Test Your Ethical Judgment

MAKING THE RIGHT CHOICES CAN SOMETIMES BE DIFFICULT.

By Kay Zekany, CMA

Accounting ethical lapses associated with financial shenanigans were in the spotlight earlier this decade, tarnishing the reputation of all accountants.

But now, "Nobody cares much about accounting scandals anymore," as Herb Greenberg reported in the July 7-8, 2007, article in *The Wall Street Journal*, "Accounting scandals: not a problem?"

Have investors become jaded by the deluge of scandals of greater magnitude? Or do we accountants have a genuine opportunity to improve our reputation? To truly restore our reputation, we must all continue to be keenly attuned to making the right ethical choices.

Having good ethics goes beyond simply following the letter of the law. To quote *The Statement of Ethical Professional Practice* published by the Institute of Management Accountants (IMA®), "A commitment to ethical professional practice includes overarching principles that express our values and standards that guide our conduct." IMA's overarching ethical principles include *honesty, fairness, objectivity,* and *responsibility*. Its standards of ethical practice include: *competence, confidentiality, integrity,* and *credibility*.

As accountants, we typically don't face ethical dilemmas on a daily basis. Instead, the dilemmas tend to surface during the quarter-end and year-end closing activities. Thus, we must be attentive to recognize ethical conflicts when they occur and then act appropriately in the presence of tension. How do you think you would fare if faced with such a situation? Maybe it's time to test your ethical judgment with your response to 14 short business scenarios.

14 SCENARIOS

To test your ethical awareness, carefully consider the following 14 scenarios, and make your best selection based on IMA's ethical principles and standards of ethical practice. Your possible selections range from "good business practice," indicating no ethical tensions involved, to "fraudulent accounting," with each response sequentially moving one additional step away from good business practice and closer to accounting fraud. The middle response, "improper, but not fraudulent," indicates that ethical tension is clearly present and could lead to pressure to misrepresent the true and fair financial condition if the business climate sours. The set of possible responses is the same for all scenarios. After choosing your responses, you can see how you did compared to the recommended responses and explanations provided.

Judgment is involved in selecting your responses. The short scenarios and limited set of responses don't allow for a full contextual understanding of the business situation, so your "score" on these questions is less important than your rationale. That is, if your response is one step off the recommended solution, take heart if your rationale is sufficient. But if your rationale is significantly different from what is recommended, you need to reassess your priorities and make the appropriate adjustments to your professional life to ensure that your decisions are not only ethical but also legally appropriate. Remember, all it takes is one misdeed that constitutes fraud or conspiracy to face a long prison sentence and the destruction of your professional reputation.

HERE'S THE TEST

1. Intense pressure was on to keep the corporation's stock from declining further. This pressure came not just from external investors and analysts but also from the CEO, whose financial well-being was precariously dependent on the corporation's stock price.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
d. Improper and a possible indicator of fraud
e. Fraudulent accounting

2. A cadre of employees is compensated well in excess of the guidelines of the company's approved salary and bonus schedules allowable for their positions. The company's pay schedule is appropriate, up-to-date, and represents current market conditions.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
d. Improper and a possible indicator of fraud
e. Fraudulent accounting

3. Financial information within the corporation is very closely guarded. Even some individuals with a need to know are denied full access to corporate information.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
d. Improper and a possible indicator of fraud
e. Fraudulent accounting

4. Managing a specific financial ratio is tremendously important to the company's profitability. As a result, management and outside analysts pay close attention to this ratio and its trends. This company's reported quarterly ratio hovered within an incredibly narrow range, even though the period was an extremely volatile time for the industry.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
d. Improper and a possible indicator of fraud
e. Fraudulent accounting

5. Each year, Internal Audit presents its final report of completed projects for the year just ended along with its plan for proposed audit projects for the upcoming year to the Audit Committee of the corporate Board of Directors. The rest of the year, Internal Audit reports to the CFO, who controls and directs their ongoing efforts and approves their promotions, salary increases, bonuses, stock options, and more.

a. Good business practice
b. Perfectly ethical, but raises a red flag
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6. The CEO assigns Internal Audit the responsibility for generating an important operational reporting package that has no audit purpose or use. Its production is time-intensive, consuming most of the time of Internal Audit's staff for at least the first six months of its inception. This effort drained scarce departmental resources and delayed scheduled audits.

a. Good business practice
b. Perfectly ethical, but raises a red flag
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7. At the end of each month, the company estimates and books a particular business expense as an adjusting entry because it is subject to delayed billings. Until the company pays the bills, the accrued amounts remain in a liability account on its balance sheet. Because these accruals are estimates, the company reevaluates them periodically to see if they are at appropriate levels. Accordingly, the company routinely adjusts its accruals as it learns more about applicable charges.

