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Chapter 1 Cases

Case 1-1 Harvard Cheating Scandal

Yes. Cheating occurs at the prestigious Harvard University. In 2012, Harvard forced dozens of students to leave in its largest cheating scandal in memory, but the institution would not address assertions that the blame rested partly with a professor and his teaching assistants. The issue is whether cheating is truly cheating when students collaborate with each other to find the right answer—in a take-home final exam.

Harvard released the results of its investigation into the controversy, in which 125 undergraduates were alleged to have cheated on an exam in May 2012. The university said that more than half of the students were forced to withdraw, a penalty that typically lasts from two to four semesters. Many returned by 2015. Of the remaining cases, about half were put on disciplinary probation—a strong warning that becomes part of a student's official record. The rest of the students avoided punishment.

In previous years, students thought of Government 1310 as an easy class with optional attendance and frequent collaboration. But students who took it in spring 2012 said that it had suddenly become quite difficult, with tests that were hard to comprehend, so they sought help from the graduate teaching assistants who ran the class discussion groups, graded assignments, and advised them on interpreting exam questions.

Administrators said that on final-exam questions, some students supplied identical answers (right down to typographical errors in some cases), indicating that they had written them together or plagiarized them. But some students claimed that the similarities in their answers were due to sharing notes or sitting in on sessions with the same teaching assistants. The instructions on the take-home exam explicitly prohibited collaboration, but many students said they did not think that included talking with teaching assistants.

The first page of the exam contained these instructions: "The exam is completely open book, open note, open Internet, etc. However, in all other regards, this should fall under similar guidelines that apply to in-class exams. More specifically, students may not discuss the exam with others—this includes resident tutors, writing centers, etc."

Students complained about confusing questions on the final exam. Due to "some good questions" from students, the instructor clarified three exam questions by email before the due date of the exams.

Students claim to have believed that collaboration was allowed in the course. The course's instructor and the teaching assistants sometimes encouraged collaboration, in fact. The teaching assistants—graduate students who graded the exams and ran weekly discussion sessions—varied widely in how they prepared students for the exams, so it was common for students in different sections to share lecture notes and reading materials. During the final exam, some teaching assistants even worked with students to define unfamiliar terms and help them figure out exactly what certain test questions were asking.

Some have questioned whether it is the test's design, rather than the students' conduct, that should be criticized. Others place the blame on the teaching assistants who opened the door to collaboration outside of class by their own behavior in helping students to understand the questions better.

An interesting part of the scandal is that, in March 2013, administrators searched e-mail accounts of some junior faculty members, looking for the source of leaks to the news media about the cheating investigation, prompting much of the faculty to protest what it called a breach of trust.

Harvard adopted an honor code on May 6, 2014. The goal is to establish a culture of academic integrity at the university.

Answer the following questions about the Harvard cheating scandal.

1. Using Josephson's Six Pillars of Character, which of the character traits (virtues) apply to the Harvard cheating scandal and how do they apply with respect to the actions of each of the stakeholders in this case?

The stakeholders in this case are the students in the class who did cheat, the students in the class who did not cheat, the professor, the teaching assistants, other students at the university, alumni of the university, parent of students and future employers of the students.
The students who did not cheat displayed trustworthiness, including honesty, integrity and reliability, respect, responsibility and fairness. The students who did cheat acted out of self- interest. The professor and teaching assistant did not seem to communicate clearly or possibly consistently to all students which may be viewed as a lack of caring or fairness. The other stakeholders are the innocent bystanders in the scandal including the university community at large that want the reputation of Harvard to be upheld.

2. Who is at fault for the cheating scandal? Is it the students, the teaching assistants, the professor, or the institution? Use ethical reasoning to support your answer.

The Harvard cheating scandal is not black or white from an ethical perspective. One way to evaluate it is by examining the behavior and actions of the stakeholders. The instructor is partly to blame because unclear questions had to be clarified and that would have promoted collaboration to better understand just what the instructor's intentions were.

