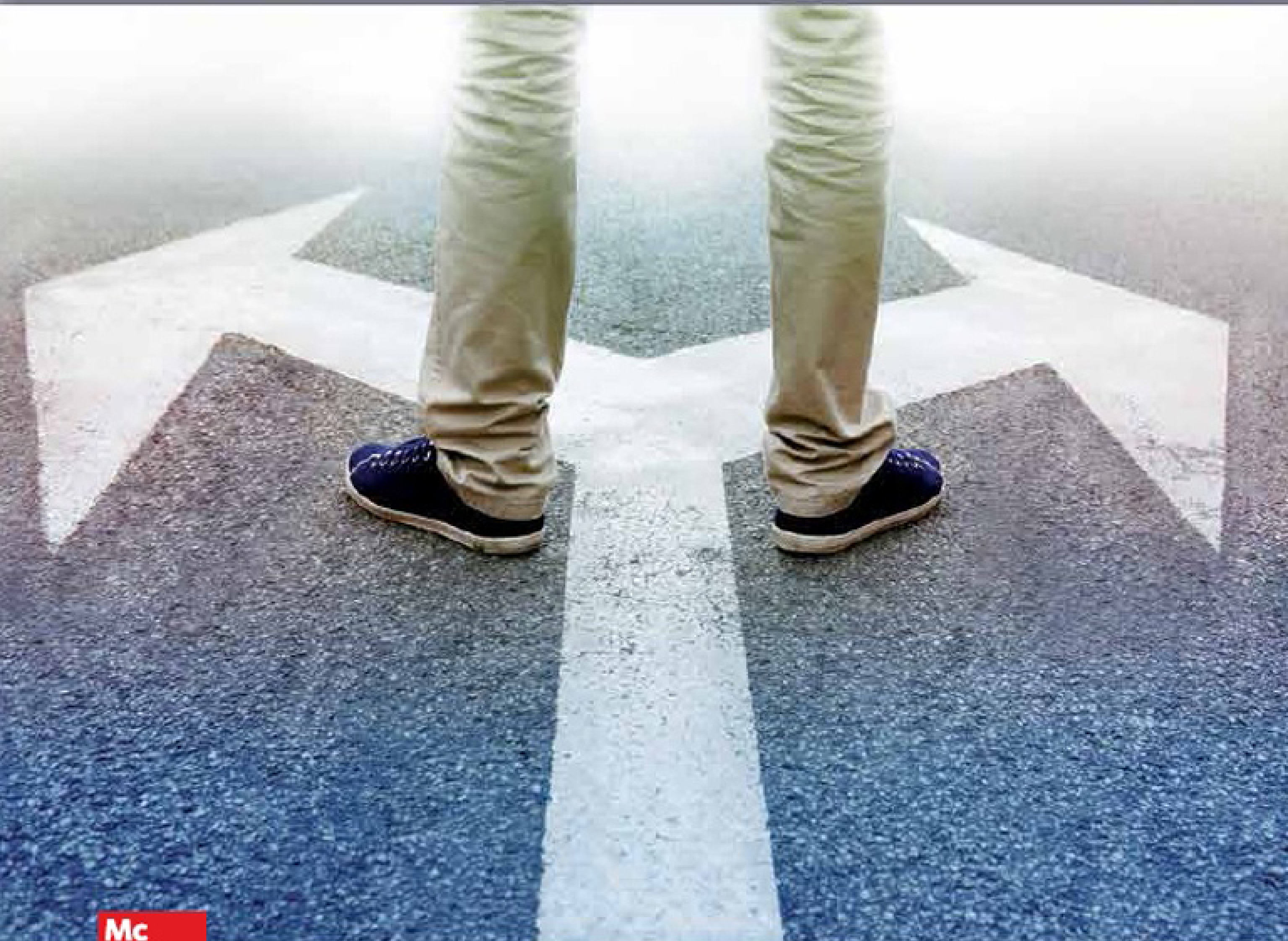
Ethical Obligations and Decision Making in ACCOUNTING

TEXT AND CASES

Fourth Edition



Mc Graw Hill Education

Steven M. Mintz   Roselyn E. Morris

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Text and Cases

Fourth Edition

Steven M. Mintz, DBA, CPA
Professor of Accounting
California Polytechnic State University,
San Luis Obispo

Roselyn E. Morris, Ph.D., CPA
Professor of Accounting
Texas State University–San Marcos

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ETHICAL OBLIGATIONS AND DECISION MAKING IN ACCOUNTING: TEXT AND CASES,
FOURTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 QVS 1 0 9 8 7 6 5 4 3

ISBN 978-1-259-54347-0
MHID 1-259-54347-1

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Cover Image: *(c) Olaser/Getty Images*
Compositor: *SPi Global*
Typeface: STIX Mathjax Main 10/12
Printer: *Quad/Graphics*

Library of Congress Cataloging-in-Publication Data

Names: Mintz, Steven M., author. | Morris, Roselyn E., author.
Title: Ethical obligations and decision making in accounting : text and cases / Steven M. Mintz, DBA, CPA, Professor of Accounting California Polytechnic State University, San Luis Obispo, Roselyn E. Morris, Ph.D., CPA, Professor of Accounting Texas State University-San Marcos.
Description: Fourth Edition. | New York, NY : McGraw-Hill Education, 2016. | Revised edition of the authors' Ethical obligations and decision making in accounting, 2014.
Identifiers: LCCN 2015044426 | ISBN 9781259543470 (alk. paper)
Subjects: LCSH: Accountants--Professional ethics--United States--Case studies.
Classification: LCC HF5616.U5 M535 2016 | DDC 174/.4--dc23 LC record available at
http://lccn.loc.gov/2015044426

2013011582

mheducation.com/highered

Dedication

> "Educating the mind without educating the heart is no education at all."
>
> *Aristotle*

What Aristotle meant by this statement is intelligence that is not informed by our hearts--by compassion--is not really intelligent at all. We strive in this book not only to educate accounting students to be future leaders in the accounting profession but to stimulate your ethical perception and cultivate virtue thereby awakening your sense of duty and obligation to the public interest.

About the Authors

Steven M. Mintz, DBA, CPA, is a professor of accounting in the Orfalea College of Business at the California Polytechnic State University–San Luis Obispo. Dr. Mintz received his DBA from George Washington University. His first book, titled *Cases in Accounting Ethics and Professionalism,* was also published by McGraw-Hill. Dr. Mintz has recently been acknowledged by accounting researchers as one of the top publishers in accounting ethics and in accounting education. He was selected for the 2014 Max Block Distinguished Article Award in the "Technical Analysis" category by The CPA Journal. Dr. Mintz received the 2015 Accounting Exemplar Award of the Public Interest Section of the American Accounting Association. He also has received the Faculty Excellence Award of the California Society of CPAs. Dr. Mintz writes two popular ethics blogs under the names "ethicssage" and "workplaceethicsadvice."

