Chapter 3
Ethics and corporate governance

Review questions

**1** The challenge is how to achieve ethical behaviour in business. How do we develop ethical behaviour – through education and training? How do we change certain attitudes, which can result in employees stealing from their employer and justifying their action on the basis that the company is making huge profits? The challenge facing the accounting profession is the same – perhaps the difference is that members of the accounting profession have to show a certain understanding of the profession’s code of ethics before being admitted as a full member. Furthermore, they are then bound by the code of ethics as they go about their work. Is it possible to develop a code of ethics for business people? How would it be enforced?

**2** Discussion should focus on the total costs of unethical behaviour. Take McKinley Tabor as an example. His initial unethical actions brought about increases in his personal wealth and could be argued was in his self-interest. However, in the end the costs of his actions outweighed his gains and his self-interest would have been best served by remaining ethical.

**3** The role of the board of directors is to represent the shareholders of the company, make decisions and endeavour to add value for the shareholders. The board is one way in which the management of the company is held accountable for its actions.

**4** The issues concerning a board of directors and its role in corporate governance include the size of the board and the number of independent directors. Should the CEO also chair the board? What qualifications should directors have? Should there be restrictions on the number of boards on which directors can sit? Should there be a time limit on the length of service on a board?

Problems for discussion and analysis

**1** The corporate governance report for Woolworths is available at [www.woolworthslimited.com.au](http://www.woolworthslimited.com.au) (click on ‘annual report’). The notes below are based on the 2013 annual report and are meant as a guide only. It is important for students to discuss whether making statements about ethical decision making, for example, provides sufficient assurances to shareholders.

**Strengths:**

• Very detailed and transparent. Meets and exceeds most of the best practice guidelines.

• There are nine on the board of directors (BOD) and all except for the CEO and CFO are claimed to be non-executive and independent, which conforms with best practice recommendations. The board size is also not too large and is within the range of what some researchers have found is desirable.

• BOD members are able to seek independent advice at the company’s expense.

• The roles of chairman and CEO are held by different people.

• Has a corporate governance committee that is responsible for the appointment of members to the BOD.

• Has an active audit committee (AC) comprised of non-executive directors with financial skills. The AC has wide ranging responsibilities. The AC requires the lead audit partner to be rotated every five years and has a policy of not appointing the firm’s auditors to the BOD at any time. The AC can also seek independent advice at the company’s expense. The AC also reviews all on-audit services provided by the external auditor.

• Has a people policy committee made up of non-executive directors, which is responsible for the establishment and review of the remuneration of the company’s senior executives.

**Improvements:**

• There are few areas where the company needs to improve, but one area not mentioned is whether the non-executive members of the BOD meet independently at any time. Another area could be in terms of directors’ access to information.

**2** Students should use their own words, such as honesty, morally right, fairness, integrity, accountability and so on.

**3** The government can regulate against fraud and it is a criminal offence with a jail term for offenders. The issue relates more to the capacity of law enforcement agencies to apprehend the perpetrators of fraud. As a white collar crime it was once viewed as much less serious than other forms of crime, but attitudes have since changed as evidenced by the public opinion towards individuals associated with companies, such as ABC Learning, Enron and Worldcom, and individuals like Bernie Madoff in the USA.

4 Facts

– You (the accountant) are preparing the tax return for Jim’s Towing Service.

– Jim is the sole owner of the business.

– Jim does not appear to be declaring his cash-based income for tax purposes.

Stakeholders

– Jim

– Australian Taxation Office (ATO)

– Other taxpayers

Problem

– What action should you (the accountant) take with respect to the undeclared income?

Values and principles

– Professional principles at issue here include the public interest (APES 110–100.1), integrity (APES 110–110), objectivity (APES 110–120), independence (APES 110–290), and technical and professional standards (APES 110–130). There is also the principle of fairness to all taxpayers. These principles would all seem to suggest that, from the accountant’s perspective, Jim’s behaviour is unacceptable.

– However, the principles above are in some conflict with the principle of confidentiality (APES 110–140 – or is there a legal or professional duty to disclose Jim’s actions?) and the accountant’s need to maintain a client and make an income.

