CHAPTER 1
ETHICAL ISSUES IN ADVANCED ACCOUNTING

ANSWERS TO REVIEW QUESTIONS

1. "Cute accounting" is stretching the **form** of accounting standards to the limit, regardless of the **substance** of the underlying business transactions or events. "Cooking the books" is fraudulent financial reporting.
2. The Equity Funding Corporation of America fraud is significant for management accountants and financial executives because the fraud was carried out over a nine-year period by at least 10 executives of Equity, several of whom were CPAs with public accounting experience. This fraud furnished clear evidence of the need for ethics codes for management accountants and other financial executives.
3. Four components of ethical conduct for management accountants, set forth in the IMA's ***Standards of Ethical Conduct for Members*** are competence, confidentiality, integrity, and objectivity.
4. **Fraudulent financial reporting** was defined by the Treadway Commission as "intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements."
5. Rules 102, 201, 202, 203, 302, and 501 of the AICPA's ***Code of Professional Conduct*** apply to all members of the AICPA, including management accountants.
6. The ethics codes of the IMA and the FEI have no specific requirements for compliance with generally accepted accounting principles.
7. **Insider trading** of corporate securities is purchasing or selling a security while in possession of material, nonpublic information or communicating such information in connection with a securities transaction.
8. No, the SEC does not accept a "good soldier" rationalization for fraudulent financial reporting, as emphasized by the SEC in ***AAER 93,*** ". . . In the Matter of Michael R. Maury," and ***AAER 538,*** ". . . In the Matter of Michael V. Barnes."
9. The IMA's ***Standards of Ethical Conduct for Members*** requires management accountant members to avoid actual or apparent conflicts of interest and to advise all appropriate parties of any potential conflict.
10. The FEI ***Code of Ethics*** requires FEI members to maintain the confidentiality of information acquired in the course of their work except when authorized or otherwise legally obligated to disclose it.

11 Article IV, "Objectivity and Independence" of "Section I: Principles" of the AICPA ***Code of Professional Conduct*** acknowledges that AICPA members not in public practice cannot maintain the appearance of independence.

12. The Public Company Accounting Oversight Board regulates the conduct of accountants both in public practice and in publicly owned business enterprises.

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SOLUTIONS TO EXERCISE

Ex. 1–1	1. *b*	7. *c*
	2. *a*	8. *b*
	3. *d*	9. *a*
	4. *a*	10. *a*
	5. *d*	11. *d*
	6. *b*	12. *b*

CASES

Case 1–1 Arguments in support of the affirmative side of the debate include the following:

(l) The word **unswerving** implies that there is never a cause for a deviation from honorable behavior by a member of the AICPA. What if the member were a victim of fraud, harassment, or other unacceptable behavior? Must members defending themselves from such indignities be precluded from "fighting fire with fire"?

(2) In today's highly competitive business and professional activities, behavior deemed dishonorable by one person might not be viewed as dishonorable by another, given that there are no specific attributes associated by all persons with such behavior.

Arguments in support of the negative side of the debate include the following:

(l) Licensed members of a profession are expected to behave in a manner above and beyond the norm for society as a whole.

(2) CPAs serve the public interest; thus, they should never engage in conduct that would harm that interest.

(3) Placing personal advantage before the best interests of the client or the public would lead to a conflict of interest—one of the most egregious types of unprofessional conduct by a CPA.

Case 1–2 A literal interpretation of the quotations would suggest that written codes of ethics are unnecessary. To be erect implies that honorable and ethical behavior is innate, rather than dictated by a set of written rules. Further, critics of codes of ethics allege that they often become the basis for a **minimum** level of conduct and for conduct that complies with the **letter,** but not the **spirit,** of an ethical rule. Loophole seekers attempt to defend what appears to constitute unethical behavior by pointing out that no specific rule of a code of ethics specifically proscribes the conduct.

Case 1–3 All three professional societies require their members to behave ethically. For example, the IMA has the following rule in its ***Standards of Ethical Conduct for Members:***

> Members have a responsibility to perform their professional duties in accordance with relevant laws, regulations, and technical standards.

A comparable rule of the FEI is as follows:

> All members of FEI will comply with rules and regulations of federal, state, provincial, and local governments, and other appropriate private and public regulatory agencies.