a. Good business practice
b. Perfectly ethical, but raises a red flag
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8. In an effort to reduce these accrued expenses (above) to meet budget, the CFO directs General Accounting to reduce a particular division's specific expense by $150 million. When General Accounting calls the Vice President of Finance of this division and asks her to reduce these expenses for her division, she refuses because there is no support for the entry. Consequently, the requested journal entry is prepared in General Accounting at Corporate.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
d. Improper and a possible indicator of fraud
e. Fraudulent accounting

9. In an attempt to reduce operating expenses, the company capitalizes "rent" on underutilized assets (excess capacity) as *prepaid capacity*.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
d. Improper and a possible indicator of fraud
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10. An accountant in General Accounting feels uncomfortable with this accounting treatment (above), believing that even considering preparing a journal entry to meet budget is "wrong and beyond aggressive accounting." He brought his concerns to the CFO, who explained the business rationale behind the entries, saying that these things were occurring to "bring the cost structure down." As the meeting ended, the CFO assured this accountant that everything would be okay. Nevertheless, the accountant wanted to resign but didn't have another job available. Despite his concern, he did nothing to communicate the issue to either internal or external auditors because he was concerned for his job security and had a family to support.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
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11. The Controller also did nothing to stop the questionable capitalization above, despite the fact that he, too, felt uncomfortable with the entries. To the contrary, he encouraged the questionable accounting treatment.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
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12. The CFO leaves voice mail for the CEO that says, "This MonRev [monthly revenue report] just keeps getting worse and worse. The copy, um, the latest copy that you and I have, already has accounting fluff in it…all one-time stuff or junk that's already in the numbers. With the numbers being, you know, off as far as they were, I didn't think that this stuff was already in there….We are going to dig ourselves into a huge hole because year to date it's disguising what is going on on the recurring, uh, service side of the business…." Nonetheless, they ultimately did make their numbers that quarter. The CEO gave no indication in the Securities & Exchange Commission (SEC) filings that the company was using nonrecurring revenue items.

a. Good business practice
b. Perfectly ethical, but raises a red flag
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13. The company has a long-term minimum purchase contract with a major customer. Under the terms of the contract, the customer agrees to refund $100 million if they fail to meet these required minimums on an annual basis, cumulatively measured at the end of five-year periods. By the end of the second year, forecasts show that this particular customer would again fall short of its annual purchase commitment. Thus, the company begins to accrue revenue on this contract ratably at $5 million per quarter.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
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e. Fraudulent accounting

14. Accounting records that should have documented the transactions under review were, in many cases, either nonexistent or in such disarray—for example, in a storage room that was disorganized and had piles of paper on the floor and spilling from boxes—that enormous effort was required to locate and identify them.

a. Good business practice
b. Perfectly ethical, but raises a red flag
c. Improper, but not fraudulent
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RECOMMENDED SOLUTIONS

All 14 scenarios are taken directly from WorldCom activities occurring during 2001. While the WorldCom scandal has many more facets to it than can be presented in a few short scenarios, these scenarios are indicative of both the work environment at WorldCom and the types of accounting fraud that occurred.

While 2001 is quickly becoming a distant memory, we must never forget the lessons learned. Fraud at WorldCom—along with Enron and others—brought our stock market prices down, tarnished the reputations of all accountants, felled a global accounting firm that was once known as the "gold standard" of accounting firms, revealed gaping flaws in U.S. Generally Accepted Accounting Principles (GAAP), and eventually brought about the rise in International Financial Reporting Standards (IFRS). In short, it changed our world.

The information in the scenarios and in some of the suggested solutions comes from published information listed in the References sidebar. Each answer below is keyed to the corresponding reference number so you can look up further information if you want.

ANSWER to 1: C. A certain amount of stock market pressure is to be expected, but the additional pressure from a CEO whose financial security is *precariously* dependent on keeping the stock price stable is very troubling. Clearly, ethical tension is both evident here and improper. Intense pressure can distort people's objectivity and erode their integrity. **Ref. 1, 4**

ANSWER to 2: C. Employees shouldn't be paid significantly more than they are worth in the marketplace for a variety of reasons. First, overpaying employees is an inefficient use of corporate funds. Second, and most important, this practice may make employees beholden to their superiors and distort their objectivity. This may create an environment where ethical problems could ferment as they did at WorldCom. **Ref. 5**

REFERENCES

1 Dennis R. Beresford, Nicholas Katzenback, and C.B. Rogers, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc., March 31, 2003 (available through FindLaw.com).

2 Max Bobbit, Minutes of the Regular Meeting of the Audit Committee of the Board of Directors of WorldCom, Inc., March 6, 2002 (available through FindLaw.com).

