

UNDERSTANDING ACCOUNTING ETHICS
Second Edition

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PREFACE

UNDERSTANDING
ACCOUNTING
ETHICS

Revised, Second Edition

by

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Preface

"This accountancy is a noble profession, and most of those who engage in it are good men. Indeed good preponderates everywhere—overwhelmingly in accountancy. After all the argument and disputation, after all the theory and doctrine, after all the study and analysis, the conclusion of the whole matter is this, that a professional man does not live unto himself alone, and what he does carries an influence far and wide. Every unworthy deed is a power for evil. Every good deed helps the world."

— A.P. Richardson, 1931, *The Ethics of a Profession*.

IT WAS A FINE SUMMER'S MORNING in Sydney, Australia. Mark Cheffers, a young CFO at a newly-formed mining company, paused for a moment from stacks of papers awaiting his attention and looked out the window to survey the stunning scene of the harbor bridge and opera house across the bay. He truly was sitting on top of the world. Only three years ago he had moved from the United States to Sydney with his young bride. They had spent their first years of marriage working in different offices for KPMG in the U.S., and, inspired by a desire to work overseas, had accepted positions at PricewaterhouseCoopers in Sydney. Mark had risen quickly up the ranks and, when just 27 years old, had been invited to become the acting CFO of newly formed publicly-traded mining company. During his first year he spent extraordinary amounts of time building accounting systems from scratch, integrating foreign operations, evaluating acquisitions, and preparing filings associated with hundreds of millions in secondary share offerings. But his successes made all of that effort more than worthwhile. He could only imagine what would be the next step in his career. Poised as he was to become one of the youngest CFOs of a company of that size in the world, his prospects seemed bright, and he had big dreams. Senior Vice President at Exxon in a few years? CFO for Mobil? The sky was the limit.

Just then, interrupting this brief reverie, the firm's Director of Finance knocked on his door and entered. "Mark, mate," he said, "We're facing a bit of a problem; we have a cash call on one of our overseas projects, and we've tied

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up most of our cash and collateral on a significant acquisition. It shouldn't be a real problem, as our cash deficiency really ought to last for at most one week." Mark had anticipated the cash call and obviously had known about this particular acquisition, but he had not realized that the Director of Finance had tied up so much cash and collateral. The Director continued, "I need you to approach XYZ Bank for a short term loan." "Are we offering collateral?" Mark asked. "If they want collateral you will have to offer them some of the same collateral that is tied up in our acquisition deal." Mark clarified, "Are you telling me that I might have to double-pledge our security for this loan?" "It's a small point," stated the Director. "This cash-flow issue is very short term. It won't have to happen again, and we absolutely have to make this cash call. Besides, there is no risk," he said with an upbeat tone in his voice.

Mark sat there, stunned. His reaction to the Director's suggestion was simple, immediate and instinctual: "No." And after another brief moment, "You will have my resignation by the end of the day."

As he said this, he thought back to the high standards of the culture he had experienced at PricewaterhouseCoopers and KPMG, where even the *slightest* suggestion of that sort of thing would not have been tolerated. That is the way he had always been taught to approach things; acting in any other way was simply not an option for him. The moment he saw that management was prepared to commit fraud, it was obvious that he could not possibly continue to work there. So Mark composed that letter of resignation. He gave them three weeks notice to find someone to replace him, and went home and informed his wife, "We're returning to the States." As for obtaining the loan—the company's chief accountant down the hall agreed to do the deed.

Mark and his wife returned to the United States and now, jobless, lived first with their in-laws and then in a modest apartment in one of the less appealing neighborhoods of Worcester, Massachusetts. From a glamorous apartment overlooking Syndey harbor on one side and the ocean on the other, to a dreary rented floor of a triple-decker in a seedy part of Worcester, all in the name of — integrity! Well, he had his integrity. Yet there is also something else; it did not take long for the maxim "honesty is the best policy" to be verified. Within a month after Mark resigned, there was a sudden and unanticipated collapse in the global gold market. The mining company found itself facing calls on its loans. It was placed in receivership, and federal investigations ensued. As the company's acting CFO, Mark would have been the first person held responsible if he had cooperated with

that 'little', 'low risk' fraud. His career and life would have been ruined.—That is how much had actually hung in the balance when he made that quick, instinctual decision to do the right (and very inconvenient) thing. Mark's act of integrity was what saved him and his family from complete economic and personal ruin.

