ahold never produced a control letter. Nonetheless, the evidence as a whole leads to the strong inference that defendants were deceived by their clients into approving the consolidation. Ahold would not have needed to go out of its way to produce false evidence of control had Deloitte been complicit in the fraud, or had they been so reckless in their duties that their audit "amounted to no audit at all," as the Southern District of New York has described the standard in *SEC v. Price Waterhouse.*

To establish a strong inference of scienter, plaintiffs must do more than merely demonstrate that defendants should or could have done more. They must demonstrate that Deloitte was either knowingly complicit in the fraud, or so reckless in its duties as to be oblivious to malfeasance that was readily apparent. The inference that we find most compelling based on the evidence in the record is not that the defendants were knowingly complicit or reckless, but that they were deceived by their client's repeated lies and artifices. Perhaps their failure to demand more evidence of consolidation was improper under accounting guidelines, but that is not the standard, which "requires more than a misapplication of accounting principles."

The court then examined the PA fraud. The plaintiffs argued that Deloitte U.S. was knowingly complicit in the fraud when it ignored several red flags, including USF's lack of internal controls to track PA income and USF management's obstruction of the internal audit and the facts and the circumstances of USF CFO Ernie Smith's resignation. With respect to USF's problems with tracking income with PAs, it is not the case that Deloitte U.S. simply ignored the weak internal controls, as the plaintiffs alleged. Rather, Deloitte U.S. raised this issue numerous times with Ahold and USF management.

Deloitte U.S. designed a confirmation process to verify USF's reported PA income in which it contacted third-party vendors and received letters from them confirming PA amounts. The

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plaintiffs described the confirmation process as one that "confirmed nothing." Yet instead of merely relying on USF representations, as the plaintiffs asserted, Deloitte U.S. obtained corroboration from vendors for the figures provided by USF. Deloitte U.S. would not have attempted to verify USF's figures with third parties if it were complicit in the scheme, nor can it be said that it was anything but proper to attempt to check the accuracy of representations made by USF management.

The plaintiffs attempted to suggest that the confirmation process was unsound because, for example, Deloitte U.S. accepted confirmation letters via fax and the letters were sent to brokers or sale executives instead of financial officers. But even if the confirmation process was somewhat flawed—which the defendants contested—the larger fact remains that the PA fraud went undetected initially only because USF and its vendors conspired to lie to Deloitte U.S. and to conceal important documents. Indeed, it was Deloitte U.S.'s confirmation process itself that ultimately revealed the fraud. In the course of the 2002 audit, Deloitte U.S. learned in early 2003 from a vendor from which it had requested PA confirmations that employees had signed inaccurate confirmation letters.

Shortly thereafter, Ahold authorized an internal investigation that revealed the extent of the fraud. No doubt it would have been better had the fraud been discovered earlier, but the strongest inference that one can draw from the evidence is that the fraud initially went undetected because of USF's collusion with the vendors, not because of wrongdoing by Deloitte U.S. As to the internal audit, the internal auditors reported not to the Deloitte U.S. external auditors but to USF, as was consistent with professional standards.

The rest of the supposed red flags pointed to by the plaintiffs also failed to create a strong inference of scienter. With respect to the plaintiffs' allegations that Smith told Deloitte U.S. about the vendor rebate fraud, the district court twice concluded that this claim had no support in the record, and we see no reason to disagree with its conclusion. The plaintiffs alleged that facts like the high CFO turnover at USF and USF's rapid growth should have alerted Deloitte U.S. that there was fraud afoot, but they failed to explain why this was the only conclusion that Deloitte could make.

Conclusion

"Seeing the forest as well as the trees is essential." With respect to both frauds, the plaintiffs pointed to ways that the defendants could have been more careful and perhaps discovered the frauds earlier. But the plaintiffs could not escape the fact that Ahold and USF went to considerable lengths to conceal the frauds from the accountants and that it was the defendants that ultimately uncovered the frauds. The strong inference to be drawn from this fact is that Deloitte U.S. and Deloitte Netherlands lacked the requisite scienter and instead were deceived by Ahold and USF. That inference is significantly more plausible than the competing inference that defendants somehow knew that Ahold and USF were defrauding their investors.

The court reiterated that it is not an accountant's fault if its client actively conspires with others in order to deprive the accountant of accurate information about the client's finances. It would be wrong and counter to the purposes of the PSLRA to find an accountant liable in such an instance.

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The court concluded that it had found no version of the facts that would create a strong inference that the Deloitte defendants had the scienter required for a cause of action under Section 10(b); the district court rightly denied the plaintiffs' motion for leave to amend their complaint.

Questions

1. **The court found that Deloitte should not be held liable for the efforts of the client to deprive the auditors of accurate information needed for the audit and masking the true nature of other evidence. Still, the facts of the case do raise questions about whether Deloitte compromised its ethical and professional responsibilities in accepting evidence and explanations provided by the client for the joint venture and promotional allowance transactions. Identify those instances and explain why you believe ethical and professional standards *may have been* violated.**

In the JV fraud, Deloitte advised Ahold on the consolidation of the joint ventures and consolidation of revenue under Dutch and U.S. GAAP. A memo explained that control of a joint venture is required for consolidation of a venture's revenues; control could be shown by a majority of voting interest, a large minority in certain circumstances, or by a contractual agreement. In 1999 to 2000, in response to Deloitte's requests Ahold obtained "control letters" countersigned by the joint ventures partners giving control to Ahold if consensus was reached by the venture partners. In October 2002 Deloitte learned of a "side letter" contradicting the control letters in one of the joint ventures. In early 2003, Ahold revealed to Deloitte that side letters existed for all the joint ventures. It is possible in the JV fraud that Deloitte was not skeptical enough and willing to take Ahold management's explanation without further evidence. Deloitte may have compromised its independence on the JV transactions because it had advised on how to account for the transactions.

