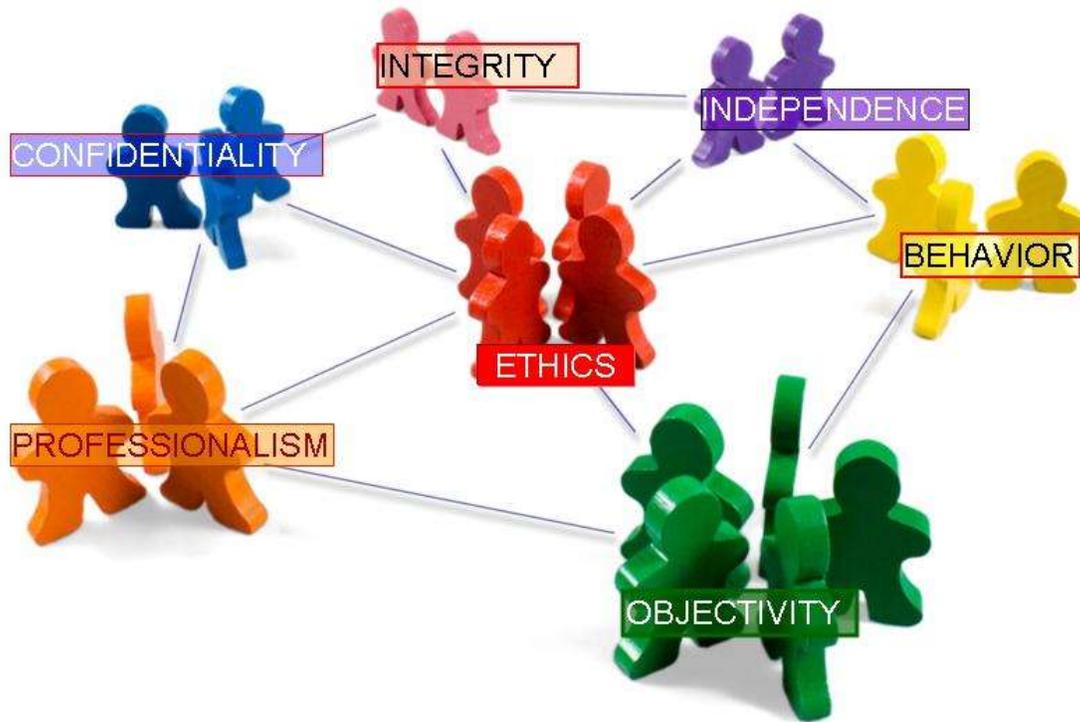


ACCOUNTING ETHICS



Course Objectives

1. To educate Texas Certified Public Accountants in ethical standards and issues associated with the practice of accounting within the State of Texas. As part of the education process, this course will:
 - a. aid Texas CPAs in applying ethical judgment when interpreting the various standards and rules applicable to the practice of public accountancy within the State of Texas;
 - b. encourage Texas CPAs to place primary importance in ethical decision-making on public rather than self-interest when evaluating their ethical decisions even at the loss of position or client.
2. To help Texas CPAs to develop more than a technical understanding of the various applicable Rules of Professional Conduct when involved in the performance of professional accounting services/work. Within this context, this Course will review and encourage open discussion of the Rules of Professional Conduct and their implications for persons in a variety of practices, including:
 - a. attest and non-attest services for Texas CPAs in public practice (§ 501.52);
 - b. internal accounting and auditing services for those Texas CPAs in industry;
 - c. education or government service.

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**Module 1 -
Human Behavior and Ethical Attitudes**

Module 1

Tab 1 – Slides and Notes

Slide
1

UVA

Human Ethical Decisions

Are we Predictably Irrational?

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Slide
2

UVA

Leslie Caldwell, formerly lead prosecutor on the Enron/Andersen case remarked that most corporate criminals are not bad people. Rather, they succumb to pressures (and/or to ego) and begin a slide down a slippery slope.



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3

UVA



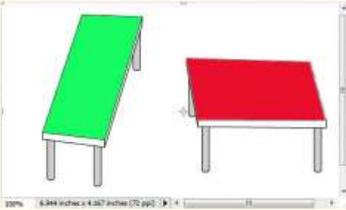
Conscious....?
Subtle and Unconscious?
Both?

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Ethical Behavior – Our Irrational Rationality




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Slide 5

How We Think

System 1

Fast / Automatic
Emotional



- Impulses / Drives
- Habits
- Beliefs
- **Group Dependent**

System 2

Slow / Effortful
Logical



- Reflection
- Planning
- Problem solving

Common blind spots in our behavior

- Our Focus of Attention.
- Diverting our Attention.

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Slide 6

Brain Short-Cuts – Bending Our Moral Compass

- At either stage, our minds often construct a view of ourselves and the world that
 - Fabricate information to fill any "blind spots";
 - Uses irrational logic and
 - leaps of faith to skew our ethical and behavioral decisions.




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7

Ethical Character – Setting the Compass

- We seem to want to be just unethical enough to be able to still “look ourselves in the mirror” . [Allingham & Sandmo, 1972; Becker, 1968; Gino, Ayal & Ariely, 2009; Gino, Gu, Zhong, 2009]
- This ability to maintain our “self-image” depends on our
 - Psychological attitude;
 - Ethical reasoning and development;
 - Cultural and background;
 - Training;
 - Awareness of applicable Codes of Conduct.

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8

Human and Ethical Behavior

“We are professionals that follow our code of ethics and practice by the highest moral standards. We would never be influenced by our own person financial well being.” [AICPA testimony to Congress]

“Consistent with decades of research in social psychology, each of these three conditions (of the Codes of Conduct (e.g., objectivity, integrity and independence) makes independence a farce.” [Bazerman, Gino, 2015]

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9

Adjusting Our Ethical Behavior – Environmental

Accountability

Colors

Smells

Framing

Our Group

Time & Stress

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10

Adjusting Our Ethical Behavior – Primal Urges

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Primal Emotions - Disgust

- Magnifies our evaluation of the act's severity and actor's character; [Horberg, 2009]
 - Transfers to the actor
 - Doggie burger?
 - Would you be more charitable in
 - A hospital; or
 - A junk yard? [Sherman, Gore, 2009; Zhong, Littlewood, et al., 2010]
 - Would you be more likely to invest with an investment advisor named
 - Bernie Madoff; or
 - Bernie Buffet?
- We distance ourselves (physically and emotionally) from the object of our disgust. [Tiedens & Linton, 2001]

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Primal Emotions - Happiness

- Signals a benign environment that moves us to Stage 2 (more efficient and rational analysis) thinking.
- Makes us more charitable in judging other's actions [Labroo & Patrick 2009]

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13

 **Primal Emotions - Sadness** 

- Signals a potentially **hostile environment** that makes us more attentive.
- Puts us on our guard; and
 - Moves us to Stage 2 thinking and *numbs* our ethical senses. [Bodenhausen, 1994; Tiedens & Linton, 2001]

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14

 **Primal Emotions – Guilt/Shame** 

- **Shame** is outward, **Guilt** is inward.
- Both affect both how we view our own as well as others actions.
 - Client’s business has taken a downturn because of your advice
 - You would be **guilty** if you believed you hadn’t done all the research you should have before giving the advice;
 - You would be **ashamed** if you believed you were not competent to offer the advice (perception of others).
- We adjust our **guilt** and **shame** through ethical actions that “balance” the unethical activity. [Khazari, Amir, Aradly, 2008; Gino, Aydi, Aradly, 2009]

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15

 **Primal Emotions – Guilt** 

- Overrides economic self-interest and **motivates ethical behavior** (however defined). [Kroll, Egan, 2004; Tangney, W Tue-wag, Mashek, 2007]
- As **guilt** increases, we
 - *Behave* more ethical;
 - Develop more self-esteem;
 - Become more
 - Empathetic;
 - Ethically aware.

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 **Primal Emotions - Shame** 

- When we're **ashamed**, we can't separate the act from who we are.
 - Causes **inferiority** and **self-doubt**.
- We **morally disengage** and **behave unethically**. [Connolly, 2012]
 - An accountant (or scientist) ashamed of not meeting group expectations will more likely falsify data (or scientific paper).
 - We do this with kids by telling them that if they do/don't do something, the other kids won't play with them.

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 **Primal Emotions – Stress** 

- We each seem to have a “reservoir” of self-control.
 - When it's used up, our ethical disposition changes – we begin to behave unethically. [Gino, Schweitzer, Foad, Ariely, 2011]
- **Stress** accelerates how fast we use up our “ethical” reservoir.
 - Lose site of ethical issues unless reminded. (Remember the billboard with eyes on the wall).

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 **Primal Emotions – Time** 

- **Time.**
 - Two types of individuals with
 - two perspectives.
- **Think about 3 significant events in your past.**
 - **Were they positive or negative events?**
- **Perspectives – Are you**
 - Present-oriented or
 - Future-oriented?

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Marshmallows

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Primal Emotions – Time

- Marshmallow test is really an evaluation of whether a person is “present-oriented” or “future-oriented”
 - Future-oriented (those who waited to eat the marshmallow) individuals usually move to Stage 2 thinking faster
- When interviewed as 18-year-olds,
 - the kids who had waited had developed a range of superior emotional and social competencies
 - better able to deal with adversity and stress
 - self-confident, diligent, self-reliant
 - seemingly higher intellectual ability [proven to be twice as good a predictor of SAT scores as IQ]. [Zimbardo, 2015]

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Moral Disengagement – Adjusting the Compass

- Means of disengaging our self from our actions through
 - **Reframing** the act as
 - *utilitarian* (for the greater good); [Strawson, 1998; Rappaport & Alexander, 1982]
 - **Dehumanizing** the act
 - Changing our “language”
 - Him/her becomes “it/they”.
 - Using numbers instead of names (e.g., prisoners).
 - **Relative comparison** – finding something else that’s worse. [Bandura, 2001]

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Moral Disengagement – Adjusting the Compass₂

- **Minimize the Negative Consequences** [Bandura, 1999]
 - Stealing from a profitable but unethical organization as a “victimless crime”.
 - Protect organization or family.
- **Shifting the Blame** to the victims [Bandura, 2002; Douglas, 1995]
- **Re-Frame** (give it another name)[Boling, 1982]
 - Label fraud as “team playing”.
- **Physical or emotional rituals** after the event
 - Wash hands
 - Cause ourselves pain [Zhong&Liljenquist, 2006; Klaassen, 2008]

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Moral Disengagement – Adjusting the Compass₃

- **Begging forgiveness** and confession [Ayal, Gino, et al, 2010]
 - Confession reduces
 - later unethical behavior (for a time);
 - after-the-fact charitable giving.
- **Displace responsibility** for the act –
 - Making the act a **group** event
 - Shakespear, the Death of Julius Ceasar;
 - Agatha Christie, Murder on the Orient Express.
 - Chain of Command:** Implicit/explicit approval from authority figures: [Kelman & Hamilton, 1989; Milgram; Sykes & Matza, 1957]
 - Hire **intermediaries** (Merk drugs): [Paharia, Kassam, et. al, 2009]
- **Create uncertainty** – we lose our ethics when no one’s looking.

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Moral Accounting – Groups

- **Group Dependent** - depends on society/group consensus on the act’s ethical nature. [Barnett & Valentine, 2004]
 - However....the more significant the consequences, the more likely people are to recognize the unethical behavior and judge it more severely. [Kish-Gephart, 2010; Vrethem, et al, 2015]

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USA Priming – Group Behavior

- It doesn't take much to make us feel part of the "group" when excusing unethical behavior
 - Clothing (such as T-shirt);
 - We'll behave more ethically if the actor is not part of the "group". [James, 2015]
 - Similar name [Pelham, Carvallo & Jones, 2005]
 - Common lack of understanding;
 - Same birthday;
 - Culture or mindset; [Gunia, Sivanathan & Galinsky, 2009]

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USA Priming – Group Behavior₂

- **Group Ethical Dilution**
 - people substitute group for personal ethics
 - **Cheating**
 - increases when it benefits the group and
 - increases in relation to group size. [Gino, 2015]

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USA Priming – Group Behavior₃

- **Group primal emotions** – we'll substitute group for personal emotions (in short – a mob)
 - Pain;
 - Embarrassment;
 - Joy. [Willer, 1997; Murray, 2002; Bristol, 1991; Jackson, Brunet, Melzoff et al, 2006]
 - **Implicitly discriminate in favor of in-group members.** [Blazerman Moore, 2008; Tenbrunsel, Diekmann, et al, 2011]

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USA Anchoring (Internal Priming)

- Our tendency to unconsciously bias or “anchor” our decisions based on known information. In short, we don’t even begin an analysis with objectivity.
 - Impacts the way we assess probabilities in business and accounting activities.
 - We prejudice most situations by making quick decisions (our Stage 1 thinking) and anchor on what we extrapolate should be the goal or result (or have an opinion of what the proper outcome should be).
- Causes us to have difficulty changing our opinion even when the information (“data”) no longer fits. (next slide)

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USA Anchoring (Internal Priming)₂

- A person’s anchor can be biased/adjusted by **external inputs**.
 - Fraud percentages for auditors.
 - Writing a known number (like our SS number).
- Similarly, we have **internal biases** that anchor us to an expected result/solution.
 - “Experienced” auditors have been shown to bias a decision by selectively relying on only those available facts and observations that tend to support his/her prior experiences.

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USA Anchoring – The Halo Effect

- Tendency to extrapolate based on very limited (and/or incomplete) information to a general result.
 - You are conducting an first time audit of a company but you have met the president in a number of fundraisers for local charities.
 - **Are you more or less likely to anticipate fraud?**
 - You are doing an audit risk assessment for a company that has turned out to be very favorable.
 - **During a later audit, you encountered inconsistent data in one or more of the major company accounts. Will you use the same account risk-level assessments that you have for other companies in the same industry?** [O’Donnell, Schultz, 2005]

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31

 **Framing** 

- The view (e.g., frame) we are offered or pick affects our ethical and behavioral attitudes.
 - We favor positive rather than negative choices.
 - When “framed”
 - positively, we prefer the least risky option;
 - negatively, we’ll prefer the risky option.
- We’re more likely to **condemn unethical behavior** when the behavior produces a **negative** versus a **positive** (e.g., good) outcome, even if the outcome was out of the other party’s hands (e.g. was random).
- Economics vs Ethics?

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32

 **Framing – Accountant’s Bias** 

- Accountants were asked to review information about a proposed complex merger involving their client. They were asked to assess the information and advise the client.
- **Biased Judgment:** A review of the accountant’s assessment showed that they
 - **unconsciously biased** their evaluation of the information in favor of their client and
 - **ignored** (e.g. failed to assimilate) information about the target that was relevant but inconsistent with their client’s interest.
 - The accountant’s were unable to adjust their thinking even after monetary rewards were included that should have adjusted their analysis. [Bazerman, Loewenstein, Moore, 2002]

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Module 2

Ethical Philosophies

Module 2
Tab 1 – Forsythe Questionnaire

Ethics Position Questionnaire

Instructions:

Below you will find a series of general statements. Each of the statements represents a commonly held opinion and *there are no right or wrong answers*. You will probably disagree with some items and agree with others. Use the questionnaire to indicate the **extent** to which you agree or disagree with each of the statements.