Moving to Worcester proved to be a good choice in another way. It seemed a good time to get that M.B.A. that he had long thought about, so Mark applied to and was accepted at Harvard Business School. After gaining his degree, he began a new career as a forensic accountant, participating in numerous successful, high-profile investigations and prosecutions.

In the course of this work he happened by chance upon accounting fraud at Enron and at another \$100 billion market-capitalization company (the name of which will remain undisclosed, because of ongoing investigations) well before these scandals became public. The story about Enron bears repeating.

One day in mid 2001 a reporter from the *Wall Street Journal* called Mark and asked him for a favor. Could he look at various financial statements and other materials that the reporter had acquired about Enron and give his opinion as to whether anything unusual was evident? The *Journal* reporter had called Mark for his professional collaboration before, but this would be a larger task, involving the review of numerous documents. Mark took some days off to look over the materials. ("When the *Journal* calls and asks you for a favor like that, you do it.") Afterwards Mark called the reporter and told him: "I can't figure out what's going on here, and that's saying something. These disclosures are almost impossible to penetrate. I can however tell you one thing: no good reason exists for some of these entities mentioned in their proxy report not to be consolidated in the financials." This was months before Enron's announcement in October 2001 of a major restatement. After the restatement and Enron's ensuing bankruptcy, Mark, who by this point was a recognized expert on accounting malpractice matters, fielded calls not just from the *Journal* also but from reporters around the world. Needless to say, his conversations with reporters would eventually turn to the liability exposure facing Andersen, then one of the Big Five accounting firms.

And as regards Andersen's exposure? After Enron's declaration of bankruptcy, Mark was one of the first commentators to claim that Andersen's exposure simply dwarfed anything that had been seen before—that it would make the \$110 million dollar settlement in the Waste Management scandal appear miniscule. A story from the December 8, 2001 *Chicago Tribune* is indicative of coverage at that early

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time in the scandal. Andersen was downplaying everything: "Andersen officials won't comment on the specifics of the Enron case, but they say the problem rests with an antiquated model for corporate financial reporting, not any failures of their systems. 'When things go wrong, sometimes it's the people. But very often it's the system, and the issues that system is struggling with,' said Andersen spokesman Dave Talbot. 'We have been on record for some time that the reporting model needs to be modernized.'" Most other commentators took a comparable view. Mark was almost alone when he was quoted as saying, presciently, that "This could be a watershed case" and that Andersen had "an extraordinary exposure", because they had actually helped design the off-balance sheet entities that were hiding Enron's debt. The *Tribune* story continued: "the potential size of claims against Andersen could be greater, because it was at least partly aware of the nature of many Enron transactions under scrutiny, Cheffers said. That could overcome rules designed to limit shareholder actions against auditors." Needless to say, the *Tribune* story and Mark's forecast did not go over well in Chicago, the home of Andersen's world headquarters. The reporter who wrote the story later told Mark that he took much heat for Mark's remarks—that is, until Andersen's collapse.

From the beginning of his career as a forensic accountant, Mark had had a twofold interest in accounting malpractice and fraud. As a participant in prosecutions, he would take on the viewpoint of the public and the aggrieved individual investor. He passionately wanted to see that there was fair compensation for the negligence and unprofessionalism that unfortunately can sometimes occur among accountants. But as a CPA himself, he has always had a deeply-felt zeal for the honor and integrity of the profession, confirmed by his own experiences. Both of these attitudes went hand-in-hand. His dismay at accounting failure was a function of his love for the standards that the profession itself pledges to uphold.

It was this twofold passion and concern that became the source of this book, when Mark approached me in late 2004 and suggested a collaboration. Mark had co-authored an earlier text on accounting malpractice.¹ But he did not know much about philosophy or theories of ethics, and those were areas of expertise for me.

¹ Cheffers, M.L., C.M. Renda, and J.R. Bourassa: 2001, *Challenges for the Next Decade: A Primer on Accounting Malpractice and Its Prevention* (AccountingMalpractice.com, Manchaug, MA).

Would I be interested in combining forces and writing a book together on accounting ethics?

