Chapter One

The Nature of Accounting and the Chief Ethical Difficulty: True Disclosure

In October 2001 Enron began to collapse as a company. On October 16, 2001, Enron took a $1.01 billion charge related to write-downs of investments. Of this, $35 million was attributed to partnerships run by CFO Andrew Fastow. According to *The Wall Street Journal,* Enron disclosed that it shrank shareholder equity by $1.2 billion as a result of several transactions, including ones undertaken with Mr. Fastow's investment vehicle. Arthur Andersen was Enron's auditing firm. On June 15, 2002, Andersen was convicted of obstruction of justice for shredding documents related to its audit of Enron, resulting in the Enron scandal. The United States Securities and Exchange Commission (SEC) does not allow convicted felons to audit public companies. The accounting firm agreed to surrender its CPA licenses and its right to practice before the SEC on August 31, 2002, putting Arthur Andersen out of business in the United States. These two companies will be tied together in financial history as an illustration of scandalous ethical behavior.

Since then there have been numerous accounting scandals. In 2002 WorldCom inflated sales by as much as $11 billion and Tyco's CEO and CFO inflated company income by $500 million. In 2003 Health South inflated earnings numbers by $1.4 billion. In 2003 $5billion in earnings were misstated at Freddie Mac. In 2005 AIG engaged in accounting fraud of $3.9 billion. In 2008 at Lehman Brothers, the accountants disguised $50 billion in loans disguised as sales. In 2009 Satyam falsely boosted revenue by $1.5 billion. And those are just a few.[1]

The Enron/Arthur Andersen collapse in 2001 – 2002 was probably a watershed moment in the history of accounting. The problems, practices, conflicts, and issues that led to the collapse were not new and as we have seen still have not been overcome. Even before Enron, there were problems and shoddy practices. In an article from *The Washington Post* in 1998, then SEC chairman Arthur Levitt,

Accounting Ethics, Third Edition. Ronald F. Duska, Brenda Shay Duska, and Kenneth Wm. Kury.

Jr., called attention to what he dubbed a "numbers game" in which companies manipulate accounting data to produce desired results. These results range from "making one's numbers" – meeting Wall Street projections – to smoothing out quarterly results to produce a steady run of increases. According to Levitt, "This process has evolved over the years into what can best be characterized as a game among market participants."

How could this happen? We would claim that either the accountants did not understand their purpose in society, or that they deliberately avoided fulfilling that purpose. The purpose of accounting is fairly simple – to make sure that the portrait the company's accountants paint in the financial statements is as accurate as possible. According to Albert B. Crenshaw in an October 1999 article in *The Washington Post*, companies try to "game the numbers" in order to meet the pressures of quarterly earnings projections.[2] It is our contention throughout this book that the fundamental ethical obligation of the accountant is to do his or her job. But what is the primary job of the accountant? To get clearer about what that job is, we need to look more closely at the nature and purpose of accounting. It should be noted that accounting is, in a sense, what ancient Greeks called an ethos, by which we mean a custom or convention. Accounting was a human convention developed to do certain things. To understand of what those activities consist, we need to examine more thoroughly the nature of accounting.

The Nature of Accounting

Accounting is a technique, and its practice is an art or craft developed to help people monitor their economic transactions. Accounting gives people a financial picture of their affairs. Its original – and enduring – fundamental purpose is to provide information about the economic dealings of a person or organization. Initially, only the person or organization needed the information. Then the government needed the information. As the economy got more complex and regulated, the number of those who needed the information – the number of users of economic statements – increased. The extent of the importance of the information to the user increased the ethical factors governing the development and disbursement of that information. Some people have a right to the information; others do not.

The accountant provides information that can be used in a number of ways. An organization's managers use it to help them plan and control the organization's operations. Owners and managers use it to help them appraise an organization's performance and make decisions about its future. Owners, managers, lenders, suppliers, employees, and others use it to help decide how much time and/or money to devote to the organization. Finally, government uses it to determine how much tax the organization must pay.[3] Hence, the accountant's role is to furnish various entities that have a legitimate right to know about an organization's affairs with useful information about those economic affairs. That useful information is owed to those various entities, and the accountant has an obligation to provide as true a picture of those affairs as possible.

Accountants issue financial statements that a range of constituencies – from company management, to tax agencies, to potential investors – need to access. Those statements, which are expected to give a reliable and useful picture of the organization's financial affairs, are made within the guidelines developed by the profession itself. The accounting practice rests on what the Financial Accounting Standards Board of the Financial Accounting Foundation calls a conceptual framework:

> The conceptual framework is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting. It is expected *to serve the public interest* by providing structure and direction to financial accounting and reporting to facilitate the provision of evenhanded financial and related information that helps promote the efficient allocation of scarce resources in the economy and society, including assisting capital and other markets to function efficiently. (Italics added.)[4]

For financial markets to work well, stock analysts and investors need to get a "true picture" of a company. The very notion of a "true" picture, however, presents some problems, for there are any number of ways to look at the economic status of an organization, and in reality several pictures of a company can be developed. Often, the picture an accountant develops may serve the interest of the party who hires the accountant more than other need-to-know parties. Depending on the techniques used, a corporate accountant can make an organization look better or worse. For loan purposes, it can be made to look better. For tax purposes it can be made to look worse. We will return to the issue of the true picture later. For now we ask: What kinds of pictures are there? What kinds of financial statements do accountants produce?

There generally are four components of financial statements:

- balance sheet;
- income statement;
- statement of changes in retained earnings;
- statement of changes in cash flow

The balance sheet has three elements: (i) assets – the tangible and intangible items owned by the company, (ii) liabilities – the organization's debts, involving money or services owed to others, and (iii) owners' equity – funds provided by the organization's owners and the accumulated income or loss generated over years. The total assets, of course, equal the total liabilities plus the owners' equity. Owners' equity equals the total assets minus the total liability. Liabilities equals the total assets minus owners' equity. These alternative views of the equation indicates how assets were financed: by borrowing money (liability) or by using the owners' money (owners' equity).