Roselyn E. Morris, Ph.D., CPA, is a professor of accounting in the Accounting Department at the McCoy College of Business, Texas State University–San Marcos. Dr. Morris received her Ph.D. in business administration from the University of Houston. She is a past president of the Accounting Education Foundation and chair of the Qualifications Committee of the Texas Board of Public Accountancy. Dr. Morris has received the Outstanding Educator Award from the Texas Society of CPAs.

Both Professors Mintz and Morris have developed and teach an accounting ethics course at their respective universities.

Preface

Ethical Obligations and Decision Making in Accounting was written to guide students through the minefields of ethical conflict in meeting their responsibilities under the professions' codes of conduct. Our book is devoted to helping students cultivate the ethical commitment needed to ensure that their work meets the highest standards of integrity, independence, and objectivity. An expanded discussion of professional judgment highlights the challenges to ethical decision-making for internal accountants and auditors, and external auditors. We hope that this book and classroom instruction will work together to provide the tools to help students to make ethical judgments and carry through with ethical actions.

The fourth edition of *Ethical Obligations and Decision Making in Accounting: Text and Cases* incorporates a behavioral perspective into ethical decision-making that encourages students to get in touch with their values and learn how to voice them in the workplace when conflicts arise and ethical dilemmas exist. We build on traditional philosophical reasoning methods by taking the process one step further, that is, to convert ethical intent into ethical action. The "Giving Voice to Values" (GVV) approach provides this link. If accounting professionals are successful in voicing values in a way that encourages doubters and detractors to join the effort, then there may be no need for whistle-blowing. We also connect many of the issues discussed in the book with a new final chapter on "Ethical Leadership."

Several states now require their accounting students to complete an ethics course prior to being licensed as a CPA. This book has been designed to meet the guidelines for accounting ethics education including:

- encouraging students to make decisions in accordance with prescribed values, attitudes, and behaviors
- providing a framework for ethical reasoning, knowledge of professional values and ethical standards
- prescribing attributes for exercising professional skepticism and behavior that is in the best interest of the investing and consuming public and the profession.

What's New in the 4th Edition?

In response to feedback and guidance from numerous accounting ethics faculty, the authors have made many important changes to the fourth edition of *Ethical Obligations and Decision Making in Accounting: Text and Cases,* including the following:

- **Connect is available for the first time** with assignable cases, test bank assessment material, and SmartBook. **SmartBook** is an excellent way to ensure that students are reading and understanding the basic concepts in the book and it prepares them to learn from classroom discussions. Several of the **Chapter Cases** are available in an auto-graded format to facilitate grading by instructors. The purpose of using the digital format is to better prepare students ahead of class to free up instructors to discuss a broader range of topics in their lectures and in the give-and-take between teacher and student. **Connect Insight Reports** will also give the instructor a better view into the overall class's understanding of core topics prior to class, to appropriately focus lectures and discussion. The **Connect Library** also offers materials to support the efforts of first-time and seasoned instructors of accounting ethics, including a comprehensive Instructor's Manual, Test Bank, Additional Cases, and PowerPoint presentations.
- **Learning Objectives** have been added and linked to specific content material in each chapter.
- **Giving Voice to Values (GVV)** approach is explained in Chapter 2 and used throughout the text. GVV is an innovative pedagogical method that complements the traditional philosophical reasoning

approaches to ethical decision-making by emphasizing developing the capacity to express one's values in a way that positively influences others. The technique is used post-decision-making and is based on developing and fine-tuning an action plan using scripting and rehearsal. It is ideal for role-playing exercises.

- **International** auditing and ethics issues are incorporated into existing chapters.
- Added five new **Discussion Questions** to each chapter as well as revised questions with more current topics and issues.
- Replaced many of the **cases** with more current and topical issues. Eighteen of the 76 cases have been specifically developed to enable students to practice the "Giving Voice to Values" technique in the context of the decision-making model.
- **Expanded the discussion of whistleblowing obligations** of accounting professionals in Chapter 3 including guidelines for reporting under Dodd-Frank and the AICPA rules of conduct.
- Added a comprehensive section on **professional judgment** in accounting and auditing to Chapter 4 and models for making judgments and exercising professional skepticism.
- Updated Chapter 4 to incorporate the **Revised AICPA Code of Professional Conduct**.
- **Expanded** the discussion of the PCAOB inspection process in Chapters 5 and 6 for audits of companies listing stock in the U.S., including Chinese companies and audit deficiencies noted in inspections of U.S. companies.
- Updated case examples used throughout the text to describe **earnings management** techniques with expanded coverage in Chapter 7.
- New Chapter 8 on **"Ethical Leadership"** that ties together many of the topics in the chapters in the text. Ethical leadership is explored in the context of making ethical decisions and judgments in the performance of professional accounting services.
- Improved and expanded the scope of major cases that can be used as an end-of-course project to enhance the experiences of upper-division undergraduates and graduate students.
- Revised and greatly enhanced **Instructor's Resource Materials** and supplements.

Chapter 1

- **New** discussion of the use of social networks and social media communications, personal responsibility, and workplace ethics.
- Expanded discussion of moral philosophies and implications for ethical reasoning in accounting and auditing.
- Expanded discussion of the Principles of the AICPA Code of Professional Conduct, the public interest obligation, and regulation in the accounting profession.

Chapter 2

- **New** discussion of moral intensity and influence on ethical decision making.
- **New** discussion of Kidder's Ethical Checkpoints and link to moral action.
- Expanded discussion of Behavioral Ethics and cognitive development.
- **New** and comprehensive discussion of the **GVV** technique that provides a mechanism for students to act on ethical intent. Chapter 2 discusses the foundation of the approach including examples on applying the methodology. There are **five cases** in the chapter to engage students in discussions of the **GVV** approach to ethical action. Subsequent chapters also contain cases with a **GVV** dimension.

Chapter 3

- **New** section on "Organizational Ethics and Leadership."
- **New** discussion of "Character and Leadership in the Workplace."
- Updated results from the National Business Ethics Survey, Association of Certified Fraud Examiners Global Survey, and KPMG Integrity Survey.
- Expanded discussion of financial statement fraud schemes.
- **New** discussion of the morality of whistleblowing.
- Added discussion of major whistleblower case of *Anthony Menendez v. Halliburton, Inc.*
- Expanded discussion of Dodd-Frank provisions for whistleblowing by internal accountants and auditors, and external auditors including when external auditors can blow the whistle on their audit firms.
- Expanded discussion of subordination of judgment rules and their application to whistleblowing.

Chapter 4

- **Extensive new discussion** of professional judgment in accounting.
- Added an explanation of KPMG Professional Judgment Framework.
- Expanded discussion of professional skepticism.
- **New** discussion of professionalism and commercialism.
- **Comprehensive** discussion of the **Revised AICPA Code of Professional Conduct** including: Conceptual Framework for Members in Public Practice and Conceptual Framework for Members in Business.
- **New** discussion of ethical conflict requirements and decision-making model under the Revised Code.
- Expanded discussion of AICPA Conceptual Framework for Independence Standards.
- Expanded discussion of integrity and subordination of judgment rules.
- **New** discussion of confidentiality and disclosing fraud.
- Expanded discussion of ethics in tax practice.
- Expanded discussion of "Insider Trading" cases against CPAs.
- **New** discussion of Global Code of Ethics.