– Also consider the legal requirements. Tax penalties apply when there is a ‘tax shortfall’, which is the difference between tax payable determined in accordance with the law (‘proper tax’) and the amount that would be payable as determined by the taxpayer (‘statement tax’). Relevant provisions are ITAA36 s.222A–226ZB. Penalty tax may be applied under s.227 and the Commissioner has power to remit the penalty in whole or part. Where the ‘tax shortfall’ is caused by intentional disregard of the law (i.e. tax evasion), a penalty of 75 per cent applies; s.226J, compounding for repeat offences and where the taxpayer hinders the Commissioner. Alternatively, taxpayers may be prosecuted under the *Tax Administration Act*, ss.8A–8ZN, and face heavy penalties or imprisonment; or under s.29B of the *Crimes Act*, which also carries a penalty of imprisonment.

Four possible courses of action

– Action one: ignore the non-disclosure

– Action two: try to convince Jim to disclose the cash income in his return

– Action three: inform the ATO that Jim has not declared all his income

– Action four: resign from the position of accountant to Jim’s business

Evaluation

Action one:

– Not in keeping with most of the professional principles (including APS 6) or with fairness to other taxpayers.

– May encourage Jim to make even more unacceptable demands upon you in the future.

– Jim may be audited by the ATO and the non-disclosure of the cash revenues would be discovered. There may be fines or other penalties imposed upon Jim and you (and the profession) would be brought into disrepute.

Action two:

– You may be able to convince Jim to disclose his cash revenues (by, for instance, pointing out the costs of his behaviour should it be discovered) and the problem then goes away.

– Consistent with paragraph 7.4 and 7.5 of APES 220:

***7.4*** *Where a Member finds that a Client or Employer has filed returns or submissions in previous years (with which the Member may or may not have been associated) that contain materially false or misleading information or omit material information, the Member should discuss the matter with the Client or Employer and advise them of their responsibilities.*

***7.5*** *In the event of a Member subsequently becoming aware that information previously provided to a Revenue Authority by the Member, which the Member had no reason to believe at the time to be incorrect, is false or misleading, the Member should recommend that the Client or Employer make an appropriate disclosure or, alternatively, the Member should obtain authority from them to make the disclosure on their behalf.*

[Source: Accounting Professional and Ethical Standards Board, *APES 220 Taxation Services*, March 2011, p. 8, <http://www.apesb.org.au/attachments/Revised%20APES%20220%20Taxation%20Services%20%28March%202011%29%20-%20Final.pdf>]

– Jim may refuse to make the disclosures and the problem remains

– Jim may sack you (the accountant) – loss of income and problem remains

Action three:

– potentially breaking principle of confidentiality to client

– not giving Jim the opportunity to change his behaviour

– likely to lose Jim as a client

Action four:

– you lose client but the problem has not been resolved

– see paragraph 7.6 of APES 220:

***7.6*** *A Member in Public Practice who*

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| *(a)*  |  *knows that a Client or the Member on behalf of the Client has filed a return or submission materially understating a tax liability to a Revenue Authority, and* |
| *(b)*  |  *finds the Client unwilling to correct such understatement,* |

*shall consider the Firm’s policies and procedures established in accordance with paragraphs 28-35 Acceptance and Continuance of Client Relationships and Specific Engagements of APES 320 Quality Control for Firms in determining whether to continue acting for the Client in a professional capacity.*

[Source: Accounting Professional and Ethical Standards Board, *APES 220 Taxation Services*, March 2011, p. 8, <http://www.apesb.org.au/attachments/Revised%20APES%20220%20Taxation%20Services%20%28March%202011%29%20-%20Final.pdf>]

Choose a plan of action

– Take a poll of the class but emphasise the requirement that class members present a *plan* of action and that they properly *justify* that plan by reference to principles and consequences. It is often helpful to ask students if they would be comfortable having their actions publicly disclosed on television or before the courts.

**5 a** Michael should advise his client that the ATO should be notified.

Note: some students would expect nothing to be done, as a monetary error by a government department in their favour seems acceptable conduct. The discussion could centre on why it would be ethically correct to obtain a monetary advantage from a government department and not from a friend.

 **b** The captain *knows* the error has been made. He knows he is not legally entitled to the money. It can be assumed that this is akin to stealing as he is taking money that rightfully does not belong to him.

 **c** Michael’s responsibility is to act professionally. His first course of action is to inform his client that the error should be reported. If the captain is unwilling to do this then Michael should state quite clearly that he cannot act on his client’s behalf. Further, Michael should let the captain be aware that he believes it is his duty to report the matter.

