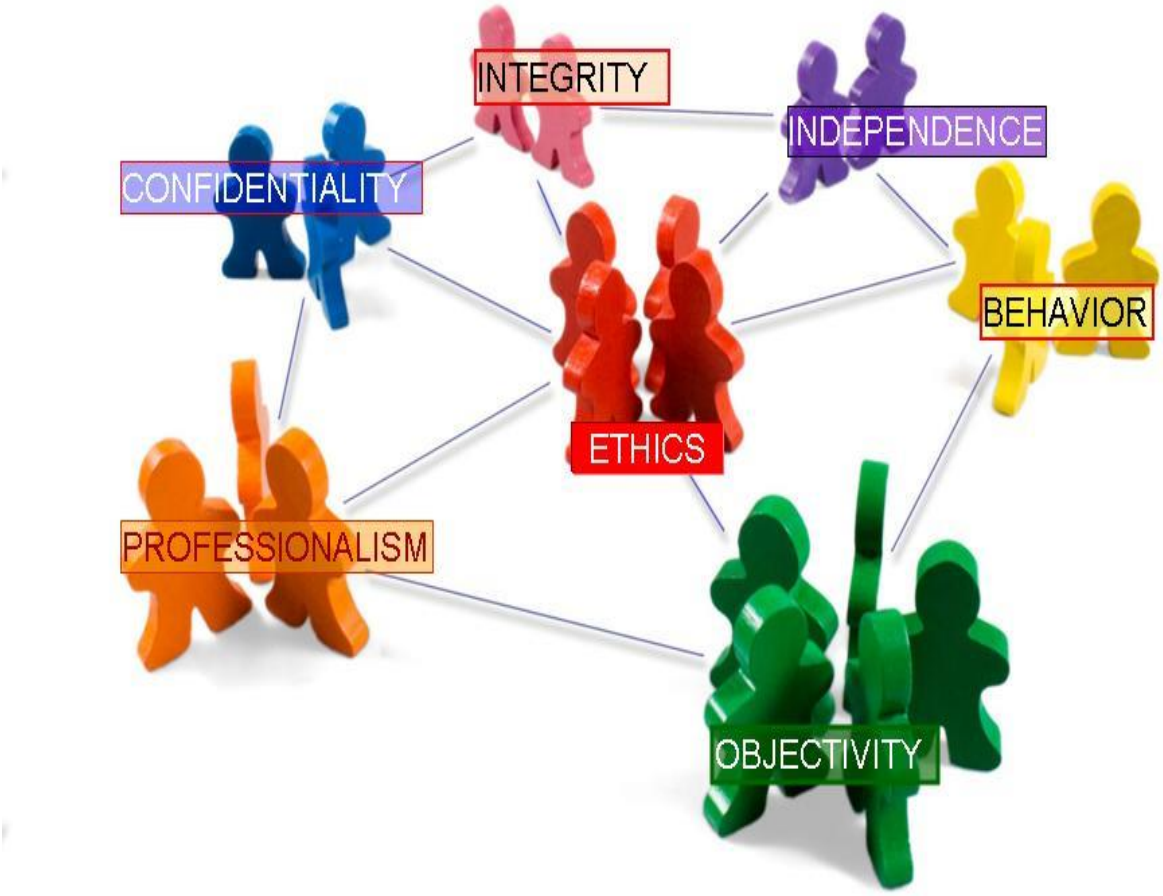
ACCOUNTING
ETHICS



Course Objective

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.

Accounting Ethics Program

This course satisfies the requirements for the required 4-hour ethics training required by the Texas State Board of Public Accountancy.
The course takes a different approach to ethical attitudes and focuses on identifying ethical behavioral components. To accomplish this, the course is divided into 5 Modules intended to help CPAs to identify and reach satisfactory conclusions about ethical issues in their practice.

1. Module 1 discusses ethics from a human behavioral standpoint to help participants understand the various "pulls and tugs" that are inherent in our human nature.

2. Module 2 reviews ethical aspects of Corporate Governance and Fraud, again with reference to existing research in the area that is associated with Governance, Fraud and managerial attitudes and behavior.

3. Module 3 examines the role of geographic as well as generational culture on our ethical attitudes.

4. Module 4 focuses on ethical philosophies with emphasis on ethical thinking and analysis, including references to existing research in ethical philosophies associated with ethical processing.

5. Module 5 will review the current Codes of Professional Conduct applicable to practice in Texas, including the current Texas and AICPA Codes of Professional Conduct.

Module 1 -
Ethical Behavior

Module 1
Tab 1 – Slides and Notes

Public Interest

Integrity
- Fundamental
- Element of Character
- Candid and honest
- Measured in terms of what is right and just
- Used to decide which part of the public to respond to.

Objectivity
- State of Mind
- Impartial
- Intellectually Honest
- Free of *appearances of* Conflicts of Interest
- Don't subordinate judgment

Due Care
- Best Interest of Client *consistent* with Public Interest
- Competence through **experience** & education
- Diligence
- Ignore pressures (*threats*)from those in a position of authority [2.170.010]

Independence

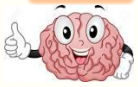
Reasonable Third Party

Biases

- Internal Biases
  -  Feelings and Emotions
  - Background, Attitudes and Experiences
  - Anchors
- Outside Biases
  - Surroundings
  - Perceptions and Framing
  - Stress and Time

Thinking & Leaps of Irrationality – **Integrity and Objectivity**

Default Setting



- Quick resolution to the situation/issue
  - Uses
    - habits,
    - experiences and
    - beliefs
  - Ignores facts
- Makes Irrational connections to help quickly resolve situation

Slow and Rational

- Slow;
- Conscious;
- Effortful;
- Reliable;
- Deliberate and Complex.

You've been asked to evaluate the internal controls for a division that has a number of complex activities. You've decided to spend some time at the division itself to review it's operations. Will you be thorough and objective in your review?

Remember that division you were asked to review? You've identified some individuals within the division that may be the "weak links" and are now focusing on them. Are you being objective in considering all of the division's circumstances? Maybe not.

You're in a group project meeting with two of your group members. Both are talking to you, but you're watching one of them while listening to the other. Are you actually hearing what they're saying?

You're interviewing applicants for a high-pressure senior executive position. For each applicant, you've put a large bowl of their favorite candy out on the desk. You intentionally are 15 minutes late to the interview. What do you check when you enter the room?

Ethical Character – **Integrity and Objectivity** – Setting the Compass

- We seem to want to be just unethical enough to be able to still feel good about ourselves. [Allingham & Sandmo, 1972; Becker, 1968; Gino, Ayal &Ariely, 2009; Gino, Gu, Zhong, 2009]
- "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]
  - Do you agree?

You're leading a new project with group members you've never met, all of whom will report to you. During the groups' first meeting, the member who will be testing key revenue and receivables for fraud pulls out a fingernail file and starts cleaning their toenails. Do you have any initial opinion about their work quality?

Feelings and Emotions – **Integrity and Objectivity**

- Primal Reactions keep us Emotional
  - Disgust, Guilt, Happiness and Sadness make us
    - more ethical
    - Less likely to become a whistleblower (tolerate other people's unethical actions).
  - Shame makes us more
    - UNethical
    - Less likely to whistleblow.
- In the middle of a preparing financial statement results for a large client, you lashed out at the team for their performance and are now ashamed of yourself for your unprofessional attitude.
  - You find that the revenue information is off by 10% from what is expected.
    - How likely are you to
      - Ignore the inconsistency?
      - Insert a number that adjusts revenue to an acceptable level? [DeHoogе, Breugelmans et al, 2008; DeHoogе, 2010, 2011]

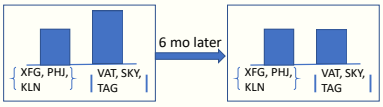
Biases

- Go to see a movie for $20
- Easy ≠True

This Message is True ✓

This Message is True ✗

- First Trading Day for Stock



- Sunk Cost/Effort

Priming – The Effect of Words

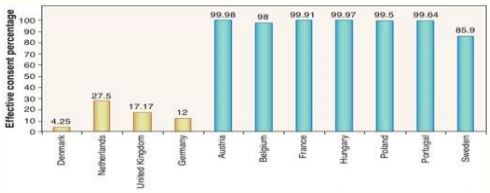
- Vacation;
- Home;
- Family;
- Summer;
- Skiing

- Retirement,
- Social Security,
- Senior Citizen,
- Assisted Living,
- Adult Community

- College students shown words conveying old age actually began to act and react older just by viewing the words.
- People rewarded for remembering the 10 commandments were 3 times less likely to cheat than those asked to remember 10 favorite songs.
- College students asked to read (or be read) and sign an Honor Code are 50% less likely to cheat on exam.