3 WorldCom Internal Audit Correspondence, June 24, 2002, 10:30 a.m. (available through FindLaw.com).

4 Dick Thornburgh, First Interim Report of Dick Thornburgh, bankruptcy court examiner, In Re: WorldCom, November 4, 2002 (available through FindLaw.com).

5 Dick Thornburgh, Second Interim Report of Dick Thornburgh, bankruptcy court examiner, In Re: WorldCom, June 9, 2003 (available through FindLaw.com).

To find these references on the FindLaw.com website, visit www.findlaw.com/legalnews/lit/worldcom/index.html or go to www.findlaw.com, click into the Legal Professional section, search for WorldCom, and click on the Legal Web Sites tab.

ANSWER to 3: D. This scenario goes well beyond an issue of confidentiality. Employees need full access to the information necessary to make competent decisions related to their positions. Denial of proper access appears to indicate that something is being hidden. **Ref. 1**

ANSWER to 4: B. While it is certainly good business practice to manage your most important ratio, reporting a steady ratio during extreme volatility may lack credibility. The suspicion is that the ratio may not fairly represent the operations of the business.

ANSWER to 5: C. The Audit Committee's proper role involves much more than merely listening to the final report for the year completed and the plan for the current year. The Bankruptcy Court finds that they "have not identified any effective participation by the Audit Committee in setting the internal audit plan. Under such circumstances, the ability of senior management to influence the focus of the Internal Audit Department away from sensitive areas may be left without the control check which the Audit Committee is expected to provide." (The quote comes from Ref. 4, pp. 55-56.) Without proper oversight, objectivity may become compromised. **Ref. 2**

ANSWER to 6: D. Such an extended delay of scheduled audits without the Board of Directors' explicit approval leads one to wonder why Internal Audit is being distracted from their proper role. The responsibility of the Internal Audit function is compromised. **Ref. 5**

ANSWER to 7: A. Estimates are involved with many adjusting entries.

ANSWER to 8: E. No journal entry should be prepared without proper support. Journal entries are never to be booked in order to meet the budget but must always be booked to reflect actual business activity only. In this scenario at WorldCom, the costs in question were line costs (the cost of essentially renting the use of telephone communication lines that customers use to connect conversing parties; the lines aren't owned by WorldCom). Supporting documentation ensures objectivity; fairness requires the financials to reflect actual operations and not just budgeted targets. **Ref. 1**

ANSWER to 9: E. Periodic rent provides current period benefits but no future economic benefits owned or controlled by the company despite the fact that its payment may be fixed for an extended future period of time. Honesty is at issue here given the assumption that lack of competency isn't the cause. Again, the WorldCom counterpart to this scenario deals with line costs. **Ref. 1**

ANSWER to 10: E. Unfortunately, not everything at WorldCom turned out okay. Accountant Troy Normand faced this particular situation while failing all four principles of ethical conduct. He had good reason to be uncomfortable with this fraud. Speaking to the CFO about his concerns was indeed appropriate, but nothing else he did was proper. As a consequence of his actions and inactions at WorldCom, Troy Normand pleaded guilty to conspiracy and securities fraud. He wasn't alone. The CFO, Scott Sullivan, pleaded guilty to three counts of securities fraud and is spending five years in jail. **Ref. 3, 5**

ANSWER to 11: E. So now we know that the fraud at WorldCom occurred, was then allowed to continue unreported, and was actually encouraged. This controller, David Myers, spent one year and one day in jail after pleading guilty to securities fraud, conspiracy to commit securities fraud, and false filings. His competence was never questioned. He clearly knew right from wrong, yet he still chose the fraudulent path. **Ref. 1**

ANSWER to 12: E. The CEO always has an obligation to present fairly, in all material respects, the true financial condition of the corporation and never to mislead the public by disguising actual performance. Bernie Ebbers, then CEO of WorldCom, was convicted of fraud for knowingly misleading the public in its SEC filings and was sentenced to 25 years in jail. **Ref. 1**

ANSWER to 13: E. It is clearly fraudulent to book a gain contingency. **Ref. 1**

ANSWER to 14: D. While simple filing errors occur even in well-run organizations, a filing room in complete disarray indicates a serious problem with record keeping. When this situation continues, the accounting records become virtually unauditable, and the integrity of the accounting system is in question. **Ref. 1**

INTEGRITY IS KEY

So how did you do? While investors may seem to be less concerned about accounting scandals today than they were leading up to the passage of the Sarbanes-Oxley Act, accountants must never forget the critical importance of having high ethical standards and following proper internal control procedures to combat the temptation of fraud. The very efficiency of our capital markets, and thus the wealth of our nation, rests on the integrity of corporate financial statements. ■

Kay Zekany, CMA, Ph.D., is an associate professor of accounting at The James F. Dicke College of Business Administration at Ohio Northern University in Ada, Ohio. You can reach her at (419) 772-2074 or k-zekany@onu.edu.