Please read each of the statements carefully and then indicate the extent to which you agree or disagree by placing in front of the statement the number that best indicates your feelings about the statement, where:

1 = Completely disagree

4 = Slightly disagree

7 = Moderately agree

2 = In Large Part disagree

5 = Neither agree nor disagree

8 = Largely agree

3 = Moderately disagree

6 = Slightly agree

9 = Completely agree

- _____ 1. A person should make certain that their actions never intentionally harm another even to a small degree.
- _____ 2. Risks to another should never be tolerated, irrespective of how small the risks might be.
- _____ 3. The existence of potential harm to others is always wrong, irrespective of the benefits to be gained.
- _____ 4. One should never psychologically or physically harm another person.
- _____ 5. One should not perform an action which might in any way threaten the dignity and welfare of another individual.
- _____ 6. If an action could harm an innocent other, then it should not be done.
- _____ 7. Deciding whether or not to perform an act by balancing the positive consequences of the act against the negative consequences of the act is immoral.
- _____ 8. The dignity and welfare of people should be the most important concern in any society.
- _____ 9. It is never necessary to sacrifice the welfare of others.
- _____ 10. Moral actions are those that closely match ideals of the most "perfect" action.
-
- _____ 11. There are no ethical principles that are so important that they should be a part of any code of ethics.
- _____ 12. What is ethical varies from one situation and society to another.
- _____ 13. Moral standards should be seen as being individualistic; what one person considers to be moral may be judged to be immoral by another person.
- _____ 14. Different types of moralities cannot be compared as to "rightness".
- _____ 15. Questions of what is ethical for everyone can never be resolved since what is moral or immoral is up to the individual.
- _____ 16. Moral standards are simply personal rules, which indicate how a person should behave, and are not to be applied in making judgments of others.
- _____ 17. Ethical considerations in interpersonal relations are so complex that individuals should be allowed to formulate their own individual codes.
- _____ 18. Rigidly codifying an ethical position that prevents certain types of actions could stand in the way of better human relations and adjustment.
- _____ 19. No rule concerning lying can be formulated; whether a lie is permissible or not permissible totally depends upon the situation.
- _____ 20. Whether a lie is judged to be moral or immoral depends up on the circumstances surround the action.
-

Module 2

Tab 2 – Slides

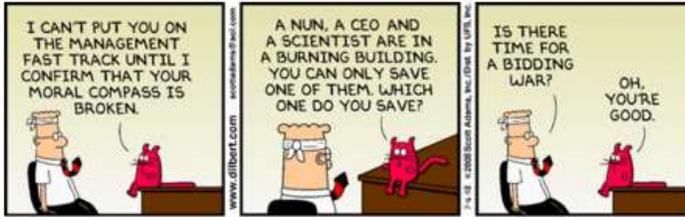
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Ethical Philosophies

1

- Virtue Ethics – our decisions make us who we are;
- Utilitarian– greatest good;
- Deontological– do what’s right



DIT Test

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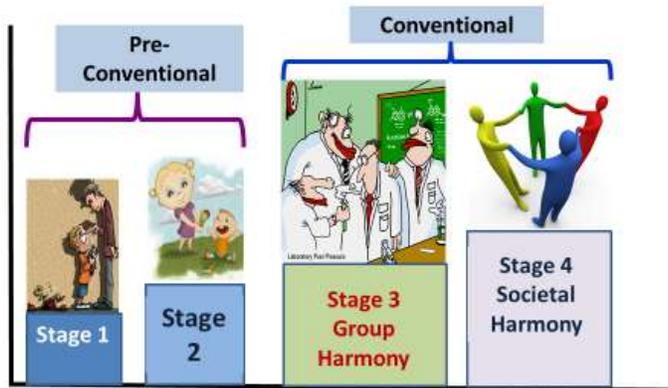
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Ethical Behavior – Kohlberg’s Stages

2



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Ethical Behavior – Kohlberg Stages

3



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4



Kohlberg Stages – Psychology

- At Kohlberg stages 3, 4 and 5, our ethics are group-based that can generate either
 - **Guilt;** or
 - Client has business setbacks because of our advice and we believe we should have done more research.
 - **Shame.**
 - Client has business setbacks because of our advice and we believe we weren't competent to advise the client. [Lewis, 1973; Tangney, 1993; Miller et al. 2011]

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5



Kohlberg – Group Impact

- The **more social consensus** (e.g., facebook, twitter), the more we rely on our perceived peers to guide our ethical thinking and attitudes. [Gialdini, 2001; Albert, Reynolds, Turan, 2015].
 - Less ashamed and
 - More likely to approve of an unethical action; (e.g., less unethical). [Gino & Galinsky, 2012]

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6



Kohlberg – Group Impact₂

- **Group Sympathy**
 - The more in-sync, the more we act to seek group approval. [Albert, Reynolds, Turan, 2014]
 - The less in-sync, the more we will act to counter the group's action. [Duckitt, 2001; Son Hing, 2007]
 - T-Shirts during quiz.
- **More Scrutiny – Less Action**
 - The more the group is watching us, the more likely we are to do nothing. [Garcia, 2009; Van Bommel, 2012]

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Kohlberg – Group Impact₃

•We're an Exclusive Club:

- The more severe the initiation, the more each group member's ethics
 - Align to the group and
 - Are defended by other group members •(Gerard & Mathewson, 1966; Zyglatas, 2013)
- Enron did this to it's employees.

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Forsythe – Ethical Thinking

•First 10 measure your *idealism*

- A person should make certain that their actions never intentionally harm another even to a small degree.
- Risks to another should never be tolerated, irrespective of how small the risks might be. The existence of potential harm to others is always wrong, irrespective of the benefits to be gained.
- One should never psychologically or physically harm another person.
- One should not perform an action which might in any way threaten the dignity and Welfare of another individual.
- If an action could harm an innocent other, then it should not be done.
- Deciding whether or not to perform an act by balancing the positive consequences of the act against the negative consequences of the act is immoral.
- The dignity and welfare of people should be the most important concern in any Society.
- It is never necessary to sacrifice the welfare of others.
- Moral actions are those that closely match ideals of the most "perfect" action.

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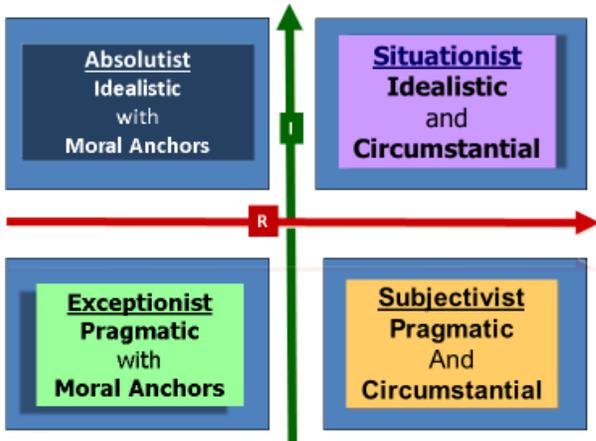
Forsythe – Ethical Thinking

– Next 10 measure your *relativism*

- There are no ethical principles that are so important that they should be a part of any code of ethics.
- What is ethical varies from one situation and society to another.
- Moral standards should be seen as being individualistic; what one person considers to be moral may be judged to be immoral by another person.
- Different types of moralities cannot be compared as to "rightness".
- Questions of what is ethical for everyone can never be resolved since what is moral or immoral is up to the individual.
- Moral standards are simply personal rules, which indicate how a person should behave, and are not to be applied in making judgments of others.
- Ethical considerations in interpersonal relations are so complex that individuals should be allowed to formulate their own individual codes.
- Rigidly codifying an ethical position that prevents certain types of actions could stand in the way of better human relations and adjustment.
- No rule concerning lying can be formulated; whether a lie is permissible or not permissible totally depends upon the situation.

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Forsythe & Behavior

- **Shame and guilt** are inversely related to **relativity** (adherence to norms).
- **Highly Idealistic persons** adjust their **shame** and **guilt** if the unethical act produces positive consequences. [O'Boyle, 2013]

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Forsythe & Behavior

- **Age** makes us
 - **Less idealistic** * [Marques et al., 2009]
 - Mixed results on **relativism**.
- **Test doesn't measure Integrity:**
 - Doesn't appear from the research that any one categories has more "integrity" than any other. [Handbook of Unethical Work behavior, 204, 2015; Singhapakdi, et al., 2000]

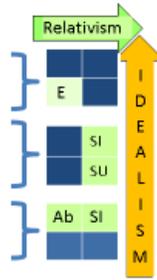
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Forsythe Worldwide

- Studies have identified patterns in ethical attitudes across cultures.
 - An **exceptionist** ethic is more common in Western countries,
 - **Subjectivists** and **situationists** are more common in Eastern countries, and
 - **Absolutists** and **situationists** more common in Middle Eastern countries.



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Forsythe – Relativists

- **Highly relativistic** individuals are skeptical about universal ethical principles.
- **Relativists** are more likely to
 - **Morally Disengage:** which would allow them to
 - Make unethical choices and condone other's unethical actions;
 - Focus on **guilt** rather than **shame**; [Long, 1998; Cates, Forrest, 1985; Wiehe, 1991]
 - **Tolerate questionable budgetary practices** (including accounting-related deviances) in organizations. [Douglas and Wier, 2000; Greenfield, Norman, Wier, 2008]
 - Reduce overall fraud risk assessment (audits).
 - **Miss the ethical components** of a situation. [Shaidt, 1995]
- Companies operating in highly relativistic cultures adopt rule-based ethical codes. [Forsyth and Boye, 2003]

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Forsythe – Idealists

- Reject the idea that harm sometimes produces a necessary good. [Handbook of Unethical Work behavior]
- More likely to
 - **Identify** and **condemn** unethical behavior;
 - **Consider outcomes** rather than personality in their ethical analysis. [Forsyth and Nye, 1990]
 - **Recognize** the ethical issues in a situation.
 - **Morally Engage:**
 - Make better ethical decisions. [Foot & Mendenhall, 1994; Lou, 2000; O'Fallon & Gresham, 2002]
 - Likely to refuse to accept questionable budgetary practices (including accounting-related deviances) in organizations. [Douglas and Wier, 2000; Greenfield, Norman, Wier, 2008]
 - **Justify** unethical actions (e.g. lie) if the act itself helps others. (e.g., highly relativistic also).
 - 77% for **high idealists** vs
 - 50% for all of the other 3 groups.

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Forsythe – Subjectivists (high relativism)



- **Pragmatists** whose actions depend on the **Circumstances.**
 - **Self-image** and fear of discovery (e.g., shame) is key
 - **Shame** will override guilt. [Forsythe & Berger, 1982]
 - Consider **consequences** rather than **motivation.**
- More likely to go along with organizational deviance. [Horkle, Giacalone, Jurkiewicz, 2005].

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Ethical Behavior

- Circumstances, development and status can significantly impact our ethical attitudes.
 - Obedience (Milgram Experiment);
 - Power and authority (Stanford Prison Experiment).

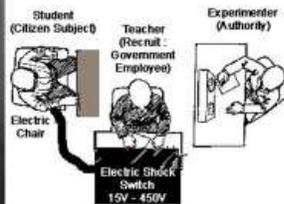
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Milgram Experiment Setup



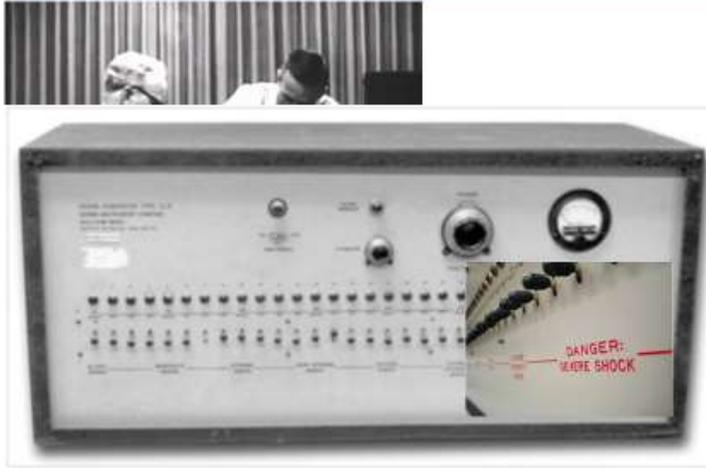
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Milgram Experiment



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Stanford Prison Experiment



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Module 2
Tab 3 – Cases and Discussion Material

Discussion Question 1:

Of the three ethical philosophies, which do you believe is most often applied to:

- business settings?
- In accounting?
- In auditing?

Are ethical philosophies relevant to the practicalities of Global business? If not, why not?

Examine your answer in relation to your understanding of the basic ethical philosophies.

Case Studies

Case 1

A woman is near death from a rare type of cancer. There is one drug that her doctors think might save her. The drug was developed by a physician in the area. After going through clinical trials and getting government approval, the physician has set up a manufacturing facility and has begun selling the drug at approximately 100 times its actual cost. Appropriate treatment with the drug consists of one shot every month for at least 24 months.

Raj, the sick woman's husband, has gone to everyone he knows to borrow the money needed to get his wife the injections that they and the doctors believe will save her life. Raj has already mortgaged their home to its maximum extent. In addition, Raj has tried every other legal means available, including lawsuits and asking the government to help. His efforts are in vain. Raj and his wife are only able to scrap together ½ of the amount needed for even 1 shot. In a final effort, Raj approaches the physician who developed the drug and asks him to sell it to him at a reduced price or to let him pay the costs over a period of time. The physician's response is that "No, I've developed and discovered the drug and I'm going to make a large profit from it." In a final fit of desperation, Raj is considering breaking into the physician's office to steal the drug for his wife.

Questions

1. Should Raj steal the drug?
2. In your opinion, is it actually wrong or right for him to steal the drug?
3. Do you think Raj has a ethical or moral duty or obligation to steal the drug?
Does it matter that Raj doesn't love his wife?
Would it matter that they've been divorced for 20 years and haven't seen each other for the last 10 years?
What if it were a pet rather than a person?
4. Is it important for people to do everything they can to save another's life?
5. Does it matter in this instance that stealing is against the law?
6. In thinking over Raj's dilemma, what would you advise Raj to do?

Case 2

Raj does break into the physician's office. He stole the drug and gave it to his wife. The following day, the local newspapers carry an account of the robbery. Mr. Brown, a police officer who knows Raj, reads about the robbery. He remembers seeing Raj running from the physician's office and believes that it was Raj who stole the drugs. Mr. Brown is now wondering whether he should report his suspicions to his superiors at the police department.

Questions

1. In your opinion, does Mr. Brown have a duty or obligation to report his suspicions to his superiors?
2. Would it make any difference to you that Mr. Brown is Raj's neighbor and best friend?

Case 3

Mr. Brown does report Raj and he's arrested and brought to court. A jury is selected, Raj's trial occurs and the jury finds Raj guilty. The judge in the case will decide Raj's sentence.