Because USF lacked an internal auditing department, Ahold hired Deloitte to perform internal auditing services at USF, which reported to the internal audit director of the company. In auditing the PA and processes, a number of documents were requested from USF management, including the vendor contracts. Management refused to produce a number of the requested documents. Several members of management refused to meet with the internal auditor for exit meetings, so that Deloitte was unable to complete all the internal audit objectives. Deloitte should have picked up on the red flags in that management did not want to provide documents or attend exit meetings. This should have raised a red flag for Deloitte auditors; instead, the firm compromised its objectivity, did not exercise sufficient care or professional skepticism, and its relationship as internal auditor created a self-review threat to independence being that it also was the external auditor.

Deloitte, as external auditor, conducted PA confirmations to verify PA income. USF's Chief Marketing Officer had induced USF's vendor to falsely report PA balances to income amounts and receivables to the auditors and had concealed the existence of written contracts with USF vendors. Deloitte did not follow normal confirmation procedures. It accepted confirmation letters via fax and from brokers and sale executives instead of financial officers. Again, Deloitte should have been more skeptical and followed up on the confirmations.

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Deloitte's acceptance of management's representations without adequate supporting evidence reflects a lack of due care. Deloitte also compromised its integrity in accepting management's word in gathering sufficient competent evidential matter to support the work of the internal audit department. The firm lacked independence because it conducted internal audit work for an external audit client. While permitted prior to the passage of the Sarbanes-Oxley Act, the conflict of interests should have been flagged by Deloitte as creating a self-review threat to independence that could not have been mitigated by any steps taken by Deloitte.

2. Evaluate the decisions made by Deloitte from an ethical reasoning perspective including the effects of its decisions on the stakeholders.

Deloitte had a duty and obligation of independence, objectivity, skepticism, due care, and competence in conducting the audit. From a utilitarian perspective, the interests of all stakeholders (public, investors, creditors, employees, and regulators) should have been considered but were not. The auditors emphasized the client's self-interests throughout (stage 3), which were perceived to be in the firm's interests (stage 2).

Using rule-utilitarianism, GAAP and GAAS should be followed and interpretations made by adhering to the spirit, not only the letter, of the rules. Any attempt to rationalize its actions from an act-utilitarianism perspective ignores the ethical point that rules should never be violated regardless of any utilitarian benefits to the stakeholders. From a justice perspective, the audit was biased towards the interests of the client thereby treating shareholders and creditors "unequally". The way in which Ahold accounted for the JV and promotional allowances lacked objectivity: the absence of an independent mindset that is required on all audits. Virtue ethics reminds us that trustworthiness requires that the auditors should not violate the investors' faith in the statements as being accurate and reliable. In the Ahold case., the public interest was not placed above the interests of the client or Deloitte thereby violating the trust that the public places in the accuracy and reliability of financial reports. Integrity requires that Deloitte should have the moral courage to withstand client pressures, and not subordinate judgment.

3. The Ahold case is an example of how the courts have, sometimes, ruled more liberally with respect to auditors' legal obligations since the passage of the PSLRA. In the wake of Enron, WorldCom, Adelphia, and other high-profile securities frauds, critics suggest that the law made it too easy to escape liability for securities fraud and thus created a climate in which frauds are more likely to occur. Comment on that statement with respect to the fraud at Royal Ahold. Do you support the more liberal interpretation of proportional liability under the PSLRA versus the previous stricter standard under joint-and-several liability?

Prior to passage of the PSLRA that established a proportional liability standard (a party would be held legally liable only for their portion of the fraud/loss), the joint and several liability principle provided that each negligent party could be held liable for the total of damages suffered, even though it was deemed responsible for only a small portion of the loss. One implication of proportionate liability is that accountants and auditors may have unconsciously veered away from the due care standard that is an essential part of carrying out

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professional responsibilities in an ethical manner, yet they may get off easy because others were also involved in the fraud**. Ask students whether this may create an environment where auditors are less likely to go the extra mile to ferret out fraud. Proportional liability reduces accountants' liability exposure.**

There is no evidence that auditors have been less diligent since passage of the PSLRA. It would seem unprofessional to approach difficult issues with a client in an audit of financial statements with an attitude that since our liability is limited, we can give this one to the client. Auditors have to apply appropriate standards before making such a decision including the assessment of materiality.

It is difficult to determine whether the proportionate liability standard motivated Deloitte to be less diligent in its audit of Ahold. The facts certainly do not bear this out. Nevertheless, it is an unconscious bias that might creep up and work in the background when insisting on supporting documentation from management and not getting it. Deloitte may not even have been aware of the bias, yet it might have influenced the firm's failure to exercise sufficient professional skepticism in the case.

Extended Discussion

This is a good case to extend the discussion about auditor legal liability to include limiting liability through various regimes. A good paper on this matter is by Nili Karako-Eya, in *The Rutgers Business Law Review, Vol. 10 No. 1 Spring 2013.* What follows is selected discussion material from the paper.[1]

Currently, auditor liability is limited in approximately thirty-three countries. Liability is limited via one or more of the following methods: contractual stipulations; setting a statutory compensation cap; adopting a proportionate liability rule; or permitting association of accountants in a limited liability corporation. Eleven countries out of the thirty-three with limited auditor liability use a statutory cap.

This international trend requires that a number of issues be addressed. Some of these include; what is the appropriate method for setting a cap? What is the appropriate method for applying a cap? What is the desirable level for a cap? These issues have not yet been reviewed in-depth and, therefore, are the center of the study.

Eleven countries out of those that limit auditors' liability use a statutory cap (i.e., Germany), either alone or with other methods. Other countries, such as the UK, allow parties to cap auditors' liability through contractual stipulation with shareholder approval. As discussed below, the methods adopted or suggested for setting or applying a cap and the cap amount differ.

The third possible liability arrangement includes setting a cap on compensation. The idea underlying this arrangement is that a maximum cap is set on the compensation amount that can be imposed on a defendant. Alone (i.e., when the proportionate liability rule is not

[1] http://businesslaw.newark.rutgers.edu/RBLJ%20Vol.%2010%20No.%201%20Spring%202013%20Nili.pdf.