**6** **a** Were the transactions unethical?

– Legal considerations: Jan Skully’s actions have most likely breached several sections of corporations law. For instance, s.232 which requires directors not to abuse their special position for self-gain; also Part VII 11 of the Act, on conduct in relation to securities, particularly ss.995–998 which outlaw misleading or deceptive conduct of the type given in the case facts. There are also common law considerations, such as Skully breaching her fiduciary duties as a director.

– Ethical considerations: Skully’s actions are inconsistent with a number of ethical principles, such as honesty, a duty of care to protect the uninformed and not to abuse her position of trust. As a member of a professional accounting body, Skully would not have complied with the principles of integrity (APES 110–110), objectivity (APES 110–120), independence (APES 110–290) and ethical behaviour (APES 110–150) – that is, bringing the profession into disrepute.

Her actions will have benefited her (and her family?) in the short term but the transfer of funds from other companies and the ramping of the share price of Extraordinary Products Ltd has eventually led to losses to the other shareholders (assuming they exist) of Skully’s related companies and the shareholders in Extraordinary. Her actions would also result in a general decline in public confidence in the share market.

**b** How could the scheme have been prevented?

– As the founder and chairperson of Extraordinary Products Ltd, Skully may well have had a very dominant position on the Board and may have seen the company as ‘her’ company. This would have made it difficult to control her actions.

– Some possible preventative measures might include:

• A strong board of directors made up of a substantial proportion of non-executive directors

• Policies in which all director share transactions must be declared to, and approved by, the board of directors

• Policies prohibiting insider trading

• Internal auditing which reviews changes in the share register and the internal auditor reports to the whole Board (or audit committee)

• A policy of disclosure in the financial report of all related party transactions along the lines of AASB 124

 Many of these suggestions have been incorporated in the Corporate Governance Best Practice Guidelines issued by the ASX. Details are provided in Chapter 12.

**7** Any increase in regulation comes at a cost and we should therefore consider whether the cost of regulating corporate governance structures would provide greater benefits. To some extent the legislative reaction, such as Sarbanes-Oxley in the US, was to be seen to be doing something in the light of the spectacular company collapses, because the research on corporate governance does not provide any conclusive evidence about ideal size of boards, number of independent directors and so on. By using the best practice approach, the market can then penalise companies if it feels the corporate governance practices of the company are inadequate.

**8** The arguments in favour of a majority of independent directors relate to the ability of external directors to more effectively monitor the performance of the company and its management than internal directors, who will be less objective in the assessment of the company’s performance. External directors will be less susceptible to manipulation from the CEO than internal directors. There is also the argument that firms with better corporate governance will be more attractive to investors and thus enjoy a share price premium.

Those who argue against this view believe that external directors do not add to the economic discipline already imposed on managers by product and factor markets, the managerial labour market and the market for corporate control. Some argue that given the large number of directorships held by many directors they do little more than provide outside contacts and advice for senior management. Internal directors have intimate knowledge about the company and are able to make more informed decisions for the benefit of the company.

Research results on this issue are mixed but the majority of papers tend to report no association between independent directors and firm performance.

 Presumably the need for independent directors to hold separate meetings is to enable them to debate issues openly which may be difficult with internal directors present, particularly the CEO. This is particularly true if they wish to discuss the performance of the CEO.

**9** It is important for audit committees to have the ability to seek independent advice on issues to enable them to properly discharge their duties. Such advice may be on legal or accounting matters if the members of the audit committee do not have the required expertise. If the committee has to seek funding permission from the CEO, then this is a limiting factor.

Members of the management team should only attend meetings when invited. This may be appropriate from time to time so the committee can ask relevant questions about the company, such as about issues to do with internal control procedures. They would attend meetings to provide information but would certainly not hold any voting rights.

Ethics case study

**a** This is a complex issue and one that confronts many businesses and universities when teaching business ethics. There is sure to be lively debate among students. Should companies behave differently in different countries or should they have the same code of conduct irrespective of location? We certainly recognise cultural differences such as the way business cards are distributed with two hands in Asian countries so why should we adopt different ethical behaviours?

**b** As stated in part a do we have different codes of ethics for different countries? The payment of facilitation fees is common in some countries but is not in Australia. If all western countries refused to pay such bribes and kickbacks would this change this practice in those countries?

**c** It is an offence to pay bribes in Australia and the offender will serve time in prison. Students may be divided in their views but can we have different laws and punishment based on the country where the bribe took place?

**d** The GRI requirement for the reporting of anti-corruption actions including risk assessment of the potential for corruption and training of staff about anti-corruption policies should improve the awareness of staff about the inappropriateness of such behaviour and assist in reducing the practice.