CASES IN ACCOUNTING ETHICS AND PROFESSIONALISM

SECOND EDITION

STEVEN M. MINTZ

CASES IN ACCOUNTING ETHICS AND PROFESSIONALISM

Second Edition

STEVEN M. MINTZ
Professor of Accounting
Southwest Texas State University

McGraw-Hill, Inc.
New York St. Louis San Francisco Auckland Bogotá
Caracas Lisbon London Madrid Mexico City Milan
Montreal New Delhi San Juan Singapore
Sydney Tokyo Toronto

This book was set in Times Roman by Better Graphics, Inc.
The editors were Johanna Schmid and Bob Greiner;
the production supervisor was Louise Karam.
The cover was designed by Karen K. Quigley.
R. R. Donnelley & Sons Company was printer and binder.

This book is printed on recycled, acid-free paper containing a minimum of 50% recycled de-inked fiber.

CASES IN ACCOUNTING ETHICS AND PROFESSIONALISM

5 6 7 8 9 0 DOC DOC 9 0 9 8 7 6 5

ISBN 0-07-042504-3

Library of Congress Cataloging-in-Publication Data

Mintz, Steven M.
Cases in accounting ethics and professionalism/Steven M. Mintz.
—2nd ed.
p. 000 cm.
ISBN 0-07-042504-3
1. Accountants—Professional ethics—United States—Case studies.
I. Title
HF5616.U5M534 1992
174'.9657—dc20 4'.9657—dc20 91-20016

About The Author

STEVEN M. MINTZ, D.B.A., C.P.A., is Professor of Accounting and Chair of the Department of Accounting at Southwest Texas State University in San Marcos, Texas. Previously, he was a Professor of Accounting and Department Chair at San Francisco State University (1981–1990). Prior to that time he taught at California State University at Hayward (1978–1981), The American University (1977–1978), Georgetown University (1973–1977), and Herbert H. Lehman College of the City University of New York (1971–1973).

Professor Mintz received his Doctor of Business Administration in 1978 from The George Washington University. He is also a Certified Public Accountant and was on the audit staff of Arthur Young and Company in New York from 1969 to 1971.

Professor Mintz has researched and spoken extensively on the need to teach accounting ethics and professionalism. He was the first academic in the nation to develop a workshop on integrating accounting ethics into the curriculum. The California Society of Certified Public Accountants honored Professor Mintz for his contributions to the development of the accounting profession and his influence on its future members by selecting him as the recipient of its 1988 Faculty Excellence Award.

To my parents, Paula, and Rebecca

Foreword

As we enter the 1990s, we find ever-increasing pressure from financial analysts, the press, politicians, and the general public for reliable, timely, and accurate financial statements. Because financial reporting is the basis for most business decisions, it is hard to overestimate the importance of good financial statements. Yet those who prepare financial statements know all too well that a lot more judgment goes into a set of financial statements than is generally recognized by those who are not accountants. Moreover, the amount of judgment is usually not emphasized in the classroom.

Rightly or wrongly, emphasis in the college and university curriculum is usually on teaching what the rules are and how the debits and credits work. There is little recognition that two different corporate controllers, with different orientations and perhaps different goals, could present vastly different pictures of their firm's operation to an outsider—depending on the choice of accounting alternatives and the choice of basically optimistic or more conservative assumptions. The assumptions underlying any comprehensive financial statement are crucial, yet in many cases they involve ethical judgments, particularly if the preparer is under pressure from management to show certain results.

The difference between statements prepared fully in accordance with generally accepted accounting principles (GAAP) and those that have resulted in disciplinary or even legal actions represents a relatively fine line. In short, the number of ethical decisions that a management accountant has to make is far greater than is generally recognized. The ethical problems and related ethical requirements for *public* accountants have been widely discussed, both in the first edition of this book and in many professional publications. But the ethical dilemmas facing preparers of these statements, *management* accountants, have received far less attention.