Framing and Anchoring

- Did George Washington die before or after age 140? How old?
  - What if I had asked you whether Washington died before or after age 9.
- What if, instead, I ask you before an audit whether you'll test revenue fluctuations only if they're above 10%?
  - What if I changed the fluctuation to 4%?
  - Should the change make a difference to your objectivity?



Bias and Experience – **Integrity and Objectivity**

- You are asked by a client to review information about a proposed complex merger. The client would like you to advise them about how to proceed.
  - **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 include in their evaluation) information about the target that was ***objectively*** relevant but unfavorable to 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]
    - What if you were told that you'd have to testify for
      - The client?
      - The other part to the merger? [Murrie, 2013]

Bias and Experience – **Integrity and Objectivity**

- You're asked to perform a review of the tax return for a client's company. You've know the client for a decade and find her to be very honest and ethical.
  - Will you examine the company's records objectively?
  - Likely not – you may ignore inconsistencies in the return in favor of the client. [O'Donnell, Schultz, 2005]
- You're meeting with your largest tax client about their upcoming tax return.
  - **If the return hasn't been filed**, what would you say are their audit chances?
  - **If the return was filed yesterday**, what would you say are their audit chances?

[Knox&Inkster, 1968; Bullens, 2013]

Time – Future and Present

- When considering the previous examples, keep in mind that we analyze future situations based on how "familiar" they are
  - When our minds can't use Stage 1 experiences, it move (slows down) to Stage 2.
  - At Stage 2, we evaluate new situations by
    - projecting to a series of solutions,
    - assigning risk factors to the solutions,
    - doing probability analysis,
    - assigning risk and then
    - picking a result.
  - Our implicit risk factors depend on the "frame" for the issue.
    - Losses are assigned higher risk (e.g., higher return required) than gains (factor of 20-30%);
    - Small risks of loss are overweighted by a factor of 2.

Positive Framing – Objectivity

Imagine that you're about to advise a client that their tax obligation for the year may be as high as $60,000. You've taken the issue to your partners and, after considering all of the available tax alternatives, you all agree to recommend two alternative approaches when talking to the client. You go the client and offer them the following:

- A: With Approach A, the client can save $20,000 in taxes.

- B: With Approach B, client has a 1/3 probability that they can save $60,000 in tax, and 2/3 probability that nothing will be saved.

Which of the two programs would the client likely choose?

Negative Framing – Objectivity

Imagine that you're about to advise a client that their tax obligation for the year may be as high as $60,000. You've taken the issue to your partners and, after considering all of the available tax alternatives, you all agree to recommend two alternative approaches when talking to the client. You go the client and offer them the following:

- C: With Approach C, the client will owe $40,000 in taxes.

- D: With Approach D, client has a 1/3 probability of owing no tax and a 2/3 probability that client will owe $60,000.

Which of the two programs would the client likely choose?

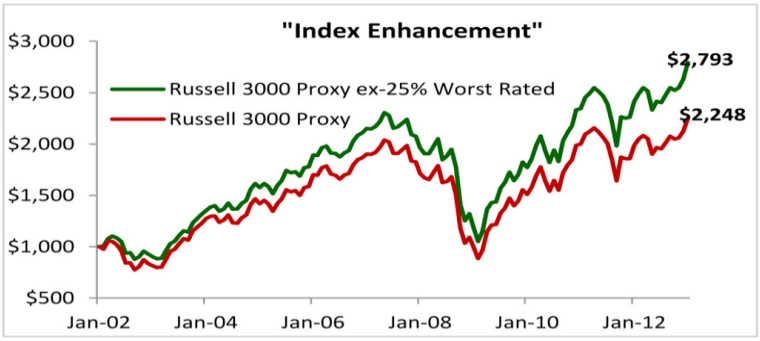
Module 2
Corporate Governance
And Fraud

Module 2
Tab 1 – Slides

"You seem to have the qualifications we're looking for in an accountant"

Fraud Costs

"Eliminating 25% of companies in the Russell 3000 Index that scored lowest on GMI Ratings' fraud detection metrics raises returns by 2.2 percentage points, from 7.6% to 9.8%, over the ten-year period. In other words, the ***including these companies in an index fund cost the investor $545 per $1,000 invested.***" [The Impact of Fraud on Shareholder Value, 2013]



Corporate Governance – General Thoughts

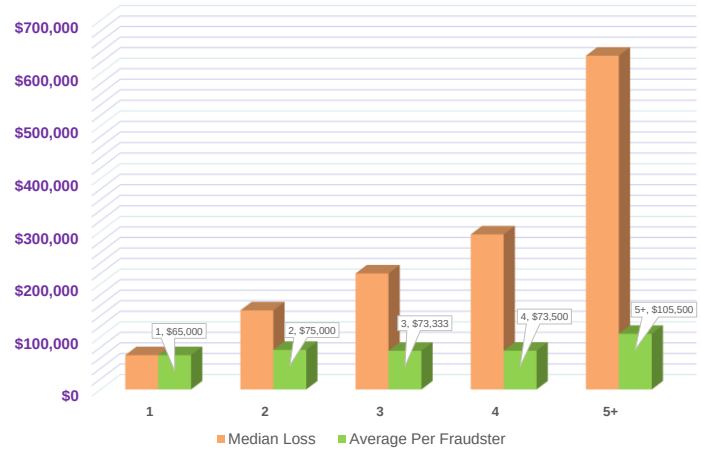
- **Money and cocaine** affect similar pathways in our brain.
  - These are **not** the same pathways as occur with natural rewards, such as food and water.
    - Are activated **just by the discussion or thought of money**. [Potenza, 2004; Tancredi, 2015]
- **Gamblers** have abnormally low serotonin levels in areas of the brain that have been shown to be associated with poor impulse control. [Tancredi, 2015; Thut, 1997]
  - Low impulse control correlates to potential fraud tendencies.

Fraud Triggers – Groups & Accountability

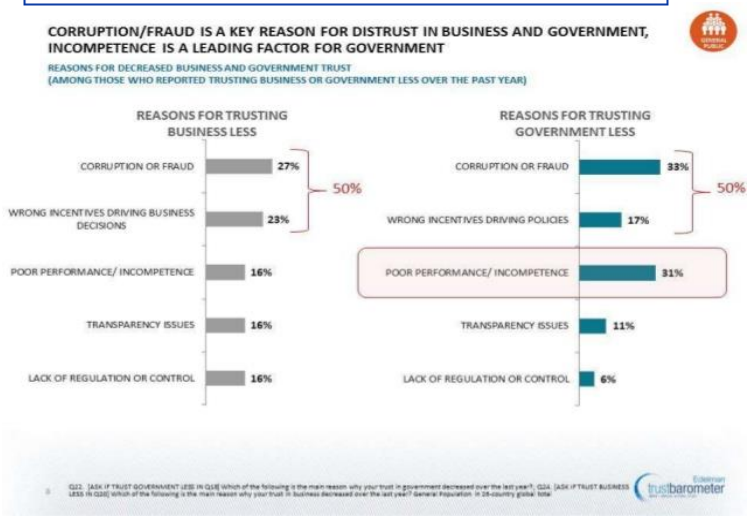
You're in a meeting with your audit team for a multi-billion dollar client. The meeting room is all glass and you can tell that the group members are all watching the CFO of the company at a secure terminal making what appear to be changes to the company's ledger. Do you speak up?
What if there's only you and the Partner in Charge in the meeting?