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added), this cap has the following impact. Where the defendant's proportionate share in the compensation exceeds or is equivalent to the cap, he/she cannot be charged for a sum higher than the cap even if the other "tortfeasors" are unavailable to pay. When the defendant's proportionate share in the compensation does not exceed the cap, the injured party can collect compensation from him/her to the cap limit (because of the joint and several liability rule). Thereafter, the defendant can collect from the remaining tortfeasors a sum between his proportionate share of compensation and the cap limit.

In contrast to the two previously discussed rules, the statutory cap arrangement divides the risk that the remaining tortfeasors will not pay the full award between the auditor and injured party. When the auditor's proportionate share in the compensation is higher or identical to the cap, the injured party has the risk that the remaining tortfeasors will not fully pay the award. When the auditor's proportionate share in compensation is lower than the cap, the risk that the remaining tortfeasors will not fully pay the award is divided between the auditor and injured party. The former has the risk that he/she cannot collect for the award portion that exceeds his/her proportionate share in the compensation to the cap limit. The latter has the risk that he/she cannot collect a sum in excess of the cap for full compensation.

The statutory cap arrangement has an additional important characteristic. When the auditor's proportionate share of compensation is greater than the cap, the auditor is exempt from paying a share of the compensation that exceeds the cap even if it was his/her fault. Absent an alternative rule, this share of the compensation is imposed on the injured party. This outcome is impossible under the previously discussed arrangements, wherein the auditor is at least responsible for his/her proportionate share of the compensation.

Limiting auditor liability though a cap raises the question of how to set the cap limit. Answering this question requires that three different issues are also considered. The first issue is the criterion used for calculating the cap. The second issue is the method used for applying the cap. The third issue is the desirable cap limit, low, intermediate or high.

One or more of the following criteria can be used to calculate the cap

- Setting a fixed, uniform sum that would apply in all cases;
- The type or size of company under audit. When the cap is set according to the type of company, the possible categories are as follows: listed companies, unlisted companies and public-interest entities (such as banks and insurance companies). When the cap amount is set according to company size, the following criteria can be used to determine its size: equity, market capitalization, net turnover, total annual revenue, total assets, and the average number of employees during the fiscal year; or
- The audit fee received by the auditor. This alternative requires an answer to an additional question. How is the fee for calculating the cap determined? The possible alternatives are as follows: a reasonable audit fee or acceptable audit fee for audit services of the extent and type underlying the claim; the audit fee received by the auditor for the audit services underlying the claim; the total fee received by the auditor from its clients

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for audit services in the relevant fiscal year; and finally, a function of the total fee (for audit and non-audit services) received by the auditor (from a specific client or all of clients) in the relevant fiscal year.

With a given criterion for setting the cap, a method for applying the cap must be determined; the options for applying the cap are as follows:

- The cap is applied separately to each successful claim against the auditor
- The cap is applied to all successful claims against the auditor in a calendar year, even if they are for different actions or omissions; or
- The cap is applied to all successful claims against the auditor that originate with the same action or omission. For this alternative, if one audit leads to several misrepresentations, the cap applies to each misrepresentation individually.

After determining the criterion for setting a cap and the method to apply it, the desired amount of the cap must be either assessed or estimated (low, intermediate or high). There is a mutual relationship between the method used to set and apply a cap and its limit. The method used to apply a cap affects the cap limit. For example, one can assume that applying the cap to
each claim individually leads to a low or intermediate cap because applying a high cap for each individual claim could have no impact on the extent of an auditor's liability. Assessment of a desirable cap limit also impacts the selection of the multipliers used in calculating the cap. Thus, the decision to adopt a high cap would lead to selection of a large multiplier and vice versa.

The high number of possible methods for setting as well as applying a cap and the necessity for approximating the cap limit raise the question, "What are the relevant considerations in deciding such issues?"

Optional Question

This is a good question to add to the case for those faculty covering chapter 6 as part of the course.

4. **Explain the legal liability of auditors under SEC regulations and the *Telltabs* ruling relied on by the Court. Include in your discussion how scienter is determined. Do you agree with the commission's conclusion that the Deloitte auditors did not violate their *legal obligations* to shareholders? Why or why not?**

In *Tellabs*, the Court prescribed the following analysis for Rule 12(b)(6) motions to dismiss Section 10(b) actions:

- *First,* . . . courts must accept all factual allegations in the complaint as true . . . .
- *Second*, courts must consider the complaint in its entirety . . . .

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- *Third,* in determining whether the pleaded facts give rise to a "strong" inference of scienter, the court must take into account plausible opposing inferences. The inference of scienter must be more than merely "reasonable" or "permissible" -- it must be cogent and compelling, thus strong in light of other explanations.

  In order to establish a strong inference of scienter, plaintiffs must do more than merely demonstrate that defendants should or could have done more. They must demonstrate that the Deloitte auditors were either knowingly complicit in the fraud, or so reckless in their duties as to be oblivious to malfeasance that was readily apparent. With respect to Ahold's two frauds, plaintiffs point to ways that defendants could have been more careful and perhaps discovered the frauds earlier, but plaintiffs cannot escape the fact that Ahold and USF went to considerable lengths to conceal the frauds from the accountants and that it was the defendants that ultimately uncovered the frauds. The strong inference to be drawn from this fact is that Deloitte U.S. and Deloitte Netherlands lacked the requisite scienter and instead were deceived by Ahold and USF. The court reiterated that it is not an accountant's fault if its client actively conspires with others in order to deprive the accountant of accurate information about the client's finances.

  The SEC may bring civil and/or criminal cases against auditors under the Securities Act of 1933, the Securities and Exchange Act of 1934, the Private Securities Litigation Reform Act of 1995, and the Sarbanes-Oxley Act of 2002. These laws create potential civil liabilities for auditors for failing to adhere to the requirements of the laws in carrying out professional obligations. Criminal liability exists when an auditor defrauds a third party through knowingly being involved with falsifications in financial statements. The Sarbanes-Oxley Act makes it a felony to destroy or create documents to impede or obstruct a federal investigation.