Questions

You have been appointed to be the judge in Raj's case. Because of its importance, both the local and national media have covered the case and will be covering your decision live. You have already been interviewed by 60-minutes and other news programs. Your appointment as judge is a lifetime appointment with no possibility of removal or firing. You have the option of giving Raj a sentence that can range from a "suspended sentence", to a fine, to 10 years in jail. Would it make a difference if your appointment as judge is an elected position?

Case 4 – ABC Company

Andrea is an experienced CPA who is employed by a local firm that has been in practice for many years. Andrea is the “in charge” accountant on several auditing engagements at any particular point in time. During a specific year, Andrea is assigned by her firm to audit the Portia Company as well as the Venice Company. While Andrea is friendly with both of the company’s top officers, neither of the companies is aware that Andrea is doing both of their audits.

In the course of her audits, Andrea discovers that Portia and Venice do business with each other. Specifically, Andrea discovers that Portia sells one of its product (schlock) to Venice that Venice considers critical in the assembly of its final output.

In recent years, Portia has acquired all of the other vendors that produced schlock in order to corner the market and maximize profits. Last year, Portia greatly increased the price of schlock. This increase caused resulted in enormous profits to Portia. Because Venice needs schlock to make its products, it has been forced to pay Portia’s price for schlock. The result, for Venice, has been that its current year financial statements show a large loss, primarily because of the increased purchasing costs for schlock. In fact, Venice is considering bankruptcy.

Because of the access to each of the company’s financial information, Andrea knows that Portia is pricing schlock well above its typical profit margin. In addition, Andrea is well aware, after having audited Venice’s books, of the hardship the price of schlock is causing to Venice.

Questions

1. Andrea has come to you for advice. She is wondering whether she should advise her firm of the situation?
2. Do you believe that Andrea’s professional and personal ethical obligations are any different? If so, what do you believe is the difference?
3. Do you see any conflicts for Andrea in this case?

Case 4B

In addition to the above information, you know:

- of a plant that is for sale that makes enough schlock to keep Venice going.
- Andrea is attending Portia’s shareholder meeting and overhears Portia’s CFO brag about cornering the schlock market. He said “...it was my idea to corner the schlock market...after all, customers like Venice will either pay the price or get out of the business.” In the course of this conversation, the CFO brags about his shrewd maneuvers to block Venice’s vertical expansion and says that he has given Venice verbal assurances of steep price cuts that he intends to honor only as long as it takes to buy the independent schlock plant discussed above.

Questions

4. Does this new information change Andrea’s ethical and professional obligations in any way?
 - a. Venice finds out that Andrea was aware of Portia’s tactics and sues Andrea and the firm for not revealing the situation to them. The case is brought before an arbitration board and, of course, you’re the head of the arbitration panel.
 - b. Presume that Andrea does tell Venice and Portia finds out and sues Andrea and the firm. In hindsight, would you have made any different recommendation to Andrea?
5. In either event, what should be the penalty for Andrea and the firm if they’re found guilty?

Case Studies

Case Study #1:

Situation 1: Individual in control of a trolley car in San Francisco that is heading down one of the largest hills in SF. Trolley has on a single track that branches to the right at the bottom of the hill. Individual now can see that if s/he goes straight (e.g. follows the main track), the trolley will strike and possibly kill/injure a group of tourists trapped in a bus that is stalled on the track. S/he can also see that if s/he turns onto the branch track, there are two workmen at the end of the track who may be injured/killed.

There is no time to warn the workmen, move the tourist bus or otherwise stop the trolley.
What do you do and why? Would your actions depend on your philosophical outlook?

Situation 2 (modified from 1): Individual is now not in the trolley but watching it from alongside the tracks. Notices that there is no one in the trolley but otherwise the situation is the same *except* that s/he notices that right next to him/her on the street is a lever that would allow him/her to direct the trolley to the side track.

What do you do and why? Would your actions depend on your philosophical outlook?

Situation 3 (modified from 2): Individual is again on the side of the tracks watching the trolley speed down the hill with no one inside. In this case there is no lever but the individual has been continually annoyed by a person in a large, bulky, loud, and garish yellow chicken outfit (call this person our “chicken guy”). Our individual can see that because of the bulk of the chicken suit, if s/he pushes the chicken guy onto the tracks it will stop the trolley and no one else will be injured.

What do you do and why? Would your actions depend on your philosophical outlook?

Case Study #2:

A salary of \$85,000 plus options to buy 30,000 shares of common stock -- it sounded like a reasonable deal to Leanne Gallagher. It was April 2011, and Gallagher was being recruited to join a start-up venture, MoniMed. The company, which had already been in operation for two years, made medical monitoring devices. Marc Cornwall, the director of engineering, who interviewed Gallagher, said the company was expected to go public within the year.

If Gallagher took the job, she would be joining the 30-person firm as a senior software engineer. She had been working at an established corporation for 15 years and had recently completed her master's degree. Now she felt ready for a more demanding challenge. Of course, she was currently making \$105,000 a year, but she was willing to risk the salary differential on stock in what looked like a viable concern. MoniMed had a good strategy that would take advantage of imminent changes in flat panel display technology. But the company had to get its product to market within the next 12 months to exploit this niche. Gallagher thought she was just the person to kick the manufacturing arm of the company into high gear.

As far as the stock went, 30,000 options at 30 cents a share seemed like a good offer though she had no way of knowing for sure. She had asked what percentage of the total outstanding shares her options represented, but Cornwall didn't have that information. None of the employees, he said, really knew what percentage of the stock they owned, but all the IPOs had been doing so well recently that everyone assumed they would come out ahead.

Although Gallagher knew from other engineers that a failure to share financial information was not uncommon at Silicon Valley start-ups, she hoped to be a little better informed before she accepted the offer. She learned from a friend with an MBA that all corporations in California had to file certain information about their boards of directors and stock plans with the secretary of state's office. She decided to contact that office and request information on MoniMed.

She got a phone number for the secretary of state's corporate status office, which she assumed was the correct department, but when she called, she learned that it was not possible to speak to an actual human being at that number. Instead, a recorded message gave a list of documents (with fees) that could be ordered. Since Gallagher didn't know which one would have the information she needed, and since any document wouldn't arrive for two weeks, she decided to abandon that route. Instead, she decided to do some general research on the Web, reading articles about options. She saw that, as a rule of thumb, \$10 was the typical target price for the initial offering. If MoniMed followed that pattern, even after purchasing the options for the \$9,000 in her salary package, she would make \$291,000 on the stock.

That should more than make up for the salary differential. Assuming she got no raises for the four years before she was completely vested, Gallagher would lose \$80,000 in salary from the job change. But she should still come out ahead unless the stock fell below the option costs combined with her salary losses, or \$89,000. That came out to about \$3 a share, which seemed unlikely. Medical device companies often came out at \$20 a share. Besides, IPOs had been going through the roof all year. On March 30, Priceline.com rose 331 percent on its first day of trading.

Of course, MoniMed might fail: The team might not produce their initial product within the window created by the advent of the new flat panel display. They might not be able to bring the costs down enough to make it attractive. Agilent or some other competitor might even now be coming up with a better product. Those were all risks Gallagher was prepared to take because she fully believed she had the right skills and ideas to help make the company a success. She decided to take the job.

What Gallagher didn't know, because Cornwall also wasn't aware of it, was that when he interviewed her MoniMed was at a critical juncture. Barry Grantz, the founder/CEO, had enough capital left from an original investment by his father and some venture investors two years earlier to keep the company going another three months. If MoniMed could not attract some new funding soon, it was going to have to close up shop. Grantz had decided not to share this information with anyone other than the CFO because he did not want to provoke a mass exodus, and besides, he firmly believed the company would eventually succeed especially with the help of his new, more experienced hires.

When Gallagher came to work the first day, she was struck at once by the youth of her colleagues. She was one of 20 engineers. Most were newly minted bachelors of science, and MoniMed was their first foray into the business world. She was a little nervous about whether such an untried crew could bring the project in on time.

But soon Gallagher realized that what they lacked in experience, they made up in enthusiasm and diligence. Eighty-hour work weeks were common. Gallagher herself went directly from graduation ceremonies to the office and stayed past midnight. Pretty soon, she lost count of the all-nighters. During the industry tradeshow, some of

her colleagues actually slept on the convention premises. They did not leave the show for a week—not even for meals.

The hours were hard on her marriage, but she considered herself one of the lucky ones. Her husband was also an engineer, and he understood the time demands. And they had no children. Many colleagues had a tougher time, with at least two divorces and one serious stress-related illness as the employees struggled to get the company ready for a public offering.

They did not receive much help from Grantz. It didn't take Gallagher long to realize that her CEO knew a lot less about biomedical devices than his staff. Of course, that wouldn't necessarily have been a problem if he had been good on the business side. His contribution, however, seemed to be primarily a rich father, who had put MoniMed together as a sort of toy for his son.

At the same time, Gallagher liked the intellectual challenges of her job, liked figuring out successful compromises between optimal solutions, time pressures and costs. As senior engineer, she was responsible for refining the dynamic physiological monitoring capabilities. She worked closely with the director of manufacturing, who had been able to reduce the unit cost while simultaneously making it more reliable. They were able to bring the project in on time, and the improvements helped the sales manager (who had been practically starving on his commission wages) to attract a large customer Acme Biosystems.

Grantz could not have been more encouraging, calling an all-hands meeting to congratulate the staff and predict a Mercedes in all of their futures. Gallagher and her colleagues were justifiably proud when, soon after Acme signed a contract to buy 400 cardiovascular monitoring devices, the IPO was announced for January.

They were jubilant for a few weeks. Soon scuttlebutt began circulating that the IPO was on hold. It was impossible to get reliable information, but water cooler gossip said an acquisition was in the works. Two companies had expressed an interest, CV Diagnostix and Fenton Health Group. At first, Gallagher thought this wouldn't be a bad fate for the company. After all, both rumored buyers were solid companies with distribution systems and marketing infrastructure unavailable to a start-up.

Gallagher asked to talk to Grantz about the proposed deals, but she was told that he would have nothing to say while negotiations were ongoing. Still, details began to leak out. Employees heard that Fenton was offering the sweeter deal, but it came with a proviso: MoniMed would have to install a new CEO. Gallagher was equally sure that such a move would be good for the company and that Grantz would never accept it. She was right. Within days, Grantz called employees together to announce that MoniMed was being acquired by CV Diagnostix at 27 cents a share for common stock.

When the financials became public as part of the deal, Gallagher was shocked to discover that the company had not done nearly as well as the employees had been led to believe. MoniMed had raised and spent over \$14 million. It had also lost another \$12.7 million, so that when CV Diagnostix acquired the company for \$10.5 million, investors were down about \$2 million.

Any options granted prior to June 2011 (including those owned by Gallagher and all the other employees) had strike prices of at least 30 cents. That meant Gallagher and the other engineers' shares were what is colorfully described as "underwater." It would cost more to exercise them than they were worth.

Oh, there were some people who made out OK. Grantz received about \$2.5 million from the sale.

Gallagher submitted her resignation the next day. In her letter to Grantz she wrote,

When I went to work for MoniMed, I knew I was taking a risk. If we hadn't been able to produce the device or if there had been no market for it, I would have accepted my losses. But we beat the odds we made a good product and attracted a large customer.

You led us to believe that the firm was doing well, but when we were acquired, you were the only person to profit. Why were the people responsible for the firm's success the biggest losers?

I went to work for you at less than my normal salary with the understanding that my stock options represented some significant ownership in the company. This deal made me a de facto investor. Beyond the monetary investment, I also put my family and health at risk through the long, demanding hours.

Didn't this at least entitle me to the basic information and protections other investors received? Shouldn't I have been told what percentage of the total stock my options represented? Didn't I have a right to know that the company was nearly out of money when I was hired? Was it fair to string me along with tales of a new Mercedes when you knew the rate at which MoniMed was burning money? Shouldn't I have been given a voice in the deal you accepted, which made my investment worthless?

1. Identify in a proper time sequence what you believe to be the **relevant** facts, omitting all other factual material. Be careful to distinguish between fact and opinions.

2. Identify and prioritize the Ethical Issues in this fact set. Structure the ethical issue sequentially – that is, what ethical issue do you need to answer before going on to the next issue, etc.
3. Use the “Facts” and “Ethical Issues” to now address each possible alternative for Leanne Gallagher in how to address her issues and offer her an opinion on which of those possible alternatives you believe is the most appropriate in her circumstance.

Case Study #3:

The School Board has received a bomb threat claiming that a bomb would be detonated at noon on Monday at the high school. The threat was received by the Board at 8 pm on Sunday night. The Board met and tried to decide how to handle the threat, keeping in mind the obligations to students, parents and the public. The school board came up with three alternatives solutions:

1. Do nothing as a majority of the time bomb threats to schools are a hoax.
2. Call off school at the high school on Monday. Have an announcement made on the 10 pm Sunday news announcing that a water main is broken. (Some members of the board feel that such an announcement of the breaking water main will prevent copycat threats.)
3. Call off school at the high school on Monday. Have an announcement made on the 10 pm Sunday news announcing that a bomb threat had been received.

Discuss which ethical theory supports each alternative. Which would you choose and why?

Case Study #4:

Susie, a newly graduated BBA in accounting, has started job with the state budgeting office. Susie has been place over expense accounts. The state has a travel policy stating that a state employee may be reimbursed up to \$90 per night for a hotel room and up to \$40 per day for meals, as long as the employee turns in food receipts. On the first expense account Susie works on, the employee has a hotel receipt for \$130 a night but no food expenses.

Susie follows the state policy and processes the reimbursement for \$90. The employee becomes irate as his reading of the travel policy is that he can be reimbursed for \$130 a night for hotel and food with a receipt. The employee claims this has never been a problem in the past and has always been reimbursed \$130 a night whether for hotel only or both hotel and food.

Discuss which ethical theory supports Susie and the employee's take on the travel policy. Which would you choose and why?

Module 2
Tab 4 – Self-Assessment Quiz

1. The best restatement of Kant's categorical imperative is:
 - a. Do to others as you would have everyone do to you.
 - b. Consider others needs before you act.
 - c. Those with a smaller stake should have a smaller say compared to those with a bigger stake.
 - d. Don't be cruel until someone is cruel to you.

Answer: a

2. Utilitarianism is based on which of the following?
 - a. Faithfulness to rules.
 - b. Bringing about as much happiness as possible.
 - c. Pleasing a supreme being.
 - d. Acting to others before others can act to you.

Answer: b

3. Virtue ethics is:
 - a. Doing what is right.
 - b. One's duty to act in a socially acceptable manner.
 - c. One's ability to meet or exceed their potential.
 - d. What one ought to do when presented with an ethical dilemma?

Answer: a

Module 3
Culture and
Ethical Attitudes

Module 3

Tab 1 – Slides

Slide
1



Cultural Values and Attitudes

Impact on Ethical Attitudes

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Generational Culture

- ***“What Is It About Twenty-Somethings? Why Are So Many People in Their Twenties Taking So Long to Grow Up?”*** (NYT)
- ***“Two Common Mistakes of Millennials at Work”*** (Harvard Business Review)
- “We [boomers] think of work as being a place - “If you’re not at work, you’re slacking off.”
- We millennials however are consistently looking for a better work/life balance than our parents- who by in large were workaholics. [Brinkehoff, Generations, the Challenge of a Lifetime...]