Chapter 5

- Expanded discussion of errors, illegal acts, and fraud.
- **New** discussion of Private Securities Litigation Reform Act and reporting requirements to the SEC; fraud and confidentiality issues explored.
- Discussion of **Professional Skepticism Scale** that measures traits conducive to developing a questioning mind and informed judgment.
- Discussion of findings of the Center for Audit Quality of audit deficiencies.
- Expanded discussion of PCAOB audit inspection process and high rate of deficiencies of audit firms.

Chapter 6

- **New** cases that explore in depth legal obligations of accountants and auditors.
- Expanded discussion of auditor legal liabilities.
- Expanded section on legal liabilities under Sarbanes-Oxley.
- **New** discussion of International Financial Reporting Standards and international enforcement.
- **New** discussion of principles versus rules-based standards and SEC position on objectives-oriented standards.
- **New** section on "Compliance and Management by Values."
- **New** section on "Global Ethics, Fraud, and Bribery" and the Foreign Corrupt Practices Act.
- Expanded discussion on regulatory issues and PCAOB inspections.

Chapter 7

- **New** section on "Non-Financial Measures of Earnings."
- Expanded discussion of earnings management and professional judgment.
- Expanded discussion of the use of accruals and earnings management.
- Introductory discussion of new revenue recognition standard.
- Detailed examples of financial statement restatements of Hertz Corporation and Cubic Corporation, and CVS-Caremark merger.

Chapter 8 – New Chapter on Ethical Leadership

Chapter 8 links back to discussions in Chapters 1 through 7 by incorporating material on "Ethical Leadership." The purpose is to leave students with a positive message of the importance of being a leader and ethical leadership in building organizational ethics. Leadership in decision-making in accounting, auditing, tax, and advisory services engagements is addressed. The chapter includes 20 discussion questions and 6 new cases. The chapter includes the following major topics:

- Discussion of moral decision-making and leadership.
- Exploring different types of leaders: authentic leaders, transformational leadership, followership and leadership, and how social learning theory influences leadership.
- Revisiting moral intensity in the context of ethical leadership.
- Ethical leadership and internal audit function.
- Ethical leadership and tax practice.
- Gender influences in leadership.
- Causes of leadership failures.
- Case studies on ethical leadership.
- Implications of ethical leadership for whistleblowing activities.
- Values-based leadership.
- Ethical leadership and the GVV technique.
- Ethical leadership competence.

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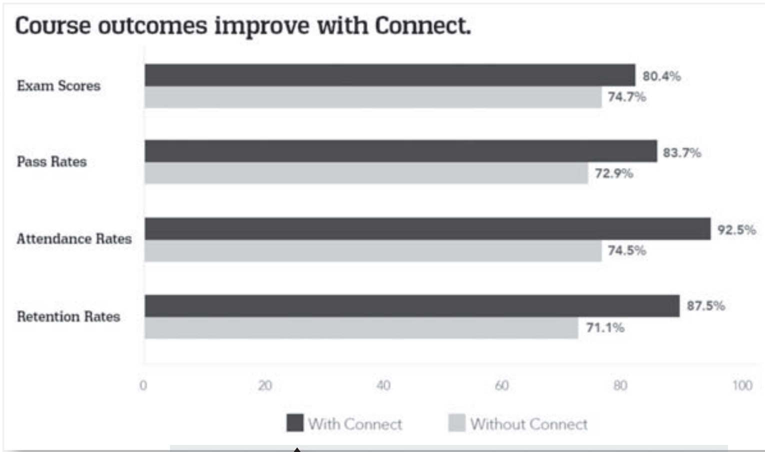

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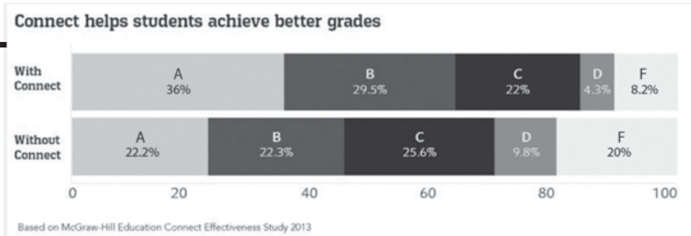

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Acknowledgments

The authors want to express their sincere gratitude to these reviewers for their comments and guidance. Their insights were invaluable in developing this edition of the book.

- Donald Ariail, *Southern Polytechnic State University*
- Stephanie Bacik, *Wake Tech Community College*
- Charles Bunn, Jr., *Wake Tech Community College*
- Kevin Cabe, *Indiana Wesleyan University*
- Rick Crosser, *Metropolitan State University of Denver*
- Denise Dickins, *East Carolina University*
- Dennis L. Elam, *Texas A&M University–San Antonio*
- Rafik Elias, *California State University–Los Angeles*
- Athena Jones, *University of Maryland University College*
- Patrick Kelly, *Providence College*
- Lorraine S. Lee, *University of North Carolina–Wilmington*
- Stephen McNett, *Texas A&M University–Central Texas*
- Kenneth Merchant, *University of Southern California*
- Michael Newman, *University of Houston*
- Robin Radtke, *Clemson University*
- John Sennetti, *NOVA Southeastern University*
- Edward Smith, *St. John's University*
- Dale Wallis, *University of California–Los Angeles Extension*

We also appreciate the assistance and guidance given us on this project by the staff of McGraw-Hill Education, including Tim Vertovec, managing director; Natalie King, senior brand manager; Kyle Burdette, marketing manager; Rebecca Mann, senior product developer; Daryl Horrocks, program manager; Angela Norris, content project manager; Jacob Sullivan and Melissa Homer, content licensing specialists; and Jennifer Pickel, buyer. We greatly appreciate the efforts of Deborah Pfeiffer, copyeditor of the book.

Finally, we would like to acknowledge the contributions of our students, who have provided invaluable comments and suggestions on the content and use of these cases.

If you have any questions, comments, or suggestions concerning *Ethical Obligations and Decision Making in Accounting,* please send them to Steve Mintz at smintz@calpoly.edu.