- The **group** sets an ethical consensus.
  - Sync our primal emotions to the group.
    - Pain;
    - Embarrassment;
      - If the group's okay with the behavior – we are too!
  - Excuse and/or ignore unethical behavior if it benefits the group.
- Minimal accountability will deter unethical activities.
  - Observation is a consistent deterrence to ethical behavior.
  - Other countries are now lowering the bar for fraud suits to deter fraudulent activities.

Fraud - Groups - Collusion



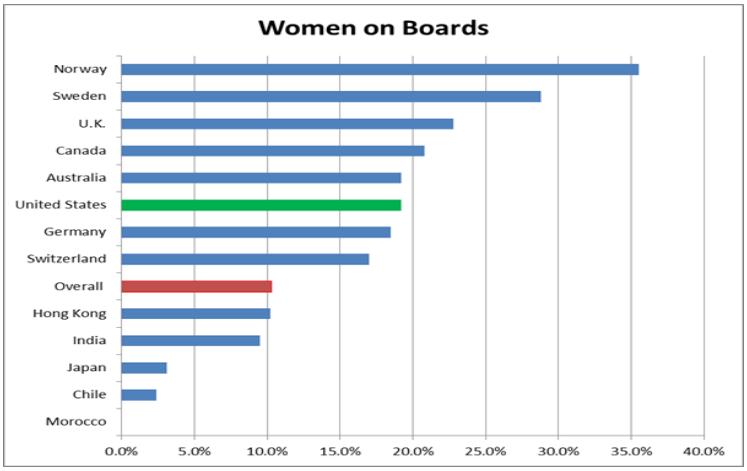
Trust Index



Trust Index – CEO Misplaced Attention

Too Much		Not Enough	
67%	Focus on short-term financial results	59%	Positive Long-Term Impact
57%	Lobbying	49%	Job Creation

Corporate Governance - Board Structure



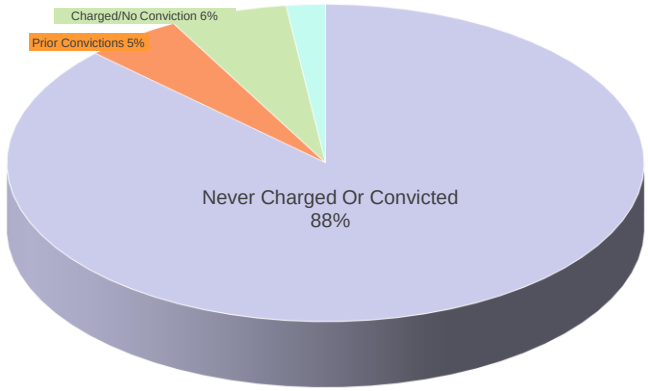
Corporate Governance - Women

- Recent studies support a relationship between the number of women on a board of directors or as CEO and
  - higher returns;
  - share price;
  - greater governance controls and accountability;
  - statistically-significant decrease in the chance of financial restatements.

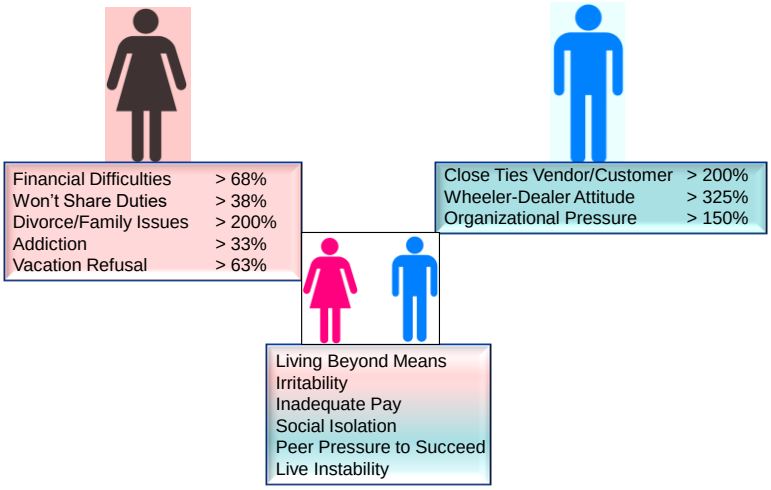
Anatomy of a Fraudster

Anatomy of a Fraudster

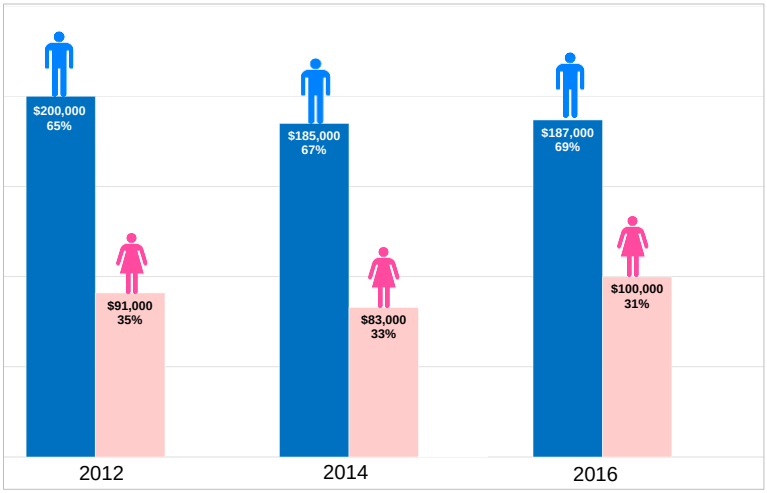
"When compared between criminals and college students, the personality and demographics of someone likely to commit fraud more closely resembled the college students than the criminals."



Fraud Driving Forces - Red Flags – Men/Women



Fraud by Gender



Fraud's and Bribery Economic Effect

Fraud Cost

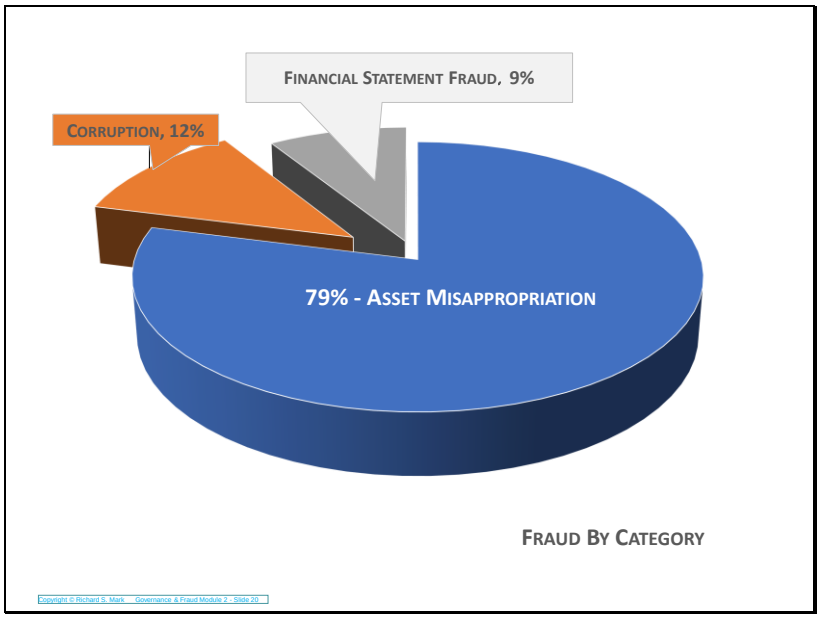
- Current Estimate – 5% Annual Revenue Loss to Fraud
- Overall loss of around $6.3 Billion annually.

Fraud Overview [ACFE 2016]

- The **median loss** caused by fraud cases is **$150,000**.
  - Nearly 1-in-4 frauds cost at least **$1 million** (~5% of gross revenue).
- Recovery
  - **12**% get full recovery,
  - **58**% never recover anything.
- **One in 7** companies may be committing corporate fraud this year.
  - Shareholder cost:
    - Overall - **22**% of enterprise value in fraudulent firms;
    - **3**% of enterprise value in **ALL** firms.
- Fraud's **market penalty**
  - $1 of inflated value → $3.08 of loss when the fraud is detected;
    - $0.36 due to expected legal penalty;
    - $2.72 due to loss of reputation.