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Generational Culture

- The Cultures:
 - **Matures (Traditionalists)** - born between 1922 and 1945
 - **Baby Boomers**: born between 1946 and 1964
 - **Generation X’ers**: born between 1965 and 1980
 - **Nexters (Millennials or Gen Y)**: born between 1981 and before 2000;
 - **Generation Z (Digital Natives)**: born after 2000.
- Current workforce
 - 50% Millennials (Gen Y) and
 - 30% Gen X. [Eisner, 2005]

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GENERATIONS	2006		2016	
	Ages	% of Labor Force	Ages	% of Labor Force
Traditionalists	61- 78	15.6%	71- 88	7.6%
Baby Boomers	42 - 60	32.4%	52 - 70	27.2%
Gen Xers	28 - 42	22.8%	38 - 52	33.2%
Millennials	7 - 27	29.2%	17 - 37	32%

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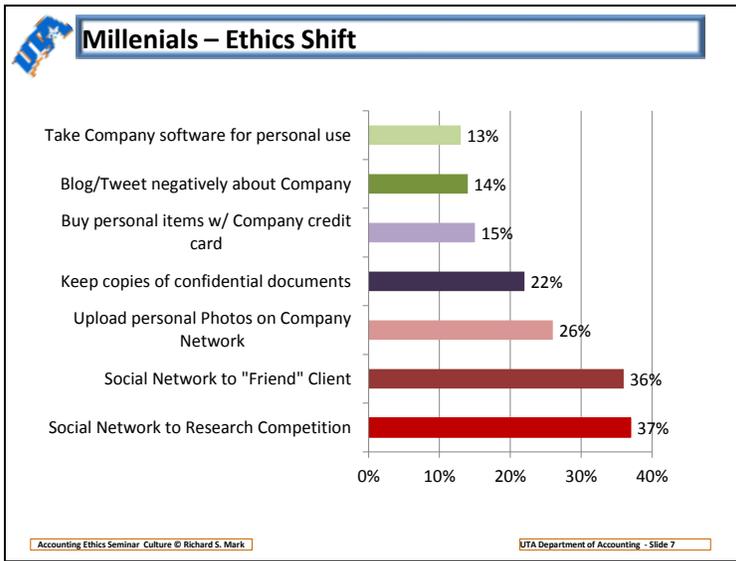
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- 
- Use social networking to find out about the company's competitors--37%,
 - "Friend" a client or customer on a social network--36%
 - Upload personal photos on a company network--26%;
 - Keep copies of confidential documents--22%
 - Work less to compensate for cuts in benefits or pay--18%
 - Buy personal items using a company credit card--15%
 - Blog or tweet negatively about a company--14%
 - Take a copy of work software home for personal use--13%
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-
- Cultural Divide**
- **Matures (Adaptive)**
 - Conformists early in their life;
 - Patient;
 - Team players;
 - Weak interest in independence and adventure;
 - Minimal **ethical awareness**.
 - **Baby Boomers (the Idealists)**
 - attacked institutions while coming of age;
 - Then retreated into self-absorbed remission.
 - Not interested in teamwork;
 - **Rules were made to be broken.**
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- Cultural Divide – Gen X**
- **The Reactive generation**
 - Independent;
 - Self-reliant (because of how they were raised) and entrepreneurial;
 - Pragmatic;
 - Team-oriented;
 - Want work-life balance;
 - Job change every 3-5 years;
 - Crave **positive** feedback;
 - **Distrust authority, businesses and boomer values.**
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Cultural Value Priorities

United States	Japan	Arab Countries
1. Freedom	1. Belonging	1. Family security
2. Independence	2. Group harmony	2. Family harmony
3. Self-reliance	3. Collectiveness	3. Parental guidance
4. Equality	4. Age/seniority	4. Age
5. Individualism	5. Group consensus	5. Authority
6. Competition	6. Cooperation	6. Compromise
7. Efficiency	7. Quality	7. Devotion
8. Time	8. Patience	8. Patience
9. Directness	9. Indirectness	9. Indirectness
10. Openness	10. Go-between	10. Hospitality

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Cultural Gaffes

- When Kentucky Fried Chicken entered the Chinese market, they discovered that their slogan “finger-lickin’ good” came out as “eat your fingers off”
- Coke tried to twist their trademark into Ke-kou-ke-la to get it to sound the same. The result, after printing thousands of signs and banners was that their slogan meant either “bite the wax tadpole” or “female horse stuffed with wax”.
 - Coke now uses “ko-kou-ko-le” which roughly means “happiness in the mouth”

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Cultural Gaffes

- When Pepsi entered the Chinese market, they tried to translate their slogan “Pepsi brings you Back to Life” into Chinese. The translation promised more than they could deliver when they found it translated to “Pepsi Brings your ancestors back from the Grave”
- In Italy, Schwepps Tonic Water” translated itself into “Schwepps Toilet Water”.
- In Mexico, Parker Pens tried to market their pens as “It won’t leak in your pocket and embarrass you” translated into “it won’t leak and make your pregnant”.
- When entering the US market, Japan’s second-largest tourist agency found it would have to change it’s name – Kinki Nippon Tourist Company.

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International Scandals

- Parmalat (Italy) - \$10 Billion;
- Australia;
 - Harris Scrfе – \$160 Million (PwC).
 - HIH (Insurance) – 2.7 Billion.
 - Guess who was their auditor?
- SK Global (Korean Trading Firm) - \$1.3 Billion;
- YGX (China – Eco-Agriculture) - \$92 Million;
- Vivendi (France - Telecom) - \$47 Billion;
- Satyam (India – Computer Services) – \$1.47 Billion.

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Hofstede's Model of Culture

- **Power/distance**
- **Uncertainty avoidance**
- **Collectivism vs. Individualism**
- **Gender**
- **Societal Orientation**
- **Self-Restraint**

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Equality - Power Distance (PD)

- Measures the culturally-embedded equality/inequality in Power and Wealth.
 - A High PD culture allows and accepts power/wealth inequalities.
 - More likely
 - to use a system that hinders significant upward mobility.
 - Permit corruption. (Tay & Khagram, 2005)
 - A Low PD culture de-emphasizes power and wealth differences between citizen's.
 - Stress equality and opportunity for everyone.

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Equality – High Power Distance Cultures

- Show less pride in work.
- Feel disconnected from the benefits of one’s efforts. [Au, 1999]
- Believe corruption is an integral part of their society. [Husted {1999}]
- Employees from **high PD** societies will
 - rigidly follow a company code of conduct;
 - Adopt organizational ethical attitudes at the expense of other employees or supervisors; [Westerman, 2007]

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Uncertainty Avoidance (UA)

- Measures how well a culture deals with uncertainty and ambiguity.
 - Directly related to ethical behavior.
- A **High UA Culture** doesn’t like uncertainty and ambiguity.
 - individuals begin to align themselves to the culture’s **least ethical standard**. [Bernardi and Long, 2004]
- A **Low UA Culture**
 - Is less rule-oriented;
 - Willing to take risks to provoke change.

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Individualism (IDV)

- Measures a culture’s attitude toward
 - **Individual vs collective** achievement and
 - **Interpersonal relationships**.
- A **High Individualism Culture** values individuality and individual rights.
 - **Less permissive** of ethical violations/corruption;
 - More likely to **openly question** organizational ethical attitudes.
 - Experience more distress when national pride and human choice are violated. [Inglehart, Welzel, 2005]
 - When coupled with **High PD**, will adopt the organization’s ethical standards. [Westerman, 2007]

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Individualism

- A **Low Individualism Culture**
 - Is collectivist by nature and
 - Encourages close ties between members of the society.
 - Reinforces extended families and collectives;
 - Everyone takes responsibility for group members.
 - Unethical behavior
 - is more **tolerated**.^[Dennis, 2001]
 - **Excused** when the culture benefits.^[Gr, Thomas, 2008]

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Masculinity (MAS)

- A **High Masculinity Culture** measures success and ethics by what are typically considered to be male characteristics
 - Monetary achievements;
 - Heroism;
 - Assertiveness;
 - Competitiveness.^[Arnold, et al, 2007; Husted, 1999]
 - Encourage unethical behavior.^[Kahn, 1986; Zimbardo, 2007]
- A **Low Masculinity Culture** fosters
 - Cooperation;
 - Relationships;
 - Quality of life;
 - Care for underprivileged.
 - In these cultures, everyone in the society is *theoretically* treated equally in all aspects of the society.

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Long-Term Orientation (LTO)

- **High Long-Term Orientation Culture** values
 - long-term commitments; and
 - respect for tradition.
- A **Low Long-Term Orientation Culture** encourage change at the sake of long-term traditions and commitments.

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Self-Restraint (IND)

- **INDULGENT cultures** want immediate gratification.
- **Restrained Cultures** are
 - willing to **postpone gratification** and/or
 - **regulate** it through social standards.

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China and the US

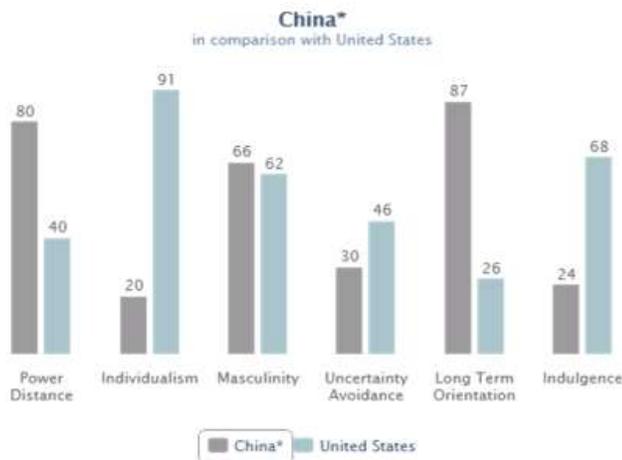
Power/Distance?
 Individual v Collective?
 Gender?
 Uncertainty Avoidance?
 Orientation?

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US and Mexico

Power/Distance?
Individual v Collective?
Gender?
Uncertainty Avoidance?
Orientation?

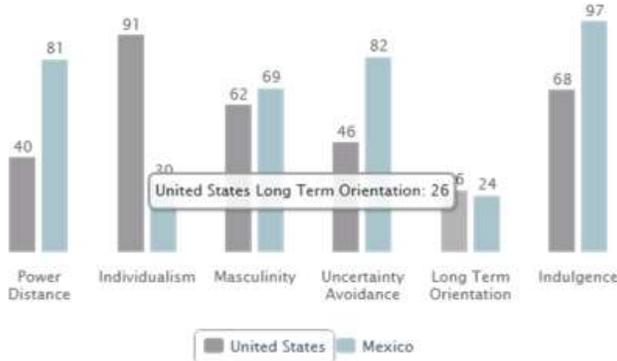
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United States
in comparison with Mexico



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India and the US

Power/Distance?
Individual v Collective?
Gender?
Uncertainty Avoidance?
Orientation?

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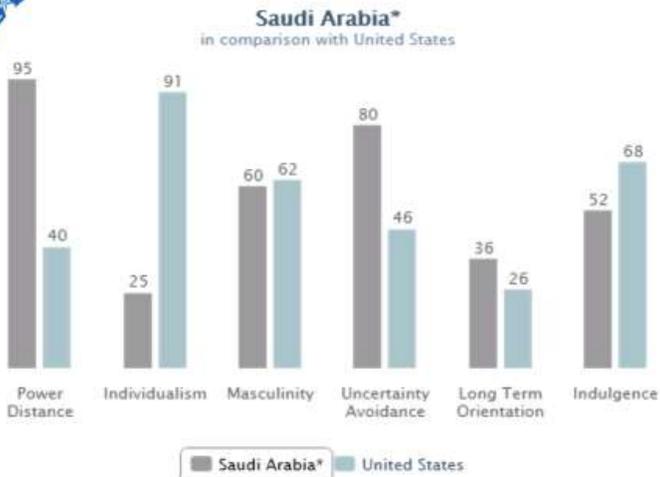
Saudi Arabia and the US

Power/Distance?
Individual v Collective?
Gender?
Uncertainty Avoidance?
Orientation?

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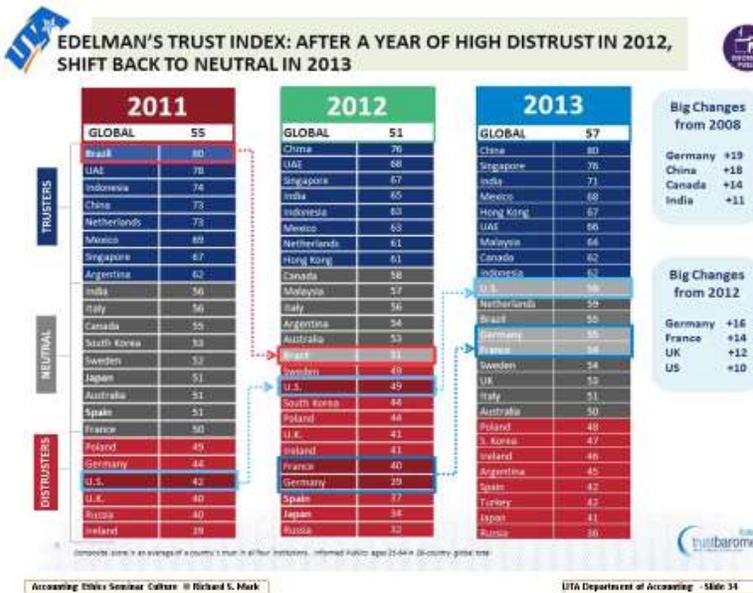
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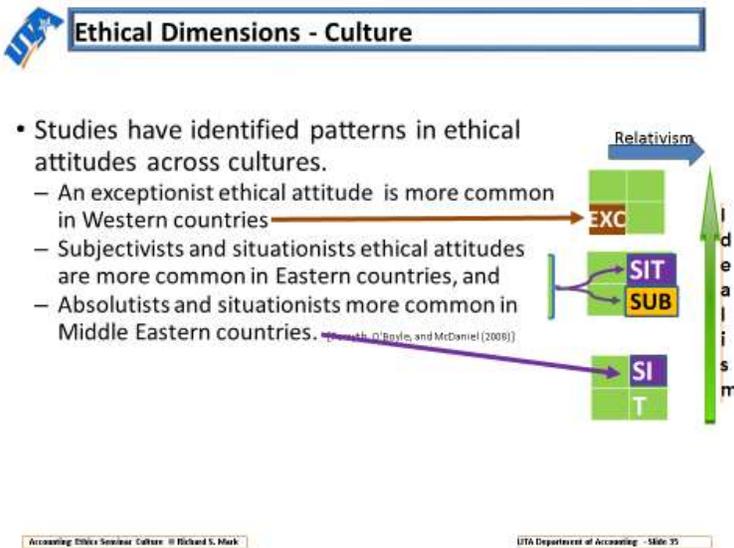
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Module 3
Tab 2 – Cases and Discussion Material

Case 1 (German Audit):

Your firm has been asked by its major audit client to do the audit of a recently-acquired German Subsidiary. Because of the client's importance to the firm, you agree to do the audit. Not having any offices in Europe, you instead locate what you believe to be a very reputable accounting firm to perform the audit and hire them to perform the audit on your behalf.