For the instructor, the students' collaborative work does make it difficult to assess individual performance—because many people's answers sounded similar, instructors could not determine who really understood the work and who was merely free-riding. As a professor, this is why a group project may require oral presentations so individual effort can be assessed and graded.

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Ironically, the motto of Harvard, the oldest education institution in the U.S. and founded in 1636, is "Veritas," which means truth in Latin. The truth is Harvard relied too heavily on students being honest – honoring its honor code – in a time when student cheating is rampant. An interesting perspective on the Harvard cheating scandal and cheating in college in general is a *Time* article "Harvard Cheating Scandal: Is Academic Dishonesty on the Rise?" by Erika Christakis and Nicholas A. Christakis, Sept. 04, 2012, http://ideas.time.com/2012/09/04/harvard-cheating-scandal-is-academic-dishonesty-on-the-rise/.

3. Do you think Harvard had a right to search the e-mail accounts of junior faculty, looking for the source of leaks to the news media? Explain.

Harvard had a right to set policies on using university owned computers and university provided email accounts. Most organizations with a computer and email usage policies state whether the organization reserves the right to monitor email usage and to review Internet history on computers. If Harvard did not have such a policy, then such a search seems to be vendetta search against the leak. Had Harvard or any of the faculty previously spoken to the press? Could the leak have come from a student? Did Harvard search the email accounts of the students at Harvard?

On March 9, 2013, the Boston Globe reported that Harvard administrators secretly accessed the email accounts of 16 resident deans in an attempt to determine who leaked communication regarding the Government 1310 cheating scandal that made its way to the media.

The searches, reported on the basis of interviews with "several Harvard officials," were for the origin of the leak of an internal email sent on August 16, 2012 by Secretary of the Administrative Board John "Jay" L. Ellison. That internal email, in which Ellison advised his colleagues about how to counsel athletes and other students implicated in the scandal, had been forwarded by a resident dean to one of his students.

Administrators informed the resident dean who had forwarded Ellison's email of the search shortly after it occurred, but did not tell the other resident deans until after being approached by the Globe. The Globe article noted that administrators searched one of two Harvard email accounts belonging to resident deans—the account for administrative matters, rather than for personal ones. Also, Harvard information technology employees were told to look only for certain email subject lines and not to read the contents of messages themselves, the Globe reported. (Source: http://www.thecrimson.com/article/2013/3/9/cheating-leak-email-search/).

4. What is meant by the culture of an organization? Can an honor code establish a culture of academic integrity in an institution such as Harvard University?

Every organization creates its own culture and normal operating procedures. The culture is highly influenced by the top officers and what is rewarded in the organization. A university is based on a principle of shared governance with administrators and faculty. Under shared governance, a task force or committee composed of administrators, faculty and students would have held many discussions of what an honor code does, what it

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should say, and the policies and procedures for when the honor code is not followed. Those discussions should encourage all to follow the prescribed standards and it brings the buy in of all and starts to change the culture. No honor code, policy or laws can eliminate all cheating but it can set the expectations.

Video Links:

http://www.youtube.com/watch?v=1PBsVH68Iig
http://www.youtube.com/watch?v=XF91EwL-qEQ
http://www.youtube.com/watch?v=TUfbrj28r4c
http://www.youtube.com/watch?v=bH4k9DTdLkA

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Chapter 1 Discussion Questions

Suggested Discussion and Solutions

1. **A common ethical dilemma used to distinguish between philosophical reasoning methods is the following. Imagine that you are standing on a footbridge spanning some trolley tracks. You see that a runaway trolley is threatening to kill five people. Standing next to you, in between the oncoming trolley and the five people, is a railway worker wearing a large backpack. You quickly realize that the only way to save the people is to push the man off the bridge and onto the tracks below. The man will die, but the bulk of his body and the pack will stop the trolley from reaching the others. (You quickly understand that you can't jump yourself because you aren't large enough to stop the trolley, and there's no time to put on the man's backpack.) Legal concerns aside, would it be ethical for you to save the five people by pushing this stranger to his death? Use the deontological and teleological methods to reason out what you would do and why.**

   Is it Ethical to Save Five People at the Expense of One?