It was only in 1983 that the National Association of Accountants issued its *Standards of Ethical Conduct for Management Accountants*. Several years later, NAA formally adopted the Ethical Standards as a mandatory part of membership in the association. Since then the NAA and the academic community have worked to raise the consciousness level of students and professors, as well as management accountants in industry, about the importance of ethical considerations. NAA, for example, has produced and distributed widely, in conjunction with the Ethics Resource Center, a videotape called "It's Up to You." This videotape provides five case studies that serve as the basis for discussions of various ethical issues in management accounting and decision making. Thus we are particularly pleased that Professor Mintz, in this second edition, has developed a number of cases specifically aimed at ethical dilemmas faced by management accountants.

The accounting profession has been the focus of several recent congressional hearings. When the Treadway Commission reviewed many of the cases that had led to these hearings, it concluded that the single most important factor in corporate behavior was the "tone at the top" of the corporation. Generally speaking, companies with good ethical standards had good financial statements; those with dubious ethical standards at the top were the subject of congressional investigation. This casebook should make each reader more aware of the importance of a good ethical climate.

Alfred M. King

Managing Director
National Association of Accountants

Preface

■

Cases in this book depict a variety of situations where accountants and auditors have to decide complex issues based on professional and ethical standards. The cases are divided into a financial accounting/external reporting section and a management accounting/internal reporting section. Brief descriptions of the substance of each case appear in the Contents. The instructor's manual contains a classification of the cases by the ethical issues raised in each case. For example, a case may be classified into the conflict-of-interest category or whistleblowing. Cross-classifications into two or more categories are presented as well. The instructor's manual also contains a matrix designed to illustrate possible course-integration of the cases. The descriptions, case divisions, classifications, and matrix integration should all be helpful to faculty in deciding which cases to assign to students. However, accounting faculty should not feel constrained by these classifications in deciding on which cases to assign in a particular course. Students who might accept positions in public accounting should be sensitized to the internal accounting environment while those who might work in industry need to be familiar with the expectations and responsibilities of public accountants.

Most of the cases in the book are based on actual experiences encountered by public accountants, internal auditors, or management accountants. Special recognition is due all the accounting professionals who freely gave of their time and energies in discussing with me some of the most difficult experiences that they encountered on the job. Their candidness and professionalism was a constant source of encouragement for me in this project. All cases are disguised in order to provide anonymity for the individuals and organizations involved.

ACKNOWLEDGMENTS

I would like to acknowledge my gratitude to the American Institute of Certified Public Accountants for permitting me to reproduce material in the Introduction from *The Code of Professional Conduct* and *Statement on Auditing Standards No. 58* and *No. 59*. I also would like to acknowledge the Financial Accounting Standards Board for its permission to reproduce material in the Edvid, Inc., case from *Statement of Financial Accounting Standards No. 48* and *No. 53*.* I appreciate the cooperation of the National Association of Accountants, the Institute of Internal Auditors, and the American Institute of Certified Public Accountants for allowing me to draw on their professional standards and ethics codes for much of the discussion in the instructor's manual. Recognition is also due Dr. Richard J. Boland, Jr., Professor of Management Information and Decision Systems at Case Western Reserve University. Dr. Boland graciously consented to permit me to use one of his cases, Video Concepts, Inc., which was included in a 1982 manuscript titled *Cases in Accounting Policy and Practice*. That case has been expanded and updated and is now referred to as Edvid, Inc. Finally, acknowledgment is due Arthur Andersen & Co. for its permission to include excerpts from the essay, *Ethics in Business: A Perspective*, developed as part of its Business Ethics Program. Robert A. Cooke, Director of the Institute for Business Ethics at DePaul University and member of the Arthur Andersen & Co. Advisory Council on Ethics, is the author of the essay. Excerpted portions from the essay are included in the section on the Philosophical Framework for Ethical Analysis.

I am indebted to the many students at San Francisco State University and Southwest Texas State University who assisted me in the development of the instructor's manual by reviewing cases and discussing possible responses to the questions posed at the end of each case. I am also very grateful to my reviewers of the second edition, Jeffrey R. Cohen, Boston College, and Wanda A. Wallace, Texas A & M University. Their comments and suggestions on integrating ethical issues into the cases have been invaluable.