  Section 11 of the Securities Act of 1933 imposes a liability on issuer companies and others, including auditors, for losses suffered by third parties when false or misleading information is included in a registration statement. Any purchaser of securities may sue; the purchaser generally must prove that: (1) the specific security was offered through the registration statements; (2) damages were incurred; and (3) there was a material misstatement or omission in the financial statements included in the registration statement. The plaintiff need not prove reliance on the financial statements unless the purchase took place after one year of the offering.

  The liability of auditors under the 1934 Act often centers on Section 10 and Rule 10b-5. These provisions make it unlawful for a CPA to: (1) employ any device, scheme, or artifice to defraud; (2) make an untrue statement of material fact or omit a material fact; and (3) engage in any act, practice, or course of business to commit fraud or deceit in connection with the purchase or sale of the security.

  The Private Securities Litigation Reform Act (PSLRA) of 1995 changed the potential liability of accountants and other professionals in securities fraud cases. Among other things, the act imposed a new statutory obligation on accountants. An auditor must use adequate procedures in an audit to detect any illegal acts of the company being audited. If something illegal is detected, the auditor must disclose it to the company's board of directors, the audit committee, or the SEC, depending on the circumstances.

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An accountant may be found criminally liable for violations of the Securities Acts of 1933 and the Securities Exchange Act of 1934, the Internal Revenue Code, and state and federal criminal codes. Under both the 1933 and 1934 Acts, accountants may be subject to criminal penalties for willful violations – imprisonment of up to ten years and/or a fine of up to $10,000 under the 1933 Act and up to $100,000 under the 1934 Act. The Sarbanes-Oxley Act created new or broader federal crimes for obstruction of justice and securities fraud, with maximum prison time of 20 or 25 years, respectively. Sentences for many existing federal crimes were enhanced. Mail and wire fraud maximum penalties were quadrupled, from 5 to 20 years. The maximum sentence for some securities law violations was doubled from 10 to 20 years, and the maximum fine against a company for the same offense was increased from $2.5 million to $25 million

In the Ahold case, the Court found that, with perfect hindsight, the auditors could have required stronger evidence of control for the joint ventures, designed a confirmation process that was not flawed, and been more careful and possibly discovered the frauds earlier. However, Ahold and USF went to considerable lengths to conceal the frauds from the auditors and it was the auditors who ultimately uncovered the frauds. Additionally, the Court pointed out that the fact that Ahold and USF concealed side letters and conspired with the vendors to lie on the confirmation letters. Thus, the auditors could not had been involved in the frauds.

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Case numbers align with the 3rd edition of the book. These are cases not covered in the 4th edition.

Case 2-5 Blues Brothers

Assume it is December 31, the last day of the fiscal year, and you are an internal accountant for Saturday Night Accessories, a privately-owned company run by the Blues Brothers, that provides personal services to consumers. On that date a $1.2 million major contract for one year of services is received. You are instructed by your supervisor who reports to the "Brothers" to record the full amount of the $1.2 million as revenue on December 31. You know that management will receive a bonus for the boosted revenue and you will receive recognition in an upcoming performance review.

QUESTIONS

1. **What is the proper way to account for the revenue in this case? Why?**

The $1.2 million contract of one year of services should be recorded as revenue in the year earned, the next fiscal year; this is required by the matching principle.

2. **How might you go about convincing your supervisor of the proper accounting? That is, what factors might enable you to get your point across and what are disablers that might prevent you from achieving that result? Under what circumstances might you consider going to the Brothers to discuss the matter?**

Your superior would like the revenue booked on December 31 in the current fiscal year. The increased revenue for the current year will increase bonuses and will help performance reviews. These are all short-term views. Long-term views would note the revenue may be needed to make next year's goals. Thus, the company is borrowing from the future to make the present look better and creating a scenario where the charade has to be continued each and every year. The snowball effect eventually collapses under its own weight. Moreover, the recording of the revenue in the current year will eventually be found out and could harm the company's and executives' reputations. A reputation of manipulating earnings could drive interest rates on financing and bank loans.

As you review the short-term and long-term views of the recording of revenue, you need to find enablers or people who support you doing the ethical action. It is helpful if you know an enabler in the company; one who may act as the conscience of the company. However, it is also helpful to find personal enablers who help you vocalize the ethical course of action and will not let you rationalize an unethical course of action. These personal enablers can also be the ones that you would not want to disappoint by being unethical and ending up on the front page of the paper. You need to plan on talking to your supervisor and your supervisor's boss. You should be prepared that the supervisor may resist waiting to record the contract until the next fiscal year. This may be due to

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wanting a larger bonus or wanting to please the "Brothers," whether they want this revenue recorded this year or not. You may also find that your supervisor's boss may also resist waiting to record the revenue for similar reasons as your supervisor's. You will need to explain the correct accounting treatment and emphasize the long term effects on reputation and lending costs for recording revenue in the current year. You should try to find out if the "Brothers" ordered the recording of revenue in the current year or if it is just the perception of what "Brothers" want. Many times reminding the disablers of the ethical alternatives and the importance of being ethical is enough to have them down from doing the unethical thing.

3. Under what circumstances might you consider going to the "Brothers" to discuss the matter?

In a private company, the "Brothers" may be hands-on acting as be the top executives of the company or may be hands-off acting as a Board of Directors. You should go the "Brothers" only after going up the chain of command in the company. If in discussing the accounting treatment of the revenue with your supervisor and his boss you were told that the "Brothers" ordered the recording of revenue in the current year, then you need to prepare for the possibility that talking to the "Brothers" may lead you to find a new job (whether by your choice or not). If the "Brothers" act more as a Board of Directors, you may want to consider talking to them individually or as a group. Also if one brother tends to understand the accounting/finance aspect of the company best, this is the brother you may want to talk to first. Like the above question, you should not discount that one person standing up for the ethical action can change minds and hearts.

