# A CPA'S GUIDEBOOK FOR ETHICAL BEHAVIOR

A Continuing Professional Education Ethics Course for Texas CPAs

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# ABOUT THE SPEAKER AND AUTHOR

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Prior to joining the UNT faculty in 2010, Professor McLeod held the position of Director of Tax Planning and IRS Audits for Lehigh Hanson North America, a major manufacturer of cement, aggregates and other building materials. Her practice included both federal and international tax planning. Professor McLeod also spent thirteen years specializing in Tax Planning with the JCPenney Corporation, Inc., and two years with Deloitte & Touche in Dallas.

Professor McLeod teaches at the university level graduate classes on Ethics, Tax Research and Corporate Income Tax. She also lectures in Financial Accounting and Individual Taxation on an undergraduate level. Since 2011, Professor McLeod has been honored to present live and on-line ethics CPE classes to CPAs across the nation. She also serves as an expert witness in accounting malpractice cases and maintains a small private practice serving individuals and small businesses. Professor McLeod has also taught at the University of North Texas College of Law as adjunct faculty.

Professor McLeod is licensed to practice law by the State Bar of Texas since 1992 and has been a Certified Public Accountant since 1993.

# COURSE OBJECTIVES

1. To educate licensees in ethics of professional accounting as Texas CPAs.

2. To convey the intent of the Rules of Professional Conduct in the performance of professional accounting services/work, not to adhere to the mere technical compliance of such rules.

3. To assist the Texas CPA in applying ethical judgment in interpreting the rules and determining public interest. Public interest should be placed ahead of self-interest, even if it means a loss of job or client.

4. To review and discuss the Rules of Professional Conduct and their implications for persons in a variety of practices, including:

    a. CPAs in client practice of public accountancy who perform attest and non-attest services per § 501.52.

    b. CPAs employed in industry who provide internal accounting and auditing services.

    c. CPAs employed in education or in government accounting or auditing.

# INTRODUCTION

Accounting scandals. Embezzlement. Fraud. "Taking the easy way out." All too often we read these words in the paper or hear it on the evening news. Most of the tales tell of the failure by individuals in their fiduciary duty to properly handle, manage and/or report company assets and operations.

Values. Ethics. Integrity. Morality. Principles. Courage. "Doing the right thing." Far more rarely reported are stories of those who are not only steadfast in their values, but also take action to right a wrong, despite the many factors that can pull an individual in many directions. Greed, management pressure, fear, and expediency are some of many different aspects that divert an individual from a righteous path to the slippery slope of moral compromise.

In an era of some managements' over-focus on analysts' expectations and pressure to meet profit and loss targets, there are unfortunately many examples of cutting corners and so-called "earnings management" which later are labeled by the action's real names: unethical behavior, criminal activity and fraud. In certain cases, the accountants become complicit, either wittingly or unwittingly, in the scandal.

How is a Certified Public Accountant ("CPA") expected to navigate such treacherous shoals?

The following course material is designed to assist the CPA in learning how to manage the ethical challenges that arise in today's work environment. We will examine in Part I the basic ethical philosophies and values that individuals rely on to determine which actions are right and which are wrong. Part II will review the various guidelines, such as the AICPA Code of Conduct and/or state specific rules, to which CPAs must adhere. After covering rules, thoughts and philosophies, Part I and II can assist the CPA in determining the rightness and wrongness of an action, Part III will discuss ways in which individuals can improve their chances of behaving ethically. Woven throughout the material are various real-world case studies to illustrate various points.

# PART I: VALUES - A STRAIGHT AND NARROW PATH OR A MINEFIELD?

What are ethics? The Encyclopedia of Philosophy gives a helpful definition:

1. A general pattern or "way of life,"
2. A set of rules of conduct or "moral code," and
3. Inquiry about ways of life and rules of conduct.[1]

Items 2 and 3 above are focused on determining what is acceptable or unacceptable based on one's values or existing rules. We will cover various schools of ethical thought as well as the specific rules governing CPA conduct in Parts I and II, respectively, of the course material.