Case Descriptions

Case #	Case Name/Description
1-1	**Harvard Cheating Scandal** *Student cheating at Harvard raises questions about responsibilities of instructors and student personal responsibilities.*
1-2	**Giles and Regas** *Dating relationship between employees of a CPA firm jeopardizes completion of the audit.*
1-3	**NYC Subway Death: Bystander Effect or Moral Blindness** *Real-life situation where onlookers did nothing while a man was pushed to his death off a subway platform.*
1-4	**Lone Star School District** *Failure to produce documents to support travel expenditures raises questions about the justifiability of reimbursement claims.*
1-5	**Reneging on a Promise** *Ethical dilemma of a student who receives an offer of employment from a firm that he wants to work for, but only after accepting an offer from another firm.*
1-6	**Capitalization versus Expensing** *Ethical obligations of a controller when pressured by the CFO to capitalize costs that should be expensed.*
1-7	**Eating Time** *Ethical considerations of a new auditor who is asked to cut down on the amount of time that he takes to complete audit work.*
1-8	**Shifty Industries** *Depreciation calculations and cash outflow considerations in a tax engagement.*
1-9	**Cleveland Custom Cabinets** *Ethical and professional responsibilities of an accountant who is asked to "tweak" overhead to improve reported earnings.*
1-10	**Better Boston Beans** *Conflict between wanting to do the right thing and a confidentiality obligation to a coworker.*

Case #	Case Name/Description
2-1	**A Team Player (a GVV case)** *Ethical dilemma for audit staff member who discovers a deficiency in inventory procedures but is unable to convince the group to report it. Application of Giving Voice to Values approach.*
2-2	**FDA Liability Concerns (a GVV case)** *Conflict between a chef and CFO over reporting bacteria found in food and FDA inspection results. Application of GVV approach.*
2-3	**The Tax Return (a GVV case)** *Tax accountant's ethical dilemma when asked by her supervisor to ignore reportable lottery winnings. Application of GVV approach.*
2-4	**A Faulty Budget (a GVV case)** *Ethical and professional responsibilities of an accountant after discovering an error in his sales budget. Application of GVV approach.*
2-5	**Gateway Hospital (a GVV case)** *Behavioral ethics considerations in developing a position on unsubstantiated expense reimbursement claims. Application of GVV approach.*
2-6	**LinkedIn and Shut Out** *Small business owner's inability to gain support from LinkedIn after a contact in his professional network scams him out of $30,000.*
2-7	**Milton Manufacturing Company** *Dilemma for top management on how best to deal with a plant manager who violated company policy but at the same time saved it $1.5 million.*

2-8 Juggyfroot
Pressure imposed by a CEO on external accountants to change financial statement classification of investments in securities to defer reporting a market loss in earnings.

2-9 Phar-Mor
SEC investigation of Phar-Mor for overstating inventory and misuse of corporate funds by the COO.

2-10 WorldCom
Persistence of internal auditor, Cynthia Cooper, to correct accounting fraud and implications for Betty Vinson, a midlevel accountant, who went along with the fraud.

Case # Case Name/Description

3-1 The Parable of the Sadhu
Classic Harvard case about ethical dissonance and the disconnect between individual and group ethics.

3-2 Rite Aid Inventory Surplus Fraud
Dilemma of director of internal auditing whether to blow the whistle under Dodd-Frank on Rite Aid's inventory surplus sales/kickback scheme.

3-3 United Thermostatic Controls (a GVV case)
Acceptability of accelerating the recording of revenue to meet financial analysts' earnings estimates and increase bonus payments.

3-4 Franklin Industries' Whistleblowing (a GVV case)
Considerations of internal accountant how best to voice her values to convince others to act on questionable payments to a related-party entity.

3-5 Walmart Inventory Shrinkage (a GVV case)
Pressure to reduce inventory shrinkage at a Walmart store amidst alleged accounting improprieties and related efforts of the protagonist to voice values.

3-6 Bennie and the Jets (a GVV case)
Ethical and professional obligations in reporting accounting wrongdoing to higher-ups in the organization.

3-7 Olympus
Major corporate scandal in Japan where Olympus committed a $1.7 billion fraud involving concealment of investment losses through fraudulent accounting.

3-8 Accountant takes on Halliburton and Wins!
Violation of confidentiality provision in a whistleblowing case under SOX after Bob Menendez reported retaliation by Halliburton subsequent to informing the audit committee of improper revenue recognition policies using bill-and-hold transactions.

3-9 Bhopal, India: A Tragedy of Massive Proportions
Evaluation of the decision-making process before, during, and after the leak of a toxic chemical that killed or injured thousands.

3-10 Accountability of Ex-HP CEO in Conflict of Interest Charges
Sexual harassment charges stemming from conflict of interest between CEO/board chair and outside contractor.

Case # Case Name/Description

4-1 KBC Solutions
Concerns about professional judgments made by audit senior after the review of workpaper files.

4-2 Beauda Medical Center
Confidentiality obligation of an auditor to a client after discovering a defect in a product that may be purchased by a second client.

4-3 Family Games, Inc.
Ethical dilemma for a controller being asked to backdate a revenue transaction to increase performance bonuses in order to cover the CEO's personal losses.

4-4 **Commercialism and Professionalism (a GVV case)**
Ethical considerations in an alternative practice structure due to threats to independence; using GVV to resolve conflict.

4-5 **Han, Kang & Lee, LLC**
Pressure between audit partner who wants the client to write down inventory and other partners that want to keep the client happy.

4-6 **Tax Shelters**
Ethical dilemma of tax accountant in deciding whether to participate in tax shelter transactions targeted to top management of a client entity in light of cultural influences within the firm.

4-7 **M&A Transaction**
Ethical issues concerning a decision to provide merger and acquisition advisory services for an audit client.

4-8 **Valley View Hospital**
Ethical obligations of CPA in deciding whether to report a hospital/client for improper Medicare payments to the government because of a faulty Medicare accounting system.

4-9 **AOL-Time Warner**
Fall out after CFO of AOL blows the whistle on improper round-trip accounting procedures in AOL-Time Warner merger and is investigated himself for his part in the fraud by the SEC.

4-10 **Navistar International**
Confidentiality issues that arise when Navistar management questions the competency of Deloitte & Touche auditors by referring to PCAOB inspection reports and fraud at the company.

Case # **Case Name/Description**

5-1 **Loyalty and Fraud Reporting (a GVV case)**
Employee who embezzles $50,000 seeks out the help of a friend to cover it up. Application of the fraud triangle and GVV.

5-2 **ZZZZ Best**
Fraudster Barry Minkow uses fictitious revenue transactions from nonexistent business to falsify financial statements.

5-3 **Imperial Valley Community Bank**
Role of professional skepticism in evaluating audit evidence on collectability of loans and going concern assessment.

5-4 **Busy Season Planning**
Role of review partner in planning an audit.

5-5 **Tax Inversion**
Questions about the use of IFRS in a consolidation with an Irish entity motivated by tax inversion benefits.

5-6 **Rooster, Hen, Footer, and Burger**
Ethical obligations of a CPA following the discovery of an unreported related party transaction and push back by client entity.

5-7 **Diamond Foods: Accounting for Nuts**
Application of the fraud triangle to assess corporate culture and analysis of fraud detection procedures.

5-8 **Bill Young's Ethical Dilemma**
Options of a friend of an auditor advising the auditor following his inappropriate downloading of client information that shows bribery of foreign officials.

5-9 **Royal Ahold N.V. (Ahold)**
U.S. subsidiary of a Dutch company that used improper accounting for promotional allowances to meet or exceed budgeted earnings targets and questions about professional judgment by auditors.

5-10 **Groupon**
Competitive pressures on social media pioneer leads to internal control weakness and financial restatements.