A very special thank you to Norma Lopez for the typing of the manuscript.

A final appreciation to McGraw-Hill, Inc., and its excellent editorial staff including Bob Greiner, Kimberly Rainis, and Johanna Schmid. In

particular, I am very grateful to Johanna Schmid for her encouragement and support during the past few years. Together we have seen this project grow from a modest eight cases that were developed in 1987 under a grant received from the Education Division of the California Society of Certified Public Accountants to the current twenty cases that are included in the second edition of the book.

As is true in any project of this kind, ultimate responsibility for any deficiencies in this book must be assumed by the author.

Steven M. Mintz

Contents

INTRODUCTION

In 1987 the accounting profession in the United States celebrated its one-hundredth anniversary. One of the most significant events during that period was the evolution of *The Code of Professional Conduct of the American Institute of Certified Public Accountants* (AICPA). The code first appeared in its current format in 1973. The code of ethics that exists today is a codification of standards, opinions, rulings, and interpretations of rules of conduct published by the Institute over many years. It reflects the public accounting profession's responses to the expectations and challenges created by itself, the business community, regulators, and other users of financial statements who rely on members' independence, integrity, objectivity, and adherence to professional standards.

On January 12, 1988, the membership of the AICPA approved six changes in its Code of Professional Conduct and other matters relating to professionalism. One of the changes required that new members joining the AICPA after the year 2000 be required to have completed 150 semester hours of education, including a baccalaureate degree or its equivalent. The increased education requirement has prompted many accounting educators and professionals to call for more ethics education in the university curriculum.

The issue of integrating ethics into the accounting curriculum has received increased attention in recent years. In 1986 the American Accounting Association (AAA) Committee on the "Future Structure, Content, and Scope of Accounting Education" (Bedford Committee) issued a report that stated, "Professional accounting education must not only emphasize the needed skills and knowledge, it must also instill the ethical standards and the commitment of a professional." The National Commission on Fraudulent Financial Reporting (Treadway Commission) recommended in its 1987 report that, "The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting." In its 1988 Report on Education Requirements for Entry into the Accounting Profession, the AICPA recommended the integration of ethics in the general education, business administration, and accounting curricula. The report emphasizes "The importance of developing ethical values in the accounting student and integrating the coverage of ethical issues and considerations with the coverage of technical knowledge throughout the curriculum." In April 1989 the chief executives of the then Big Eight accounting firms issued a position paper, "Perspectives on Education: Capabilities for Success in the Accounting Profession," that presented the firms' views on the level of skills and knowledge needed by individuals embarking on a career in public accounting. Three categories of general skills are identified as essential to success in public accounting—communication skills, intellectual skills, and interpersonal skills. The paper states that successful public accountants must also be able to solve diverse and unstructured problems in unfamiliar settings. They must also be able to identify ethical issues and apply a value-based reasoning system to ethical questions.

In response to increased calls for changes in the academic preparation of accountants to improve their capabilities for successful accounting careers, the AAA in 1989 established the Accounting Education Change Commission (AECC). The AECC was formed to foster changes in accounting education by administering a $4 million Big Six accounting firm–funded grant program to support departments or schools of accounting, colleges, and universities that are attempting to implement curriculum changes that are responsive to the need for a reorientation of accounting education. In its first position statement that was issued in September 1990, "Objectives of Education for Accountants," the AECC recommended that accounting graduates "should know and understand the ethics of the profession and be able to make value-based judgments. They should be prepared to address issues with integrity, objectivity, competence, and concern for the public interest."

The need for ethics in the curriculum is evident from the number of businesses and savings and loan institutions that have engaged in fraudulent accounting and financial reporting practices. Two examples from the business community, MiniScribe and the Regina Company, are indicative of the nature of such practices. In both companies top corporate officials engaged in fraudulent activities including shipping obsolete or defective merchandise and recording revenue in advance of shipments or in amounts greater than ordered. In both instances the external auditors did not uncover the fraud.