While it goes without saying that it is essential that a person have some frame of reference to determine the correctness of an action, the greater challenge is in Item 1 above, integrating this knowledge into ethical action into a way of life. Ideally, one's values and ethical rules are so internalized that doing the right thing becomes more of a reflex than conscious decision. This topic will be covered in Part III of this course.

## THE ETHICAL FRAMEWORK

Two of the primary branches of ethics are ***normative ethics*** and ***applied ethics***.[2]

***Normative ethics*** address the issues of right and wrong actions. A normative theory makes claims or offers guidelines or norms about how to discern the right action. We will be focusing on the various types of normative ethics in this segment.

***Applied ethics*** investigates how a normative system plays out in a practical situation. Business and Accounting ethics are a type of applied ethics. We will discuss in Part III how to put our values and ethical rules into practice in our everyday work lives.

### Normative Ethical Theory

There are three major normative ethical schools of thought – consequentialism, deontological theory and virtue ethics.[3]

#### *Consequentialism*

Consequentialism focuses on choosing the right action, which is determined by looking at the consequences of that action.

 

One of the noted consequentialists from the late 1700s was Jeremy Bentham, who espoused the concept of *utilitarianism*. This theory states that the correct action is the one that maximizes good. Good is defined as pleasure and Evil as pain. The weakness in this theory is the fact that an individual may define good as the action that brings him or herself pleasure without regard to whether or not the action brings good or bad results to others. Complete focus on pleasure for one's self is called *hedonism*. Henry Sidgwick, a Victorian philosopher pointed out the downside that when the objective is pleasure, pleasure becomes elusive. This is known as the "hedonist's paradox."

Bentham contemporary John Stuart Mill refined this theory by stating that actions have utility when they maximize happiness. He focused on the pleasure of <u>all</u> who would be affected by the action not just one's own pleasure.[4]

The oft-repeated maxim, *ends justifies the means*, is often used to describe an individual's desire to achieve a particular outcome irrespective of whether the actions taken to realize these goals are good or bad in themselves. This ethical framework in itself is certainly a valid one assuming that the end result has a noble purpose that outweighs the cost of achieving it.

For example, many of us viewing in isolation the techniques used during military boot camp might consider the harsh physical activity, sleep deprivation, unyielding structure, and yelling to be cruel and unnecessary. All military branches are responsible for transforming undisciplined, out-of-shape, and sometimes unmotivated young recruits into physically capable and mentally controlled individuals that are able to obey orders and complete the mission even in the face of confusing, chaotic or dangerous situations. Why? Because in many cases, our country depends on these young men and women to do their jobs in order to keep the rest of us safe. If the recruits had not been subjected to such extensive and rigorous training, their superiors could not rely on them to execute orders in crucial situations and all could be lost. Likewise, business may have to ask employees to work overtime to reach a particular short-term goal. Another appropriate example is choosing not to "fix" an immaterial accounting error since the time and resources needed to rectify the situation outweigh any benefit that could be derived.

The phrase *ends justifies the means* more often conjures up visuals of dramatic characters, such as the Machiavellian mobster family in the popular television show, *The Sopranos*, who are willing to commit any brutal or repulsive act in order to "maintain peace in the 'family.'" And indeed, there are many real-world financial statement fraud cases where the *ends justify the means* theory of ethical thought has been misused by management teams overly focused on achieving analysts' expectations. We do not have to go back many years to recall the spate of accounting scandals that set new lows on the financial statement manipulation that companies were willing to employ. The shock of the World Com, HealthSouth, and Enron failures were unfortunately eclipsed by Bernie Madoff and the many players in the recent mortgage crisis -- Lehman Brothers, Goldman Sachs, Moody's, AIG, JP Morgan, and Countrywide -- to name a few. So many of these organizations justified their unethical business practices based on the short-term benefits (mostly to themselves) to be derived. Little consideration was given to the devastating impact to the shareholders, the employees and indeed the global economy. Thus, one of the major shortcomings of consequentialism is the fact that sometimes the full extent of outcome is not always known at the time the act occurs.