Case #	Case Name/Description
6-1	**Advanced Battery Technologies: Reverse Merger** *Application of legal standards to assess auditor liability following a reverse merger transaction by a Chinese company.*
6-2	**Heinrich Müller: Big Four Whistleblower? (a GVV case)** *Ethical dilemma of tax accountant after finding confidential files of a client engaged in tax avoidance transactions in Liechtenstein in view of a culture of strict loyalty to the firm.*
6-3	**Richards & Co: Year-end Audit Engagement** *Questions about audit procedures used to assess client's improper use of a credit received from a client to prop up revenue in one year while agreeing to repay the supplier in the following year.*
6-4	***Anjoorian et al.:* Third-Party Liability** *Application of the foreseeability test, near-privity, and the Restatement approach in deciding negligence claims against the auditor.*
6-5	***Vertical Pharmaceuticals Inc. et al. v. Deloitte & Touche LLP*** *Fiduciary duties and audit withdrawal considerations when suspecting fraud at a client.*
6-6	**Kay & Lee LLP** *Auditor legal liability when foreseen third party relies on financial statement.*
6-7	**Getaway Cruise Lines: Questionable Payments to do Business Overseas (a GVV case)** *Ethical dilemma of Director of International Accounting in voicing her values with respect to a dispute within the company over how to report "questionable payments" made to a foreign government.*
6-8	**Con-way Inc.** *Auditor legal and audit responsibilities to assess facilitating payments and internal control requirements under the FCPA.*
6-9	***Satyam: India's Enron*** *Questions about corporate culture and fraud risk assessment surrounding CEO's falsification of financial information and misuse of corporate funds for personal purposes.*
6-10	***Autonomy*** *Investigations by U.S. SEC and UK Serious Fraud Office into accounting for an acquisition of a British software maker by Hewlett-Packard (HP).*

Case #	Case Name/Description
7-1	**Nortel Networks** *Use of reserves and revenue recognition techniques to manage earnings.*
7-2	**Solutions Network, Inc. (a GVV case)** *Ethical challenges of a controller in voicing values when the company uses round-trip transactions to meet earnings targets.*
7-3	**GE: "Imagination at Work"** *Assessing whether GE used earnings management techniques to accelerate revenue and meet financial analysts' earnings expectations.*
7-4	**Harrison Industries (a GVV case)** *Challenges faced by first-year accountant in voicing values upon questioning the appropriateness of recording an accrued expense.*
7-5	**Dell Computer** *Use of "cookie-jar" reserves to smooth net income and meet financial analysts' earnings projections.*
7-6	**Tier One Bank** *Failure of KPMG to exercise due care and proper professional judgment in gathering supporting evidence for loan loss estimates.*
7-7	**Sunbeam Corporation** *Use of cookie-jar reserves and "channel stuffing" by a turnaround artist to manage earnings.*

Case #	Case Name/Description
7-8	**Sino-Forest: Accounting for Trees** *Failure of Ernst & Young to follow generally accepted auditing standards and lapses in professional ethics related to Chinese company's nonexistent forestry assets; cultural considerations of doing business in China.*
7-9	**The North Face, Inc.** *Questions about revenue recognition on barter transactions and the role of Deloitte & Touche in its audit of the client.*
7-10	**Beazer Homes** *Use of cookie jar reserves to manage earnings and meet EBIT targets.*

Case #	Case Name/Description
8-1	**Research Triangle Software Innovations (a GVV case)** *Advisory services staff member recommends the software package of an audit client to another client and deals with push back from her supervisor who is pushing the firm's package; issues related to leadership and application of GVV in resolving the matter.*
8-2	**Cumberland Lumber** *Difference of opinion between chief internal auditor and aggressive CFO about recording year-end accruals.*
8-3	**Parmalat: Europe's Enron** *Fictitious accounts at Bank of America and the use of nominee entities to transfer debt off the books by an Italian company led to one of Europe's largest fraud cases.*
8-4	**KPMG Tax Shelter Scandal** *Major tax shelter scandal case involving KPMG that explores ethical standards in tax practice and in developing tax positions on tax shelter products in a culture that promoted making sales at all costs.*
8-5	**Krispy Kreme Doughnuts, Inc.** *Questions about ethical leadership and corporate governance at Krispy Kreme, and audit by PwC, with respect to the company's use of round-trip transactions to inflate revenues and earnings to meet or exceed financial analysts' EPS guidance.*
8-6	**Rhody Electronics: A Difficult Client (a GVV case)** *Conflict between audit manager and controller over audit planning and execution and implications for ethical leadership.*

Major Cases

Case #	Case Name/Description
1	**Adelphia Communications Corporation** *SEC action against Deloitte & Touche for failing to exercise the proper degree of professional skepticism in examining complex related-party transactions and contingencies that were not accounted for in accordance with GAAP.*
2	**Royal Ahold N.V. (Ahold)** *Court finding that Deloitte & Touche should not be held liable for the efforts of the client to deprive the auditors of accurate information needed for the audit and masking the true nature of other evidence.*
3	**Madison Gilmore's Ethical Dilemma (a GVV case)** *Distinguishing between operational and accounting earnings management and efforts of controller to voice values and convince the CFO about inappropriateness of recoding revenue on a bill-and-hold transaction.*
4	**Cendant Corporation** *SEC action against Cendant for managing earnings through merger reserve manipulations and improper accounting for membership sales, and questions about the audit of Ernst & Young.*
5	**Vivendi Universal** *Improper adjustments to EBITDA and operating free cash flow by a French multinational company to meet ambitious earnings targets and conceal liquidity problems.*
6	**Waste Management** *Failure of Andersen auditors to enforce agreement with the board of directors to adopt proposed adjusting journal entries that were required in restated financial statements.*

Brief Contents

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Chapter 1

Ethical Reasoning: Implications for Accounting

Learning Objectives

After studying Chapter 1, you should be able to:

LO 1-1 Explain how integrity enables a CPA to withstand pressures and avoid subordination of judgment.

LO 1-2 Discuss the relationship between one's values and ethics, and legal obligations.

LO 1-3 Describe how the pillars of character support ethical decision making.

LO 1-4 Differentiate between moral philosophies and their effect on ethical reasoning in accounting.

LO 1-5 Explain the concept of the public interest in accounting.

LO 1-6 Discuss the Principles section of the AICPA Code of Professional Conduct.

LO 1-7 Apply the IMA Statement of Ethical and Professional Practice to a case study.