   Lessons from the Talmud

   The Trolley Problem is a thought experiment in ethics, first introduced by Philippa Foot in 1967. Others have also extensively analyzed the problem including Judith Jarvis Thomason, Peter Unger, and Frances Kamm as recently as 1996. The authors used these problems in ethics class to challenge students' moral intuition.

   The choice is between saving five lives at the cost of taking one life. Before we get to the "answers," we want to explain how one researcher is using MRI technology to map brain response while analyzing the dilemma. Joshua Greene at Harvard University was more concerned to understand why we have the intuitions, so he used functional Magnetic Resonance Imaging, or fMRI, to examine what happens in people's brains when they make these moral judgments.

   Greene found that people asked to make a moral judgment about "personal" violations, like pushing the stranger off the footbridge, showed increased activity in areas of the brain associated with the emotions. This was not the case with people asked to make judgments about relatively "impersonal" violations like throwing a switch. Moreover, the minority of subjects who did consider that it would be right to push the stranger off the footbridge took longer to reach this judgment than those who said that doing so would be wrong. Interesting results to say the least.

   Many do not believe it to be ethical to intentionally end someone else's life whether it is to save others or not. Most do not believe it is a moral responsibility to sacrifice one life in order that others may go on. If you push someone in the way to save others, you may

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as well say you killed a man. How could you forgive yourself? The man has a family and people who love him, so how could you explain your actions to his family?

We have no right to sacrifice the life of one person to save others. There is a saying from the Talmud, an authoritative record of rabbinic discussions on Jewish law, Jewish ethics, customs, legends and stories: "Whoever destroys a soul, it is considered as if he destroyed an entire world. And whoever saves a life, it is considered as if he saved an entire world."

We have no right to decide who lives and who dies. Yes, if we can save one person without harming others we have a moral obligation to do so. However, to save one life while sacrificing others is an arbitrary act in many ways. What if the one sacrificed is a humanitarian, well-respected and well-known person who works tirelessly for the poor and others who can't help themselves? What if those saved are criminals who committed murder and escaped from prison. You see the dilemma? Who are we to judge who is a good person, and be saved, and who is a bad person? We should focus on leading the best possible life we can; to serve others whether through medicine, the clergy, the law, a teacher, nurse, or first-responder.

Utilitarianism might be used to rationalize saving the life of five people by sacrificing one person's life. We could say that more people benefit than are harmed by taking that action. This is consistent with act utilitarianism. On the other hand, a rule utilitarianism approach would posit that certain rules should never be violated in the name of maximizing net benefits. One rule is that it is wrong to take a life of another. Thus, rule utilitarianism is a modifying force on the literal application of act utilitarianism.

2. **Another ethical dilemma deals with a runaway trolley heading for five railway workers who will be killed if it proceeds on its present course. The only way to save these people is to hit a switch that will turn the trolley onto a side track, where it will run over and kill one worker instead of five. Ignoring legal concerns, would it be ethically acceptable for you to turn the trolley by hitting the switch in order to save five people at the expense of one person? Use the deontological and teleological methods to reason out what you would do and why.**

   Again, like above in number 1 you should not intentionally take a life, but if your intentions were to save four people at the sacrifice of one life, and if you were unaware of the damage it would do to the sole man, then you acted out of goodwill and that is more admirable. We can envision a cost-benefit analysis of the ethical dilemma that supports saving four lives at the expense of a fifth person. On the other hand, all of those people have a right to live and no one has the right to decide who lives and who dies.

3. **The following two statements about virtue were made by noted philosophers/writers:**
   1. **MacIntyre, in his account of Aristotelian virtue, states that integrity is the one trait of character that encompasses all the others. How does integrity relate to, as MacIntrye said, "the wholeness of a human life"?**

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Integers are whole numbers. This is the base word for integrity. Things with integrity are the same all the way through, or whole throughout. Thus, integrity equates with the consistency of one's actions. We must be consistently ethical to become an ethical person. If we can assume that everyone knows good treatment of their own interests and everyone knows good choices for their own short run, integrity might mean applying those same best choices to situations which affect others or affect the long run of all concerned.