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CHAPTER 2

1. **Aristotle believed that there was a definite relationship between having practical wisdom (i.e., knowledge or understanding that enables one to do the right thing) and having moral virtue, but these were not the same thing. Explain why. How do these virtues interact in Rest's Four Component Model of Ethical Decision Making?**

A person who has all the right moral virtues (i.e., courage, temperance, self-discipline, moderation, modesty, humility, generosity, friendliness, truthfulness, honesty, justice) knows what ends to pursue, but without practical wisdom, that person will not know how to set about pursuing the right ends. Aristotle believed that having one's heart in the right place is not good enough: being a good person requires a kind of practical wisdom as well as a good disposition. Or, as author John Bradshaw puts it in his book, *Reclaiming Virtue*: **Practical wisdom "is the ability to do the right thing, at the right time, for the right reason."** A person who has practical wisdom but does not have the right moral virtues will be very effective in devising means to personal ends, but those ends might not be noble. The villain in a James Bond film might be seen as a portrait of a person with practical wisdom but no moral virtue.

For this reason, Aristotle believed that practical wisdom was the virtue that made all the other virtues possible. Without the correct application of practical wisdom, the other virtues would be too much or too little and turn into vices. Aristotle recognizes that what we truly and firmly believe influences our behavior. If we have really internalized the practical wisdom and thought about the reasoning to support it, we will be more likely to exhibit moral virtue. According to Aristotle moral virtue comes as a result of habitually doing the right thing. One becomes virtuous just by habitually doing virtuous things (i.e., be fair-minded, honest, trustworthy) One becomes courageous by habitually doing courageous things (i.e., don't subordinate judgment).

Aristotle's moral virtues correlate with Rest's moral character while practical wisdom correlates with the moral sensitivity, moral judgment, and moral motivation in Rest's four-component model of ethical decision making.

1. **Some empirical research suggests that accountants and auditors may not achieve their higher levels of ethical reasoning. Why do you think this statement may be correct?**

Kohlberg was working on stage 6 at the time of his death and believed that this stage rarely occurred. Published studies during the 1990s indicate that CPAs reason primarily at stages 3 and 4. CPAs are influenced by relationships with peers, superiors, and clients (stage 3) and by the rules (stage 4). One hindrance to reaching stage 6 is that there are no universal accounting rules as the convergence to a single set of standards is showing. However, CPAs should be moved to reason at stage five and evaluate harms and benefits of actions on stakeholders; be far-minded and objective; and act in a virtuous manner.

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2. **Do you agree with Carol Gilligan's criticism of Kohlberg's model that women reason differently than men and rely more on a care-and-response orientation? Why or why not? Do you believe Kohlberg's model is culturally biased? Why or why not?**

Gilligan interviewed twenty-nine women from referrals of abortion and pregnancy-counseling centers and found different takes on the three level of moral development than Kohlberg. She found that in using Kohlberg's model that men typically think in formulas of peoples' rights, like a math problem. And in turn, women are more uncomfortable responding to ethical dilemmas. When looking at situation, men will ask of themselves what the "right" answer is. They will ask themselves the why, what, when questions. Women, on the other hand, will tend to solve an ethical dilemma without trying to hurt anyone. Perhaps this is why "Men are from Mars and Women are from Venus."

Ask you class how they felt about the ethical dilemmas presented in chapter 1 discussion questions 1 and 2. You might find some students are uncomfortable being asked to decide whether the runaway train is harming or killing five people or one. Some would prefer an option that does not kill anyone. Some students also prefer to discuss the dilemma as saving one versus five. This discomfort may not fall solely along gender differences.

3. **Arthur Andersen LLP was the auditor for Enron, WorldCom, Waste Management and other companies that committed fraud. Andersen was forced to shut its doors forever after a U.S. Department of Justice lawsuit against the firm that it had obstructed justice and lied to the government in the Enron case. One thing Andersen had done was to shred documents related to its audit of Enron before the government could get its hands on them. Some in the profession thought the government had gone too far given the facts and mediating circumstances including top management's deception; others believed the punishment was unjustified because most accounting firms got caught up in similar situations during the late 1990s and early 2000s (pre-Sarbanes-Oxley). What do you believe? Use ethical reasoning to support your answer.**

At the time of Enron and Andersen scandal, most of the big accounting firms were making more off of consulting engagements rather than auditing engagements. (Urban legend has it that one accounting firm even paid $10,000 to a company in order to obtain the company's audit engagement, which was tied to a consulting engagement.) Auditing engagements had become the loss leader for the firms. The large consulting engagements affected the independence of the audit in appearance, if not in fact. Using the utilitarianism approach, one could argue that keeping the client happy on an audit was in the greater good of the accounting firm, the client, shareholders, public, suppliers, employees, and the market. Using the Golden Rule approach, one could argue that in order for the accounting firms to be considered trusted advisers, they could not disapprove of every business of the client; all CPAs had to treat their clients in this way, at least prior to Sarbanes-Oxley. By becoming trusted advisers, the clients would then award more consulting contracts, and the firms would benefit. Using the deontology approach, the firms had a duty to protect the confidentiality of the client. Therefore, documents should be shredded and not turned over to the authorities. All these have a fallacy of confirming the consequences. In

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other words, the ends do not justify the means. There is no ethical justification to destroying documents to "save a client."

4. **In this chapter we discuss the role of Sherron Watkins in the Enron fraud. Evaluate Watkins' thought process and actions from the perspective of Kohlberg's model. Do you think she went far enough in bringing her concerns out in the open? Why or why not?**

Watkins identified the ethical issues in the Enron debacle. She was motivated to do the right thing by self-interest and possibly enlightened egoism; this implies that Watkins was at Kohlberg's stage 2 (satisfying one's own needs). It is hard to judge whether she was at stage 3 (fairness to others), since she did not mention the interest of stockholders, employees, retirees of Enron, although her memo mentioned that Enron could implode from the business model and accounting cover-up.

In determining whether Watkins went far enough to bring her concerns out in the open is a bit like being a Monday morning quarterback. She did bring her concerns to the chair of the board. Should she have taken the concerns to the audit committee, independent member of the board, and/or the entire board? Should she have gone outside the company – to the SEC, or a news reporter? Was she waiting on a response from Lay? How much time was involved? Did she need time to sell her Enron stock before telling outsiders? Watkins has been a licensed Texas CPA since 1983; she may have felt constrained by the obligation of confidentiality. She tried to do the right thing perhaps for selfish reasons (i.e., concern about ever getting another job if Enron implodes). She did not carry through ethical thought with ethical action.