In early June 2016, a pair of would-be robbers held up a McDonald's restaurant on the outskirts of Paris, seizing approximately $2,000. What was probably obvious to the criminals is the fact that there was a chance of being caught by the police during the course of the robbery, assuming the authorities would be able to arrive on time. Perhaps in the thieves' mind, the benefits of obtaining the loot (the ends) outweighed the calculated possibility of being caught by the police. What was not anticipated by these burglars was the fact that eleven armed members of the French Paramilitary Special Forces (France's version of the Navy Seals or Army Rangers) were eating lunch at the restaurant that day. It goes without saying that the soldiers acted decisively to efficiently apprehend the crooks in record time.[5]

The criminals may have contemplated a particular consequence (apprehension by the police) and its attendant risk (only a remote possibility of being captured) with respect to robbing the bank but the risk ended up being far higher and the outcome far more painful.

This story is an unfortunate parallel for the unintended consequences that often occur as a result of financial statement fraud. Recent studies have found that the more the management is focused on meeting analysts' expectations or internal metrics, the less transparent financial reporting becomes. Thus, the accountants may be under great pressure to "fudge" numbers or improperly shade transactions in order to meet executives' demands for the financial statements to conform to the desired goal. Unfortunately, this short-term focus on meeting expectations comes at the price of at a minimum, "bad/aggressive accounting" which can easily lead to fraud. Most individuals do not intend to commit white-collar crime, but they fail to look past the immediate pressure to see that their wrongful act can lead to loss of license, suspension, jail time, and a stigma that would be hard for a family to bear.

***Case Study: Willful Ignorance and the Subprime Mortgage Crisis***

Much ink has been spilled in the aftermath of the Great Recession, which was spurred on in large part by the greed and ignorance of the major players on the financial stage. Unfortunately, it becomes a cautionary tale of what can occur if individuals and institutions look ONLY to their own interests and do not consider at all the catastrophic consequences such actions leave in its wake.

It seemed that no one, from the major banks, insurers and ratings agencies down to the mortgage brokers and homebuyers, cared about the long-term devastating impact to the global economy in general and to themselves in particular. One of the biggest culprits of the financial meltdown from 2007-2010 was associated with the mortgage crisis. A brief discussion of the major events that lead to the implosion of the global economy is warranted.

Prior to the securitization of debt (which will be discussed below), banks traditionally would lend money -- via mortgages or a line of credit -- to customers who were depended upon to pay the funds back at an agreed-upon time. Since most banks kept the mortgage or notes until maturity, it was critical that both the borrower was solvent and trustworthy and that the asset being mortgaged was stable and valuable enough to satisfy the note should it become repossessed.

Starting in the 1970s, banks discovered that it was far more lucrative to sell financial products securitized by a bundle of mortgages to the public and other financial institutions. These products were also known as mortgage-backed securities ("MBSs"). If there was interest or dividends due to the MBS investor or they wanted to be redeemed out, the Banks would need to rely on a steady cash flow from borrowers consistently paying off their mortgages. The beauty of this scheme is that poor-quality mortgages – known as subprime – could be mixed in with AAA rated mortgages without significantly impacting the MBS holder's risk of loss under the theory that the underlying assets were diversified. It seemed that the public's appetite for MBSs was endless, and many of the major financial institutions were happy to rake in the profits. There were also some other players indirectly benefitting from the MBS golden goose: insurance companies who gleefully received billions in premiums in exchange for insuring what they considered the unlikely event of loss should certain tranches of mortgages underlying the MBSs fail. These products were known as "credit default swaps" or "CDSs." There were infinite permutations and secondary markets of the MBSs and CDSs and many came to the party. What many people failed to realize was that billions of dollars of "wealth" all hinged on whether the underlying assets – the bundle of mortgages --- were current and the houses which they secured had at least as much or more value than the money that was owed on them.