- What questions might you want to ask the German Audit firm before and during the audit process?
- The German audit firm provides you with and you accept a clean opinion for the German subsidiary. Two months later, you find out that the German subsidiary is bankrupt and is under investigation by the German equivalent of the SEC. What would you believe to be your responsibilities and liabilities in this matter?

Answer: German law makes the main contractor responsible for all acts of all subs.

Case 2 (Italian Taxes):

Georgia has been hired away from her tax manager position in a national accounting firm to take over the financial management of a new Italian branch of a global banking and investment firm. She's completed the Italian tax return for the year and reported and paid what she believes is a middle-of-the-road, conservative approach to the branch's income for the year.

- 3 months after submitting the return, an auditor from the Italian Revenue Agency advises her that all of her deductions and other exclusions on the return have been denied and that taxes are going to be assessed on total gross revenue. What would you suggest to Georgia?

Answer: If Georgia would have checked herself or hired a local tax expert, she would have found that in Italy, one always understates their taxes with the understanding that the correct amount will be negotiated with the Revenue Agent.

Case 3: Plant Relocation

You are the chief executive of Electrocorp, an electronics company, which makes the onboard computer components for automobiles. In your production plants, complex hydrocarbon solvents are used to clean the chips and other parts that go into the computer components. Some of the solvents used are carcinogens and must be handled with extreme care. Until recently, all of your production plants were located in the United States. However, the cost of production has risen, causing profits to decline.

A number of factors have increased production costs. First, the union representing the workers in your plant waged a successful strike resulting in increased salary and benefits. The pay and benefits package for beginning employees is around \$15/hour. A second factor has been stringent safety regulations. These safety procedures, which apply inside the plant, have been expensive in both time and money. Finally, environmental regulations have made Electrocorp's operations more costly. Electrocorp is required to put its waste through an expensive process before depositing it at a special disposal facility.

Shareholders have been complaining to you about the declining fortunes of the company. Many of Electrocorp's competitors have moved their operations to less-developed countries, where their operating costs are less than in the United States, and you have begun to consider whether to relocate a number of plants to offshore sites. Electrocorp is a major employer in each of the U.S. cities where it is located, and you know that a plant closure will cause economic dislocation in these communities. You know that the employees who will be laid off because of plant closures will have difficulty finding equivalent positions and that increased unemployment, with its attendant social costs, will result. However, you are aware of many other corporations, including your competitors, that have shut down their U.S. operations, and it is something that you are willing to consider.

You have hired a consultant, Martha Smith, to investigate the sites for possible plant relocation. Ms. Smith has years of experience working with companies that have moved their operations to less-developed countries to reduce their operating costs. Based on your own research, you have asked Ms. Smith to more fully investigate the possibility of operations in Mexico, the Philippines, and South Africa. A summary of her report and recommendation for each country follows:

- **Mexico:** A number of border cities in Mexico would be cost-efficient relocation sites based on both labor, and health and safety/environmental factors. Workers in production plants comparable to Electrocorp's earn about \$3 per day, which is the prevailing wage. There is frequent worker turnover because employees complain that they cannot live on \$3/day, and they head north to work illegally in the United States. However, a ready supply of workers takes their place.

Mexican health and environmental laws are also favorable to production. Exposure to toxic chemicals in the workplace is permitted at higher levels than in the United States, allowing corporations to dispense to some degree with costly procedures and equipment. Mexico's environmental laws are less strict than those of the United States, and a solvent recovery system, used to reduce the toxicity of the waste before dumping, is not required. The only identifiable business risk is possible bad publicity. The rate of birth defects has been high in many Mexican border towns where similar plants are in operation. Citizen health groups have begun protests, accusing the companies of contamination leading to illness.

- **Philippines:** Conditions in the Philippines are more favorable than those in Mexico in terms of labor and health and safety/environmental factors. The prevailing wage in the Philippines is about \$1/day, and young workers (under 16) may be paid even less. As in Mexico, the workers complain that the rate of pay is not a living wage, but it is the present market rate. The health and safety and environmental regulations are equivalent to those in Mexico, but there have been no public complaints or opposition regarding birth defects, cancers, or other illnesses.

- **South Africa:** Conditions in South Africa are positive in some respects, but not as favorable in economic terms as in Mexico or the Philippines. The prevailing wage in South Africa is about \$10/day. Furthermore, there is a strong union movement, meaning that there may be future demands for increases in wages and benefits.

The unions and the government have been working together on health and safety issues and environmental protections. Exposure to toxic chemicals in the workplace is not permitted at as high a level as in Mexico and the Philippines. Although the equipment necessary to reduce toxic chemicals to an acceptable level is not as costly as in the United States, this expense would not be incurred in the other two countries. Furthermore, there are requirements for a solvent recovery system, which also increases operation expenses.

You have the responsibility of advising the company on how to proceed based on the information you have in this material and what you can acquire through research. You will then present your conclusions and recommendations to the Board of Directors.

Module 3
Tab 3 – Self-Assessment Quiz

1. A culture in which "rank has its privileges" is acceptable would be considered to be high in which Hofstede variable?
 - a. Collectivism.
 - b. Power-Distance.
 - c. Uncertainty avoidance.
 - d. Orientation (long or short-term)

Answer: b.

2. True or False? A bank auditor who has issued favorable reports on a bank for the last 10 years is less likely to close that same bank down in light of current unfavorable information.
3. True or False? Accountants and auditors will tend to seek out and believe subsequent data that supports their original conclusion and ignore or discount data that refutes their original conclusion.
4. The endowment effect would result in a person:
 - a. not wanting to sell assets they own.
 - b. keeping a stock that's declined 50% in value in the hopes that it will rebound.
 - c. believing that the assets they own are worth less than actual market value.
 - d. believing that they are due a job when they graduate.
 - e. doing all of the above items.

Answer: c.

5. "Money illusion" could describe which of the following situations?
 - a. feeling safer after we graduate from college and get a job.
 - b. being able to buy a house.
 - c. determining that the stock you own has gone up in value by 2% when inflation is 5%.
 - d. feeling good about a 2% raise when everyone else gets a 5% raise.

Answer: c.

Module 4
Corporate Governance
And Fraud

Module 4

Tab 1 – Slides

Slide 1

Corporate Governance – Ethical Attitudes

- 65% don't report unethical conduct
 - But 73% believe they've observed a high level of unethical conduct at their workplace in the last 12 months; and
- Over 50% believe that the unethical conduct, if disclosed, would cost the firm their "public trust".
- Most common excuse for misconduct was attributed to pressure to do "whatever it takes" to meet business goals.



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Corporate Governance [SHRM]

- When asked, 85% believe they're more honest/ethical than average.
- Why keep quiet?
 - 96% fear being accused of not being a team player;
 - 81% believe anything they did do would be ignored;
 - 68% feared retribution.
- For lower-level employees
 - Externally-administered
 - reporting channel with
 - Training;
 - Offsets group, obedience (Milgram), and power (Stanford) issues.
 - Directly related to
 - Employees perception of the corporate ethical climate. (Zheng, 2009)
 - Culture
 - Individualism; and
 - Masculinity.



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Corporate Governance – General Thoughts

- **Money and cocaine** affect similar pathways in our brain.
 - These are not the same pathways as occur with natural rewards, such as food and water. (Taccioli, 2015, Ch 10, pp. 1; Tuck, 1997, Activation of the human brain by monetary reward)
- These pathways are activated just by the discussion or thought of money.
- **Gamblers** have abnormally low serotonin levels in areas of the brain that have been shown to be associated with poor impulse control.

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Corporate Governance – Internal Controls

- Strong internal controls without
 - Training and
 - Emphasis on proper behavior;
 - Results in encouraging managerial self-interested behavior. (Falk & Kosfeld, 2006; Tenbrunsel & Messick, 1999; Hangpan, 2006)
- How controls are presented (e.g., framed) make a difference to potential fraud.
 - if framed as a coordinating effort (e.g., suppliers, company, etc), stronger controls result in more fraudulent reporting whereas
 - if framed as a monitoring control, stronger controls result in less fraudulent reporting. (Liu, Wright, Wu, 2013)



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Economic Effect of Fraud

- A recent study indicated that there is **nearly a 15% probability** that any company is committing corporate fraud in any given year.
 - The study estimates that the average corporate fraud costs shareholders
 - 22% of enterprise value in fraudulent firms;
 - 3% of enterprise value in ALL firms.
- Separate study showed the Russell 3000 gain would increase by nearly 22% if the 25% most fraudulent companies were eliminated.

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Economic Effects of Fraud₂

- Fraud evokes a market penalty on shareholder value
 - \$1 of inflated value → \$3.08 of extra value loss upon fraud detection;
 - \$0.36 due to expected legal penalty;
 - \$2.72 due to loss of reputation.

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Economic Effect of Fraud₃

- Corporate fraud is nearly always accompanied by a change in auditor. Among fraudulent companies,
 - 60% change their auditor while the fraud is occurring.
 - 40% switch auditors in the quarter before the fraud begins.
- Fraudulent firms
 - increase investment and employment during the fraud period, and then
 - shed assets and labor after fraud revelation. (Kedia and Phillips (1995, 2000))

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Economic Effects of Fraud₄

- The World Bank estimates that more than \$1 Trillion dollars is actually paid in bribes annually.
 - They noted that countries that made efforts to reduce corruption (Chile, Costa Rica, Slovenia) significantly increased per capita income (www.worldbank.org).
- A new study shows an **18%** increase in fraud worldwide in the last 10 years.

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Economic Effects of Fraud_s

- Employee theft costs retailers **\$40.7 Million a day** [Hollinger & Davis, 2002]
- **“Wardrobing”** (the practice of purchasing an item of clothing, wearing it, and then returning it to the store for a refund) costs retailers over **\$10 billion a year**. [National Retail Federation, Nov. 2003]
- Each supermarket employee steal **\$1,209 of cash/goods each year**. [Jones, Siera, & Boys, 1990]
- **85% of Hospitality Industry Employees** engage in some form of sabotage against their ER and customers every week. [Harris and Ogborn, 2001]
- **50% of fast food** restaurant and convenience store employees admit to stealing cash/supplies. [Wimbush & Dalton, 1997]

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Fraud and Audit

- **International auditing standards** now encourage auditors to consider “organizational attitudes” toward fraud when making their fraud assessment [Int'l Auditing and Assurance Standards, 2009]
- Considerable evidence that **Corruption** can be offset through
 - Extensive disclosure requirements; [Ball, 2003; Khalil, et al, 2013; Ball, 2001]
 - Auditor “incentives” to identify & disclose corruption
 - Lower the burden of proof in litigation vs auditors. [Draft Guide for Anti-Corruption Risk Assessment, United Nations]

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Fraud and Audit – The Bad News

- **PCAOB report** - auditors fail to effectively modify their standard audit procedures in response to fraud risk. [Hoffman, Zimbelman, 2009]
- Nearly **1/3 of SEC enforcement actions** cite auditor failure to consider a client's fraud potential. Allegations include
 - Failure to **gather sufficient competent audit evidence** (73%);
 - Failure to exercise **due professional care** (67%);
 - Insufficient level of **professional skepticism** (60%);
 - Failure to obtain **adequate evidence** related to management representations (54%);
 - Failure to express an appropriate audit opinion (47%). [Feroz, 1991; Beasley, et al, 2013]

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Fraud and Audit – The Good News

- Use of a **logit** (vs. fraud) checklist achieved more accurate fraud risk assessments than any other fraud aid. [Eining, 1997]
- **Group (Brainstorming) Thinking** works:
 - identify more ways fraud could occur [Carpenter, 2007]
 - design better procedures in response to fraud risk. [Brazel, 2007]

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Fraud – Internal Audit

- **Internal auditors** make better fraud risk assessments
 - With **“formal” training** vs
 - Self-study (e.g. do a lot of reading about fraud).
- **Experience** proved to be of no use to internal auditors.

[Wier, Achilles, 2015].

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Fraud - Bribery

- 96% of top executives list bribery as the most likely form of corruption.
- **Bribery**
 - **Increases the cost of financing** [Cuervo-Cazurra, 2008]; and
 - **Reduces the flow of capital** [Wu, 2009]
 - **EU** now has regulatory guidance requiring auditors to address bribery mitigation, detection, and disclosure.

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Fraud – Lying

- **Males** lie nearly two to three times as often as females.
 - Men lie for advantage and to highlight their accomplishments;
 - Women lie primarily for self-protection.
- **Lying** decreases as our emotional attachment increases.

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Global Fraud and Corruption

- **Kroll Corruption Index**
 - <http://fraud.kroll.com/interactive-map/>
- **Transparency International Corruption Perception Index**
 - <http://www.transparency.org/cpi2014>
- **World Bank Group Corruption Index**
 - <https://www.enterprisesurveys.org/data/exploreTopics/Corruption>
- **PWC – global economic crime report.**
 - <http://www.pwc.com/gx/en/services/advisory/consulting/forensics/economic-crime-survey.html>

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Executive Summary [ACFE]

- **The median loss caused by fraud cases was \$145,000.**
 - 22% had at least \$1 million in loss.
 - Represents about 5% of an organization’s gross revenue
 - \$3.7 Trillion worldwide.
- **Collusion** increases the loss
 - 2 people – 2.5 times average loss;
 - 3 people – 4.2 times average loss;
 - 4 or more – 6.25 times average loss.
- **Recovery** (Large/Small)
 - 14/17% get full recovery,
 - 58/68% never recover anything.

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Fraud Data - ACFE

- **Fraud by Industry:**
- **Fraud Schemes by Department:**
- **Worldwide Corruption.**

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Accounting Considerations

- **Partners** have an inflated view of the ethical environment of their organization **compared to non-partners** (accounting firm) [Bobek, 2010] **unless**
 - non-partners are involved in shaping/maintaining the firm’s ethical environment and
 - **360 degree evaluations/mentoring** among/between various levels of professional employees. [Bobek, Hageman, Radtke, 2013]
- Ethical environment “Achilles heel” appears to be the reward/punishment component. [Bobek, Radtke, 2007].

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Accounting Considerations₂

- **Organizational fit** (e.g., sync between the employee and the organization’s ethical climate) and
- **Job satisfaction** are key to maintaining an ethical environment. [Ashforth, Mael, 1989; Trevino, 2008; Domino, Wingreen, Blanton, 2015].
 - Interestingly, the more the employee and the org sync on ethical issues, the higher the tolerance level for unethical/fraudulent activities. [Wood&Bandura, 1989]

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Accounting Considerations

- Non-partners typically score higher in both
 - **relativism** (Bass, 1998; Hartikainen & Torstila, 2004) and
 - **idealism** than the partners (e.g., less alignment with organizational goals, objectives).
- **Idealism** seems to be the key to ethical attitudes.
 - Makes us more sensitive to ethical situations. (Chan & Leung, 2006)

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Anatomy of a Fraudster

- Usually comes from one of 6 departments
 - Accounting;
 - Operations;
 - Sales;
 - Executives;
 - Customer service;
 - Purchasing.