Charles Bowsher, the head of the General Accounting Office and comptroller general of the United States, has stated that the cost to the public to clean up the problems caused by current and anticipated future failed savings and loan institutions will be about $500 billion. Many of the problems are due to fraudulent activities by thrift institutions. One example of such activity is the failure of Lincoln Savings & Loan. It has received a great deal of public attention because of investigations into alleged improprieties by five senators by intervening with regulators on behalf of Lincoln's owner, Charles Keating, Jr., who gave them $1.3 million for campaigns and voter registration drives. All but one senator, Alan Cranston (D., Calif.), were found to have broken no specific rules or laws. Lincoln and its parent company, American Continental Corporation, went into receivership in 1979 following a series of questionable financial activities that may result in losses to the federal deposit insurance fund of more than $2 billion. Thousands of California retirees lost their life savings after buying uninsured subordinated debentures issued by American Continental and sold through Lincoln branches. Arthur Young & Co. (now Ernst & Young), the auditors of American Continental, issued unqualified opinions on the entity's financial statements for fiscal years 1986 and 1987. The audit opinions were part of the annual reports of American Continental that were furnished prospective buyers of the now-worthless debentures. Ernst & Young recently agreed to pay $1.5 million to settle charges it portrayed Lincoln as profitable. An Ernst & Young auditor was put on probation for three years and prohibited from participating in audits for twelve months.

Accounting education needs to focus more on an integrative approach combining the coverage of technical material with the conceptual and analytical issues and incorporating a sensitivity to ethical and professional concerns in decision making. Case studies are excellent vehicles to accomplish this goal. Presently, however, there are very few case study books dealing with issues relating to accounting ethics and professionalism that are relevant to the accounting environment as it exists today.

The purpose of this book is to provide a group of cases that will serve not only as the basis for a course in ethics and professionalism but also as the basis for the consideration of ethics and professionalism in a variety of accounting courses as well. The book also provides a philosophical framework that relies on the application of moral reasoning to resolve ethical dilemmas.

Auditing courses at both the graduate and undergraduate levels and senior-level undergraduate accounting seminars or graduate accounting environment and policy courses would be ideal places in the curriculum for the integration of these cases. At the same time, many of the cases would be useful in other accounting courses such as intermediate financial accounting and management accounting courses. Most cases would also be useful in introductory undergraduate and graduate-level accounting courses as an approach to exposing all business students to ethical and professional issues of concern to accountants. Finally, international issues are raised in two of the cases. Banco de Moldavia deals with audit issues that are raised when a client's operations are affected by international events. Telecommunications, Inc., focuses on accepting contracts from a foreign government and applicable provisions of the Foreign Corrupt Practices Act.

The second edition of this book differs from the first edition in three important respects. First, this edition includes seven additional cases designed specifically to expose students to some of the ethical and professional issues of concern to management accountants. With the exception of two cases, Creative Toys, Inc. and Financial, Inc., the first edition was devoted primarily to the external accounting environment. The addition of seven cases focusing on the internal accounting environment should enable management accounting faculty to better integrate ethics into their courses. Second, a separate section has been devoted to exposing students to ethical philosophies that can serve as a framework for analyzing ethical issues raised by the facts of a case. This framework can be used along with the appropriate accounting framework represented by the professions' technical and ethics rules and standards to support student responses to case situations. Questions posed at the end of the cases have been designed to drive the ethical analysis. Finally, cases in the book have been grouped into two major parts: financial accounting/external reporting and management accounting/internal reporting. The purpose of grouping cases into the two parts is to guide faculty teaching in these areas of the curriculum. However, faculty should not feel constrained by the groupings. Several of the cases in each part could be assigned in both financial and management accounting-oriented courses. For example, the Creative Toys case previously mentioned examines the issue of inventory write-downs from both a managerial accounting and auditing perspective. The Software Innovations and Engineering Associates cases focus on potential conflicts that may develop between management consultants working for CPA firms and their clients. While these two cases are included in the financial accounting section they could just as effectively be used in management accounting courses.

One of the goals of integrating ethics into the curriculum is to expose accounting students to a variety of ethical dilemmas they might face on