Ethics Reflection

Penn State Child Abuse Scandal: A Culture of Indifference

What motivates an otherwise ethical person to do the wrong thing when faced with an ethical dilemma? Why does a good person act wrongly in a particular situation? These are the ethical questions that arise from the Penn State scandal. Football head coach Joe Paterno and administrators at Penn State University looked the other way and failed to act on irrefutable evidence that former assistant coach Jerry Sandusky had molested young boys, an offense for which Sandusky currently is serving a 30- to 60-year sentence. According to the independent report by Louis Freeh that investigated the sexual abuse, the top administrators at Penn State and Joe Paterno sheltered a child predator harming children for over a decade by concealing Sandusky's activities from the board of trustees, the university community, and authorities. They exposed the first abused child to additional harm by alerting Sandusky, who was the only one who knew the child's identity, of what assistant coach Mike McQueary saw in the shower on the night of February 9, 2001.[1] McQueary testified at the June 2012 trial of Sandusky that he observed the abuse[2] and informed Paterno, who reported the incident to his superiors but did not confront Sandusky or report the incident to the board of trustees or the police.[3]

Reasons for Unethical Actions

The report gives the following explanations for the failure of university leaders to take action:

- The desire to avoid the bad publicity
- The failure of the university's board of trustees to have reporting mechanisms in place to ensure disclosure of major risks
- A president who discouraged discussion and dissent
- A lack of awareness of the Clery Act, which requires colleges and universities participating in federal financial aid programs to keep and disclose information about crimes committed on and near their campuses
- A lack of whistleblower policies and protections
- A culture of reverence for the football program that was ingrained at all levels of the campus community

Explanations for Unethical Actions

Former Penn State president Graham Spanier, who was fired by the board of trustees in November 2011, is quoted as discussing in an interview with Jeffrey Toobin of the *New Yorker* about how the university worked that "honesty, integrity, and always doing what was in the *best interests of the university* [italics added] was how everyone agreed to operate and . . . we've always operated as a family. Our personal and social and professional lives were all very intertwined."[4]

A culture that fosters organizational interests to the exclusion of others explains what happened at Penn State, and it happens in other organizations as well, such as Enron and WorldCom. The culture of an organization should be built on ethical values such as honesty, integrity, responsibility, and accountability. While Penn State may have claimed to follow such principles, the reality was that its actions did not match these behavioral norms.

Postscript

The Penn State case just does not seem to go away. Here is a list of actions subsequent to the initial case:

- As of the summer 2015, at least seven civil cases as well as criminal complaints against three former Penn State administrators have been pending.
- In January 2015, the National Collegiate Athletic Association (NCAA) agreed to restore 111 of former head coach Joe Paterno's wins between 1998–2011, making Paterno once again the winningest coach in major college football.
- The Paterno family brought a lawsuit to contest the consent decree's statement that the head coach covered for Sandusky to protect the school's football program.
- The statue of Paterno that was tore down will be replaced by a projected $300,000 life-sized bronze sculpture downtown, about two miles from the original site, after Pennsylvanians overwhelmingly voted to support the school putting the statue out again by a margin of 59 to 25.

Ethical Blind Spots

Leaders of organizations who may be successful at what they do and see themselves as ethical and moral still cultivate a collection of what Max Bazerman and Ann Trebrunsel call *blind spots*.[5] Blind spots are the gaps between who you want to be and the person you actually are. In other words, most of us want to do the right thing—to act ethically—but internal and external pressures get in the way.

As you read this chapter, think about the following questions: (1) What would you have done if you had been in Joe Paterno's position, and why? (2) Which ethical reasoning methods can help me to make ethical decisions in accounting? (3) What are my ethical obligations to the public?

> Have the courage to say no. Have the courage to face the truth. Do the right thing because it is right. These are the magic keys to living your life with integrity.
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> *W. Clement Stone (1902–2002)*

This quote by William Clement Stone, a businessman, philanthropist, and self-help book author, underscores the importance of integrity in decision making. Notice that the quote addresses integrity in one's personal life. That is because one has to act with integrity when making personal decisions in order to be best equipped to act with integrity on a professional level. Integrity, indeed all of ethics, is not a spigot that can be turned on or off depending on one's whims or whether the matter at hand is personal or professional. As the ancient Greeks knew, we learn how to be ethical by practicing and exercising those virtues that enable us to lead a life of excellence.

Joe Paterno and other university leaders did not act with integrity. They let external considerations of reputation and image dictate their internal actions. Ironically, the very factor—reputation—that they guarded so closely was the first to be brought down by the disclosure of a cover-up in the sex scandal case.

In accounting, internal accountants and auditors may be pressured by superiors to manipulate financial results. The external auditors may have to deal with pressures imposed on them by clients to put the best face on the financial statements regardless of whether they conform to generally accepted accounting principles (GAAP). It is the ethical value of integrity that provides the moral courage to resist the temptation to stand by silently while a company misstates its financial statement amounts.

Integrity: The Basis of Accounting

LO 1-1

Explain how integrity enables a CPA to withstand pressures and avoid subordination of judgment.

According to Mintz (1995), "Integrity is a fundamental trait of character that enables a CPA to withstand client and competitive pressures that might otherwise lead to the subordination of judgment."[6] A person of integrity will act out of moral principle and not expediency. That person will do what is right, even if it means the loss of a job or client. In accounting, the public interest (i.e., investors and creditors) always must be placed ahead of one's own self-interest or the interests of others, including a supervisor or client.

Integrity means that a person acts on principle—a conviction that there is a right way to act when faced with an ethical dilemma. For example, assume that your tax client fails to inform you about an amount of earned income for the year, and you confront the client on this issue. The client tells you not to record it and reminds you that there is no W-2 or 1099 form to document the earnings. The client adds that you will not get to audit the company's financial statements anymore if you do not adhere to the client's wishes. Would you decide to "go along to get along"? If you are a person of integrity, you should not allow the client to dictate how the tax rules will be applied in the client's situation. You are the professional and know the tax regulations best, and you have an ethical obligation to report taxes in accordance with the law. If you go along with the client and the Internal Revenue Service (IRS) investigates and sanctions you for failing to follow the IRS Tax Code, then you may suffer irreparable harm to your reputation. An important point is that a professional must never let loyalty to a client cloud good judgment and ethical decision making.

Worldcom: Cynthia Cooper: Hero and Role Model

Cynthia Cooper's experience at WorldCom illustrates how the internal audit function should work and how a person of integrity can put a stop to financial fraud. It all unraveled in April and May 2002 when Gene Morse, an auditor at WorldCom, couldn't find any documentation to support a claim of $500 million in computer expenses. Morse approached Cooper, the company's director of internal auditing and Morse's boss, who instructed Morse to "keep going." A series of obscure tips led Morse and Cooper to suspect that WorldCom was cooking the books. Cooper formed an investigation team to determine whether their hunch was right.