Unfortunately, a catastrophic number of mortgages defaulted, causing the MBSs to drop tremendously in value. Those owning the MBSs sustained direct losses, as did the insurance companies that underwrote them. Storied firms such as Lehman Brothers and Bear Stearns disappeared or were swallowed up by others. Massive lay-offs and the freezing of the credit markets caused the economy to go into a death spiral. Ordinary citizens who had little to do with the mortgage crisis found themselves as collateral damage. Most of us know of friends, relatives and perhaps yourself who experienced loss of job, reduction in wages, and tremendous financial stress. No one was unscathed. What were some of the factors, which led to this monetary Armageddon?

- ***Mortgage companies*** such as Countrywide who were willing to lend money to individuals who were either not credit worthy or simply did not have the income level to support large mortgages. These companies knew they could underwrite faulty loans and profitably unload them on conglomerates who were repackaging them and selling them off in pieces via the CDOs. NINJA (No income, no job, no assets) loans, subprime mortgages, "liar" loans and unconscionable adjustable rate mortgages ultimately became some of the instruments of destruction. These mortgage companies neither knew nor cared whether the loans would go into default because it would not be their problem once the asset had been peddled to someone else.

- ***Regulators*** such as the Office of the Comptroller of the Currency and the Office of Thrift Supervision which looked the other way even when the attorneys general of some of the states reported predatory real estate financing by several of the banks.

- ***Banks*** such as Goldman Sachs, Lehman Brothers, Bear Stearns, Citibank and JPMorgan, who recklessly purchased these mortgages and essentially foisted them upon investors even though an even cursory review would have revealed that the MBSs would be based on financial quicksand. These financial institutions also carried an enormous amount of debt compared to their equity, in some cases 40-to-1. This created the situation where even a modest decrease in the value of the bank's assets would almost immediately cause insolvency.

- ***Insurers*** such as AIG who recklessly issued policies via the CDSs without performing due diligence. The losses sustained during the meltdown were greater than they had resources to cover The US taxpayers ended bailing out most of these insurers via the billions injected by the Federal Reserve.

 

- ***Ratings Agencies*** such as Moody's Standard & Poor's and Fitch's which allowed their clients to "buy" excellent ratings on these investments. The purpose of the agency ratings is to indicate to the investing public the risk level of financial product, and in theory these ratings are supposed to be impartial. However, the investment's sponsor was the one having to pay for the analysis. As a result, agencies would oblige their customers with inflated ratings in fear of losing their business Investors therefore bought MBSs and other derivatives – and insurers issued CDSs—based on these strong ratings not knowing or perhaps caring that they were taking on far more risk than they had anticipated.

- ***Freddie Mac/Fannie Mae*** strayed from their original purpose of being the purchaser and/or insurer of last resort for troubled mortgages. Originally, these entities were designed to be a mechanism for keeping capital smoothly flowing into the lending market. Due to misguided governmental expansionist policies, Freddie and Fannie became willing dumping grounds for these home loans that would have never happened had the lender been completely accountable for the losses. When a critical number of the mortgages that had been guaranteed started to go into default, Freddie and Fannie experienced huge losses. They were then unable to continue purchasing any more mortgages, resulting in a freezing in liquidity and adding precipitous momentum to what became the Great Recession.

- ***Individuals*** who were willing to borrow up the limit all the money the mortgage companies were offering even though common sense would have easily shown that they did not have the personal wherewithal to support the debt. Many people allowed the promise of sudden riches by "flipping" houses cloud their judgment and sign on to loans that were unsustainable. One could argue that had individuals not been enthralled by the idea of owning their "dream home" or by greed of quick success, they would have borrowed only a sensible amount. The real estate bubble may not have been as dramatic, and perhaps the implosion of the economy would have been far more muted.

What becomes obvious in reviewing this debacle is that all the characters involved were acting almost entirely in their own interests and were indifferent as to how their individual callous and unethical behavior would collectively bring the world economy nearly to a complete collapse. In the interim, many individuals who had nothing to do with the mortgage shenanigans were indelibly affected through loss of job, home and family. Suicide became more prevalent as some people became increasingly more desperate as the Great Recession dragged on. It can be argued that those parties who willingly participated in what many people described as a mortgage Ponzi scheme have blood on their hands.