Developing such statements is where the art and craft of accounting comes in, for it requires skill, judgment, use of the appropriate technique, and the application of principles to determine what counts as assets and liabilities. Sometimes, the assets and liabilities are clear; at other times, they depend on the accountant's judgment which, for better or worse, can be influenced by the pressures of the situation. As with all general principles, however, there are simply times when the principles used don't fit the situation and individual judgment is required.

For example, T. Rowe Price's manager, Richard P. Howard, says that many accountants' way of looking at companies is out of sync with modern markets, which focus on a company's earnings rather than its asset value:

> One of the problems that accountants have is that they're still working on the theory that the balance sheet [the statement of assets and liabilities] is sacrosanct. So they err on the side of writing down assets. They think that they're being conservative, but that's wrong.[5]

Howard points out that writing down assets – reducing their value on the company's books – actually results in aggressive statements of profit:

> For example, if you write down the value of a plant, you take a one-time hit, but in future years the depreciation that would be assigned to the plant, and that would be subtracted from earnings, is reduced or gone, so earnings are higher. And as equity is reduced, the same amount of income produces higher return on equity.[6]

Assets and liabilities can be classified as either current or noncurrent. Noncurrent assets and liabilities are noncurrent receivables and fixed assets such as land, buildings, and long-term investments. Current assets include cash, amounts receivable, inventories, and other assets expected to be consumed or readily converted into cash in the next operating cycle. Hence, the owners' equity is divided between common or preferred stock, paid-in capital, and retained earnings, where common stock is the set dollar per share, paid-in capital is the premium paid for the stock (shares), and retained earnings is the amount earned/lost in the past and dividends distributed to owners. But what is "expected" to be consumed or converted into cash? Such items can be manipulated or at the least reported in any number of ways to determine what the owners' equity is.

The income statement shows net income (profit) when revenues exceed expenses and net loss when expenses exceed revenues. The statement of changes in retained earnings explains the changes in those earnings over a reporting period: assets minus liabilities equal paid-in capital and retained earnings. The statement of changes in financial position identifies existing relations and reveals operations that do or do not generate enough funds to cover an organization's dividends and capital investment requirement.

Because, as we noted, preparation of these statements allows great leeway in what to take account of and what not, as well as where to put things in presenting the statements, opportunities abound to paint different pictures of an organization's financial affairs. It takes little imagination to envision a manager who, for fear of his job and wanting to impress his board, puts pressure on the managerial accountant to "cook the books" so that retained earnings look much more substantial than they are. But cooking the books and "creative accounting," as the terms suggest, clearly have an unethical element and are activities that must be examined under the ethics of truth telling and disclosure. More recently, "aggressive accounting" and "pro-forma accounting" are euphemisms, at least in some cases, for presenting pictures of a company's financial situation that, while not deceptive, are less than candid.

Ethics of Disclosure

The ethics of truth telling and disclosure is a complicated issue for the accountant. *Why and to what extent is the accountant ethically obliged to disclose a true picture? Is there such a thing as a true picture?* To discern the principles that will help to answer the first question, we will reflect for a moment on three things: first, how accounting is involved in an exchange that encompasses selling; second, how exchange and selling are market transactions; and third, what lack of disclosure in market transactions has in common with lying.

Accounting is developing information that is going to be used. If the use of the information is benign and the information is truthful, no ethical problems arise. But if the information persuades people to act in one way or other, and their action either benefits or harms the persons giving or getting the information, this information giving takes on ethical importance. Depending on the use, giving out information can be very much like selling. For example, the CEO is "selling" the board or the stockholders on the soundness of the company's financial situation. His bonus might be tied to how rosy a picture he paints. The worth of the CEO's stock options rests on the financial picture. He may sell the IRS a different picture of the company, and sell still a different picture to potential investors or lenders. Because accounting entails presenting the product to be sold, it enters into and influences market transactions.

In the ideal market transaction, two people decide to exchange goods because they hope the exchange will make both better off. In a market exchange, nothing new has been produced, but the exchange is beneficial to both people. Ideally, there is perfect information about the worth of what is being given and received in return. Such a trade, freely entered into with full information, should maximize satisfaction on both sides. That is the genius of the market and the defense of our free market system – freedom of exchange that leads to the overall improvement of the trader's lot.

If, however, one of the parties is misled into believing a product is what it is not because the product is misrepresented, that misrepresentation undermines the effect of both sides being better off. Deception usually leads to the deceived party's getting something different and less valuable from what he or she expected. The deceived party most likely would not have *freely* entered into the exchange had that party known the full truth about it. The bank would not have made the loan, the public offering of stock would not have been so successful, the CEO's bonus would not have been so large, if the true picture of the company had been available.

Thus, the conditions for an ideal market transaction include the freedom or autonomy of the participants and full knowledge of the pertinent details of the product. Both conditions are required for what is often called *informed consent.* Consent cannot be presumed if a party is either forced into an exchange or lacks adequate knowledge of the bargained-for product. It might even be said that a choice based on inadequate information is not a choice at all.

It is important to note that lying is not synonymous with saying something false. Sometimes people simply make a mistake or inadvertently misspeak. In that case, they say something false, but their action can hardly be construed as lying. Telling a lie involves more than simply getting things wrong and not telling the truth. The essence of lying is found in its purpose, which is to alter another's behavior. Lying involves deliberately misrepresenting something to another person to get that person to act in a certain way, a way the liar suspects the person would not act if that person knew the truth. We can characterize lying, therefore, as an attempt by one person – usually through spoken or written words that are untrue (lying can also be accomplished with gestures or looks) – to get another person to act in a way that person would probably not act if he or she knew the truth. Misrepresentation or lying can thus be defined as a deceptive activity meant to evoke a certain response that would not have occurred if the truth were told. Simply put, we lie and deceive others to get our way. If Enron officials misrepresented the company's financial health to their employees to persuade them to hold on to their stock in order to keep the value up so the officials could cash their own stock options at an inflated price, the officials did so, realizing that if the employees had known, they probably would have sold their shares, thereby deflating the value of the stock even more.