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Anatomy of a Fraudster

- “When compared between criminals and college students, the personality and demographics of someone likely to commit fraud **more closely resembled the college students than the criminals.**”
- Fraudsters, when compared to other property offenders, are less likely to
 - Be caught;
 - Turned in;
 - Arrested;
 - Convicted;
 - Jailed;
 - Serve long prison sentences. (Romney, Albrecht, Cherrington)

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Fraud Markers – “F-score”

- Measured vs firms subject to SEC enforcement action.
- Trigger seems to be an “f” score of over 1.4. (Dechow et al, 2010 in Contemporary Accounting Research)
 - **accrual quality** and amount reported on financial statements as well as when they reverse:
 - **changes in receivables** –
 - in years prior to the manipulations and are unusually high and as high as in the actual manipulation years;
 - **changes in inventory.**

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Module 4
Tab 2 – Cases and Discussion Material

Discussion Video #1: Enron – The Smartest Guys in the Room –
<http://www.youtube.com/watch?v=0zMakN-EMLg>.

Discussion Summary of Recent Frauds #2 (Forbes):

Company	When Scandal Went Public	Allegations	Investigating Agencies	Latest Developments	Company Comment
Adelphia Communications (otc: ADELA - news - people)	April 2002	Founding Rigas family collected \$3.1 billion in off-balance-sheet loans backed by Adelphia; overstated results by inflating capital expenses and hiding debt.	SEC; Pennsylvania and New York federal grand juries	Three Rigas family members and two other ex-executives have been arrested for fraud. The company is suing the entire Rigas family for \$1 billion for breach of fiduciary duties, among other things.	Did not return repeated calls for comment.
AOL Time Warner (nyse: AOL - news - people)	July 2002	As the ad market faltered and AOL's purchase of Time Warner loomed, AOL inflated sales by booking barter deals and ads it sold on behalf of others as revenue to keep its growth rate up and seal the deal. AOL also boosted sales via "round-trip" deals with advertisers and suppliers.	SEC; DOJ	Fears about the inquiry intensified when the DOJ ordered the company to preserve its documents. AOL said it may have overstated revenue by \$49 million. New concerns are afoot that the company may take another goodwill writedown, after it took a \$54 billion charge in April.	No comment.
Arthur Andersen	November 2001	Shredding documents related to audit client Enron after the SEC launched an inquiry into Enron	SEC; DOJ	Andersen was convicted of obstruction of justice in June and will cease auditing public firms by Aug. 31. Andersen lost hundreds of clients and has seen massive employee defections.	Did not return repeated calls for comment.
Bristol-Myers Squibb (nyse: BMY - news - people)	July 2002	Inflated its 2001 revenue by \$1.5 billion by "channel stuffing," or forcing wholesalers to accept more inventory than they can sell to get it off the manufacturer's books	SEC	Efforts to get inventory back to acceptable size will reduce earnings by 61 cents per share through 2003.	Bristol will continue to cooperate fully with the SEC. We believe that the accounting treatment of the domestic wholesaler inventory buildup has been completely appropriate.

CMS Energy (nyse: CMS - news - people)	May 2002	Executing "round-trip" trades to artificially boost energy trading volume	SEC; CFTC; Houston U.S. attorney's office; U.S. Attorney's Office for the Southern District of New York	Appointed Thomas J. Webb, a former Kellogg's CFO, as its new chief financial officer, effective in August.	No comment.
Duke Energy (nyse: DUK - news - people)	July 2002	Engaged in 23 "round-trip" trades to boost trading volumes and revenue.	SEC; CFTC; Houston U.S. attorney's office; Federal Energy Regulatory Commission	The company says an internal investigation concluded that its round-trip trades had "no material impact on current or prior" financial periods.	Although the effect [of these trades] on the company's financial statements was immaterial, we consider improper trades in conflict with the company's policies. To address this we have made changes to our organization, personnel and procedures.
Dynergy (nyse: DYN - news - people)	May 2002	Executing "round-trip" trades to artificially boost energy trading volume and cash flow	SEC; CFTC; Houston U.S. attorney's office	Currently conducting a re-audit. Standard & Poor's cut its credit rating to "junk," and the company said it expects to fall as much as \$400 million short of the \$1 billion in cash flow it originally projected for 2002.	Dynergy believes that it has not executed any simultaneous buy-and-sell trades for the purpose of artificially increasing its trading volume or revenue.
El Paso (nyse: EP - news - people)	May 2002	Executing "round-trip" trades to artificially boost energy trading volume	SEC; Houston U.S. attorney's office	Oscar Wyatt, a major shareholder and renowned wildcatter, may be engineering a management shakeup.	There have been no allegations or accusations, only requests for information. The company has confirmed in multiple affidavits that it did not engage in "round-trip" trades to artificially inflate volume or revenue.
Enron (otc: ENRNQ - news - people)	October 2001	Boosted profits and hid debts totaling over \$1 billion by improperly using off-the-books partnerships; manipulated the Texas power market; bribed foreign governments to win contracts abroad; manipulated California energy market	DOJ; SEC; FERC; various congressional committees; Public Utility Commission of Texas	Ex-Enron executive Michael Kopper pled guilty to two felony charges; acting CEO Stephen Cooper said Enron may face \$100 billion in claims and liabilities; company filed Chapter 11; its auditor Andersen was convicted of obstruction of justice for destroying Enron documents.	No comment.

Global Crossing (otc: GBLXQ - news - people)	February 2002	Engaged in network capacity "swaps" with other carriers to inflate revenue; shredded documents related to accounting practices	DOJ; SEC; various congressional committees	Company filed Chapter 11; Hutchison Telecommunications Limited and Singapore Technologies Telemedia will pay \$250 million for a 61.5% majority interest in the firm when it emerges from bankruptcy; Congress is examining the role that company's accounting firms played in its bankruptcy.	No comment.
Halliburton (nyse: HAL - news - people)	May 2002	Improperly booked \$100 million in annual construction cost overruns before customers agreed to pay for them.	SEC	Legal watchdog group Judicial Watch filed an accounting fraud lawsuit against Halliburton and its former CEO, Vice President Dick Cheney, among others.	Halliburton follows the guidelines set by experts, including GAAP (generally accepted accounting principles).
Homestore.com (nasdaq: HOMS - news - people)	January 2002	Inflating sales by booking barter transactions as revenue.	SEC	The California State Teachers' Retirement pension fund, which lost \$9 million on a Homestore investment, has filed suit against the company.	No comment.
Kmart (nyse: KM - news - people)	January 2002	Anonymous letters from people claiming to be Kmart employees allege that the company's accounting practices intended to mislead investors about its financial health.	SEC; House Energy and Commerce Committee; U.S. Attorney for the Eastern District of Michigan	The company, which is in bankruptcy, said the "stewardship review" it promised to complete by Labor Day won't be done until the end of the year.	Did not return repeated calls for comment.
Merck (nyse: MRK - news - people)	July 2002	Recorded \$12.4 billion in consumer-to-pharmacy co-payments that Merck never collected.	None	The SEC approved Medco's IPO registration, including its sales accounting. The company has since withdrawn the registration for the IPO, which was expected to raise \$1 billion.	Our accounting practices accurately reflect the results of Medco's business and are in accordance with GAAP. Recognizing retail co-payments has no impact on Merck's net income or earnings per share.
Mirant (nyse: MIR - news - people)	July 2002	The company said it may have overstated various assets and liabilities.	SEC	An internal review revealed errors that may have inflated revenue by \$1.1 billion.	This is an informal inquiry, and we will cooperate fully with this request for information.

<p>Nicor Energy, LLC, a joint venture between Nicor (nyse: GAS - news - people) and Dynegy (nyse: DYN - news - people)</p>	July 2002	<p>Independent audit uncovered accounting problems that boosted revenue and underestimated expenses.</p>	None	<p>Nicor restated results to reflect proper accounting in the first half of this year.</p>	<p>Our focus now is to stabilize this venture and put some certainty to its financial results. The company is evaluating its continued involvement in this venture.</p>
<p>Peregrine Systems (nasdaq: PRGNE - news - people)</p>	May 2002	<p>Overstated \$100 million in sales by improperly recognizing revenue from third-party resellers</p>	SEC; various congressional committees	<p>Said it will restate results dating back to 2000; slashed nearly 50% of its workforce to cut costs; is on its third auditor in three months and has yet to file its 2001 10-K and so, consequently, is in danger of being delisted from the Nasdaq.</p>	<p>We have been and will continue to cooperate with the SEC and the Congressional committee.</p>
<p>Qwest Communications International (nyse: Q - news - people)</p>	February 2002	<p>Inflated revenue using network capacity "swaps" and improper accounting for long-term deals.</p>	DOJ; SEC; FBI; Denver U.S. attorney's office	<p>Qwest admitted that an internal review found that it incorrectly accounted for \$1.16 billion in sales. It will restate results for 2000, 2001 and 2002. To raise funds, Qwest says it is selling its phone-directory unit for \$7.05 billion.</p>	<p>We are continuing to cooperate fully with the investigations.</p>
<p>Reliant Energy (nyse: REI - news - people)</p>	May 2002	<p>Engaging in "round-trip" trades to boost trading volumes and revenue.</p>	SEC; CFTC	<p>Recently replaced Chief Financial Officer Steve Naeve with Mark M. Jacobs, a managing director of Goldman Sachs and a Reliant adviser.</p>	<p>We're cooperating with the investigations.</p>
<p>Tyco (nyse: TYC - news - people)</p>	May 2002	<p>Ex-CEO L. Dennis Kozlowski indicted for tax evasion. SEC investigating whether the company was aware of his actions, possible improper use of company funds and related- party transactions, as well as improper merger accounting practices.</p>	Manhattan district attorney; SEC	<p>Said it will not certify its financial results until after an internal investigation is completed. The Bermuda-based company is not required to meet the SEC's Aug. 14 deadline. Investors looking to unseat all board members who served under Kozlowski may launch a proxy fight to do so.</p>	<p>The company is conducting an internal investigation and we cannot comment on its specifics, but we will file an 8-K on the initial results around Sept. 15.</p>

WorldCom
(nasdaq:
[WCOEQ](#) -
[news](#) - [people](#)
)

March
2002

Overstated cash flow by booking \$3.8 billion in operating expenses as capital expenses; gave founder Bernard Ebbers \$400 million in off-the-books loans.

DOJ; SEC; U.S. Attorney's Office for the Southern District of New York; various congressional committees

The company stunned the Street when it found another \$3.3 billion in improperly booked funds, which will bring its total restatement up to \$7.2 billion, and that it may have to take a goodwill charge of \$50 billion. Former CFO Scott Sullivan and ex-controller David Myers have been arrested and criminally charged, while rumors of Bernie Ebbers' impending indictment persist.

WorldCom is continuing to cooperate with all ongoing investigations.

Xerox (nyse:
[XRX](#) - [news](#) -
[people](#))

June
2000

Falsifying financial results for five years, boosting income by \$1.5 billion

SEC

Xerox agreed to pay a \$10 million and to restate its financials dating back to 1997.

We chose to settle with the SEC in April so we can put the matter behind us. We have restated our financials and certified our financials for the new SEC requirements.

Module 4
Tab 3 – Self-Assessment Quiz

1. The Fraud Triangle includes
 - a. Greed.
 - b. Competence.
 - c. Rationalization.
 - d. Laziness.
 - e. All of the above.

Answer: c

2. WorldCom's main accounting manipulation was _____.
 - a. Under funding pension accounts
 - b. Improperly valued inventory
 - c. Improperly capitalizing expenses
 - d. Theft of assets
 - e. misappropriation of assets.

Answer: c.

3. What is the most important system for preventing fraudulent financial reporting?
 - a. Tone at the top
 - b. Control environment
 - c. Monitoring
 - d. External auditing.

Answer: a.

Module 5

Codes of Conduct

Module 5

Tab 1 – Slides

Slide
1

Code of Professional Conduct (CPC) - 2015

- Conceptual Framework [0.100]
- Part 1: Members in public practice [1.000]
- Part 2: Members in business [2.000]
- Part 3: All Other Members [3.000]
- Only applicable in the US.

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2

CPC 2015 – Concept Threats [1.000.010.07, 2.000.010, 3.000]

- **Identify** Threat(s) based on
 - relationship(s) and/or
 - engagement(s).
- **Evaluate** Threat(s) to see if they can be
 - eliminated?
 - Reduced to acceptable level?
- **Standard** for Evaluation
 - Reasonable third party
 - Having all relevant information;
 - Including safeguards;
 - Would conclude that the **post-safeguard threat level** would not compromise a **member's compliance with the Standards**.

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CPC – Threats [1.000.010.08]

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4

 CPC – Terminology [0.400]

- **Covered member;**
 - For attest (Part 1) engagements;
 - On the team;
 - **Can influence the engagement;**
 - Partner/principle/manager **providing >10 hours** non-attest services;
 - Partner/principle in the **same office** as the lead engagement;
 - Firm;
 - **Any entity controlled by any of the above.**

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5

 CPC – Terminology₂

- **Close relative** – parent, sibling, non-dependent child.
- **Network** and network firms – association that form to enhance professional services and share:
 - Name;
 - Control;
 - Management or ownership.
 - Business strategy;
 - Professional resources;
 - Required quality control procedures/policies.

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6

 CPC – Terminology

- **Affiliates** –
 - Based on **control not necessarily ownership**
 - **ability exert significant influence** (SEC 303-10-10) based on
 - horizontal (parent/sub) or
 - vertical (brother/sister) influence.
 - On attest engagements – best efforts to identify all affiliates
 - If information can't be found
 - Discuss w/ those charged with governance;
 - Document results and efforts;
 - Obtain written assurance from client about lack of affiliate information.

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7

 Integrity/Objectivity [TX 501.73; AICPA 1.100]

- Identify and manage threats to **integrity and objectivity.**
 - **Evaluation is considered in relation to the**
 - Professional service;
 - Relationship; and/or
 - **Matter** (undefined).
- **based on**
 - **Conflicts of interest;**
 - Adverse and self interest threats.
 - **Knowing misrepresentation of facts**
 - **Subordinating judgment.**

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8

Integrity/Objectivity [1.130.020]

- Differences of professional opinion above an *acceptable threat level* must now be discussed/disclosed
 - Audit issues;
 - GAAP issues;
 - “other relevant professional standards”
- Differences within acceptable threat level
 - discuss with those with a different position. [1.130.020.08]
- Differences above acceptable threat level, discuss with superiors
 - Within the firm;
 - Check legal obligations to disclose;
 - Consult with legal counsel;
 - Document issue;
 - Leave.

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9

Conflict of Interest [AICPA 1.110]

- Evaluate based on the relationship(s) between
 - Member/firm and client;
 - Member/firm and multiple clients
- **Establish policies** to identify and deal with conflicts. [1.110.010.10]
- Threats can be addressed through
 - Disclosure*; and
 - General; or
 - Specific.
 - Appropriate waiver.