In its initial investigation, the team discovered $3.8 billion of misallocated expenses and phony accounting entries.[7] Cooper approached the chief financial officer (CFO), Scott Sullivan, but was dissatisfied with his explanations. The chief executive officer (CEO) of the company, Bernie Ebbers, had already resigned under pressure from WorldCom's board of directors, so Cooper went to the audit committee. The committee interviewed Sullivan about the accounting issues and did not get a satisfactory answer. Still, the committee was reluctant to take any action. Cooper persisted anyway. Eventually, one member of the audit committee told her to approach the outside auditors to get their take on the matter. Cooper gathered additional evidence of fraud, and ultimately KPMG, the firm that had replaced Arthur Andersen—the auditors during the fraud—supported Cooper. Sullivan was asked to resign, refused to do so, and was fired.[8]

One tragic result of the fraud and cover-up at WorldCom is the case of Betty Vinson. It is not unusual for someone who is genuinely a good person to get caught up in fraud. Vinson, a former WorldCom mid-level accounting manager, went along with the fraud because her superiors told her to do so. She was convinced that it would be a one-time action. It rarely works that way, however, because once a company starts to engage in accounting fraud, it feels compelled to continue the charade into the future to keep up the appearance that each period's results are as good as or better than prior periods. The key to maintaining one's integrity and ethical perspective is not to take the first step down the proverbial *ethical slippery slope.*

Vinson pleaded guilty in October 2002 to participating in the financial fraud at the company. She was sentenced to five months in prison and five months of house arrest. Vinson represents the typical "pawn" in a financial fraud: an accountant who had no interest or desire to commit fraud but got caught up in it when Sullivan, her boss, instructed her to make improper accounting entries. The rationalization by Sullivan that the company had to "make the numbers appear better than they really were" did nothing to ease her guilty conscience. Judge Barbara Jones, who sentenced Vinson, commented that "Ms. Vinson was among the least culpable members of the conspiracy at WorldCom. . . . Still, had Vinson refused to do what she was asked, it's possible this conspiracy might have been nipped in the bud."[9]

Accounting students should reflect on what they would do if they faced a situation similar to the one that led Vinson to do something that was out of character. Once she agreed to go along with making improper entries, it was difficult to turn back. The company could have threatened to disclose her role in the original fraud and cover-up if Vinson then acted on her beliefs. From an ethical (and practical) perspective it is much better to just do the right thing from the very beginning, so that you can't be blackmailed or intimidated later.

Vinson became involved in the fraud because she had feared losing her job, her benefits, and the means to provide for her family. She must live with the consequences of her actions for the rest of her life. On the other hand, Cynthia Cooper, on her own initiative, ordered the internal investigation that led to the discovery of the $11 billion fraud at WorldCom. Cooper did all the right things to bring the fraud out in the open. Cooper received the Accounting Exemplar Award in 2004 given by the American Accounting Association and was inducted into the American Institute of Certified Public Accountants (AICPA) Hall of Fame in 2005.

Cooper truly is a positive role model. She discusses the foundation of her ethics that she developed as a youngster because of her mother's influence in her book *Extraordinary Circumstances: The Journey of a Corporate Whistleblower.* Cooper says: "Fight the good fight. Don't ever allow yourself to be intimidated. . . . Think about the consequences of your actions. I've seen too many people ruin their lives."[10]

Religious and Philosophical Foundations of Ethics

Virtually all the world's great religions contain in their religious texts some version of the Golden Rule: "Do unto others as you would wish them to do unto you." In other words, we should treat others the way we would want to be treated. This is the basic ethic that guides all religions. If we believe honesty is important, then we should be honest with others and expect the same in return. One result of this ethic is the concept that every person shares certain inherent human rights, which will be discussed later in this chapter. Exhibit 1.1 provides some examples of the universality of the Golden Rule in world religions provided by the character education organization Teaching Values.[11]

EXHIBIT 1.1 The Universality of the Golden Rule in the World Religions

Religion	Expression of the Golden Rule	Citation
Christianity	All things whatsoever ye would that men should do to you, Do ye so to them; for this is the law and the prophets.	Matthew 7:1
Confucianism	Do not do to others what you would not like yourself. Then there will be no resentment against you, either in the family or in the state.	Analects 12:2
Buddhism	Hurt not others in ways that you yourself would find hurtful.	Uda–navarga 5,1
Hinduism	This is the sum of duty, do naught onto others what you would not have them do unto you.	Mahabharata 5, 1517
Islam	No one of you is a believer until he desires for his brother that which he desires for himself.	Sunnah
Judaism	What is hateful to you, do not do to your fellowman. This is the entire Law; all the rest is commentary.	Talmud, Shabbat 3id
Taoism	Regard your neighbor's gain as your gain, and your neighbor's loss as your own loss.	Tai Shang Kan Yin P'ien
Zoroastrianism	That nature alone is good which refrains from doing to another whatsoever is not good for itself.	Dadisten-I-dinik, 94, 5

Integrity is the key to carrying out the Golden Rule. A person of integrity acts with truthfulness, courage, sincerity, and honesty. Integrity means to have the courage to stand by your principles even in the face of pressure to bow to the demands of others. As previously mentioned, integrity has particular importance for certified public accountants (CPAs), who often are pressured by their employers and clients to give in to their demands. The ethical responsibility of a CPA in these instances is to adhere to the ethics of the accounting profession and not to subordinate professional judgment to the judgment of others. Integrity encompasses the whole of the person, and it is the foundational virtue of the ancient Greek philosophy of virtue.

The origins of Western philosophy trace back to the ancient Greeks, including Socrates, Plato, and Aristotle. The ancient Greek philosophy of virtue deals with questions such as: What is the best sort of life for human beings to live? Greek thinkers saw the attainment of a good life as the *telos,* the end or goal of human existence. For most Greek philosophers, the end is *eudaimonia,* which is usually translated as "happiness." However, the Greeks thought that the end goal of happiness meant much more than just experiencing pleasure or satisfaction. The ultimate goal of happiness was to attain some objectively good status, the life of excellence. The Greek word for excellence is *arete,* the customary translation of which is "virtue." Thus for the Greeks, "excellences" or "virtues" were the qualities that made a life admirable or excellent. They did not restrict their thinking to characteristics we regard as moral virtues, such as courage, justice, and temperance, but included others we think of as nonmoral, such as wisdom.[12]

Modern philosophies have been posited as ways to living an ethical life. Unlike virtue theory that relies on both the characteristics of a decision and the person making that decision, these philosophies rely more on methods of ethical reasoning, and they, too, can be used to facilitate ethical decision making. We review these philosophies later in the chapter.

What Is Ethics?

LO 1-2
Discuss the relationship between one's values and ethics, and legal obligations.

The term *ethics* is derived from the Greek word *ethikos,* which itself is derived from the Greek word *ethos,* meaning "custom" or "character." Morals are from the Latin word *moralis,* meaning "customs," with the Latin word *mores* being defined as "manners, morals, character."

In philosophy, ethical behavior is that which is "good." The Western tradition of ethics is sometimes called "moral philosophy." The field of ethics or moral philosophy involves developing, defending, and recommending concepts of right and wrong behavior. These concepts do not change as one's desires and motivations change. They are not relative to the situation. They are immutable.

In a general sense, ethics (or moral philosophy) addresses fundamental questions such as: How should I live my life? That question leads to others, such as: What sort of person should I strive to be? What values are important? What standards or principles should I live by?[13] There are various ways to define the concept of ethics. The simplest may be to say that ethics deals with "right" and "wrong." However, it is difficult to judge what may be right or wrong in a particular situation without some frame of reference.