If we apply the notion of lying to an activity in which we paint a false picture of an organization's affairs to change a prospective investor's view of the company's financial health, we misrepresent the state of the organization to get the investor to do what we think he wouldn't do if the investor had a true picture. Viewed from this perspective, a deceptive sale is an activity whose goal is to induce the buyer to do what the seller thinks the buyer probably won't do if the buyer knows the truth. From an economic point of view, such behavior violates the ideal market principle of free exchange based on perfect information. But more important, from a moral point of view, in getting the buyer to do other than the buyer would, the seller takes away the buyer's *real* choice in the situation and thereby uses the buyer for the deceiver's own ends thereby harming the buyer. Such use, as we will see in the next chapter, is unjust and immoral and often called exploitation or manipulation.

We recognize that we shouldn't lie because people will not trust us if we do. That is true, but it is a somewhat self-centered reason for not lying. From a moral perspective, the primary reason for you not to lie is that it subordinates another to your wishes without the other person's consent, for your benefit without concern for the other person. It violates the rule, a version of the Golden Rule, which says, "Don't do to others what you wouldn't have done to you." You want to know what you are getting when you buy something. So does everyone else.

Does failure to disclose information fit these considerations? Some would say that not disclosing isn't lying; it's just not telling. But that misses the point. Any action of deliberately withholding information, or coloring information to get others to act contrary to the way they would if they had true information, has the same deceptive structure and consequence as an overt lie. It doesn't allow an informed choice.

But how much must the accountant disclose? Must the accountant disclose everything?

It is an accepted principle of effective salesmanship (not to be confused with ethical salesmanship) not to say anything negative about the product the salesperson is selling and certainly not to disclose shortcomings unnecessarily. A manager selling the worth of his company to a bank where he hopes to obtain a loan is in much the same situation. How many of the company's "warts" must the manager expose to the bank? What is the accountant's obligation in this situation? There are pictures, and there are pictures. Is the obligation in business more stringent that the obligation in private affairs?

As an example, if you are selling your home, is it necessary to point out all the little defects that only you know? There are, after all, laws that require disclosure of some things. Are you ethically obliged to go beyond the law? If you do, you might succeed in discouraging every prospect from buying your home. Job applicants, as another example, need to sell themselves. Should they point out their flaws to their potential employers? No job counselor is likely to suggest that.

The questions arise, therefore, about how much a party needs to disclose and to what extent failure to disclose can be construed as market misconduct. Certainly, some failure to disclose is wrong, but how much must be disclosed? The above characterization of lying should help us decide. Whenever you are tempted not to disclose something, ask yourself why. If you are withholding information because you fear the person won't act as you wish that person would if he or she knew the whole story, you are manipulating.

Some might argue that if a person doesn't benefit from a nondisclosure, as in some social occasions, it is not lying. For example, when your friends ask how you are, you don't have to disclose that you feel miserable. They probably don't want to hear it. Or when your coworker asks you if she looks okay, you don't have to say, "You look terrible, like you just crawled out of bed." That kind of social nondisclosure is acceptable because you are not trying to change another's behavior to benefit personally from it. Hence, if you shade the truth for some reason other than manipulating the behavior of the person to whom you are talking, it may not be wrong. This is what we call a "white lie."

Nevertheless, a caveat is in order. Paternalism – the desire to help, advise, or protect that may neglect individual choice and personal responsibility – may be involved in such social situations. There also may be many assumptions, perhaps false, about what the other person wants or needs. It is not clear that social nondisclosure is a totally harmless activity.

But to return to our main point: it may be difficult in some situations to decide how much to disclose. The accountant must at least meet the disclosure requirements of governing authorities. What sort of disclosure and auditing requirements do accountants produce? The disclosures occur in the financial statement. Let's turn our attention to that aspect of accounting.

The Financial Statement

The Securities and Exchange Commission (SEC) oversees financial statements of corporations. The financial statements are prepared by the company's own accountants. Outside accountants audit the financial statements. (In the United States, certified public accountants execute the audits. In the United Kingdom and its affiliates, chartered accountants perform the audit function.) Accountants certify that the companies' financial statements are *complete* in all material aspects and the figures have been calculated through the *use of acceptable measurement principles.*

The most common measurement principles are generally accepted accounting principles (GAAP). Those principles are supervised by the Financial Accounting Standards Board (FASB), not the SEC, which does have the statutory authority to set financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, SEC's policy has been to rely on the private sector to set standards. In the United States, much of this is now under review, given some of the shortcomings of the regulatory system that surfaced during the Enron/Andersen investigations, and self-regulation has been superseded by the Public Company Accounting Oversight Board (PCAOB).

But even with adherence to GAAP, problems of disclosure arise. Take, for example, the problem of determining and disclosing asset value. Asset measurement presents a problem because it can be based on what assets cost or on what assets could be sold for now. It can be manipulated in other ways, too. For example, according to a 1994 report by Howard M. Schilit in *Business Week*, Heilig-Meyers Company's books showed that the company included installment sales in revenues before sales were final. Now such a practice is perfectly legal and in accordance with GAAP, but according to Schilit, such accounting policies "may distort the true financial condition" of the company.[7]

So what is asset value? Asset value is the value to the owners or what the company would be willing to pay the owners, which can be determined by what the company expects to be able to do with the asset. Asset value depends on three factors: the amount of anticipated future cash flows, the timing, and the interest rate.

Asset value can also be determined by the amount the company could obtain by selling its assets. This determination, however, is rarely used because continued ownership of an asset implies that its present value to the owner is greater than its market value, which is its apparent value to outsiders. (Such a formulation enters into values beyond monetary, even including possible ethical values.)

In addition to asset value, there is asset cost. Most assets are measured at cost because it is difficult to verify forecasts upon which a generalized value system would have to be based. The historical cost of an asset equals the sum of all the expenditures the company made to acquire it. This, obviously, is sometimes difficult to determine.

Consequently, with so much latitude in establishing the value of an organization's assets, the financial and economic picture can be skewed in any number of ways. Thus, it is important from an ethical standpoint to determine (i) who the financial picture is being created for and for what purposes, (ii) who has the right to the picture and for what purposes, and (iii) what is to be done when different pictures benefit different parties at the expense of other parties entitled to those pictures.

For example, should the financial picture developed for the IRS show less in assets and earnings than the picture developed for a prospective financier? Should those two pictures be different from the one developed for the board or the stockholders? Further, should the 10 K form reflect merely the quantitative picture of the company, or should it point out the red flags and trends that will affect an organization's operations in the next business cycle?