Economic Effects of Fraud - Bribery

- 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).
- 96% of top executives list bribery as the most likely form of corruption.


Financial Statement Fraud, 9%
Corruption, 12%
79% - Asset Misappropriation
Fraud By Category
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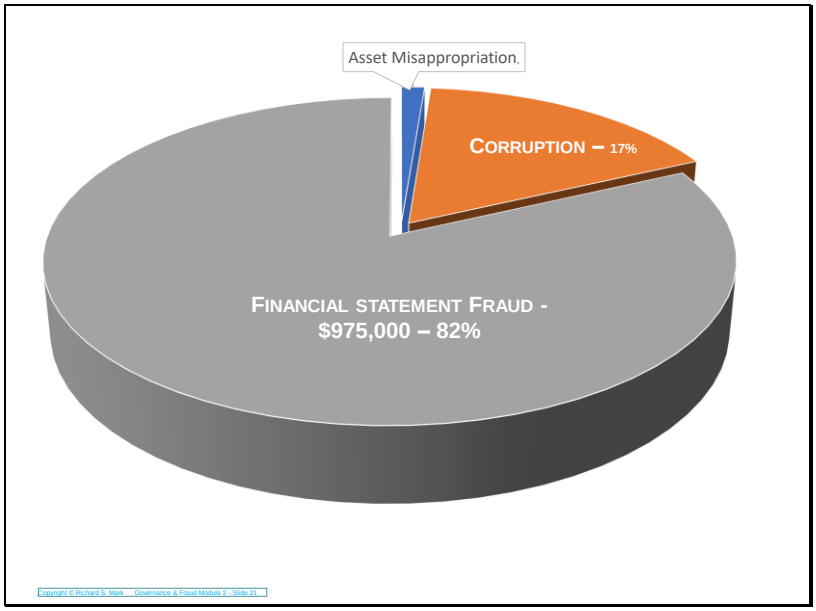
Asset Misappropriation,
Corruption – 17%
Financial statement Fraud -
$975,000 – 82%
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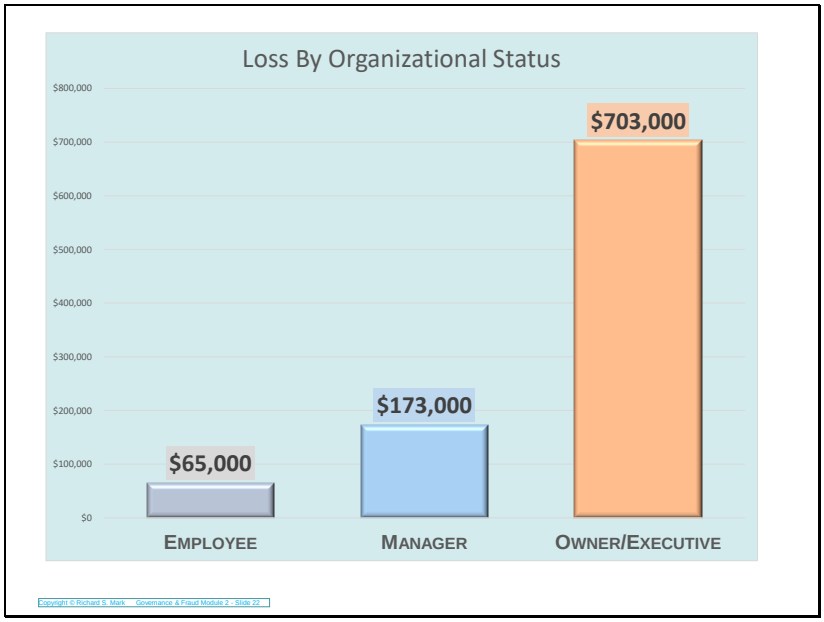
Loss By Organizational Status
$800,000
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
$65,000
$173,000
$703,000
Employee
Manager
Owner/Executive
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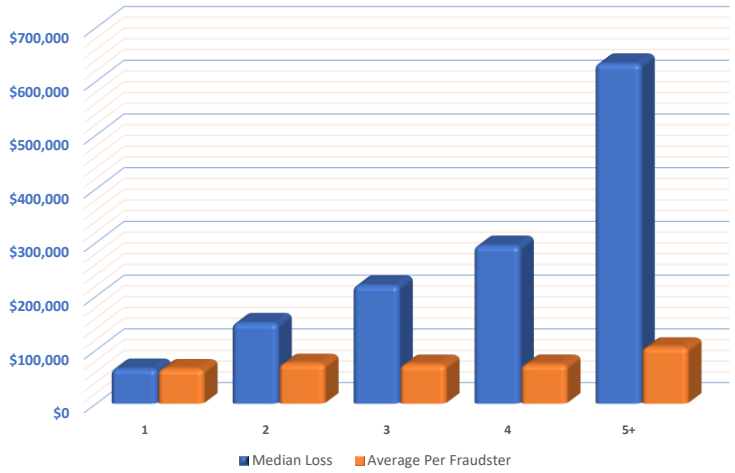
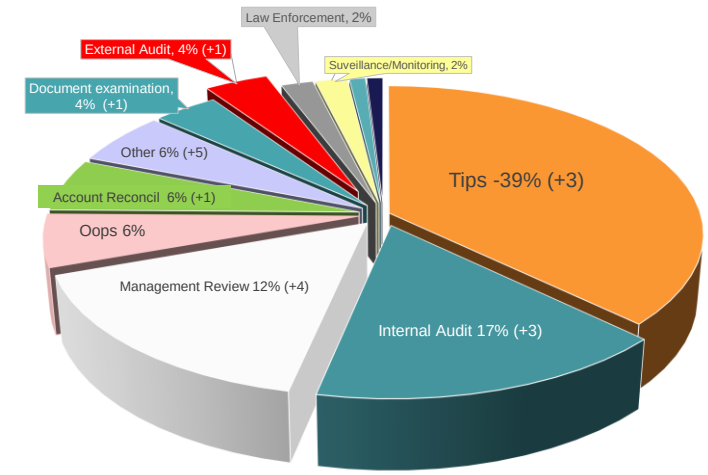
Collusion