In addition, the ethical standards for a profession, such as accounting, are heavily influenced by the practices of those in the profession, state laws and board of accountancy rules, and the expectations of society. Gaa and Thorne define ethics as "the field of inquiry that concerns the actions of people in situations where these actions have effects on the welfare of both oneself and others."[14] We adopt that definition and emphasize that it relies on ethical reasoning to evaluate the effects of actions on others—*the stakeholders.*

Difference between Ethics and Morals

Ethics and morals relate to "right" and "wrong" conduct. While they are sometimes used interchangeably, they are different: ethics refer to rules provided by an external source, such as codes of conduct for a group of professionals (i.e., CPAs), or for those in a particular organization. Morals refer to an individual's own principles regarding right and wrong and may be influenced by a religion or societal mores. Ethics tend to be more practical than morals, conceived as shared principles promoting fairness in social and business interactions. For example, a CEO involved in a sex scandal may involve a moral lapse, while a CEO misappropriating money from a company she is supposed to lead according to prescribed standards of behavior is an ethical problem. These terms are close and often used interchangeably, and both influence ethical decision making. In this text we oftentimes use the terms synonymously while acknowledging differences do exist.

Another important distinction can be thought of this way: When we form a moral judgment, we are employing moral standards—principles against which we compare what we see in order to form a conclusion. Such judgments might be about particular conduct, which includes a person's actions, or it might be about a person's character, which includes their attitudes and beliefs. Ethics, on the other hand, involve the study and application of those standards and judgments which people create or are established by organizations. So, we could say that ethics are the operational side of morality.

Norms, Values, and the Law

Ethics deal with well-based standards of how people *ought* to act, does *not* describe the way people *actually* act, and is prescriptive, not descriptive. Ethical people always strive to make the right decision in all circumstances. They do not rationalize their actions based on their own perceived self-interests. Ethical decision making entails following certain well-established norms of behavior. The best way to understand ethics may be to differentiate it from other concepts.

Values and Ethics

Values are basic and fundamental beliefs that guide or motivate attitudes or actions. In accounting, the values of the profession are embedded in its codes of ethics that guide the actions of accountants and auditors in meeting their professional responsibilities.

Values are concerned with how a person behaves in certain situations and is predicated on personal beliefs that may or may not be ethical, whereas ethics is concerned with how a moral person should behave to act in an ethical manner. A person who values prestige, power, and wealth is likely to act out of self-interest, whereas a person who values honesty, integrity, and trust will typically act in the best interests of others. It does not follow, however, that acting in the best interests of others always precludes acting in one's own self-interest. Indeed, the Golden Rule prescribes that we should treat others the way we want to be treated.

The Golden Rule requires that we try to understand how our actions affect others; thus, we need to put ourselves in the place of the person on the receiving end of the action. The Golden Rule is best seen as a consistency principle, in that we should not act one way toward others but have a desire to be treated differently in a similar situation. In other words, it would be wrong to think that separate standards of behavior exist to guide our personal lives but that a different standard (a lower one) exists in business.

Laws versus Ethics

Being ethical is not the same as following the law. Although ethical people always try to be law-abiding, there may be instances where their sense of ethics tells them it is best not to follow the law. These situations are rare and should be based on sound ethical reasons.

> Assume that you are driving at a speed of 45 miles per hour (mph) on a two-lane divided roadway (double yellow line) going east. All of a sudden, you see a young boy jump into the road to retrieve a ball. The boy is close enough to your vehicle so that you know you cannot continue straight down the roadway and stop in time to avoid hitting him. You quickly look to your right and notice about 10 other children off the road. You cannot avoid hitting 1 or more of them if you swerve to the right to avoid hitting the boy in the middle of the road. You glance to the left on the opposite side of the road and notice no traffic going west or any children off the road. What should you do?
>
> **Ethical Perspective**
>
> If you cross the double yellow line that divides the roadway, you have violated the motor vehicle laws. We are told never to cross a double yellow line and travel into oncoming traffic. But the ethical action would be to do just that, given that you have determined it appears to be safe. It is better to risk getting a ticket than hit the boy in the middle of your side of the road or those children off to the side of the road.

Laws and Ethical Obligations

Benjamin Disraeli (1804–1881), the noted English novelist, debater, and former prime minister, said, "When men are pure, laws are useless; when men are corrupt, laws are broken." A person of goodwill honors and respects the rules and laws and is willing to go beyond them when circumstances warrant. As indicated by the previous quote, such people do not need rules and laws to guide their actions. They always try to do the right thing. On the other hand, the existence of specific laws prohibiting certain behaviors will not stop a person who is unethical (e.g., does not care about others) from violating those laws. Just think about a Ponzi scheme such as the one engaged in by Bernie Madoff, whereby he duped others to invest with him by promising huge returns that, unbeknownst to each individual investor, would come from additional investments of scammed investors and not true returns.

Laws create a minimum set of standards. Ethical people often go beyond what the law requires because the law cannot cover every situation a person might encounter. When the facts are unclear and the legal issues uncertain, an ethical person should decide what to do on the basis of well-established standards of ethical behavior. This is where moral philosophies come in and, for accountants and auditors, the ethical standards of the profession.

Ethical people often do less than is permitted by the law and more than is required. A useful perspective is to ask these questions:

- What does the law require of me?
- What do ethical standards of behavior demand of me?
- How should I act to conform to both?

The Gray Area

When the rules are unclear, an ethical person looks beyond his / her own self-interest and evaluates the interests of the stakeholders potentially affected by the action or decision. Ethical decision making requires that a decision maker be willing, at least sometimes, to take an action that may not be in his / her best interest. This is known as the "moral point of view."

Sometimes people believe that the ends justify the means. In ethics it all depends on one's motives for acting. If one's goals are good and noble, and the means we use to achieve them are also good and noble, then the ends do justify the means. However, if one views the concept as an excuse to achieve one's goals through any means necessary, no matter how immoral, illegal, or offensive to others the means may be, then that person is attempting to justify the wrongdoing by pointing to a good outcome regardless of ethical considerations such as how one's actions affect others. Nothing could be further from the truth. The process you follow to decide on a course of action is more important than achieving the end goal. If this were not true from a moral point of view, then we could rationalize all kinds of actions in the name of achieving a desired goal, even if that goal does harm to others while satisfying our personal needs and desires.

Imagine that you work for a CPA firm and are asked to evaluate three software packages for a client. Your boss tells you that the managing partners are pushing for one of these packages, which just happens to be the firm's internal software. Your initial numerical analysis of the packages based on functionality, availability of upgrades, and customer service indicates that a competitor's package is better than the firm's software. Your boss tells you, in no uncertain terms, to redo the analysis. You know what she wants. Even though you feel uncomfortable with the situation, you decide to "tweak" the numbers to show a preference for the firm's package. The end result desired in this case is to choose the firm's package. The means to that end was to alter the analysis, an unethical act because it is dishonest and unfair to the other competitors (not to mention the client) to change the objectively determined results. In this instance, ethical decision making requires that we place the client's interests (to get the best software package for his needs) above those of the firm (to get the new business and not upset the boss.

Ethical Relativism

Ethical relativism is the philosophical view that what is right or wrong and good or bad is not absolute