Finally, to complete our discussion of the financial statement, we need to highlight some of the chief concepts and techniques that accountants utilize:

- *Net income.* Net income indicates the change in a company's wealth, during a period of time, from all sources other than the injection or withdrawal of investment funds.
- *Transactions approach.* This approach recognizes as income only those increases in wealth (that can be substantiated) from data pertaining to actual transactions that have taken place with persons outside the company. The approach does not recognize, for example, the wealth that a service company gains by hiring a dynamic new employee who will produce salable commodities.[8]
- *Recognition of income.* This involves revenue estimates and expense estimates. The accountant needs to estimate the percentage of gross sales, recognizing that for some goods payment will never be received. Expense estimates are based on historical cost of resources consumed. Thus, net income equals the difference between value received from the use of resources and the cost of the resources consumed in the process.
- *Historical cost less depreciation.* To determine the value of assets, it is necessary to depreciate some items. There are several depreciation formulas, including but not limited to the modified accelerated cost recovery system, accelerated cost recovery system, straight-line method, double declining balance method, and sum of the year's digits method. Which of these an accountant uses will certainly affect the picture of the company's financial affairs.
- *Cost of goods sold formulas.* To determine the cost of goods sold, the accountant one can use one of several measurement methods:
    - *FIFO (first in, first out).* In FIFO, the cost of goods sold is equal to the total cost of various batches of goods available, starting with the oldest batch when beginning the inventory.
    - *LIFO (last in, first out).* The opposite of FIFO, LIFO means that the most recently purchased items are recorded as sold first.
    - *Average cost.* In this method, it is assumed that the cost of inventory is based on the average cost of the goods available for sale during the reporting period. Average cost is determined by dividing the total cost of goods available for sale by the total units available for sale.

Once again, when we look at the multiple procedures that are acceptable to portray an organization's financial affairs, it is clear that there are ample opportunities to present a picture that meets acceptable methods of accounting but, with clever manipulation, distorts the picture of the company.

Roles an Accountant can Fulfill

Although the accountant's primary purpose is to present a picture of an organization's financial affairs, accountants play many other roles. We have mentioned some in the introduction, but we will enumerate those and others now, while discussing more fully the previously mentioned roles in later chapters (Auditing in Chapter 7, Managerial Accounting in Chapter 8, and Tax in Chapter 9):

- *Auditing.* One of the most important roles is the role of the independent accountant (auditor). The auditor's function is to determine that the organization's estimates are based on formulas that seem reasonable in the light of whatever evidence is available and to see that those formulas are applied consistently from year to year – thus, to ensure reasonable application and consistent application. The role of the auditor is not to determine whether the formulas are justifiable. That, at least in the United States, is FASB's job.
- *Managerial accounting.* A second role for accountants is managerial accounting. Businesses need controllers and internal auditors. For example, they need in-house accountants whose role is to give the most accurate picture of the organization's economic state so that the company can flourish. The accountant's main responsibility is to the company, but if the company's board, managers, and shareholders are at cross-purposes, the accountant is conflicted. These conflicts form the grounds for many ethical problems.
- *Tax accounting.* A third role for accountants is the determination of tax liabilities for clients, either individual or corporate.
- *Financial planning.* More and more accountants are engaging in a fourth kind of activity, which springs from their knowledge of tax law and financial investment markets, financial planning. Some might argue this is not a role of an accountant as such, but rather a role the accountant may be well qualified to assume, given his or her areas of expertise.
- *Consulting.* Finally, there is the area of consulting. Because an accountant is exceedingly familiar with the financials of companies, the accountant can become a valuable company consultant in money management, income distribution, and accounting and auditing functions. Here, too, some might argue that this is not the accountant's role per se, but rather one he or she can assume based on the accountant's expertise.

In Chapters 7, 8, and 9 we will examine the first three of these roles – auditing, managerial accounting, and tax accounting – along with the consequent ethical responsibilities that they create. We will also look at the role of consulting and the difficulties it brings with respect to conflict of interest and independence, particularly for accountants or firms that are fulfilling both an auditing and consulting role for a client.

The performance of all of these different functions has moved the accounting profession from the more traditional profession of auditor to the more entrepreneurial professions of consultant and planner. Many claim that the move has generated a crisis for accountants and contend that the dual roles have been circumscribed by the passage of the Sarbanes–Oxley Act.

Because of the events of the past several years, accounting is no longer viewed as a staid, reliable profession. It is now viewed as a profession in crisis, whose credibility is coming into question. The face of accounting is changing, if not in accounting itself, which maintains the same functions – auditing, attesting, preparing taxes, and running the financials of a company – then at least in the makeup and orientation of accounting companies.

Long before the Enron/Andersen debacle, Rick Telberg made this pessimistic observation in *Accounting Today*:

> In fact we are probably past the time when independence mattered. CPA [certified public accounting] firms long ago became more like insurance companies – complete with their focus on assurances and risk-managed audits – than attestors. Auditors are backed by malpractice insurance in the same way that an insurance company is backed by a re-insurer, so they have become less like judges of financial statements than underwriters weighing probabilities.

Some in the profession have even argued that auditors should function less like ultimate arbiters of fact and financial reality, and be allowed, instead, to function more like investment bankers, and provide only “due diligence.” So that CPAs, who once valued fairness and truthfulness in financial reporting, would then promise little more than nods and winks, all beyond the reach of meaningful oversight.[9]

The danger in Telberg’s scenario is that if every auditor or attestor acted in that way, audits and attestations would be worthless. There would still be a use for accountants as tax preparers and financial reporters, but the audit function – the heart of the accounting profession – would be excised from the practice, rendered virtually useless by its misuse.

If we take the stand that the function of the accountant is to do what is required for a company to flourish monetarily, that would not be ethics. Society needs audited reports. It needs truthful reports. If the delivery of these reports is not profitable, then accounting firms committed to maximizing their own profit will eschew the audit function. That will leave an enormous accounting job still to be done. Someone will step into the gap and perform the service. That person will then be subject to the same ethical requirements as the professional auditor of today. The names may change, but the function will remain.