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CPC Part 1 – Public Practice

Independence
TX 501.70
AICPA 1.200

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CPC Part 1 - Independence

- “Consistent with decades of research in social psychology, each of these three conditions (of the Codes of Conduct [Bazerman, 2015] (e.g., objectivity, integrity and independence) makes independence a farce.”
- Independence required for attest engagements for an attest client.
- Attest engagements
 - Audit
 - Review
 - Compilations where lack of independence is not disclosed for a financial statement attest client. [0.400.16]
- Strong emphasis for use of quality control systems (QC §10) for whether independence threats have been addressed appropriately. [1.298.010.02]

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CPC Part 1 – Independence

- Familiarity threats can occur when a partner/principle has been a member of the engagement team “...for a **prolonged period.**”
[1.210.010.14]
- Affiliates – based on *immediate family, close relatives, and relationships.*
 - Includes subsequent employment with attest client in *key position*
 - Ability to influence, control impact attest engagement.
- Can you include a **“hold harmless” or indemnification clause** in the engagement letter?
- Could you indemnify the attest client?
- Can you require ADR rather than litigation?

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CPC – Part 1 – Independence

- Threats that **cannot be made “acceptable”**
 - **Unpaid fees** over a **year old** would limit future attest functions.
 - Measured from the start date of the current year’s report.
[1.210.010.03]
 - **Material Financial Interests** whether **direct or indirect;**
[1.240.010]
 - *Member, immediate family and close relative* ownership interests (equity or otherwise) of >5% in an attest client and affiliates;
[1.270.100]
 - Can include control as trustee or executor
 - Threshold now goes to 10%.
 - Indirect includes self-directed retirement accounts, non-diversified mutual funds (if material) and share-based compensation arrangements.

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CPC – Part 1 – Independence Threats – Non-attest services

- Advisory services;
- Appraisal, valuation, actuarial services;
- Pension plan administration
- Disbursement functions (bookkeeping, distribution, etc)
- Risk consulting
- Finance consulting
- Investment advisory or management
- Executive recruiting
- Forensic accounting
- IT
- Internal audit
- Tax

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15

 Competence [TX 501.74, AICPA 1.300.010]

- **Competence**
 - Adequate information (*relevant data*) to reach conclusion:
 - Technical qualifications;
 - Ability to supervise and evaluate work;
 - Adequate planning and supervision.
 - Exercise of due professional care;
 - Obtaining sufficient data to opine
- **Due care**
 - Adequate *planning* and *supervision* of audit.

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 Discreditable Acts [TX 501.90, AICPA 1.400.010]

- **Discrimination & Harassment in employment practices**
- **Professional Attitude Toward Clients:**
 - Negligence when preparing financial statements and records
 - Repeated failure to respond to a client’s inquiry within reasonable time without good cause.
- **Public allegations of a client’s lack of mental capacity not supported in fact.**
- **Causing a breach in security of the CPA examination.**

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17

 Solicitation and Advertising [TX 501.82, AICPA 1.400.090]

- **No false or misleading advertising.**
 - Includes “puffing” about skills, background, awards
- **No persistent and harassing contact with a prospective client** [501.82 (c)]
 - Seeking services; unless
 - Communication was “invited”.
 - **AICPA has no similar rule, but “persistent contacting” probably a discreditable act.**

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18

 False/Misleading/Deceptive Advertising [AICPA 1.400.200]

- **Setting a fee unrealistically low knowing it will have to be increased.**
 - **AICPA now particularly defers to any more stringent state standard.**
- **Any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.**

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Client Records

- Texas [TX 501.76] - CPA must return client records, including:
 - Worksheets
 - Adjusting and closing J.E.'s [and supporting details, if necessary]
 - Consolidating or combining journal entries and worksheets.
- AICPA – max 45 day turnaround. [1,400.200.09]
- AICPA allows work papers to be withheld for
 - Unpaid fees;
 - Litigation;
 - **BUT... now also generally defers to more restrictive state standards**

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Client Records

- CPA can charge (time and costs) to furnish client with a copy of
 - Client's tax return;
 - Any report or other published document;
 - Work papers not otherwise available to client
- CPA should retain attest service work papers for a **minimum of 5 years** from report date
 - Failure to do so may be considered an admission the work papers do not comply with professional standards.
- TSBPA recommends that CPA obtain a receipt or other written documentation of records delivery to a client.

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Contingent Fees [TX 501.72, AICPA 1.510.005]

- No contingency fees if you are also
 - Performing services requiring independence;
 - Testifying as expert;
 - Preparing tax return.
 - Are the **member's** spouse and the member isn't involved. [1,510.030]
- Fees are **not** contingent if
 - "based on the findings of governmental agencies..."
 - RAR representations;
 - PLR requests;
 - Amended return for refund on a tax issue that is the subject of a non-client test case;
 - Interest/penalty refunds in assessed value proceedings. [AICPA 1.510.005.03]

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Commissions & Referral Fees [TX 501.71, AICPA 1.520.001]

- Prohibited on attest engagements
 - An audit or review of financial statements; or
 - A compilation
 - When there is a reasonable expectation that third party(ies) will use the financial statement; or
 - An examination of prospective financial information.
- Applies to **member** but not spouse as long as **member**
 - is not significantly involved;
 - Activities are separated.

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Advertising [TX 501.82, AICPA 1.600]

- Texas
 - Keep mailing lists for 36 months (from the date of last use)
 - A list of persons to whom advertising was sent.
 - not required if the CPA did not make first contact
 - A client, or
 - Sought out the CPA whether or not another CPA was providing services.
- AICPA – based on **threats that a reasonable person would misunderstand or be deceived.**
 - No false, unjustified expectations;
 - Don't imply ability to influence government agencies or courts
 - Don't substantially underbid

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Client Confidentiality [TX 501.75, AICPA 1.700]

- Generally, no disclosure without client approval.
- Exceptions for
 - Fulfilling GAAP or GAAS disclosure requirements;
 - Valid and enforceable subpoena;
 - Peer review;
 - Investigative or disciplinary proceeding.;
 - Litigation.
- Withdrawal – can “suggest” new CPA to ask client to allow them to discuss matters. [1.700.020.02]

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Reportable Events [TX 501.91]

- Reported in writing to TSBPA within 30 days:
 - Felony conviction;
 - Includes deferred adjudication.
 - Any crime related to functions or duties of the CPA;
 - Alcohol or controlled substance abuse.
 - Any crime involving
 - Embezzlement; or
 - Improper financial statements.
 - Cancellation of right to practice as a CPA in any jurisdiction, including by SEC or IRS.

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Module 5
Tab 2 – Cases and Discussion Material

Integrity and Objectivity:

Case 1: Your firm is doing the CFO's tax return as well as the company audit. You are a partner in the same office as the lead engagement partner for the audit. In the course of preparing the CFO's tax return, you discover that the CFO is reporting twice what his company salary would indicate on his tax return.

- What added questions would you like to ask the CFO?
- If you're not comfortable with the CFO's answers, what are your options?

Answer: The AICPA's Statement of Standards for Tax Service (SSTS) are incorporated into the Texas Rules per Rule 501.62. As a result, under SSTS 2, a CPA must make a reasonable effort to obtain information to answer all questions when preparing return but is NOT required to independently verify the information unless the information appears to be incomplete, inconsistent or incorrect. Supporting documentation is not required unless necessary to verify numbers on the tax return. The fact that the answer may not be in taxpayer's favor is irrelevant.

If the client is informed of what the CPA believes to be an error, you can withdraw from the engagement. There are NO disclosure requirements.

Case 2: You've been asked to be the director of a bank that is not an audit client of the firm. The bank has a significant number of CPAs and your clients as customers of the bank.

- What added questions might you want to ask?
- Can/should you take the position?

Response: Whether compensated or not, before agreeing to be a director for the bank the CPA should consider the possible potential conflicts of interest and confidentiality issues under Rules 501.73 (integrity and objectivity) and 501.71.

There are potential confidentiality issue if as a director, the CPA would be making decisions that would impact bank customers that would include the CPA's clients since the CPA may be privy to information about one or more of the bank customers (e.g., his clients) that would cause him to make decisions as a director that would not have been made without that information. This in turn may result in the CPA breaching his or her fiduciary duties as director.

Separately, this arrangement may be considered to be a "relationship with another person, entity, product, or service that could, in the certificate or registration holder's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the certificate or registration holder's objectivity." If so, it is appropriate to disclose to all parties and, with appropriate positive responses, continue on as director.

Independence:

Case 1: Ima Gready, CPA has worked for Energy Co. for 5 years. She has recently been offered a position with the accounting firm that does Energy's audit.

- What added questions and/or information would you need to assess her ability to take the job offer?
- What ethical issues would you expect Ima would have to address before she can take the job?

Answer:

- One would want to know what Ima's responsibilities at the accounting firm would be in relation to the Energy audit or whether she is assuming other non-audit responsibilities. It would be best to make full disclosure to both Energy and the accounting firm of all possible conflicts and she should confirm both with Energy and the accounting firm that information provided during prior audits would remain confidential.
- Ima would have to consider her responsibilities under Rule 501.71 for independence. If this is a public company subject to the SEC jurisdiction, there would be a one year "cooling off" period. She would probably also want to make sure that any relationship to the audit is disclosed with Energy.

Case 2: Phil N Thropic Charitable Foundation is the sole beneficiary of the Brim Estate that has been in probate for a number of years. The Foundation has asked your wife to serve as Trustee. You are in discussions with both the Executor of the Brim Estate and the Foundation to perform annual audits.

- Both as to the Foundation and the Estate, could you take assume the trustee position?

Answer: Whether or not any fees are paid to the spouse as trustee, this situation would most likely be considered to treat the CPA as having impaired their independence. [AICPA Interpretation 101.1]

Case 3: Bob is a senior audit partner in a national accounting firm. Both he and his spouse have used Integrity Financial Services as the trustee for their retirement plans for over 10 years. Integrity happens to provide similar services for a number of other partners in the accounting firm. Integrity has provided both trustee and investment advisory services to Bob, his spouse and the other members of the partnership during that time. Integrity has approached Bob about performing their annual audit.

– Can Bob and/or the firm accept the engagement? Can Bob participate in the audit?

Answer: Independence is not necessarily impaired so long as Integrity is providing the same services under its normal terms to Bob and the other partners. Impairment may occur if the potential risk of loss to any of the covered members were to become material.

Risk of loss could include financial instability of Integrity or potential market declines to the retirement assets. Risk of loss can consider: (1) loss protection provided by state or federal agencies; (2) insurance, public or private, on the retirement assets; (3) whether the retirement funds are pooled with Integrity's general funds and subject to credit risk or segregated in separate account(s) that are protected from general creditors.

Case 4: Tamesha is an audit partner in a regional accounting firm. She also is a general partner in the Wildcatter Partnership, a private oil and gas drilling venture. Slick, Wildcatter's managing general partner, is forming a second private partnership to act as refiner to the Wildcatter partnership. Slick intends to be the managing general partner for the new partnership.

Slick has asked Tamesha if she and her firm will provide attest services for the new partnership, including helping her put together the financial portions of the private placement memorandum.

– Can Tamesha and/or her firm accept the engagement?

Answer: Subject to materiality considerations on Tamesha's part, since Slick has control over both partnerships, Tamesha's interest in Wildcatter would potentially impair her independence on any attest engagement for the new partnership. Since Slick has significant influence over both partnerships, Tamesha would be considered to have a joint, closely-held financial interest with Slick.

Professional Standards:

Case 1: A Member cannot certify statements under GAAP if those statements contain departures from GAAP

- Does it matter that the member didn't know of the discrepancy? (NO)
- Does the variation have to be material? (YES)
- What if the discrepancy
 - makes the statements more accurate?
 - Makes the statements more informative?

Response: "If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement"

Case 2: Greg Garious was one of your first clients when you started your practice in 1990. Since then, you have been preparing his tax returns and otherwise advising him on tax matters. In 2009, because of some differences over how aggressive to be on the tax return, Greg informed you that he would not be retaining your services in the future. At the time, Gregg had not paid his bill for over a year and owes you over \$45,000.

Early in 2011, Greg writes you a letter requesting that you send all of his papers as well as your workpapers to his new accountant.

- How would you respond to this request?
- Would your response be different if the engagement had been terminated before it was completed?

Response: Rule 501.76 would not allow the CPA to hold such records hostage whether fees were due or not and could subject the CPA to a citation, a fine—or worse. From a loss-prevention standpoint, it's usually unwise to add fuel to the fire by not cooperating with former clients' transition to another CPA. Interestingly, while the AICPA would allow transmission to the new CPA, Texas Rules only require that the materials be provided to the client.

Much of this issue's risk exposure stems from confusion over what constitutes client records. AICPA ET Sec. 501.01 defines "client records" as any accounting or other records belonging to the client and provided to the CPA by, or on behalf of, the client. Texas considers client records to include: (1) worksheets in lieu of books of original entry, e.g. cash receipt or disbursement listings; (2) worksheets in lieu of G/L or subsidiary ledgers, e.g. A/R trial balances; (3) adjusting and closing J.E.'s [and supporting details, if necessary]; (4) consolidating or combining journal entries and worksheets.

If an engagement isn't completed, the CPA must return or furnish the originals of only those records originally obtained by the certificate or registration holder from the client. While AICPA interpretation 501-1 allows retaining adjusting entries, closing entries, consolidating entries until client pays a past due fee Texas does not allow this.

CPA developed working papers remain the property of the CPA, and ordinarily need not be provided to the client. However, a CPA must provide his/her workpaper detail to the client if either the work papers result in changes to the client's records or they constitute part of the records ordinarily maintained by the client.

Note: TSBPA recommends that CPA obtain a receipt or other written documentation of records delivery to a client.

Confidentiality:

Case 1: Hy Road, CPA specializes in accounting for gas processing companies. Hy is getting ready to do the annual audit for one of his oldest and best audit and tax clients, DeepDrill.

Hy is currently conducting a first-year audit engagement for PipeLine Ltd, a competitor of DeepDrill. During the PipeLine audit, Hy learns that a major gas supplier to the refineries for both companies is about to file for bankruptcy.

- Can Hy perform the audit for both clients?
- Can the information Hy becomes privy to while doing the PipeLine audit be used in the DeepDrill engagement?

Response: A CPA is not prohibited from performing engagements for competing clients. In fact, specializing in specific industries for competing companies can increase professional competence and expertise. The problem that can develop is in disclosure of information learned in audits of competitors. Rule 501.75—"Confidential Client Information"—states: "a certificate or registration holder or any partner, officer, shareholder, or employee of a certificate or registration holder shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional services rendered to the client by the certificate or registration holder" This rule prohibits the CPA from disclosing this information without the specific consent of the client, unless the information is a matter of public record and is acquired independently of the DeepDrill engagement.

The CPA firm should disclose the competing client relationships to each client prior to undertaking the engagements. This will help protect the firm from impairments of independence in appearance (as might be perceived by an aggrieved client if things go bad). Different partners at the firm should handle each engagement.

Case 2: Junkie Financial Services (Junkie) is a public company involved in the financial services sector, primarily in the leasing of capital assets to manufacturers. The leases are generally financial leases. The VP of Finance at Junkie since 2007 is Sarah Gold, CPA. Sarah obtained the CPA license in 1997 and worked for a BTG, Ltd, a large regional accounting firm until she took the job with Junkie.