A person of integrity acts with courage, sincerity, and honesty. Integrity encompasses all the other traits or values of character because it also implies action. Integrity requires a person to be honest, but to also act on that honesty. Integrity requires that a person have courage but also to act on that courage. Integrity requires that people not only have principles and values, they also have to stand by those principles and values and not bow to pressure thereby foregoing those principles.

Students often think that integrity is synonymous to honesty. Many dictionaries even state that honesty is the synonym for integrity and vice versus. Yet, just because a thief is being honest in one circumstance does not mean that he has integrity. A thief may admit to stealing only after being caught. We might say it is an honest act but it lacks integrity because the thief failed to consider the consequences of his actions on those he stole from or their rights not to be robbed. Moreover, the thief failed to admit the mistake after being caught; promise not to do it again; and then act consistently with the integrity standard thereafter. A way to consider integrity is how consistently honest a person is, not just whether that person was honest in one circumstance.

2. **David Starr Jordan (1851–1931), an educator and writer, said, "Wisdom is knowing what to do next; virtue is doing it." Explain the meaning of this phrase as you see it.**

This quote addresses the fact that it is not enough to know what is right or wrong; one must also act on that knowledge. Knowledge without action would be hollow. The well-known author Maya Angelou (1928 - 2014) has said that "Courage is the most important of all the virtues, because without courage you can't practice any other virtue consistently. You can practice any virtue erratically, but nothing consistently without courage."

Ethical dilemmas are situations where deciding what is best requires weighing ethical arguments between alternatives. Deciding what the best thing to do is almost always easier than actually doing it. Josephson Institute refers to moral temptations as a choice which is clear but still unattractive. The ratio of moral temptation to ethical dilemma might be four to one. Even those of us with the worst eating and exercise habits seem to know a lot about healthy alternatives. However, making yourself eat vegetables when you are hungry for chocolate is difficult and making yourself consistently prefer vegetables to cheeseburgers

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might require something beyond our abilities. Wisdom is mostly knowledge but virtue is mostly desire, and habit.

4.

1. **Do you think it is the same to act in your own self-interest as it is to act in a selfish way? Why or why not?**

   Acting selfishly and in your own self-interest are not the same thing. Normally, acting selfishly is only being concerned with self, not others, and being very short sighted; it is being concerned with immediate gratification of some sort. Acting in one's best interest may also mean acting in the best interest of all involved. For instance, I can turn up the television loud while I study because that is what I like, who cares if it is bothering my roommate or anyone else. Or, I have the television at a moderate volume so as not to disturb my roommate or anyone else. Or, I could use earphones so my roommate is not disturbed at all. I do this in hopes that
   I am not disturbed by loud volumes at 3 am while I'm trying to sleep and my roommate is coming in from a job. In the former case I am acting selfishly and in the other I am acting in my self-interest while considering others. In short, acting in my self-interest may be to act selfishly but only after I have considered how my actions affect others and weigh it in my decision.

2. **Do you think "enlightened self-interest" is a contradiction in terms, or is it a valid basis for all actions? Evaluate whether our laissez-faire, free-market economic system does (or should) operate under this philosophy.**

   "Enlightened self-interest" may seem like a contradiction in terms. Nevertheless, an individual has to be "enlightened" to consider the long term effects of a choice upon self, others, and the whole of humanity. For example, an individual may want the road near his house to be free of litter out of self-interest (resale value, dislike of clutter and untidiness, etc.), but can extend that desire to wanting all the roads of a neighborhood or city to be free of litter for the good of the community. In fact, long term self-interest requires that an individual consider others, since an individual does not live in a vacuum without interaction with others. A person who uses enlightened self-interest as a basis for ethical actions hopes others will consider her interests when making a decision that affects that person. A totally selfish person will probably face negative consequences from others.