In an ideal world, the conventions developed in an ethos work for the common good. So in an ideal world accountants would do what they should do and fulfill their responsibilities. But that raises two questions. They might lack knowledge of what the best way to do things is, and they might be tempted to do things that are self-serving that violate these practices. To answer these problems societies develop standards that outline best practices and regulate behavior. When the ethos or ethics breaks down, we need legal constraints, hence the development of regulatory bodies and standards. At this point it will be helpful to engage in a brief survey of the development of explicit accounting standards.

Development of Explicit Accounting Standards and Regulations

While much of the general public has become familiar with the breakdown of the accounting ethos because of the Enron/Arthur Andersen debacle, and with the consequent attempt to answer these breakdowns with the Sarbanes–Oxley Act, there were previous attempts to regulate and guide the accounting profession. Before reviewing some of the provisions of Sarbanes–Oxley, let's look at a brief history of some (space prohibits reviewing all) attempts to regulate accounting standards that were deemed necessary to produce ethical behavior.

Beginning in the 1920s, accounting standards were driven by a period of industrial growth with a corresponding surge in stock prices. "Accounting standards were developed privately, often poorly designed and unregulated. As a result, they were subject to manipulation with accurate financial reporting easily compromised to drive stock prices, meet loan covenants, or attract new investors."[10]

The *Securities Acts of 1933 and 1934* were Congress's response to the Depression, which to some extent resulted from manipulation and fraud in the securities markets. Part of the acts' purpose was to promote ethical behavior through legislation and regulation. Congress established the Securities and Exchange Commission (SEC), regulated securities trading, mandated common accounting standards, and required CPA firm audits of publicly traded companies. "The Acts signified a landmark change in corporate accountability and provide the foundation for growth of the CPA Profession as external auditors."[11]

The *Federal Trade Commission* (FTC) in 1933 adopted the following rule to provide guidance on what it means to be an independent auditor. The FTC mandated both independence in fact and independence in appearance:

> The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such an accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or to whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director or person performing a similar function.[12]

During this time period, an auditor could not be found liable to third parties (other clients who may use the client's financial information) who did not enter into a contract directly with the auditor.[13] Unless an auditor actively committed fraud, he or she would not be found liable to third parties who relied on a negligently prepared report. This decision held until 1968.

In 1947, the *Institute of American Accountants* (IAA), the industry trade group at the time, adopted a statement on independence, insisting that "independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."[14]

Around 1950, several major accounting firms expanded their service lines to offer new "management advisory services" or "administrative services," a move that raised some ethical concerns. In 1957, "Ethical Considerations in Rendering Management Services" was published in the *Journal of Accountancy,* exploring the issues arising from offering management services to audit clients.

Also in 1957, the SEC issued its annual report and voiced concern about the breadth of services that auditors were providing. In 1958, the SEC's chief accountant, Andrew Barr, maintained that an auditor performing managerial services for a client risked the possibility of the auditor losing his objectivity.[15]

During the 1950s and 1960s, most accountants who reached the level of partner were assured of their tenure until they retired. If they stood up to clients regarding questionable practices, they expected their firms to back them. At that time, the Big Eight accounting firms were not afraid to speak and write about major accounting principles. There was no marketing to new clients, because advertising was frowned upon, as were other forms of self-promotion. Partners were rewarded on the quality of the audit services that they provided.[16]

The *American Institute of Certified Public Accountants* (AICPA) in 1963 published Opinion #12 on Independence that stipulated, " … normal professional or social relationships would not suggest a conflict of interest in the mind of a reasonable observer." This opinion, with some caveats, allowed the combining of auditing and management consulting.[17] The AICPA also determined, at that time, that the fees from management services would not have an impact on the audit because most management fees were not recurring.[18] The popular belief was that doing both consulting and auditing would be beneficial to the companies.[19]

The result (to place too much emphasis on the appearance of independence, rather than independence in fact) might be to deprive clients of valuable creative contributions to improved management which their auditor, through their familiarity with the client's business, acquired in the course of an audit, are in a better position than anyone else to make.

To split the accounting profession into two segments – one a group of ivory tower auditors who did nothing but attest to the fairness of financial statements, and the other a group of experts in management and tax problems – would not only reverse the actual trend of accounting practice which has evolved over a century of experience, it would also add substantially to the cost of providing business with all the professional accounting service it needs.

To contend that a CPA acting as an auditor should have no relations with his client except those involved in his work as an auditor, for fear that the public might suspect a conflict of interest, would lead to an absurd situation.[20]

Whether combining consulting and auditing services is right or wrong, affects independence, or creates a conflict of interest is open to debate. But several consequences followed this practice of combining services. In the 1960s the real estate scandals began. The 1970s and 1980s evidenced international fraud and bribery, which led to the prohibition of non-accounting related services, along with disclosure requirements for the amount and nature of non-audit services.

In 1974, the AICPA established the Cohen Commission to investigate if "a gap may exist between what the public expects and needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved."[21]

The Cohen Commission found fault with the accounting profession for failing to keep pace with the business environment and for not dedicating enough time or money to the field of auditing. Although the commission did not determine that consulting compromised the auditor's ability to remain independent, it did:

> … recommend that the auditor fully inform the board of directors (or its audit committee) of all services and their relationship to the audit services provided, and that the board of directors (or its audit committee) duly consider all services provided by the auditor.[22]

The *US Senate's Subcommittee on Reports, Accounting, and Management* launched the Metcalf Committee in 1977 to investigate the accounting profession. It recommended that the profession improve its procedures for assuring independence in view of the public's needs and expectations. It also recommended as best policy to require that independent auditors of publicly owned companies perform only services directly related to accounting. It suggested that only certain management advisory services are appropriate to public audit clients, such as certain computer and systems analysis necessary to improve internal control procedures. The committee cautioned that other services should *not* be provided to audit clients, such as executive recruitment, marketing analysis, plant layout, product analysis, and actuarial services.