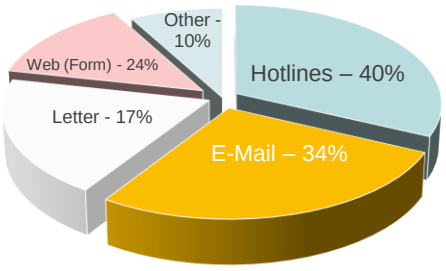


Corporate Governance
Fraud Deterrence
Whistleblowing

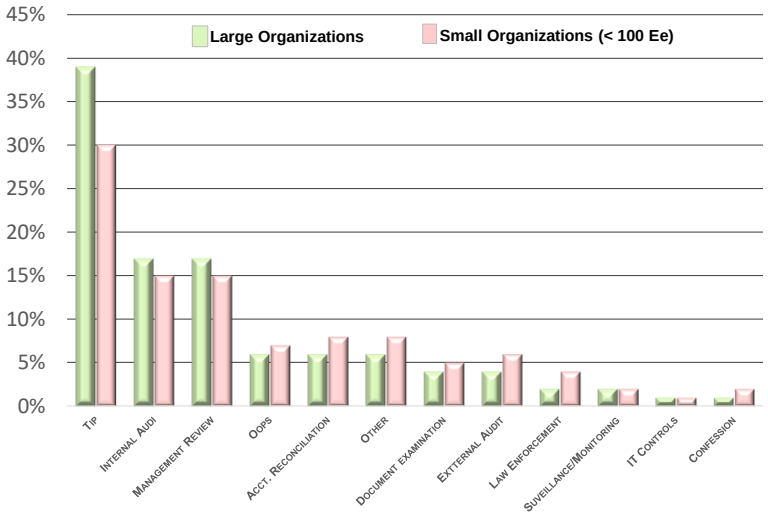
Fraud Detection



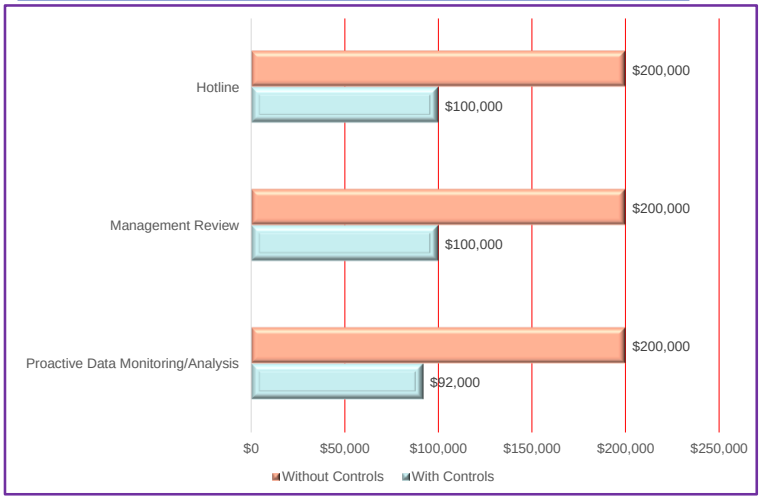
Whistleblowing



Fraud Deterrence – Organizational Size



Fraud Loss with/without Controls



Fraud and Financial Reporting

- International auditing standards now encourage auditors to consider "organizational attitudes" toward fraud when making their fraud assessment.
- EU now has regulatory guidance requiring auditors to address bribery mitigation, detection, and disclosure.
- Considerable evidence that Fraud/Corruption can be offset through
  - Extensive disclosure requirements;
  - Auditor "incentives" to identify & disclose corruption
    - Lower the burden of proof in litigation vs auditors.
  - Inter-company cooperation. [Zahra, et al, 2007]

Corporate Governance & Organization

Corporate Governance

- For most employees
  - **Externally-administered**
    - reporting channel with
    - training
- Offsets group, obedience (Milgram), and power (Stanford) issues. [Mesmer-Magnus, 2005; Near & Miceli, 1996; Gao, Greenberg, Wiing, 2015; Dworkin & Baucus, 1998; Wier, Achilles, 2015; Zhang, 2009]
- Framing Internal Controls can significantly impact potential fraud.
  - IC's framed as
    - **Coordinated effort** (e.g., suppliers, company, etc) caused **more fraudulent** reporting.
    - **monitoring cont**rols resulted in less fraudulent reporting. [Falk & Kosfeld, 2006; Tenbrunsel & Messick, 1999; Hannan, 2006]

Risk Assessment

- Use of a logit (vs. fraud) checklist achieved more accurate fraud risk assessments than any other fraud aid.
- Group (Brainstorming) thinking works:
  - identify more ways fraud could occur;
  - design better procedures in response to fraud risk.
- Internal auditors made 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.

Fraud and Financial Reporting$_3$

- **PCAOB report** - auditors fail to effectively modify their standard audit procedures in response to fraud risk.
- 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%);
  - Exercise **due professional care** (67%);
  - Exhibit adequate level of **professional skepticism** (60%);
  - Obtain adequate **evidence** related to **management representations** (54%);
  - Express an **appropriate audit opinion** (47%).

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

Module 2
Tab 2 – Cases and Discussion Material

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	The company says an internal investigation concluded that its round-trip trades had "no	Although the effect [of these trades] on the company's financial statements

			Regulatory Commission	material impact on current or prior" financial periods.	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.
Dynegy (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.	Dynegy 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.
Nicor Energy, LLC, a joint venture between **Nicor** (nyse: GAS - news - people) and **Dynegy** (nyse: DYN - news - people)	July 2002	Independent audit uncovered accounting problems that boosted revenue and underestimated expenses.	None	Nicor restated results to reflect proper accounting in the first half of this year.	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.
Peregrine Systems (nasdaq: PRGNE - news - people)	May 2002	Overstated $100 million in sales by improperly recognizing revenue from third-party resellers	SEC; various congressional committees	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.	We have been and will continue to cooperate with the SEC and the Congressional committee.
Qwest Communications International (nyse: Q - news - people)	February 2002	Inflated revenue using network capacity "swaps" and improper accounting for long-term deals.	DOJ; SEC; FBI; Denver U.S. attorney's office	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.	We are continuing to cooperate fully with the investigations.
Reliant Energy (nyse: REI - news - people)	May 2002	Engaging in "round-trip" trades to boost trading volumes and revenue.	SEC; CFTC	Recently replaced Chief Financial Officer Steve Naeve with Mark M. Jacobs, a	We're cooperating with the investigations.

				managing director of Goldman Sachs and a Reliant adviser.	
Tyco (nyse: TYC - news - people)	May 2002	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.	Manhattan district attorney; SEC	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.	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.
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 3
Culture and
Ethical Attitudes

Module 3
Tab 1 – Slides

Cultural Values and Attitudes

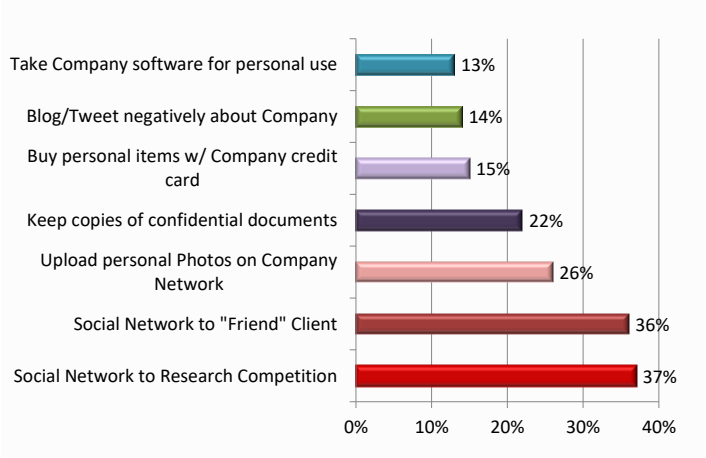
Impact on Ethical Attitudes

- **Matures (Traditionalists)** - born between 1922 and 1945
- **Baby Boomers**: born between 1946 and 1964
- **Gen X**: born between 1965 and 1980
- **Nexters (Gen Y or Millenials)**: born between 1981 and early 1990s;
- **Generation Z** (**Digital Natives**): born after late 1990s.
- Current workforce
  - 50% Millennials (Gen Y) and
  - 30% Gen X. [Eisner, 2005]

Generational Divide

- Over the first 10 years in the workforce, young workers will
  - Change jobs an average of **7** times;
  - Change **careers** an average of **3** times. [Crumpacker, 2007; Topel & Ward, 1988; Morrison, et al, 2006; Martin, 2005]
- Make long-term commitments to an organization of an average of **1** year.

Millenials – Ethics Shift



Cultural Divide

- **Matures** (**Adaptive**) – Conservative & Disciplined
  - **Conformists**;
  - **Patient**;
  - **Team players;**
  - Minimal **ethical awareness.**
- **Baby Boomers** – Time-Stressed & Materialistic
  - Attacked institutions while coming of age;
  - Individualistic rule-breakers.

Cultural Divide – Gen X (1965-1980)

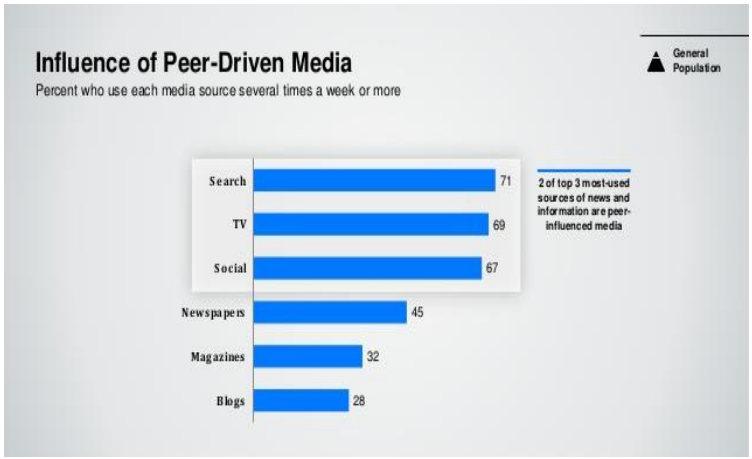
- The **Reactive** generation
  - Independent;
  - **Self-reliant** (because of how they were raised) and **entrepreneurial**;
  - **Pragmatic**;
  - **Team-oriented**;
  - **work-life balance**;
  - **positive feedback**;
  - **Job change** every 3-5 years;
  - **Distrust authority**, businesses and boomer values.