   The doctrine of laissez-faire, a free market system is based upon the belief that economies should not be encumbered by regulation; an economy works best with enlightened self-interest, competition, and the laws of supply and demand. Adam Smith used the term "invisible hand" to describe how enlightened self-interest, competition, and supply and demand worked to self-regulate markets without needing government intrusion. The 2007-2008 financial crisis has raised questions as to whether the invisible hand works. There were many cases during the crisis where enlightened self-interest gave way to greed and egoism. Such cases have raised cries for new/stricter regulations of the free markets. Although competition

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and, sometimes, supply and demand can be regulated, can self-interest, egoism or greed really be regulated? If those could be regulated, then regulations alone could create and protect a moral economy.

5. **In this chapter, we have discussed the Joe Paterno matter at Penn State. Another situation where a respected individual's reputation was tarnished by personal decisions is the resignation of David Petraeus, former U.S. military general and head of the Central Intelligence Agency (CIA). On November 9, 2012, Petraeus resigned from the CIA after it was announced he had an extramarital affair with a biographer, Paula Broadwell, who wrote a glowing book about his life. Petraeus acknowledged that he exercised poor judgment by engaging in the affair. When Federal Bureau of Investigation (FBI) agents investigated the matter because of concerns there may have been security leaks, they discovered a substantial number of classified documents on her computer. Broadwell told investigators that she ended up with the secret military documents after taking them from a government building. No security leaks had been found. In accepting Petraeus's resignation, President Obama praised Petraeus's leadership during the Iraq and Afghanistan wars and said: "By any measure, through his lifetime of service, David Petraeus has made our country safer and stronger." Should our evaluation of Petraeus's lifetime of hard work and Petraeus's success in his career be tainted by one act having nothing to do with job performance?**

   Although at first glance adultery had nothing to do with Petraeus' job, an officer in the military is subject to the Uniform Code of Military Justice (UCMJ). Under article 133 an officer can be court-martialed for conduct unbecoming to an officer and a gentleman. Article 134-2 identifies adultery as an act unbecoming to an officer and a gentleman. The timing of the affair between Broadwell and Petraeus is not known, but many have opined that had the affair been during his time as general he would have been subject to court-martial and possibly dishonorably discharged from the Army.

   Conduct unbecoming to an officer and a gentleman is premised upon the fact that leaders cannot be seen as willing to violate their own rules, principles and those of the organizations they represent.

   Under the Six Pillars of Character, Petraeus violated the pillar of trustworthiness. Leaders cannot enforce rules that they violate, and they cannot maintain trust by showing that they are willing —as in adultery—to betray others to whom they have promised fidelity. And when a leader breaks the rules of his own organization, the message sent throughout the organization is that breaking rules is really OK. Lying is fine. Integrity doesn't matter. Once that cultural norm is inflicted on an organization by its leader, the organization itself will become dysfunctional, untrustworthy and corrupt. A leader must be trusted to mean what he says, and to act according to the stated rules of the organization he leads.

   A similar situation is the Lance Armstrong affair where he repeatedly lied about not using performance enhancing drugs. His good reputation was tarnished by this act and a

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lifetime of being a role model and doing good works through his Live Strong organization went down the tubes. The Joe Paterno situation is another such case. Remind students that it takes a long time to build a reputation for trust but not very long to lose it.

Update: In April 2015, former CIA director and retired general David Petraeus pleaded guilty to a misdemeanor charge of handing over classified information to his mistress and biographer, Paula Broadwell. He was sentenced to two years' probation and a $100,000 fine. Petraeus had passed on several 5-by-8 inch black notebooks containing classified information to Broadwell. Despite his conviction, the former general remains a trusted adviser to the White House on its strategy in Iraq.

Students might enjoy discussing the similarities between Petraeus and Hillary Clinton in the use of her personal email server for state department business. There is concern about the proper classification of material sent, both at the time of sending it and in hind sight. When personal servers are used, the determination of classification can, after the fact, render top secret information more vulnerable to outside influences and cause more harm than if the security systems protecting the state department computer systems were at play. Do the policies and criteria for handling of classified materials need to be changed in the current environment of communications devices?