In 1977, the AICPA created a division for CPA forms, composed of a SEC Practice Section (SECPS) and a Private Companies Practice Section. The SECPS adopted criteria for the scope of services and prohibited an auditor from providing the following services to a public audit client: psychological testing, public opinion polls, mergers and acquisitions, assistance for a finder's fee, executive recruitment, and actuarial services to insurance companies. Members were required to report to the audit committee of each SEC client the amounts and nature of management advisory services performed on an annual basis. To oversee the activities of the SECPS, the AICPA established the *Public Oversight Board* (POB). The POB was charged with establishing and enforcing quality-control standards for public accounting firms and instituting a peer review process.

The SEC, in 1978, required companies to disclose any non-audit services when the fees paid to the auditor were at least 3 percent of the audit fees paid. In the same year, the AICPA rescinded its ban on advertising and other forms of client solicitation. In 1979, the POB recommended that no rules should be imposed to prohibit certain services. It would be better, the POB said, to rely on the public disclosures of non-audit services required by the SEC. In 1982, the SEC concluded that the required disclosure of fees for non-audit service was not useful to investors in making decisions, and the 1978 disclosure requirement was repealed.

The 1980s were a time of intense competition among accounting firms, a major change from previous decades. The competitive situation was exacerbated by the trend of mergers, which limited the number of clients available. Some clients asked for bids, and others said that they would "shop around." The accounting firms responded to the new economic pressures in that competitive environment by merging with each other and expanding into highly lucrative non-audit services. From 1983 through 1985, revenues from audits at the Big Eight grew by only 14 percent, while revenues for management consulting grew 33 percent and for tax practice, 28 percent.

The *National Commission on Fraudulent Financial Reporting* (the Treadway Commission) was formed in 1985 by the AICPA, the American Accounting

Association (AAA), Financial Executives International (FEI), the Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA). In 1986, the *AICPA Special Committee on Standards of Professional Conduct for Certified Public Accountants* found that "the competitive environment has placed pressures on the traditional commitment to professionals in the practice of public accounting." An increasingly competitive environment changed the job security of partners.[23]

The National Commission on Fraudulent Financial Reporting issued a study in 1987 that included 49 recommendations directed at the SEC, public companies, independent public accountants, and the education community. These recommendations were designed to promote reliable financial reporting and to help public companies, both large and small, tighten internal controls. This study was repeated in 2007 and presented descriptive information rather than prescriptive recommendations.[24]

In response to the Treadway Commission, the *Auditing Standards Board* issued 10 new auditing standards in 1988. These Statements on Auditing Standards (SASs) include requirements affecting the auditor's responsibility to detect and report errors and irregularities, the consideration of internal control structure in a financial statement audit, and communication with a company's audit committee.

In that same year, three major accounting firms petitioned the SEC to modify the independence rules and allow expanded business relationships with their audit clients. By 1989, all of the Big Eight had applied for a modification of the independence rules.

The *POB's Advisory Panel on Auditor Independence* (Kirk Panel) in 1994 issued a report. "Growing reliance on non-audit services," the report stated, "has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function."[25] The stage for the collapse of Enron and Andersen was being set.

The *Sarbanes–Oxley Act* in 2002 established the Public Company Accounting Oversight Board and the Financial Accounting Standards Board.

The Sarbanes–Oxley Act (SOX)

The Sarbanes–Oxley Act (SOX) was designed primarily to regulate corporate conduct in an attempt to promote ethical behavior and prevent fraudulent financial reporting. The legislation applies to a company's board of directors, audit committee, CEO, CFO, and all other management personnel who have influence over the accuracy and adequacy of external financial reports. SOX has changed the basic structure of the US public accounting profession.

The first Section of the act creates the Public Company Accounting Oversight Board (PCAOB), imposing external independent regulation on the profession and ending self-regulation under the AICPA. The PCAOB now sets the auditing standards and conducts inspections of CPA firms. It is also responsible for disciplinary actions against CPAs and for setting the ethical tone for the profession.

Section 301 of SOX addresses the responsibilities of the board of directors' audit committee. These responsibilities increased significantly from basically having an audit committee to designating specific responsibilities of the audit committee. Under SOX, audit committees are directly responsible for appointment and compensation of the external auditor and must approve all non-audit services provided by the external auditor. The audit committee members must be independent, which means that they may not receive fees from the company other than for board service and may not be affiliated in other ways.

Section 302 affects senior management. Both the CEO and the CFO must personally sign and certify that the company's financial report does not contain any known untrue material statements or omit a material fact. They must admit that they are responsible for establishing and maintaining internal controls. CEOs and CFOs are subject to a $5 million fine or a 20-year prison term, without an option for parole, for violation of the certification regulation, which falls under federal court jurisdiction.

Sections 303, 304, and 306 promote ethical conduct by the board of directors, corporate executives, and key employees. It is unlawful for an officer or director to take any action to influence or mislead the external auditor. CEOs and CFOs must forfeit bonuses and profits when earnings are restated due to fraud. Executives are prohibited from selling stock during blackout periods and are prevented from receiving company loans unavailable to outsiders.

Sarbanes–Oxley takes a much stronger position on incarceration than previous attempts to legislate morality in business. It contains maximum prison terms for securities fraud, mail and wire fraud, and for destroying, altering, or fabricating records in federal investigations. Furthermore, it requires the preservation of key financial audit documents and email for five years with a penalty for destroying any such documentation. All of these charges fall under federal jurisdiction.

SOX Section 406 requires public corporations to have a code of ethics for senior executives or to state in their annual report that they do not have such a code and the reasons why they do not. The SEC provides the following guidance for the code: It should promote honest and ethical conduct, full and fair disclosure, compliance with the laws, internal reporting for violations, and accountability for adherence to the code.

Section 201 is a direct response to the conflict of interest arising from the consulting and external audit services provided to Enron by Andersen. It prohibits most of the other professional services that auditors historically performed for their audit clients, and the board of directors' approval is required for any additional service the external auditor provides that is not specifically prohibited by SOX.

In addition, PCAOB now has the authority to determine any other impermissible services. Section 203 mandates partner rotation; the lead auditor must rotate off an audit every five years with a five-year time-out. Other audit partners must rotate after seven years with a two-year time-out.