5. **Do you think Betty Vinson was a victim of "moral blindness"? Why or why not?**

Betty Vinson's situation at WorldCom: she knew it was wrong to "cook the books" 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. She was concerned for her job, understandably, but did not see the big picture that the WorldCom fraud was hurting many people (i.e., stockholders, employees) and she might have been able to stop it. Thus, Betty did not act on her ethical intent and did not display ethical behavior.

Moral blindness is used to describe someone who can't tell right from wrong, rather than just choosing to ignore doing "the right thing." Since Betty knew that it was wrong to "cook the books" she was not a victim of moral blindness. She was weak in not staying true to her ethical values; she may have felt pressured and did not have a choice except to go along. That is different from moral blindness.

6. **Interpretation 102-4 of the AICPA Code of Professional Conduct that was discussed in Chapter 1 provides that a CPA should not knowingly misrepresent facts or subordinate her judgment when performing professional services. Explain how Rest's model of moral development influences the steps a CPA should take to avoid subordinating professional judgment.**

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Rest's model has four components (moral sensitivity, moral judgment, moral motivation, and moral character). A CPA requires moral sensitivity to know when his judgment is being pressured towards subordination to the client or other interests. The CPA needs to keep the interest of the public foremost in making judgments and remaining skeptical, be objective, and independent in the situation (moral judgment). He will then need moral motivation and moral character (courage) to resist the pressure to subordinate judgment. This may require that the CPA act as an internal or external whistleblower, as permitted by the profession's codes of ethics.

(This is a good question for chapter 3)

7. **In a June 1997 paper published in the *Journal of Business Ethics,* Sharon Green and James Weber reported the results of a study of moral reasoning of accounting students prior to and after taking an auditing course. The study also compared the results between accounting and non-accounting students prior to the auditing course. The authors found that: (1) accounting students, after taking an auditing course which emphasized the AICPA Code, reasoned at higher levels than students who had not taken the course; (2) there were no differences in moral reasoning levels when accounting and non-accounting majors were compared prior to an auditing course; and (3) there was a significant relationship between the Seniors' levels of ethical development and the choice of an ethical versus unethical action.[39] Comment on the results of this study.**

The results of the study show that ethical training and emphasis can make a difference in behavior, level of ethical development and the knowledge of ethical versus unethical. The study does not indicate the duration of the ethical training or optimal intervals of when to update the training. The discussion of the profession's codes of ethics keeps the expectations of the profession uppermost in one's mind. Even though discussion of ethics with students may lead to more ethical behavior, it still requires the moral conviction to act on what students might learn is the right thing to do as an accounting professional. It is this last crucial step that we should strive as educators to help students achieve in practice.

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Ethical Obligations and Decision Making in Accounting Text and Cases 4th edition Mintz Solutions Manual

Cognitive Processes and Ethical Decision Making in Accounting

Chapter 2

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Ethical Obligations and Decision Making in Accounting Text and Cases 4th edition Mintz Solutions Manual

Cognitive Development Approach

- 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
- These stages characterize the way people think about ethical dilemmas

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Kohlberg and Cognitive Development

- Psychologist
- 20 years of research
- Moral reasoning processes becomes more complex and sophisticated with development
- Higher stages are consistent with philosophical theories of rights and justice

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Heinz and the Drug

- Heinz's wife has a rare cancer
- A radium drug could help
- Druggist charged 10 times what drug cost ($200 cost; $2,000 for small dose of drug)
- Heinz could only get together $1,000
- Druggist would make no exceptions to price of drug
- What should Heinz do?

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Sample Responses to the Heinz Dilemma

- **Egoism:** Steal the drug, depending on how much Heinz likes his wife and how much risk to stealing
- **Ends justify the means:** Steal the drug, due to loving the wife so much and cannot watch her die
- **Act Utilitarianism:** Weigh the costs and benefits of alternative actions
- **Rule Utilitarianism; justice:** Do not steal the drug, since stealing is against the law
- **Rights:** Right to life above all else (Constitutionally: life, liberty, and the pursuit of happiness)

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Kohlberg's Stages of Moral Development

- Lawrence Kohlberg's six stages of moral development are divided into three levels of moral reasoning
  - Level 1 – Preconventional
  - Level 2 – Conventional
  - Level 3 - Postconventional

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Level 1 - Preconventional

- Rules are seen as something external imposed on one's self
- Individual is very self-centered
  - Stage 1 – Obedience to rules; avoidance of punishment
  - Stage 2 – Satisfying one's own needs (egoism); follow rules only if they satisfy one's needs

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Level 2 - Conventional

- Individual becomes aware of the interests of others and one's duty to society
- Personal responsibility is an important consideration in decision-making.
  - Stage 3 – Fairness to others; commitment to loyalty in the relationship
  - Stage 4 – Law and order; one's duty to society, respect for authority, maintaining social order

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Level 3 - Postconventional

- Individual recognizes there must be a society wide basis for cooperation
- Orientation to principles that shape whatever laws and role systems a society may have
  - Stage 5 – Social contracts; upholding the basic rights, values, and legal contracts of society
  - Stage 6 – Universal ethical principles that everyone should follow, Kohlberg believed this stage rarely existed; Kant's categorical imperative

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Gilligan's Ethics of Care

- Care-and-response orientation that characterizes female moral judgment
- Females look for ways of resolving dilemma where no one will experience pain
- Criticism: Implication that men lack a caring response when compared to females

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Characteristics of Kohlberg's Model

- Kohlberg maintains that his stage sequence is universal
  - Same in all cultures
- Contrary to Geert Hofstede's cultural dimensions
- Stages refer not to specific beliefs, but
- Underlying modes of reasoning
- Suggests that people continue to change their decision priorities over time and with additional education and experience.
- Individual's moral development can be influenced by corporate culture, especially ethics training.