In like vein, Rule 102 Integrity and Objectivity of the AICPA *Code of Professional Conduct* reads as follows:

> In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

The foregoing rules clearly provide strong support for resisting “cook-the-books” pressure applied by a chief executive officer of a business enterprise.

Case 1–4 The chief financial officer and the controller of an SEC registrant enterprise should view the obligation to sign the registrant's **Form 10-K** and **Form 10-Q** reports as an affirmation that the reports comply with the requirements of the ***Securities Exchange Act of 1934*** and the rules and regulations of the SEC thereunder. Due professional care obligates the signatories of the reports to ascertain, to the best of their ability, that the reports are free from material errors, either of omission or of commission.

Case 1–5 One might agree with the Walters statement by pointing out that management accountants possibly have inherent conflict of interest problems in that their salaries and other remuneration such as bonuses and stock options depend in some measure on the financial results that they report for their employer enterprises. However, the Institute of Management Accountants, in developing ***Standards of Ethical Conduct for Members;*** the Treadway Commission, in specifying the obligations of chief accounting officers; and the Securities and Exchange Commission, in issuing ***Accounting and Auditing Enforcement Releases No. 93*** and ***No. 538,*** certainly must have given consideration to the concerns raised by Walters and concluded that the management accountant's obligations to the public override any excuse for the accountant's succumbing to the temptation to place his or her interests, or the interests of others in the enterprise, above the public interest.

Case 1–6 In today's society, where some government agencies, the media, and telemarketers appear to be intruding more and more into the private affairs of other individuals, many persons feel strongly that their private lives should be divorced completely from their careers and public lives, and that what they do in private should not enter into evaluations of their professional or public conduct. In contrast, some professional organizations, being ***voluntary*** in their membership, believe that establishing standards of conduct for all phases of their members' activities is appropriate. In their view, prospective members uncomfortable with the obligation to conduct personal affairs at all times with honesty and integrity need not join the organization. Student Ross sides with this view.

Case 1–7 Vernon Cass appears to be somewhat naive in his request to John Conroy; he couched the request in a way that indicates his lack of awareness of the obligations of managements of publicly owned enterprises to issue truthful financial and other reports, regardless of the profitability or financial position of the enterprises. It might be appropriate for Conroy tactfully to remind Cass of such obligations. However, Conroy's suggestions for changes in estimates affecting depreciation and doubtful accounts expense should not be challenged as “cooking the books” unless no basis may be found for changing the estimates. For example, paragraph 10 of ***APB Opinion No. 20*****,** "Accounting Changes," states: ". . . accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained." Further, the subjectivity that enters into accounting estimates is recognized as follows in ***Statement on Auditing Standards No. 57*****,** “Auditing Accounting Estimates”: “. . . estimates are based on subjective as well as objective factors. . . .” If there is **justification** for extending the economic lives of Tingley Corporation's plant assets and reducing the percentage used to estimate Tingley's doubtful accounts, such changes should be made. Justification obviously should not be based solely on enhancing Tingley's net income and earnings per share.

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In contrast, deferral of advertising costs other than **direct-response advertising** as described in AICPA ***Statement of Position 93-7*,** "Reporting on Advertising Costs," which would be a change in accounting principle, would be difficult to support. The period or periods to be benefited by such costs, if they were deferred, generally are impossible to estimate. Thus, if John Conroy includes such deferral in his recommendations to Tingley's audit committee, the committee most likely should reject the recommendation.

Case 1–8 Resignation from one's job is a trying experience. Appropriately, it is listed in ***Standards of Ethical Conduct for Members*** as the **last resort** for management accountants faced with an unresolved ethical conflict. Nevertheless, resignation is the only logical course of action for a management accountant who has exhausted all other possibilities for resolution of ethical conflict set forth in the ***Standards.*** Unfortunately, the Securities and Exchange Commission's **Form 8-K,** "Current Report," does not require a publicly owned company to report resignations of accounting employees as it requires reports of replacement of independent auditors. Thus, the resigning management accountant, in addition to being unemployed, may find difficulty in obtaining an alternative accounting position because of a lack of references from the former employer. In sum, the management accountant who resigns because of an unresolved ethical conflict is in a "Catch-22" position.