I leapt at the chance, for several reasons. First, I had long admired Mark's expertise and tenacity as a forensic accountant. I wanted to learn more about the field firsthand. Second, I was fascinated with the application of ethical principles to the world of business, because so much can be at stake there. In the world of academic philosophy and classical scholarship, where I was principally engaged, if someone makes a foolish mistake this might perhaps be pointed out in a review or critical notice, which would be the worse thing that would follow from it, but in business a mistake or act of folly can cost large sums of money. Thus, sound ideas are tested and verified quickly, directly, and in practice—which appealed to me very much. Third, I was interested in what might be called "The Fundamental Problem of Accounting Ethics", which involves the use and limitation of rules in guiding our practices. This problem had been considered at some length by philosophers as diverse as Aristotle and Wittgenstein. The field of accounting seemed an interesting field in which to examine it, because drawing up rules is something that accountants do very well; it seems part of the mindset of an accountant. In the efforts of accountants, one may see as clearly as anywhere else the limits of rules: if a rule *could* accomplish something, accountants would have been able to construct a rule to accomplish it, and, contrariwise, any defect in rules devised by clever accountants will likely imply a defect in rules *tout court*. Fourth, and finally, to collaborate with Mark on a book on accounting ethics seemed a way simply to achieve something good. Philosophers perhaps more than other academics are beset by a concern that their thought and writing actually lead to something fruitful and helpful to others. I am convinced that that is the reason why many philosophers in mid-career abandon serious philosophy and turn instead to political activism (although admittedly philosophy is difficult enough, and many quit simply because they find other things easier). If through writing a book with Mark on accounting ethics I could lend some clarity and contribute to the ethical idealism of what is undeniably an extremely important profession in modern society, then, I figured, I would be doing something genuinely good.

Thus *Understanding Accounting Ethics* was born. It was an unusual collaboration: a seasoned forensic accountant joining forces with an expert in ethics and classical philosophy. The book was well received and welcomed by practitioners for bringing needed light to the ethical nature of the profession. But

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that was 2005. Since that time we have seen major convictions and sentencings in the Enron and WorldCom scandals. Other scandals have come to light. The effects of Sarbanes-Oxley have become clearer. Moreover, through the helpful, positive feedback of instructors who used *Understanding Accounting Ethics*, and our own experiences in teaching from the book, we noted many ways in which it could be improved. Hence we are bringing out now a new and substantially revised second edition.

It would be appropriate here to say something about the structure of this book and how it differs from the first edition. For this new edition of *Understanding Accounting Ethics*, we have adopted the framework for education in accounting ethics recommended by a recent and major study of the subject sponsored by the International Federation of Accountants (IFAC).² We agree with the conclusion of that study, that accounting education may usefully be understood as involving four steps: (1) gaining *knowledge*; (2) acquiring *perceptiveness*; (3) exercising *judgment*; (4) planning for continued *growth in professionalism*. Accordingly, we have organized our eight chapters following this general framework. We begin with two theoretical chapters: Chapter 1 explains why the accounting profession has an inherently ethical character, and Chapter 2 sets down basic ideas and foundations for an approach to accounting ethics. These chapters together constitute the basic philosophical 'knowledge' that an accountant needs as a basis for ethical accounting. The next two chapters aim to help the student become alert to the ethical dimensions of accounting. We do this by examining high-profile scandals in accounting. Our rationale is that, in these high-profile scandals, all of the significant aspects of accounting ethics can be seen, as it were, 'writ large'. It is as if someone wanted to become alert and sensitive to the distinctive marks of a particular period in art, say, the Italian Renaissance. To teach these things, you would not show such a person a tiny miniature sketch, or a precious watercolor. No, you would begin with the greatest and most remarkable examples of art from the period, such as Michelangelo's *David* or Raphael's *School of Athens*. Likewise, we think that the best way to teach 'sensitivity' to ethics is through the use of remarkable and dramatic cases of ethical malfeasance in accounting. Thus Chapter 3 discusses the Enron scandal, and Chapter 4 discusses WorldCom. These chapters

² IFAC: 2006, *Approaches to the Development and Maintenance of Professional Values, Ethics and Attitudes in Accounting Education Programs* August, 192 Pp. (Available at: http://www.ifac.org/Members/Downloads/Information_Paper_Final.pdf).

complement each other nicely, because the nature of the accounting malfeasance was very different in each.