6. **One explanation about rights is that "there is a difference between what we have the right to do and what is the right thing to do." Explain what you think is meant by this statement. Do you believe that if someone is rude to you, you have a right to be rude right back?**

Having a right to do something allows one to be concerned with one's self interest only (egoism). Doing the right thing often requires one to consider others besides and before one's self (at a minimum enlightened egoism, but also utilitarianism, deontology, justice, and virtues). An example is shouting there is a fire in a crowded movie theater. We have the right to do so but it is not the right thing to do.

Rudeness begets more rudeness and eventually breaks down civility. People start to be taken for granted and not treated as individuals who should be respected absent some reason not to do so. Students sometimes treat instructors rudely by continuing to talk after the instructor attempts to begin her lecture. Ask students how they would feel if you, as the instructor, engage in a conversation with a student in class while observing a final oral presentation of another student. Would it disrupt the flow of what that student wants to say? Will he lose his train of thought?

7. **Steroid use in baseball is an important societal issue. Many members of society are concerned that their young sons and daughters may be negatively influenced by what apparently has been done at the major league level to gain an advantage and the possibility of severe health problems for young children from continued use of the body mass enhancer now and in the future. Mark McGwire, who broke Roger Maris's 60-home-run record, initially denied using steroids. He has never come close**

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to the 75 percent positive vote to be in the Hall of Fame. Unfortunately for McGwire, his approval rating has been declining each year since he received 23.7 percent of the vote in 2010 and only 10 percent of the sportscasters voted in 2015 to elect him into the Hall. Some believe that Barry Bonds and Roger Clemens, who were the best at what they did, should be listed in the record books with an asterisk after their names and an explanation that their records were established at a time when baseball productivity might have been positively affected by the use of steroids. Some even believe they should be denied entrance to the baseball Hall of Fame altogether. The results for Bonds (36.8 percent) and Clemens (37.5 percent) in their third year of eligibility (2015) were not close to meeting the 75 percent requirement, and that led some to question whether these superstars would ever be voted into the Hall. Evaluate whether Bonds and Clemens should be elected to the Hall of Fame from a situational ethics point of view.

Using steroids is cheating. What theories would support cheating? Virtue ethics emphasizes that doing the right thing should become a habit. Deontology would emphasize the duty of doing the right thing. Fairness would emphasize equals competing against one another on a level playing field. When athletes compete against one other, each one should have the same advantages and disadvantages. Another concern with steroids is safety. If competition is pressuring some individuals to do dangerous things, agreeing about what *everyone* will not do protects all from that pressure.

Steroids might increase speed and strength if well administered and athletes could make a case that if every baseball player had access to them competition would be equalized; similar to giving every one access to good shoes or the weight room. There are two dangerous issues to consider. A steroid-using batter facing an equally enhanced pitcher might seem fair, and steroid-using Yankees against steroid-using Red Sox might seem fair, but faster pitching hit by stronger hitters might create a danger to spectators and players.

Underneath an almost cult like reverence for athletes is the celebration of sporting, unearned luck of birth talent, healthy respect for the virtues of diligence, courage, dedication, discipline, and sometimes teamwork. Baseball is different from some other sports in that until very recently, it looked like a sport anyone could play. Baseball looks like a fair game in that short guys, fat guys, skinny guys, and athletic looking guys all got to play. In ordinary life, we are not all born with talent and not all born with inherited resources but we all can be diligent, brave, honest, and fair.

Students may argue that cheating has become part of our culture so why should sports be any different. They may argue this point using ethical relativism. A useful response is that if everyone were allowed to use steroids, where would it stop? What about 'corked bats.' What about 'juiced up' baseball balls to allow for more home runs? What about pitchers throwing 'spit balls'? All of these things have happened over time and steroid use is just the choice method of cheating in today's sports society, or so the student argument may go. The problem is ethical relativism allows each person to decide for herself what is right or wrong, a clear violation of the universality perspective in Rights Theory.

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It is worth mentioning that the players elected to the Hall of Fame in 2015 all had twice the approval rate as Bonds and Clemens as follows: Randy Johnson (97.3%); Pedro Martinez (91.1%); John Smoltz (82.9%); and Craig Biggio (82.7%).