 

## *Deontology*

Another normative ethical theory is deontology. A deontologist espouses the maxim that one should do the right thing based solely on the fact that it is right, irrespective of the consequences of the action. Their mantra would be "do your duty for duty's sake." A person therefore must tell the absolute truth even though the fall-out could be significant. A deontologist does not look to the future or the effect of an action. They merely do the right thing because it is the right thing to do.

One of the leading deontologists from the mid- 18th century was Immanuel Kant. He championed the belief that an act is moral because it is right, not because of its consequences. He held that if we have a duty, we must perform that duty without exception.[6]

Deontologist base their decisions about what's right on broad abstract universal ethical principles or values such as honesty, promise-keeping, fairness, loyalty, rights (to safety, privacy), justice, responsibility, compassion, and respect for human beings and property. According to some deontological approaches, certain moral principles are binding, regardless of the consequences. Therefore, some actions would be considered wrong even if the consequences of the action were good. In other words, a deontologist focuses on doing what is right whereas a consequentialist concentrates on doing what will maximize societal welfare.

During World War II, some of the individuals being interrogated would lie to Nazis and state that they were not hiding Jews even though they were in fact doing so. While we generally have a duty to tell the truth to authorities, in this case the individuals found that the value of human life outweighed the duty to tell the truth. A deontologist would not consider being untruthful to the authorities since lying in itself is a bad act, even though such a confession would put another's life into peril. A consequentialist would condone lying in that circumstance since a human being is more important that telling a lie.

The downside to deontology is that there can be over focus on merely doing one's duty or "following the rules" without considering the bigger picture. Often, accountants will look for guidance (e.g., GAAP, IFRS, tax law) to determine how to treat a particular transaction. While it is appropriate to gather this information, this should not be the end of the inquiry. Meeting the rules should be the starting point for whether or not a matter is ethical, not the end of the investigation. After ensuring that the transaction meets the minimum legal requirements, CPAs should then ask additional questions: Is the transaction ethical? Even though it meets the letter of the law, does the proposed treatment subvert the policy for which the rule exists? Is it the right thing to do? Does the transaction "smell bad?"

***Case Study: Toronto-Dominion Bank Lives its Values***

The shenanigans of selling mortgage-backed securities to an unsuspecting public were not limited to the United States. In Canada, similar products called asset-backed commercial paper (ABCP) were also being widely sold. ABCP were short-term debt instruments issued by a trust and secured by assets such as mortgages. The weakness of this product was that the ABCP depended on the cash flow of its underlying assets. If mortgages started defaulting, then there potentially could be a lack of funds to satisfy the ABCP when they became due. We can see in hindsight that many of the mortgages did begin to falter, and a liquidity crisis ultimately ensued starting in mid-2007. However, the management of Toronto-Dominion Bank, one of the largest conglomerates in the Canadian financial sector, had the foresight in 2005 to exit the structured loans products market, including interest rate derivatives and MSBs. Their CEO, Edmund Clark, had determined that the business model underlying the ABCP was faulty and incomprehensible. Further, the specter of potential default presented far more risk to the shareholders than was conscionable. Most of Toronto-Dominion's profits in 2005 and later were generated by traditional but stodgy source, such as consumer lending and money management. Competitors from 2005 to 2007 seemed to be riding high by comparison due to the outsized returns from the ABCP. Toronto-Dominion practically became a laughingstock during this period due to its conservative strategic choices. However, Clark's foresight in rejecting transactions that were not based on his contemporaries' business paradigms became enviable once the mortgage crisis took hold in Canada. Of the five major banks, only Toronto-Dominion escaped relatively unscathed.