After a student has acquired the basics of knowledge about accounting ethics, and has become alert to the ethical dimensions of accounting, he is equipped to begin to practice applying his own judgment to ethical matters. This is best done through the case study method. There are many available case studies in accounting ethics. In Chapter 5 we offer ten cases which constitute, we think, a distinctive contribution to this already large body of literature. Our cases are all derived from actual forensic accounting practice. Thus they admit of two sorts of answer. One sort of answer is the ideal answer, the solution that might seem best working from the basic ethical principles of the discipline. But then there is the 'actual answer', that is, how things actually played out in the courts and in the public domain. To look at cases that have this second 'answer' is especially useful to a student, for a variety of reasons: the student sees in a vivid way that "ideas have consequences"; he can observe the connection that typically holds between idealism and long-term advantage; and he can study the relationship between poor ethical decisions and exposure to risk in the daily practice of an accountant. Then in Chapter 6 (originally Chapter 2 in the first edition) we include something of a philosophical meditation on the essential insufficiency of rules. This chapter brings home the lesson that "rules are not enough". Rules are in service to deeper principles and need to be interpreted with good professional judgment. This chapter, then, stresses the importance of developing precisely that good judgment that the cases of the preceding chapter are designed to help exercise and develop.

Finally, Chapters 7 and 8 consider how a student (or practitioner) may continue to grow in ethics. Clearly, a concern with being ethical does not and cannot stop with a single ethics course. Aiming to be good at anything is not a matter of studying something for a few hours and passing an exam. This holds for golf, a musical instrument, a profession, and also the ethical aspect of a profession. Thus, any adequate treatment of accounting ethics must include a thorough and realistic discussion of practical steps that should be taken, over time, to foster growth in ethics. This growth can be fostered either by an individual with a view to his own actions solely, or by a firm, with a view to the culture and organization of the firm as a whole, and the effects that these have on practitioners in the firm. We discuss both of these tasks in Chapter 8. Given that this book is, after all, a philosophical text, we preface this very practical discussion with a more general and more theoretical consideration, in Chapter 7, of the very old question of

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whether virtue can be taught. That is, first we ask philosophically, "Can virtue be taught?", and we answer affirmatively, and then, given that it can, we explain how.

The main changes in the content of this book from the first edition are as follows. (i) We have completely replaced and expanded the Introduction (Chapter 1). The earlier Introduction was not entirely satisfactory, because we explained the importance of ethics in accounting in too close a relation to then recent high-profile accounting scandals. The approach taken in this second edition is much more satisfactory, as we explain why, quite independently of these scandals, ethics is inherent in the profession of accounting. (ii) The first edition dealt with the foundations of ethics with two chapters, one which discussed the basics of ethics, and the other which discussed specifically basics of accounting ethics. In the current edition we cover the same material in a single chapter (Chapter 2), which allows for the development of a more direct and elegant argument. (iii) As mentioned above, we include ten new cases of accounting ethics, derived from forensic practice. Finally, (iv) we give a much fuller and detailed discussion of the practical measures that can be undertaken by individuals and firms to teach and encourage commitment to the highest standards of the profession.

Readers of the first edition will understand that our examination of accounting ethics has been distinctive for taking a so-called 'virtue-based' approach. We believe that, given the shortcomings in any system of rules, the most helpful way to view the subject is with regard to the 'virtues' of an accountant, which need to be grasped in relation to the 'distinctive role' that an accountant is meant to occupy in a modern market economy. That is, we deal with accounting ethics in complete continuity with ancient discussions of 'function' (*ergon*) and 'excellence' (*aretê*), which stretch back to Socrates, Plato, and Aristotle. One benefit of this approach is that we can actually give an explanation for why codes of professional conduct for accountants emphasize competence, objectivity, independence, integrity, due diligence and confidentiality. Another benefit of taking this approach is that we can develop analogies between a profession such as accounting, and Plato's notion of a skill (*technê*) as a form of service to another. Our approach also ties in nicely with recent calls from accounting ethicists such as Stephen Mintz to foster a culture of 'heroes of accounting', and with the recognized importance of stories and examples for the teaching of virtues.