Recent Scandals that Provoked More Regulation

The WorldCom scandal immediately followed the Enron/Andersen scandal. WorldCom started its questionable practices when the company did not meet earnings expectations. Its fraudulent accounting led to a $9 billion restatement that was the largest in US history. "Accounting managers were given promotions, raises and made to feel responsible for a likely collapse of the stock price if they did not manipulate the books."[26]

Moreover, cooking the books didn't stop with the demise of Enron, Andersen, and World Com – or even with the passage of the Sarbanes–Oxley Act. Since then, there have been other scandals, the most notorious of which is HealthSouth, where estimates indicate that accounting fraud may have manufactured $4 billion of false earnings (2004). Reports say that the accountants focused on changing the contractual adjustments account – the difference between the gross billings and what the health care providers will pay – to increase revenues. This serves to increase net revenue; adjustments are made in the balance by falsifying fixed-asset accounts.

It is speculated that because many of HealthSouth's employees were formerly employees of Ernst and Young, they knew the sort of adjustments that they could make without detection, and if the adjustments were noticed, the employees simply provided false documents to back the numbers up.

The SEC accused HealthSouth management of fabricating $2.74 billion in earnings. Five CFOs were convicted; 15 financial employees pleaded guilty. Former CEO Richard Scrushy was the first CEO to be charged under the Sarbanes–Oxley Act for signing a false certification of financial statements. Although he avoided conviction, he was indicted on 85 counts and subsequently lost a civil suit fining him $2.9 billion.

Whether and to what extent the Sarbanes–Oxley Act is successful are matters of conjecture. Nevertheless, because it is the foremost legislative attempt to promote ethical behavior in accounting, we have summarized in Appendix A what the Act is and what it prohibits.

The financial crisis of 2007–2008 set off a new round of regulation impacting the accounting profession. In 2010 Congress passed the Dodd–Frank

Wall Street Reform and Consumer Protection Act. The Act set up the Financial Stability Oversight Council to monitor the overall stability of the financial markets and the Office of Financial Research to collect and standardize data on financial firms. The Act also enhances the duties and responsibilities of the SEC. The primary focus of Dodd–Frank is on financial firms; however, all publicly traded companies are impacted by its enhancement of disclosure requirements for executive compensation and conflict minerals, the introduction of whistleblower rules, and the exemption of small public companies from Section 404(b) of the Sarbanes–Oxley Act which requires an independent auditor's assessment of a firm's internal control system. The whistleblower rules of the act clarify the responsibility of a CPA's role in reporting fraud and other discrepancies of client financial information to authorities.

Conclusion

In summary, the accounting profession was developed to give a true and accurate picture of the financial affairs of organizations. That picture is important to a variety of constituencies. The accuracy of the picture is crucial. The creation of inaccurate pictures used to exploit those with a legitimate right to know the true picture is equivalent to the unethical behavior of lying. That constitutes a distortion of the accountant's true function. Such distortions then lead to regulations and mandated best practices.

Although it has always been the case, it has become even more apparent since the Enron/Andersen debacle that financial statements must be accurate and usable in a market system that relies on thorough information to make rational decisions. But pictures are not always accurate. They can be distorted to produce desired results, like "meeting one's numbers" or "smoothing out quarterly reports." We need to examine why and to what extent such distortions constitute unethical procedures. But first, we must provide an overview of the nature and purpose of accounting, for it is only in the light of that purpose that we can effectively evaluate accounting behavior in ethical terms. This discussion can be found in Chapter 4.

In Chapter 10, the final chapter of this book, we will examine numerous ways the profession is in crisis today. Largely, it is an ethical crisis. But before we can deal with some of the specific issues, we need to spell out what ethics involves. When applied to areas of accounting, it is not the simple matter we learned it to be when applied to everyday life. Accounting functions are complex procedures. We need a sophisticated set of ethics to deal with them. Consequently, at this point let us move on to a deeper examination of what constitutes ethics.

Discussion Questions

1. There are many constituents of accounting numbers. How do the various users rely on the accounting numbers and what impact does this reliance have on the profession?
2. Why is accounting seen as art and craft and how does this lead to professional judgment?
3. Why and to what extent is an accountant ethically obliged to disclose a true picture?
4. What are the various roles that accountants can fill and what are potential ethical issues that can occur in the performance of the various roles?
5. Accounting standards have evolved over time. What has been the driving force behind the changes and how do the changes strengthen the profession of accounting?

In the News

SEC sues Chinese subsidiaries of five biggest accounting firms

The US Securities and Exchange Commission (SEC) has sued the Chinese subsidiaries of the five biggest accounting firms, according to news reported on December 4, 2012. The SEC has been investigating nine Chinese companies that might have had accounting fraud, but these accounting firms declined to provide auditing draft to the SEC.

The SEC claimed that the Chinese subsidiaries of Deloitte, Ernst & Young, KPMG, Price Waterhouse Coopers, and BDO International have violated the US Securities Exchange Act and Sarbanes–Oxley Act. These Acts require overseas accounting firms to submit auditing drafts when overseas company plan IPOs (initial public offerings) in the United States.

This legal act sharpened the legal conflicts that have long existed between China and the US. The accounting firms said that the intension makes it stuck in the dilemma that they violate the laws of both countries: In the US they will be punished for not disclosing the documents, and on the contrary they will be guilty in China for disclosing the documents.

Robert Khuzami, president of the law enforcement department of SEC said:

> Only by taking the audit drafts of overseas accounting firms can SEC inspect the quality of auditing, so as to prevent investors from the harm of accounting fraud. Those who know clearly that they cannot provide auditing drafts according to the legal requirement but still conduct auditing will face severe punishment.

Due to SEC's investigation toward possible fraudulent practices of Chinese companies listed in the US, the tension between the two countries and accounting firms remains. Up until now, 50 Chinese companies have been delisted from American securities exchanges. Additionally, the SEC has sued 40 Chinese individuals or companies for fraud.

Price Waterhouse Coopers (PWC) said that this act is a "professional level incident". It claimed that its subsidiary PWC China has cooperated with this acts. "However, PWC China will continue to obey the Chinese law." Ernst & Young and Deloitte claimed that they will compromise with supervisory institutions.