Cultural Divide – Millenials (1981- mid-1990s)

- Consumer Mentality
  - Degree in exchange for money. [Delucci & Korgen, 2002]
  - Technical information vs learning. [Hassel & Lourey, 2005]
- Ethically aware. [Arsenault, 2004]
  - more tolerant of ethical variance.
- Work preferences
  - Positive differences (62%);
  - Making a difference (53%).
- Influenced by peers NOT policies.
- Immediate and positive criticism/feedback;
- High maintenance (perceived, not proven);
- Quick to change jobs if their goals aren't met (less than Gen X) [Entrepreneur Magazine, 2014]

- Now 7% of the workforce;
- Instant gratification;
- Acceleration and next, next, next;
- Different concept of "community";
- Pressure to succeed.

Edelman Trust Index 2016



Cultural Variables and Ethical Attitudes

Slide

Cultural Value Priorities

United States	Japan	Middle East 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

Cultural Gaffes

- When **Kentucky Fried Chicken** entered the Chineses 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"

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 you 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.

International Scandals

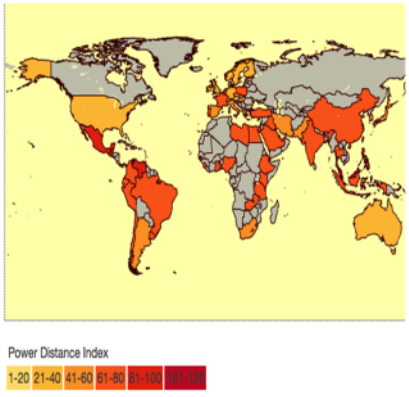
- Parmalat (Italy) - $10 Billion;
- Australia;
  - Harris Scarfe – $160 Million (PwC).
  - HIH (Insurance) – 2.7 Billion.
    - Guess who was their auditor?
- SK Global (Korean Trading Firm) - $1.3 Billion;
- YGX (China – Eco-Agriculture) - $92 Million;
- Vivendi (France - Telecom) - $47 Billion;
- Satyam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

Hofstede's Model of Culture

- **Power/distance (PD)**
- **Uncertainty avoidance (UA)**
- **Collective vs. Individualistic (IND)**
- **Gender Orientation (MAS)**
- **Societal Orientation (LTO)**
- **Self-Restraint (IND)**

Equality - Power Distance (PD)

- A **High PD** culture allows/accepts power/wealth inequalities.
  - More likely to
    - Use a system that hinders significant upward mobility.
    - Permit corruption.
- A **Low PD** culture de-emphasizes power and wealth differences between citizens.

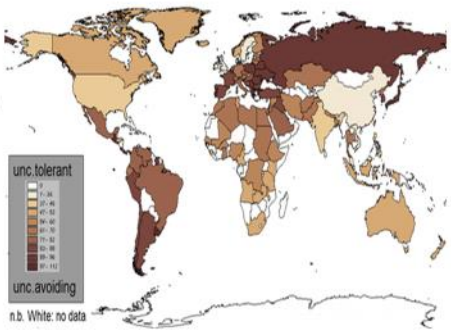


Equality – High Power Distance Cultures

- Show **less pride** in work.
- Feel **disconnected** from the benefits of one's efforts.
- Believe **corruption** is an integral part of their society.
- 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;

Uncertainty Avoidance (UA)

- A **High UA Culture** doesn't like uncertainty and ambiguity.
  - individuals align to the culture's **least ethical standard**.
- A **Low UA Culture**
  - less rule-oriented;
  - Takes risks to provoke change.



Individualism (IDV)

- A **High IDV Culture**
  - **Less permissive** of ethical violations/corruption;
  - More likely to **openly question** organizational ethical attitudes.
- A **Low IDV Culture**
  - Is usually collectivist;
  - Encourages close ties between members of the society.
    - Reinforces extended families and collectives;
    - **Shared Responsibility -** everyone takes responsibility for group members.
    - Unethical behavior
      - is more **tolerated**.
      - **Excused** when the culture benefits.

Masculinity (MAS)

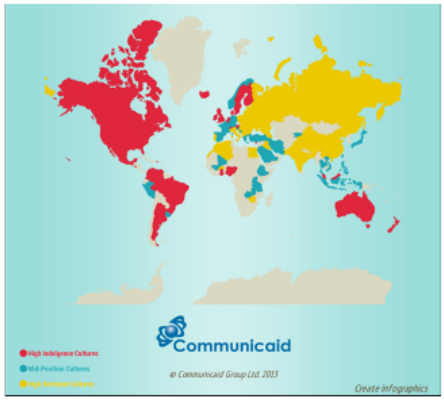
- A **High MAS Culture** measures success **and ethics** by what are typically considered to be male characteristics
  - Monetary achievements;
  - Heroism;
  - Assertiveness;
  - Competitiveness.
  - Encourage unethical behavior.
- A **Low MAS Culture** fosters
  - Cooperation;
  - Relationships;
  - Quality of life;
  - Care for underprivileged.
  - In these cultures, everyone in the society is *theoretically* treated equally in all aspects of the society.

Long-Term Orientation (LTO)

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

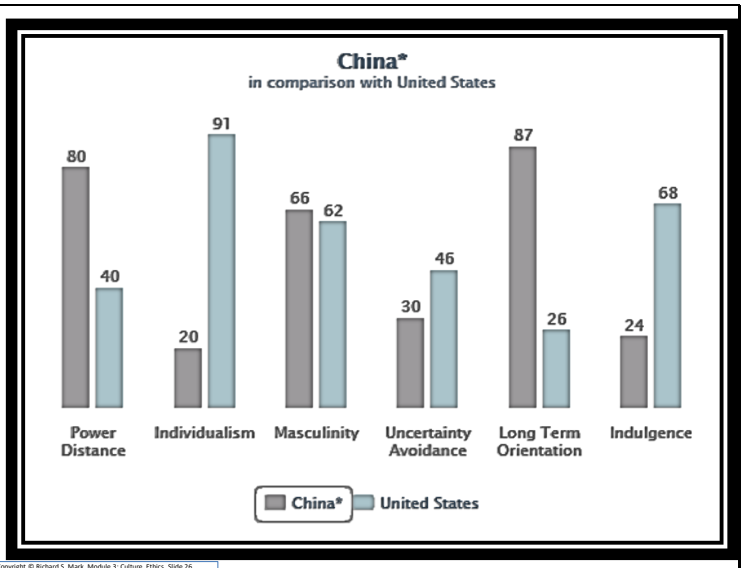
Self-Restraint (IND)