This is our general way of dealing with the subject. But it might be useful in a preface such as this to draw attention to the main themes of our treatment of the

subject, by way of both anticipation and summary. The most important claims in the book, and those we wish to emphasize above all, are the following:

- There is a sharp and real distinction between a profession and a business.
- Professions are different from businesses in being directed at incommensurably higher goods.
- Accounting is a profession which has as its function the providing of the conditions of trust in a modern market economy.
- The virtues of an accountant may be derived through reflection on the distinctive role or function of an accountant.
- There are two fundamentally distinct sorts of virtue: intellectual virtues and virtues of character.
- The code of professional accountant for an accountant is best understood in terms of an accountant's distinctive virtues.
- As a profession, accounting is in many respects the most altruistic and ethically demanding of the professions.
- The remuneration of a professional for his or her work as a professional necessarily has the nature of an honorarium.
- Virtues are acquired and preserved through first actions, small actions, and analogous actions: not big things, but small things.
- Again, much accounting fraud becomes big by starting from an initially small malfeasance.
- Rules give at best necessary but not sufficient conditions for correct action.
- Good judgment is necessary for interpreting rules.
- Ethics and expedience coincide in the long run, and very often in the short run as well.

One marked improvement in the second edition is that we have brought appropriate emphasis to the theme of *truth*. We maintain that the distinctive role of an accountant is to foster the conditions of trust within a modern market economy. In the first edition, we only implicitly linked this description of an accountant's role to truth. In this edition, we emphasize explicitly that someone can foster trust only by being *trustworthy*, and that someone is trustworthy only if he is consistently and reliably *truthful* in what he discovers and reports. Hence one of the most fundamental descriptions of an accountant is that he is a "seeker of truth" as regards the financial condition of an enterprise.

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We have recast entirely the presentation of accounting ethics in this second edition to make the book even more serviceable as a textbook. The first edition was designed to be a compact and elegant statement of what we regarded as the essential ideas of accounting ethics. We took the approach then that a very concise treatment would have the greatest effect and would also carry along with it something of the inspirational character that (frankly) we think any successful treatment of ethics from a practical point of view must have. However, it became clear to us from the success of that book that the text could be even more useful if it incorporated to a greater degree the characteristics of a textbook. Therefore in this second edition we have included not only fuller explanations of some of the more difficult concepts, but also an ample supply of charts, diagrams, and other study guides, as well as a full stock of questions at the end of each chapter for further study, discussion, and research. We have also expanded the bibliography and now include full suggestions for further reading at the end of each chapter. We believe that these improvements will make the second edition of *Understanding Accounting Ethics* especially suitable for use in an accounting ethics course or module in an undergraduate accounting program, or in courses for the continuing professional education (CPE) of practitioners, while at the same time not detracting from the readability and interest of the text for managers, executives, and other interested professionals.

It is easy to construct a variety of courses based on this book. Here are some examples:

- 4 credit-hour first course in the foundations of accounting ethics: coverage of the first two chapters, along with a consideration of cases from chapter 5 as time permits.
- 4 credit-hour second course in the practical side of accounting ethics: either Chapter 3 or Chapter 4; Chapters 5 and 6; Chapter 8.
- A one-semester comprehensive college course on accounting ethics: devote one week to each chapter, interspersed with weeks devoted to a judicious selection of readings from the bibliography, as well as an examination of the most important codes, laws, and regulatory statements.

In teaching a one semester course, the instructor may find it best to allow the first third of the course or so to be really a 'philosophy' course dealing with fundamental concepts. Do not be too concerned about arriving quickly at practical applications. Allow students ample time to become 'immersed' in the concepts, which may at

first be foreign to them. Supplement the book with generous selections on 'virtue ethics' taken from the bibliography. This time spent on fundamentals at the beginning of the course will yield a much greater understanding of practical matters later on. An instructor whose expertise is solely in accounting, not ethics, and who is perhaps tempted to shy away from philosophy, should consider that, as Aristotle said, philosophy is originally a matter of wondering at things and feeling appropriately puzzled in the face of conceptual difficulties and problems. One very effective way for an instructor to teach philosophy is by candidly confessing one's own puzzlement and then taking on the position of 'student', side-by-side with the students in the class, initiating discussions in a 'Socratic' style as much as by lecturing. Some even hold that this is the only way to teach philosophy, on the grounds that in philosophy everyone is fundamentally a learner.

We have not aimed to reproduce in this book the texts of the codes of professional conduct of the major accounting professional bodies, since these are readily available on the internet in their most recent, updated form, together with the latest authoritative rulings and interpretations. We are presuming here that any comprehensive course in accounting ethics will include the appropriate study of relevant codes, laws, and regulations; our aim here is to provide the foundations for such a study.

We should very much like to acknowledge, as regards the final drafting of this book, the helpful assistance of Ryan Shea, whose research, editorial work and preparation of supplementary materials has proved invaluable.

Michael Pakaluk
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