US supervisory institutions have always been negotiating with the Chinese subsidiaries of these accounting firms and reached a temporary agreement of allowing US supervisory institutions to inspect accounting firms based in Asia. But it is yet not clear within what range they can inspect them.[27]

1. What ethical issue(s) is found in the case?
2. What is the challenge for the accounting profession and individual firms?

Ethical Sensitivity Exercise

Test your Level of Ethical Concern about Accounting Actions

Indicate the extent to which you have ethical concerns about the behavior described. There are no correct answers per se, but you might form a group and compare your score with other members of that group. If you disagree two places, you have a serious disagreement and should examine the different reasons for that.

	Level of Ethical Concern				
	None (Score 0)	**Minor (Score 1)**	**Moderate (Score 2)**	**Major (Score 3)**	**Score**
1. You allow the utilization of a tax shelter, that makes no business sense except to save your company substantial tax liability.					
2. You send a memo to the CEO of the company warning that the controller had used a questionable technique to level out the growth curve on the financial statement.					

3. You go along with a subtle suggestion of your manager to cut your billable hours so the client's bill won't be so expensive.					
4. You are hesitant to take the word of a client who is a dear friend about a tax entry on his books that you audit.					
5. You don't reveal information to the AICPA, which you possess, about possible market conduct violations of a fellow CPA.					
6. You defer to your manager who tells you to ignore what you think is an irregularity in a financial statement because your company has already spent too much time on the audit.					
7. You don't report a mistake you have discovered on a recently submitted tax return. The mistake has saved the company considerable money and is unlikely to be discovered.					
8. You tuck away unanticipated earnings for later when they can be used to get reported earnings closer to their target.					
9. Your firm does consulting work for a company that it audits because you know their books better than anyone else.					
10. You allow the purchase of a tax scheme from your company's tax accountants with the condition that the accountants get 10% of the tax savings.					

11. You arrange that some expensive perks be given to the representative of another country when it is clear that such perks are expected in that culture in order to get the business.					
12. You do not object when your supervising executive publicly gives you unfair negative feedback.					
	Total score				

Notes

1. See: Barry Ritholtz, "10 Worst Corporate Accounting Sandals," ritholtz.com (accessed 29 January 2018).
2. Albert B. Crenshaw, "In the Red or in the Black? Pictures Painted by Company Statements, Audits Questioned," *The Washington Post*, October 24, 1999, Sunday Final Edition, Financial Section, p. H02.
3. Cf. *Encyclopedia Britannica Micropaedia*, Accounting.
4. "Proposed Statement of Financial Accounting Concepts; Using Cash Flow Information and Present Value in Accounting Measurements," Exposure Draft (Revised) from the Financial Accounting Standards Board of the Financial Accounting Foundation (FASB), March 13, 1999, Revision of Exposure Draft issued June 11, 1997.
5. Albert B. Crenshaw, "In the Red or in the Black? Pictures Painted By Company Statements, Audits Questioned." *The Washington Post*, October 24, 1999, Sunday Final Edition, Financial Section, p. H02.
6. Ibid.
7. Michael Schroeder, "The Sherlock Holmes of Accounting," *Business Week*, September 5, 1994.
8. The problem of what counts as wealth is a perennial one for economists, dating back even before Adam Smith's argument with the monetarists.
9. Rick Telberg, *Accounting Today,* Editorial, September 26, 1999.
10. Rockness, H. and Rockness, J. 2005. Legislated Ethics: From Enron to Sarbanes–Oxley, the impact on corporate America. *Journal of Business Ethics*, 57: 31–54.
11. Ibid.

12. Securities and Exchange Commission 17 CFR Parts 210 and 211, (Release No. 33-7507; 34-39676; IC-23029; FR-50) Commission Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence.
13. *Ultrameres v. Touche*, 1931.
14. *Carey*, 1970, 182.
15. Previtz, G.J., Roybark, H.M. and Coffman, E.N. 2003. Keeping watch! Recounting 25 years of the office of Chief Accountant, U.S. Securities and Exchange Commission, 1976–2001. *ABACUS*, 39: 147–185.
16. Debbie Freier, "Compromised Work in the Public Accounting Profession: The Issue of Independence," GoodWork Project Series, Number 35. http://thegoodproject.org/pdf/35-Compromised-Work-7_04.pdf (accessed January 5, 2018).
17. Association of Certified Public Accountant Committee on Professional Ethics. 1963. Opinion No. 12 – Independence.
18. Debbie Freier, "Compromised Work in the Public Accounting Profession: The Issue of Independence," GoodWork Project Series, Number 35, p.11. http://thegoodproject.org/pdf/35-Compromised-Work-7_04.pdf (accessed January 5, 2018).
19. *Carey*, 1970, 195–196. According to a study by professors at Brigham Young and Texas A&M, "hiring an audit firm to provide both internal and external audits, a practice that was banned by the Sarbanes–Oxley Act, actually reduced companies' accounting risk." Sarah Johnson, "The Cost of Auditor Independence," CFO.com. February 12, 2009, (accessed January 5 2018).
20. Ibid.
21. Debbie Freier, "Compromised Work in the Public Accounting Profession: The Issue of Independence," GoodWork Project Series, Number 35. http://thegoodproject.org/pdf/35-Compromised-Work-7_04.pdf (accessed January 5, 2018).
22. American Institute of Certified Public Accountants (Cohen Commission), "Commission on Auditors' Responsibility: Report, Conclusions, and Recommendations," AICPA, New York, NY, 1978.
23. American Institute of Certified Public Accountants. Special Committee on Standards of Professional Conduct for Certified Public Accountants. (1986). Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment, 1986.
24. http://www.coso.org/Publications/NCFFR.pdf (accessed 5 January 2018).
25. Rockness, H. and Rockness, J. 2005. Legislated Ethics: From Enron to Sarbanes–Oxley, the Impact on Corporate America. *Journal of Business Ethics*, 57: 31–54. http://www.springerlink.com/content/t2137117t883h718/ (accessed January 5, 2018).
26. Susan Pulliam, 2003. "Ordered to Commit Fraud, A Staffer Balked, Then Caved," 6/23/2003, Vol. 241 Issue 121, pA1. 0p. https://www.wsj.com/articles/SB105631811322355600 (accessed January 31, 2018).
27. Source: Benchmark Information Limited, December 4, 2012.