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Ethical Domain in Accounting and Auditing

- Four key constituent groups of accountants and auditors' domain are the:
- Client organization that hires and pays for accounting services
- Accounting firm that employs the practitioner
- Accounting profession including various regulatory bodies
- General public who rely on the attestation and representation of the accounting firm

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Accountants Ethical Behavior

- Accounting profession has professional standards to encourage ethical behavior
- These standards, an individual's attitudes and beliefs, and ethical reasoning capacity influence professional judgment and ethical decision making
- Post conventional reasoning is the ethical position to take even though it may go against corporate culture of, "go along to get along"

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Empirical Studies

- Studies have shown that:
  - Ethical reasoning may be an important determinant of professional judgment
  - Unethical and dysfunctional audit behavior may be systematically related to the auditor's level of ethical reasoning
  - Ethical reasoning may be an important cognitive characteristic that may affect individual judgment and behavior

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Moral Reasoning and Moral Behavior

- Moral judgment is the single most influential factor of a person's moral behavior
- Morality requires
  - Person's actions be rational
  - Motivated by purpose or intent
  - Carried out with autonomous free will
- Criticism of Kohlberg
  - Draws too heavily from Rawl's Theory of Justice
  - Makes deontological ethics superior to other ethical perspectives

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Rest's Model of Morality

James Rest's model of ethical action is based upon the presumption that an individual's behavior is related to her/his level of moral development. He breaks down the ethical decision making process into four major components.

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Components of Rest's Model

- Moral Sensitivity – ability to identify what is moral and amoral.
- Moral Judgment – ability to reason through several courses of actions and making the right decision when faced with an ethical dilemma.
- Moral Motivation – influences that affect an individual's willingness to place ethical values ahead of nonethical values.
- Moral Character – having one's ethical intentions match actions taken.

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Moral Intent

- Critical component of ethical decision making
- Internalization of virtues
- Acting in accordance with principles
- One must want to make the ethical decision

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Components Interact

- All processes must take place for moral behavior to occur.
- This framework is not a linear decision making model, the processes instead work through sequence of “feed-back” and “feed-forward” loops.
- Moral failure can occur when there is a deficiency in any one component.

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Moral Intensity

- Developed by Thomas Jones
- Characteristics of moral issue (Moral Intensity) affects decision making
- Model links moral intensity to Rest's Model
  - Magnitude of Consequences
  - Temporal Immediacy
  - Social Consensus
  - Proximity
  - Probability of Effect
  - Concentration of Effect

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Libby and Thorne: Virtues Important for Auditing

- Intellectual virtues: indirectly influence individual's intentions to exercise professional judgment
  - Most important: integrity, truthful, independent, objective, dependable, principled, and healthily skeptical
- Instrumental virtues: directly influence individual's actions
  - Most important: diligent, alert, careful, resourceful, consultative, persistent, and courageous

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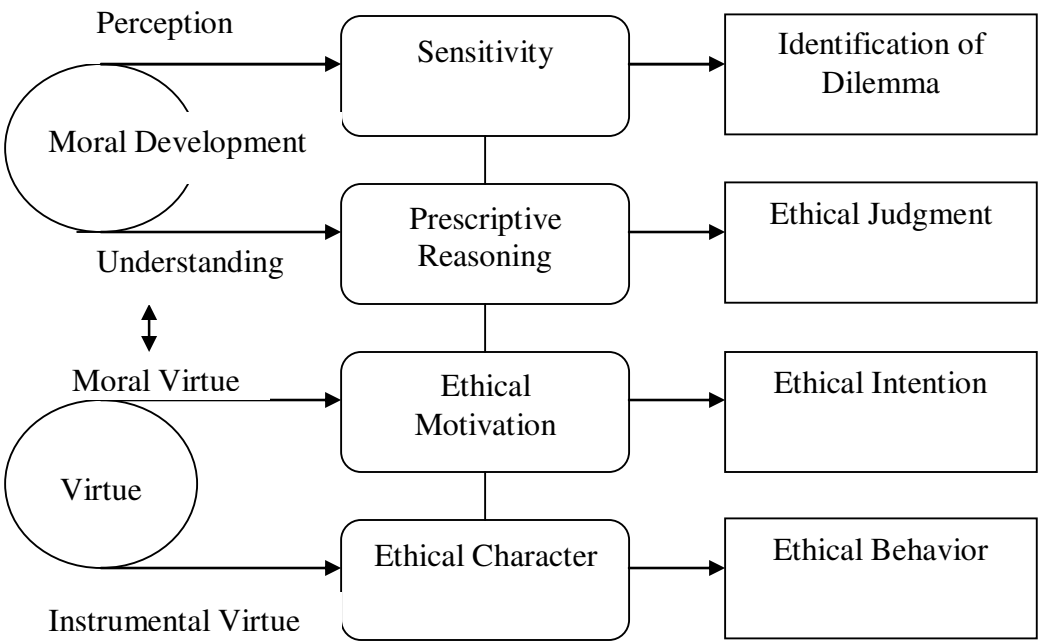
Linda Thorne's Integrated Model of Ethical Decision Making



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Ethical Decision-Making Models

- Consciously thinking about and analyzing what one has done (or is doing).
- A systematic process to organize the various elements of ethical reasoning and professional judgment.
  - Evaluate stakeholder interests
  - Analyze the relevant operational and accounting issues
  - Identify alternative courses of action.

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Kidder's Ethical Checkpoints

- Recognize that there is a moral issue.
- Determine the actor.
- Gather the relevant facts.
- Test for right-versus-wrong issues.
- Test for right-versus-right paradigms.
- Apply the ethical standards and perspectives.
- Look for a third way.
- Make the decision.
- Revisit and reflect on the decision.

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Integrated Ethical Decision-Making Process

1. Identify the ethical and professional issues (ethical sensitivity)
2. Identify and evaluate alternative courses of action (ethical judgment)
3. Reflect on the moral intensity of the situation and virtues that enable ethical action to occur (ethical intent)
4. Take action (ethical behavior)

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Ace Manufacturing

- Three stockholders: Smith, Williams, & Jones
- Jones hires son Paul to manage the office
- Paul is given complete control over payroll, approves disbursements, signs checks, reconciles G/L cash to bank statement
- Paul hires Larry Davis to help with accounting
- While Paul is on medical leave, Davis finds $10,000 total in payments over payroll amount to Paul in January and February
- What should Davis do?