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



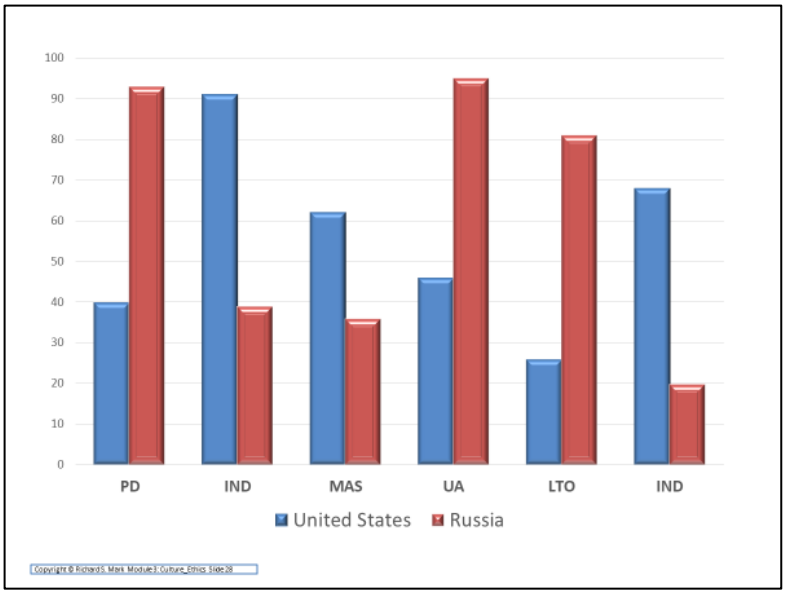
China and the US

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



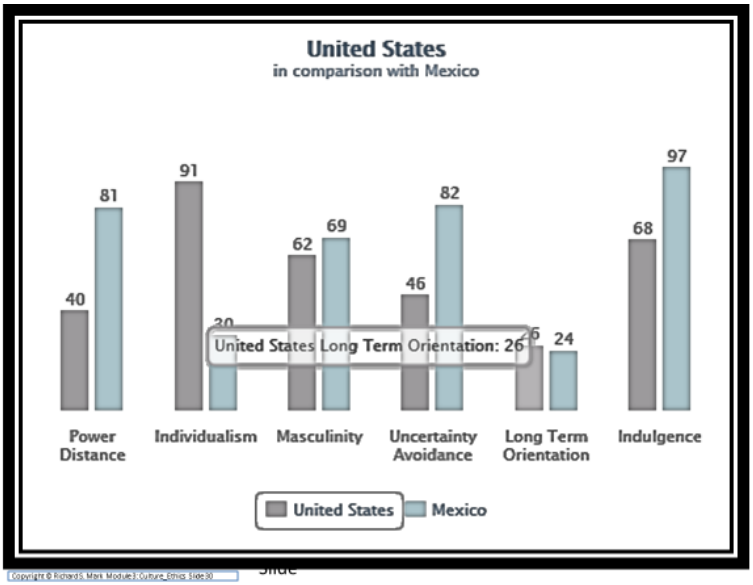
US and Russia

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



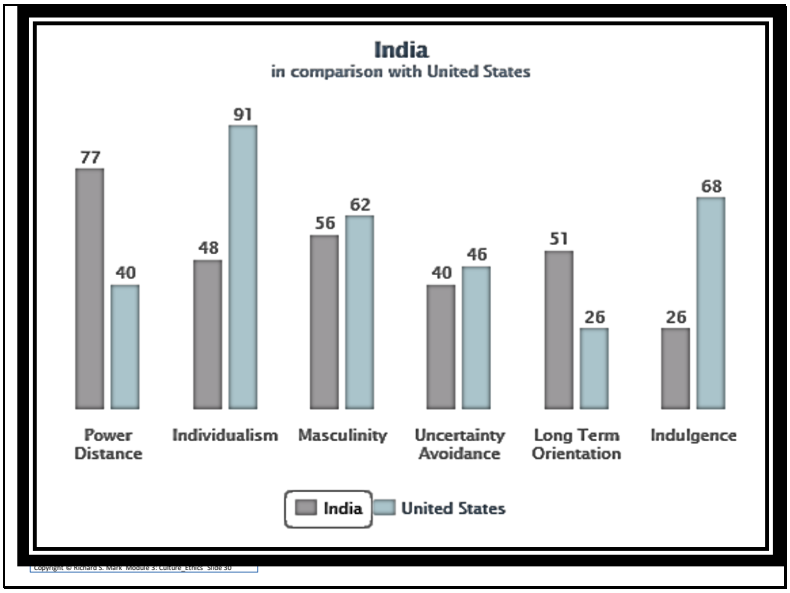
US and Mexico

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



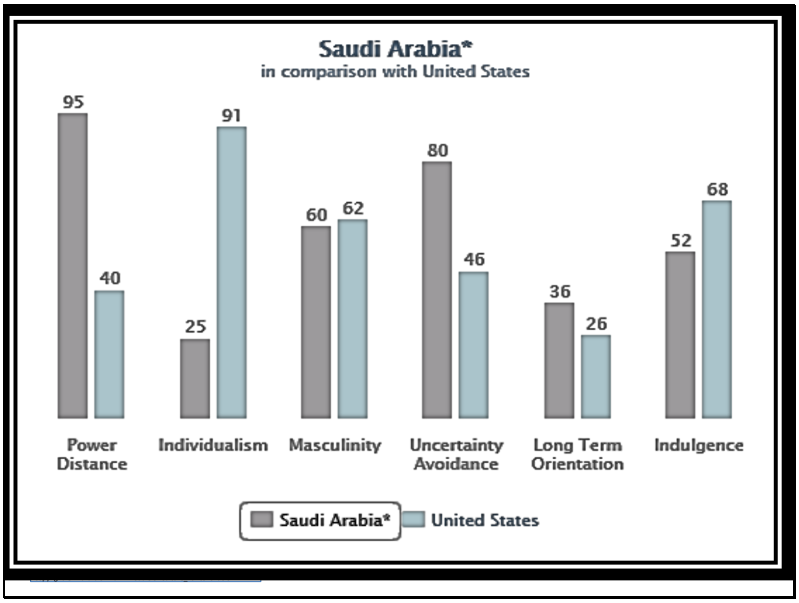
India and the US

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



Saudi Arabia and the US

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


Saudi Arabia*
in comparison with United States
95
40
25
91
60
62
80
46
36
26
52
68
Power Distance
Individualism
Masculinity
Uncertainty Avoidance
Long Term Orientation
Indulgence
Saudi Arabia*
United States

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 to the Board of Directors.

Module 4
Ethical Philosophies
And Behavior

Module 4
Tab 1 – Forsyth 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 no 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 4
Tab 2 – Slides

Ethical Philosophies – Utilitarianism

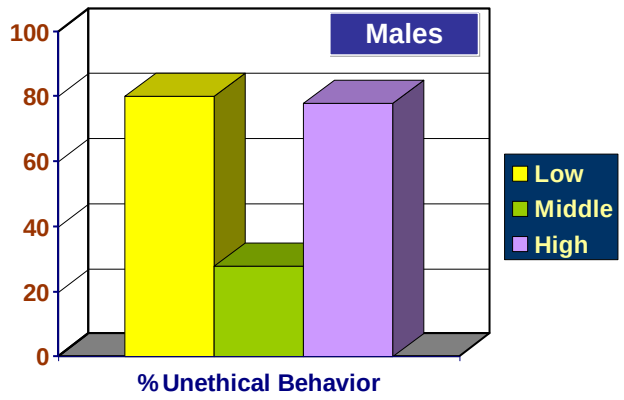
- Recent studies show that we tend to "shift" philosophies based on whether the situation is "impersonal" or "personal"
  - We are utilitarian when our actions are impersonal – we don't personally cause harm to others;
  - We become non-utilitarian when our actions are personal – we're asked to cause harm to others. [Gleichgerrcht E, Young L (2013)]
    - About 90% **won't** take affirmative ***personal*** action to injure another person even if it would be for the best of the "group".

Ethical Philosophies - Utilitarianism

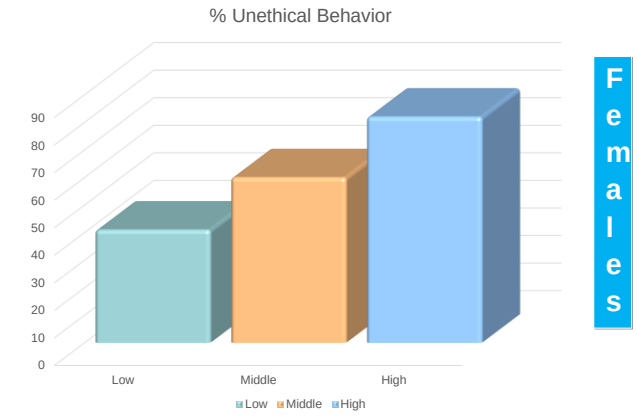
- In psychological tests,
- Utilitarians showed reduced levels of empathy in personal situations.
- More interestingly, the 10% discussed in the previous slide that would take personal action to injure another were shown to have personalities that were psychopathic, Machiavellian or put a low value on life.