*Story as relayed by Brooks, Leonard, and Dunn, Paul, Business & Professional Ethics: For Directors, Executives & Accountants, 7th ed., (CT: Cenage, 2015) pgs. 605-607.*

## *Virtue Ethics*

The third normative ethical theory is virtue ethics, which espouses that the most important aspect of morality is having the right character. In other words, possessing the right set of virtues is central to morality because what makes an action right is that it is one that a virtuous person would take.[7]

Virtue ethics states that having the right character, or virtues, is the most important aspect of morality. Aristotle is the most famous proponent of virtue ethics. He championed a list of major virtues that each individual should possess or be in the process of obtaining:

1. Courage
2. Temperance - moderation
3. Liberality – spending money well
4. Magnificence – living "well"
5. Pride – taking pleasure in accomplishments
6. High handedness - concern with the noble, not with the petty
7. Diligence – between reckless ambition and total lack of effort
8. Gentleness -- Concern for others
9. Truthfulness – not being boastful
10. Wit – pleasure in group discussions
11. Friendliness – pleasure in group associations
12. Modesty – pleasure in personal conduct
13. Righteous indignation
14. Justice[8]

The virtue ethics approach focuses more on the integrity of the moral ***actor*** than on the moral ***act*** itself (the decision or behavior). The goal here is to be a good person because that is the type of person you wish to be. A virtue ethics perspective considers the actor's character, motivations, and intentions. According to virtue ethics, it is important that the individual intends to be an upright being and exerts effort to develop him or herself as a moral agent.[9]

While we may sometimes feel that based on the numerous stories in the media that corporate wrong-doing seems to be the norm rather than the exception, certain organizations -- such as Toronto-Dominion Bank discussed above -- consistently uphold their values and are shining examples of what it means to be ethical even when it seems that no one else is playing by the rules.

***Example: The Whistleblowers***

Time Magazine's 2002 Persons of the Year included whistleblowers Sherron Watkins (Enron) and Cynthia Cooper (WorldCom). Both of these women discovered discrepancies in their respective employers' financial records, which led them to uncover underlying fraudulent transactions. Both of their companies ultimately collapsed under the weight of the financial deceptions.

CPAs who find themselves in similar circumstances can use any of the three ethical frameworks we discussed above to help him or her determine whether or not to alert the authorities about any irregularities.

In considering ***Consequentialism***, the individual may ask, "if I disclose/don't disclose to the appropriate individuals this fraud, what will be the impact to the shareholders, employees, lenders, investors, board, and customers?"

The CPA analyzing his or her potential actions using ***Deontology*** would contemplate, "What is my duty? What does the law/applicable rule say must be done?" Consequences of the action would not be part of the decision.

Finally, an individual relying on ***Virtue Ethics*** will use character and virtues to guide him or her. The main determination here will be, "what would a courageous, truthful, and just person do in this situation?" A person relying on virtue ethics would not consider the consequences of their choice or even whether or not any parameters apply (such as a confidentiality agreement or a law). Their focus is acting in a way that a righteous person would behave.

## THE BOTTOM LINE

The ethical theories discussed above can aid an individual in establishing his or her values. Values oftentimes are also a result of upbringing, experiences, environment, and perhaps even "the school of hard knocks." These standards can help guide a person in determining what actions are acceptable or unacceptable when faced with a moral dilemma.

We will discuss values and its role in shaping ethical behavior in Part III.

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[1] The Encyclopedia of Philosphy, e. Paul Edwards, Macmillan Publishing Co., Inc., New York, 1967 Vol. 3, pp. 81-82.
[2] Jackson, Cecil, Detecting Accounting Fraud: Analysis and Ethics (NJ: Pearson, 2015), pg. 25.
[3] Jackson, page 25.
[4] Jackson, page 25-26.
[5] https://www.washingtonpost.com/news/morning-mix/wp/2016/06/08/two-guys-allegedly-tried-to-rob-a-french-mcdonalds-but-off-duty-special-forces-unit-was-eating-inside/ . Downloaded 7/17/2016 1:23 p.m.
[6] Jackson, pgs. 26-27.
[7] Jackson, page 27.
[8] Cherrington, Owen, and Cherrington, David, Moral Leadership and Ethical Decision Making (UT: CHC Forecast, 2000), pgs. 18-19.
[9] Trevino, Linda and Nelson, Katherine, Managing Business Ethics: Straight Talk About How to Do It Right, 6th edition (NJ: Wiley, 2014), pg 46.