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Application of Decision Making Model to Ace Manufacturing

- Identify the ethical and professional issues (ethical sensitivity)
  - GAAP – Potential fraud, misstated F/S, incorrect taxable income
  - Stakeholders – owners, Paul, Davis, IRS, banks
  - Ethical/professional standards – objectivity, integrity, due care
- Identify and evaluate alternative courses of action (ethical judgment)
  - Legal issues – GAAP, fraudulent F/S, tax understatement
  - Alternatives/ethical analysis – do nothing, confront Paul, report to Jones or all the owners. Rule utilitarianism and rights argue for informing other partners who have a right to know, although Paul can be approached first under the theory he has a right to correct the matter
- Reflect on the moral intensity of the situation and virtues that enable the ethical action to occur (ethical intent)
  - Will Davis be responsible for getting Paul in trouble? What is the right thing to do? Can Davis trust Paul again?
- Take action (ethical behavior)
  - Have courage, insist on correction to accounting, give Paul an opportunity to explain

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Behavioral Ethics

- Considers how individuals make decisions in the real world versus how they would make decisions in an ideal world.
- Kahneman's two distinct modes of decision making:
  - System 1: intuitive system of processing info; fast, automatic, effortless, and emotional decision processes
  - System 2: slower, conscious, effortful, explicit, and a more reasoned decision process

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Leon Festinger

- Recognized the limitation of philosophical reasoning approaches integrated into decision making models
- How we think we should behave is different from how we decide to behave
- Coined term of Cognitive Dissonance in 1956

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Cognitive Dissonance

- Inconsistency between our thoughts, beliefs, or attitudes and behavior creates the need to resolve contradictory or conflicting beliefs, values, and perceptions.
- Only occurs when we are “attached” to our attitudes and beliefs.
- How we think we should behave is different from how we decide to behave.
- Example of Betty Vinson of WorldCom

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Giving Voice to Values

- Behavioral ethics approach with an emphasis on developing the capacity to effectively express one's values in a way that positively influences others
  - Finding levers to effectively voice and enact one's values
- Ask to think about the arguments others might make that create barriers to expressing one's values in workplace
- Ask to think how best to counteract these "reasons and rationalizations"
- Used post-decision making (already decided what to do)

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GVV Questions

- How you get it done effectively and efficiently?
- What do you need to say, to whom, and in what sequence?
- What will the objectives or push-back be, and, then
- What will you say next?
- What data and examples do you need to support your point of view?
- GVV relies on developing arguments, action plans, and rehearsing how to voice/enact moral values.

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Reasons and Rationalizations

- Expected or Standard Practice – “Everyone does this.”
- Materiality – “The impact is not material. It doesn’t really hurt anyone.”
- Locus of Responsibility – “This is not my responsibility; I’m just following orders.”
- Locus of Loyalty – “This is not fair to the client, but I don’t want to hurt my reports/team/boss/company.”
- Isolated Incident – “This is a one-time request.”

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4 – Step GVV Process

- What are the main arguments you are trying to counter? That is, what are the reasons and rationalization you need to address?
- What's at stake for the key parties, including those with whom you disagree?
- What levers can you use to influences those with whom you disagree?
- What is your most powerful and persuasive response to the reasons and rationalizations you need to address?

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Doing Good by Being Good: GVV

- Matt and Becca head up Accounting Club fundraising for hurricane victims in the college community
- Donations totaled $20,367 and 2,000 hours of volunteer work
- Only $20,000 given to victims
- Where is the other $367 or where is receipt for the fees on gift cards?

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Doing Good Analysis with GVV

- What are the main arguments to counter or reasons and rationalizations to address?
  - Locus of loyalty, materiality, isolated incident, student graduating
- What's at stake for the key parties?
  - Reputation, leadership stake, faculty advisor and community
- What levers can you use to influence those with whom you disagree?
  - Speak to other officers, approach Matt, go to faculty advisor, jeopardizing respect
- What is your most powerful and persuasive response to the reasons and rationalizations?
  - Cheating, job in Big 4, loyalty to club, consequences to club and officers in cover up

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Ace Manufacturing Analysis with GVV

- What are the main arguments to counter or reasons and rationalizations to address?
  - No one hurt, private company, sympathy card, materiality, not being compensated properly, isolated incidents, Jones has approved, will pay back
- What's at stake for the key parties?
  - Reputations, embarrassment, right to know, loss of job, ability to obtain loan
- What levers can you use to influence those with whom you disagree?
  - Ask for supporting documents for coding of expenses, harm to company and embarrassment to dad, long-term effects, telling all the owners
- What is your most powerful and persuasive response to the reasons and rationalizations?
  - Verifying that vendor is not paid twice, using money for personal use is stealing and no materiality test, challenges Jones about knowing, owners need (have a right) to know

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Concluding Thoughts/Key Issues

- "The road to success is littered with failures, but the lessons learned are crucial in plotting your course to success." Kristi Loucks
- Kohlberg's model of moral development
- Rest's model of ethical decision-making
- Cognitive development
- Issues of moral intensity and virtue in Integrated Decision-Making mode
- Behavioral ethics
- Moral reasoning skills
- Giving Voice to Values

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Video Links

- Ethics Relationships: http://www.youtube.com/watch?v=Lhwhgf01Ozw&feature=related
- Personal Behavior: http://www.youtube.com/watch?v=NxdbzcR4nfA
- https://www.youtube.com/watch?v=6yXuNnjnnEA
- Case 2-9 Phar-Mor: http://www.youtube.com/watch?v=NAMz8QR6c5w
- Case 2-10 WorldCom: http://www.youtube.com/watch?v=7g_d-phoUrU
- https://www.youtube.com/watch?v=6yXuNnjnnEA (Cynthia Cooper interview)

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