Case 1–9 Many accountants believe oversight by professional societies is preferable to oversight by governmental agencies; thus, they welcome the opportunity to join professional societies that emphasize **self-regulation** through their codes of ethics of conduct and their bylaws. Membership in professional societies also gives accountants opportunities to share knowledge, to better the accounting profession, to provide **pro bono** services to less fortunate members of society, to enjoy collegiality with fellow professionals, and to have quality opportunities for continuing education in accounting and related subjects. Thus, accountants who seek membership in the AICPA, the FEI, or the IMA feel that adherence to codes of ethics or conduct is a small price to pay for the advantages of membership.

Case 1–10 To: Roy Weber, Chairman, Audit Committee

From: ________________________ , Chief Financial Officer

Date: ________________________

Subject: Recognition of Revenue for "Bill and Hold" Sales

In ***Accounting Series Release No. 292*,** " . . . In the Matter of Arthur Andersen & Co.," the Securities and Exchange Commission described "Bill and Hold" sales as follows:

> "Bill and hold" generally is a practice whereby a customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment to designated locations. (footnote 5)

Paragraph 84a of ***Statement of Financial Accounting Concepts No. 5*,** "Recognition and Measurement in Financial Statements of Business Enterprises," states that, in recognizing revenue:

> The two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered . . . , and revenues from manufacturing and selling activities . . . are commonly recognized at time of sale (usually meaning delivery).

Furthermore, paragraph 78 of ***Statement of Financial Accounting Concepts No. 6*,** "Elements of Financial Statements," defines ***revenues*** as "inflows or other enhancements of assets of an entity . . . from delivering or producing goods. . . ."

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At first glance, the foregoing excerpts from the Financial Accounting Standards Board's ***Statements of Financial Accounting Concepts*** suggest that revenues from "bill and hold" sales should be recognized at the time the toys ordered by retailer customers are shipped to them. However, the word "producing" in ***Statement 6*** implied that ***delivery*** of goods is not always required for the recognition of revenue. Further, two sections of the ***Uniform Commercial Code*** should be considered, as follows:

> Sec. 401(1). Title to goods cannot pass under a contract for sale prior to their identification to the contract.
>
> Sec. 501(1). The buyer obtains a special property and an insurable interest in goods by identification of existing goods as goods to which the contract refers.

The foregoing suggest that revenue from "bill and hold" sales can be recognized when the toys ordered under such sales contracts are segregated and identified as ***customer-owned.***

Finally, I have found that the Securities and Exchange Commission, in ***Accounting and Auditing Enforcement Release (AAER) No. 108*****,** " . . . In the Matter of Stewart Parness," established the following conditions for the recognition of revenue from "bill and hold" sales:

(1) The risks of ownership must have passed to the buyer;

(2) The customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation;

(3) The buyer, not the seller, must request that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;

(4) There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e.g., storage periods are customary in the industry);

(5) The seller must not have retained any specific performance obligations such that the earning process is not complete;

(6) The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and

(7) The [goods] must be complete and ready for shipment.

The foregoing conditions were reaffirmed in ***AAER 817*****,** " . . . In the Matter of Cypress Bioscience Inc. . . ."

Concluding, I opine that, if "bill and hold" sales of Playthings, Inc. meet the criteria of ***AAER 108*****,** revenue can be recognized prior to shipment of the goods.

Case 1–11

a. According to the SEC, in ***AAER 1140***, "In the Matter of W. R. Grace & Co., Respondent," during the period 1991 through 1995, Grace established "cookie-jar reserves" to defer excess earnings of a subsidiary, National Medical Care, Inc., during 1991 and 1992, and thereafter at various times reversed the bogus reserves, to increase actual earnings growth rate of the subsidiary by as much as 150% (to 35% from 14%).

b. In ***Staff Accounting Bulletin No. 99***, "Materiality," issued August 12, 1999, the SEC staff emphasized that generally accepted accounting principles require consideration of ***qualitative*** as well as ***quantitative*** issues in determining the materiality of a misstatement in financial statements. In doing so, the SEC staff referred frequently to the Financial Accounting Standards Board's ***Statement of Financial Accounting Concepts No. 2***, "Qualitative Characteristics of Accounting Information," and referenced ***AAER No. 1140*** in footnote 6.

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