In 2016, Junkie requested proposals for the selection of auditors. Three firms submitted proposals, including BTG. The bids each included a quote for audit services. The BTG proposal team was led by audit partner, Jerome Snookie, who was a classmate and good friend of Sarah's at UTA. While meeting Sarah for dinner one evening before the proposals were submitted, Jerome was able to obtain information about the bid amounts from the other accounting firms. As a result, the bid submitted by BTG was priced at \$30,000 less than the lowest bid, and this helped ensure that BTG obtained the audit. Sarah has already told Jerome that once they start the audit, they could get all sorts of "other work."

Response: Sarah is a "covered member" [0.400.12] in a position to influence the attest engagement. As a result, her actions may constitute "threats" [AICPA 0.210.010.06] as a breach of client confidentiality [1.110.10 and 1.400.070]. Sarah's actions could also be viewed as creating an indirect financial interest [1.240.010.02], which if material, could impair independence.

There are also potential violations by:

- Sarah of Rule 501.75 (client confidence) since she has disclosed what may potentially be considered to be client confidential information to an outside party (Jerome).
- Both Sarah and Jerome of Rule 501.73(a) and (b) (integrity and objectivity) as the disclosure and later arrangements may constitute a conflict of interest.

- Both Sarah and Jerome of Rule 502.90(17) since Sarah has voluntarily disclosed employer information in connection with her accounting services.
- Generally, the arrangement may be considered to be acts discreditable to the profession.
- This may be considered to be a contingent fee under Rule 501.72 from Jerome’s perspective since other work is being offered in the future.

Conflict of Interest:

Case 1: Imp Petuous, CPA’s best audit clients (Wimpy) owns a series of successful fast-food franchises in the DFW area. Wimpy has recently been approached by two outside investors to fund opening two more fast-food stores in a neighboring city. After considering the offer and being advised by both Imp and his attorney, Wimpy decides to accept the investor’s offer.

As part of the process, Wimpy incorporates all of his fast-food stores and goes public, bringing in the outside investors. He has asked Imp to sit on the new corporation’s board of directors and Imp has agreed. As a member of the Board, Imp was offered stock options in the new corporation which he accepted. Imp has used the options to buy stock in the corporation and—applying avoidance of conflict-of-interest guidelines—disclose his lack of independence to appropriate parties.

A large tax client (Xia Wang) who has recently sold her business and has significant cash reserves has asked you to recommend one or more good investments for her funds.

- Imp would like you to comment on his recent stock purchase.
- Would you recommend Wimpy’s company to Xia? If so, under what conditions? If not, why not?

Response: Referring Xia to another client would be imprudent from the standpoint of integrity and objectivity [1.100.001], which provides among other things that “a member shall maintain objectivity and integrity in the performance of any professional service.” Investing in business deals with clients is often a mistake, especially when you also provide professional services to the business. Everyone is usually happy as long as the deal performs well and the client perceives you as a competent adviser with the client’s best interests at heart.

When such a deal goes down the tubes, the client’s perception of you can change quickly. To the client you appear to no longer have his or her best interests at heart, and juries tend to sympathize with clients, especially with the benefit of hindsight and all the facts laid out by a skilled attorney. In court the CPA is portrayed as having sacrificed the best interests of the client to self-interest.

In addition, disclosing a conflict of interest to the client looking for a good investment, while helpful, doesn’t solve the problem. It later can be argued the client’s consent was not “informed” by a third party such as an attorney. Don’t get too comfortable with disclosure as a form of protection. In the end, the question is whether there is a perception the CPA no longer has unfettered loyalty to his or her clients.

Advertising

Case 1: Norman CPA sends a direct-mail communication about his/her tax practice services to all of his audit client whose tax work is done by other CPA firms. Does Norman need to follow the “36 month” provisions?

Response: Not likely that the audit and tax work would be split; however, it is a client, but not for that service. Technically he probably does not have to retain for 36 months the communication and list that party, but would be prudent to do so.

Cumulative Case Study 1:

Mary Eaves, CPA, runs her public accounting practice from home.

A. Ralph Gora Paving

In the summer of 2015, Mary’s residence driveway was repaved by Ralph Gora Paving; Ralph was paid cash for the service. In early 2016, Ralph asked Mary if she could get his books up to date and file his personal tax return. Mary agreed and compiled the statements from the records and documents available and filed the return. Mary noted that there was no invoice and no deposit recorded for the repaving of her driveway, and similarly for the repaving of the driveway of three of her friends. Before filing the tax return, Mary got a letter from Ralph wherein he declared that the records provided to her were complete and correct.

B. Honest Ivan Ltd.

Mary started the audit of the financial statements of Honest Ivan Ltd. (HIL), a used car parts dealer. Mary completed the interim audit and by the time she was completing the year-end audit, she formed a supportable opinion that HIL was selling stolen car parts. She confronted the owner with the problem and was told to keep her nose out of it. Mary immediately resigned from the audit.

Two days later she got a letter from another CPA inquiring about the existence of any circumstances he should consider in deciding whether to accept the engagement. Feeling somewhat relieved, Mary sent a letter saying she had withdrawn because the client was limiting the scope of her audit. The CPA then notified Mary that he had accepted the engagement and would contact her about information he may need; at this point Mary immediately packed up all of HIL's records that she still had, made copies of her working paper files and sent them to the CPA.

Potential Responses:

Part A – Public Accounting Practice – Ralph Gora Paving

1. Integrity and Due Care
 - Mary did not perform her services with integrity and due care by ignoring the illegal activities she had discovered in the course of her work.
2. False or Misleading Documents
 - Mary associated herself with a financial statement and tax return she knows are incomplete and misleading; the letter from Ralph does not relieve her from her professional responsibilities.
3. Compliance with Professional Standards
 - Mary failed to comply with professional standards for compilation engagements by not requesting additional information about her findings and by not withdrawing from the engagement
4. Unlawful Activity
 - Mary associated herself with an unlawful activity; she knows that the client is not declaring all of his income, and that tax evasion is illegal. The letter provided by the client offers no protection to **Mary**.

Part B. Honest Ivan Ltd.

5. Communication with Predecessor
 - Mary failed to inform the successor firm that a suspected illegal activity was a factor in her withdrawal from the engagement.
6. Co-operation with Successor – Texas Rule 501.75, 76; AICPA Code 1.400.200.09
 - Mary failed to comply with by transferring the client's files and working papers to the successor without proper instruction and authorization from the client. The AICPA requires that the files be transferred to the client or an identified client representative within 45 days.
7. Confidentiality of Information
 - Mary may have failed to comply with Rule 501.75 at the same time because the exception does not justify sending all records and working papers to the successor firm.
8. Maintenance of Reputation of Profession
 - As a result of the above breaches, Mary failed to maintain the good reputation of the profession.

Cumulative Case Study 2:

A few months ago, Jeremy Johnson, CPA, opened his public practice as a sole practitioner under the name "Jeremy Johnson, Certified Public Accountant and Associates". Robert White, a non-CPA, works for Jeremy and is paid an annual salary equal to 50% of his billings to clients. Robert, who is keen on bringing in new business, has convinced two clients of a national CPA firm to move their accounting and auditing business to Jeremy's, telling them that he would personally serve them better and that if a CPA is needed to sign something, he works for one. He guarantees that the fee will be no more than half of that paid in the prior year to the former accountants.

Robert pays his cousin, a CPA in public practice, a \$200 referral fee for the clients discussed above. The cousin is very busy but very selective when accepting new clients. Robert also pays his girlfriend a \$500 referral fee; she teaches English to new immigrants, many of whom are starting businesses and require accounting and taxation services.

When Robert tells Jeremy about the new business, Jeremy agrees to reimburse Robert for these payments. Jeremy's brother, John, is also a CPA with a sole practitioner practice in another city. Jeremy and John have no financial interest in each other's practices but have agreed to act as each other's representatives in their respective cities.

Nick, a friend of Jeremy and a CPA who is not in public practice, makes his living from a number of

commercial real estate properties he owns and operates in another city. Nick has agreed to act as Jeremy's representative in his town and is paid \$100 for referrals.

Jeremy's letterhead and promotional material includes the following under his practice name.

- Jeremy Johnson – City one – phone and fax numbers
- Robert White – City one – phone and fax numbers
- John Johnson – City two
- Nick Drake – City three.

At the bottom of the letterhead page the phrase "Jeremy Johnson is one of Texas' Best Certified Public Accountants, Recognized by the Texas State Board of Public Accountancy with National Honors." Jeremy had placed in the top 10 in Texas on the CPA examination in the year he took the exam.

Potential Responses:

1. Public Accounting Practice – Organization and Conduct – Rule 501.77 and 501.81. See the new Networking standards under 1.220.010 that would treat all of the various associations above as a single network. As a result, Jeremy would be responsible for Robert, a non-member in Jeremy's public practice, and he failed to make Robert abide by the RPC in various ways:
 - Fee Quotation: Robert failed to obtain adequate information about the engagement prior to quoting a fee.
 - Advertising and Solicitation: Rule 501.82.
2. Robert's client solicitation techniques are arguably making unfavorable reflection on the competence of another firm are prohibited.
 - Payment or Receipt of Commissions. Rule 501.71 and 501.73(d); AICPA 1.500. Robert paid a commission to his girlfriend, a person who is not a public accountant (PA). In addition, Jeremy himself potentially breached Rule 501.71 by reimbursing Robert for the payment of commissions to his girlfriend.
 - Advertising and Promotion: Rule 501.81. Although Jeremy's claim about placing in the top 10 in Texas can be substantiated, the claim that he is one of Texas' best CPAs, recognized by the TSBPA with regional honors is arguably misleading.
 - o Claiming skills or attributes superior to those possessed by colleagues with equal qualifications contravenes the fundamental principles governing the conduct of CPAs.
 - o The letterhead is misleading because the firm appears larger than it actually is.
3. Association with Non-CPAs in Public Practice. Rules 501.77, 501.80 and 501.82. Jeremy may have violated the Rules by allowing the following:
 - John and Nick appear as associates of Jeremy while they actually are not.
 - The reference to City two and City three is misleading given that the firm has no office in either cities.
 - Nick appears to be engaged in public practice while he actually is not.
 - The firm name should only make reference to one associate (Robert).
 - John's name could be included as long as he is clearly identified as a representative.
4. The firm has failed to ensure compliance with the rules of professional conduct (maintain the good reputation of the profession, integrity, etc.). As a result of the above, Jeremy, John and Nick, and the firm Jeremy Johnson have failed to maintain the good reputation of the profession.

Cumulative Case Study 3:

Wide & Diggs CPAs has been in public practice for a number of years. Two years ago, Wide compiled the financial statements of Perfect Plumbing Ltd. (PPL) and helped negotiate a loan from a private lender. PPL is owned and operated by the common-law spouse of three years of Wide's mother. Wide & Diggs billed PPL \$1,000 for these services. Wide & Diggs, now needing money to renovate its office space, borrowed \$15,000 from PPL under the terms of a contract specifying the loan, interest and repayment terms.

Wanting to increase his firm's revenues, Wide asked his spouse to convince her good friend Agnes Able, a CPA working for a public accountants firm, to leave her firm and to bring her clients to Wide & Diggs. Wide's spouse took to the task with considerable zeal and called Agnes Able daily. After about one month, Wide & Diggs received a letter from the Texas State Board of Public Accountancy asking to reply in writing about a complaint of harassment made by Agnes Able. Wide personally called her and apologized. She accepted his apology and said there were no hard feelings. Wide thought nothing more of the matter.

Jake Overland, a very successful immigration lawyer, approached Diggs about the affairs of his business and more specifically about two items.

First, Overland would like Diggs to perform the annual mandatory audit of a lawyer's trust accounts required by

the Texas Bar. Second, Overland, who has always charged a flat fee for his services, has recently found out that his services are not subject to franchise tax although he has been withholding and paying tax on such amounts.

From his past experience with other lawyer clients, Diggs believed that the audit of the trust accounts would not take much time, and agreed to perform the work for \$500. Overland and Diggs agreed to the above on a handshake. Diggs also offered to have his firm determine Overland's franchise tax amount in exchange for 50% of the recovered amount.

The partners at Diggs & Wide agreed to split the work on the Overland engagement with Diggs doing the audit and Wide, the franchise tax claim.

Proposed Response:

1. Requirement to Reply in Writing. Rule 501.93. Wide & Diggs (W&D) failed to reply in writing within 30 days to the letter from the Institute that specifically requested a written reply from the firm.
2. Borrowing from Clients. AICPA 1.260.020. W&D may have contravened the Rules when borrowing \$15,000 from PPL, a client that is not a financial institution or in the business of private lending; however, the following must be determined to establish if the Rules have really been breached:
 - Would Wide's common-law spouse's mother be considered a related party for purposes of the independence rules?
 - Is W&D performing any accounting or auditing services for PPL presently.
3. Fee Quotation. Rule 501(b)(1)(E); AICPA 1.230 and 1.600.010. Diggs failed to obtain adequate information about the engagement on the trust accounts. He may however argue that the experience gained with the other lawyers' trust accounts gave him a sound basis to quote a fee.
 - While not required, it would be prudent for Diggs to obtain a written engagement letter from Overland.
4. Contingent Fee. Rule 501.52(11); AICPA 1.510. Although the contingent fee for the franchise tax engagement is in itself acceptable, the engagement acceptance seems to be tied to the offering of an audit engagement. If so, the fee arrangement could be seen as an influence which impairs judgment or objectivity on the audit engagement; the fee on the franchise tax engagement could be substantial given the success of the law firm. However, allocating the audit and the state tax engagements to two different partners could help mitigate the problem.
5. Solicitation. Rule 501(b)(7) and 501(c); AICPA 1.600. Wide contravened the Code by soliciting professional engagements from Agnes in a manner that is persistent or harassing.

Module 5
Tab 3 – Self-Assessment Quiz

1. The Texas and US concept of **integrity** requires an accounting professional to:
 - a. be honest and candid within constraints of client confidentiality.
 - b. observe both the spirit and form of technical and ethical standards.
 - c. perform all of your professional services with due care.
 - d. all of the above are included in the concept.
 - e. none of the above are included in the concept.

Answer: d

2. Which of the following items would **not** be a violation of the code of professional responsibility?
 - a. failing to stop another person from including a false entry in a company's financial statements.
 - b. allowing a company to issue financial statements that do not include relevant financial information.
 - c. the partner in charge of an audit issues a "clean" opinion audit when you know that your work papers include references to the company's solvency.
 - d. All of the above would be violations of portions of the code of professional responsibility.
 - e. None of the above would violate any portion of the code of professional responsibility.

Answer: d

3. In which of the following circumstances would a CPA be independent in both fact and appearance?
 - a. The CPA's brother is the controller of the company being audited.
 - b. The CPA serves on the board of a non-profit with the CFO of the company being audited.
 - c. The CPA borrowed money for a new car from the CEO of the company being audited.
 - d. The CPA owes an office building that he leases to the client
 - e. A CPA is not independent in any of the above circumstances.

Answer: b

4. "Materiality" in GAAS and GAAP depends on whether the information provided, in light of surrounding circumstances, makes it _____ that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.
 - a. Likely.
 - b. Probable.
 - c. Possible.
 - d. More Likely Than Not.

Answer: b

5. Which of the following is not a core value of the accounting profession?
 - a. Independence.
 - b. Rationality.
 - c. Objectivity.
 - d. Integrity.
 - e. All of the above are core values.

Answer: b