[Bartels and Pizarro].

Kohlberg Scores and Related Unethical Behavior



Kohlberg Scores and Related Unethical Behavior



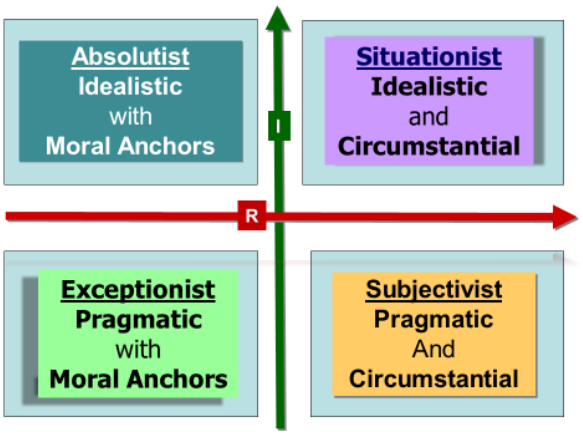
Kholberg Scores

- Why the difference between men and women?
  - Researchers believe that it may be due to the fact that the DIT is structured toward a **justice orientation** rather than a **caring orientation** for women. [Gilligan 1982; Reiter 1996)].

Kohlberg and Accountants

- Beginning accountants score higher on ethics tests than do managers or partners.
  - increase to supervisor level;
  - Then sharply decreases from manager to partner. [Ponemon]
- Ethical development is related to an accountant's practice activities and adjusts for
  - ↓sensitivity to management competence and integrity [Ponemon 1995]
  - ↑Ability to resist management pressure to misstate financial statement [Tsui and Gul 1995];
  - ↑Propensity to whistle-blow [Ponemon 1990];
  - ↑Billable time management [Ponemon 1992];
  - ↑Overall objectivity [Ponemon 1995];
  - ↓Tax vs financial or audit (with tax on a lower ethical level).

Forsyth Ethical Dimensions



Forsyth Ethical Dimensions - Idealism

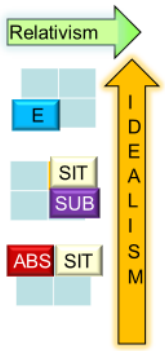
- **Idealists** work for positive results for everyone
  - ethically alert;
  - Recognize and make better ethical decisions;
  - Evaluate ethical behavior based on outcomes, not actions or actor;
  - intolerant of questionable budgetary practices;
  - Condone unethical actions (e.g. lie) if the act itself helps others.

Forsyth Ethical Dimensions - Relativists

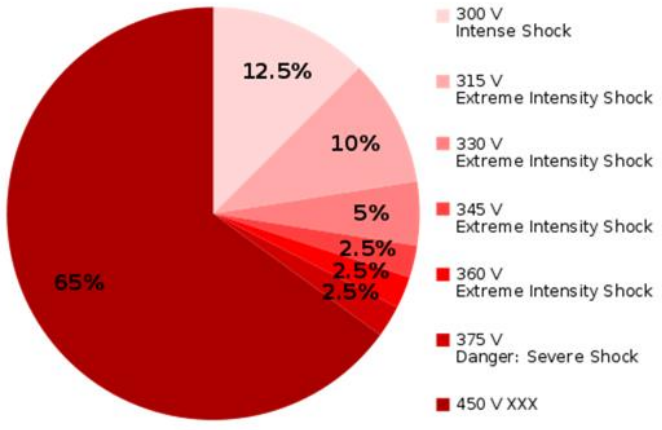
- Relativists are more likely to be ethically numb.
- If the results are positive, relativists have less
  - Shame/Guilt about their actions;
  - Depression;
  - Anxiety.
- More "ethically numb"
  - miss ethical issues;
  - make unethical choices;
  - condone other's unethical actions;
  - Tolerate questionable budgetary practices (including accounting-related deviances) in organizations;
  - Minimize fraud risk in their assessments.

Ethical Dimensions - Culture

- Studies have identified patterns in ethical attitudes across cultures.
  - An **exceptionist** ethic is more common in Western countries;
    - Less likely to be bothered by workplace favoritism.
  - **Subjectivists** and **situationists** are more common in Eastern countries, and
  - **Absolutists** and **situationists** more common in Middle Eastern countries. [Forsyth, O'Boyle, and McDaniel (2008)]



Milgram Experiment Results



Module 4
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 it's 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

1. 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 it's 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 it's 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

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

Case 4B

In addition to the above information, you know:

- of an 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

5. 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?
6. 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 tally 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 alterative 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 5
Codes of Professional Responsibility

Module 5
Tab 1 – Slides

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.

CPC 2015 – Concept Threats[1] [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.*

CPC – Threats [1.000.010.08]

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.**

CPC – Terminology$_2$

- **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.

CPC – Terminology

- Affiliates –
  - Based on **control not** necessarily **ownership**
    - **ability exert significant influence** [ASC 323-10-15] 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.

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.**

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.

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.

CPC Part 1 – Public Practice

Independence
TX 501.70
AICPA 1.200

CPC Part 1 - Independence

- "Consistent with decades of research in social psychology, each of these three conditions (of the Codes of Conduct[Bazerman, Gino, 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]

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?

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.[1.230.010.02]
  - **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.

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

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.

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.

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.**

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.

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**

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.

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 is involved.[1.510.030]
- **Fees are <u>not</u> contingent if**
  - **"based on the findings of governmental agencies…"**
  - **RAR reprerepresentations;**
  - **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]**

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.**

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

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]

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.

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?

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?

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?

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?

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?

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?

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?

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 no 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?

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?

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 2009, 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."

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?

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?

Cumulative Case Study 1:

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

A. Ralph Gora Paving

In the summer of 2010, Mary's residence driveway was repaved by Ralph Gora Paving; Ralph was paid cash for the service. In early 2011, 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.

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.

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.

Module 5
Tab 2A– Responses to Cases and Discussion Material

Integrity and Objectivity:

Case 1:

Response: 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:

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 direct that would not have been made without that information. This is 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: Response: 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: Response: 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: Response: Independence is not necessarily impaired so long as Integrity is providing the same services under it's 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: Response: 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:

- Does it matter that the member didn't know of the discrepancy? (NO)
- Does the variation have to be material? (YES)
- 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: Response: Rule 501.76 would not allow the CPA to hole 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: 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 Top Fish 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: Response: The Texas Code prohibited this as recently as 1997! However, AICPA has no such restriction and as Texas now follows AICPA independence rules, it would appear that this is no longer a violation. However, this could be viewed as creating an indirect financial interest, which if material, could impair independence.

There are also potential violations by:

- Sharah 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: Response: Referring Xia to another client would be imprudent from the standpoint of integrity and objectivity per ET section 102-3, 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: Response: Not likely that the audit and tax work would be split; however, it is a client, but not for that service. Technically probably do not have to retain for 36 months the communication and list that party, but would be prudent to do so.

Cumulative Case Study 1:

Potential Responses***:***

Part A – Public Accounting Practice – Ralph Gora Paving

- 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.
- 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.

- 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
- 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.

- Communication with Predecessor
  - Mary failed to inform the successor firm that a suspected illegal activity was a factor in her withdrawal from the engagement.
- Co-operation with Successor
  - Mary failed to comply with Rule 501.76 by transferring the client's files and working papers to the successor without proper instruction and authorization from the client.
- 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.
- 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:

Potential Responses:

1. Public Accounting Practice – Organization and Conduct – Rule 501.77 and 501.81
   Jeremy is 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). 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.
     - Claiming skills or attributes superior to those possessed by colleagues with equal qualifications contravenes the fundamental principles governing the conduct of CPAs.
     - 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:

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. 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). 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.

- Contingent Fee. Rule 501.52(11). 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.

- Solicitation. Rule 501(b)(7) and 501(c). Wide contravened the Code by soliciting professional engagements from Agnes in a manner that is persistent or harassing.