8. **Your best friend is from another country. One day after a particularly stimulating lecture on the meaning of ethics by your instructor, you and your friend disagree about whether culture plays a role in ethical behavior. You state that good ethics are good ethics, and it doesn't matter where you live and work. Your friend tells you that in her country it is common to pay bribes to gain favor with important people. Comment on both positions from a relativistic ethics point of view. What do you believe and why?**

The basic moral principles of respect, fairness and kindness are timeless and worldwide; although different circumstances can affect how they are implemented. There have to be certain ways of treating people that almost always hurt and are almost always wrong; you might mention a few obvious ones, like robbery, rape, and murder. Likewise, there are cultural practices of great importance without moral significance. An example is which side of the road you drive on. Left and right sides might be morally equal, but once everyone promises to drive on the left side, the wrong side becomes promise-breaking and deadly. Playing "football" in any country besides the United States implies a promise not to use one's hands, and doing so would be considered cheating. Touching the ball and thereby breaking the rules might ruin the game, but is not often a life and death betrayal. In many countries, restaurant staffs are not tipped, in other countries, nearly everyone tips the same percent and in some places how much you tip is influenced by how well you are treated. A lot, but not all of cultural morality differences are unwritten rules and expectations that seem fair if applied to and by everyone. Arbitrary choices become moral obligations when other peoples' well-being depends on keeping promises to follow those choices. Some cultural differences in morality have to do with beliefs more than differences in ethical reasoning. In some places, people are accorded better treatment according to their sex, age, race, wealth, or status. This mixes personal traits which are earned with traits that unearned or due to birth. If you believe wealth and power are earned, then their privileges seem fair, but if you believe children do not choose or earn their parents, then those very same privileges are unfair and discriminatory.

Hofstede's cultural variables might be discussed here. In countries with a low score on Individualism, it might be argued that cheating is ethical because it brings benefits to the entire society or work group. This is the argument sometimes used in some countries where software piracy is tolerated and even encouraged.

Paying bribes is a way of conducting business in some countries. In others it is considered unethical. In the U.S., small amounts of bribes that are made to induce a person to do what they should be doing anyway by virtue of their position is known as a facilitating ("grease" payment) and legal. On the other hand, bribing someone to do something they are under no obligation to do is wrong and unethical. It does not mean one country is good while the other is bad. The key question is should a U.S. company do business in a country with a culture where grease payments are a way of life and bribery

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is tolerated. Is it the old adage that "When in Rome, do as the Romans do?" Or, should U.S. companies apply an American ethical perspective to doing business in other countries with differing cultures?

9. **Hofstede's Cultural Dimensions in Exhibit 1.2 indicate that China has a score of only 20 in Individualism, while the U.S. score is 91. How might the differences in scores manifest itself when the public interest is threatened by harmful actions taken by a member of management who has direct control over an employee's standing within the organization? Should cultural considerations in this instance influence ethical behavior?**

   Individualism (IDV) focuses on the degree that the society reinforces individual or collective achievement and interpersonal relationships. In individualist societies (high IDV), people are supposed to look after themselves and their direct family, while in collectivist societies (low IDV), people belong to "in-groups" that take care of them in exchange for loyalty. Imagine, for example, you are the manager of workers from different cultures and cheating/unethical behavior occurs in the workplace. A workgroup with collectivist values such as China (low IDV) might be more prone to covering up the behavior of one member of the group, whereas in the United States (high IDV), there is a greater likelihood of an individual blowing the whistle.

   Culture of upbringing and family background affect an individual's value system. It is up to the individual to act upon those values. As discussed in the answer to question 3, an individual needs integrity, courage, wisdom and virtue to act upon one's convictions and values.

10.
    1. **What is the relationship between the ethical obligation of honesty and truth telling?**

       Ask Students to differentiate between telling a lie and breaking a promise. List some lies no one believes and therefore are not very harmful and list some lies that people might believe and thus could be hurt by believing them. List some promises no one believes and some people might believe and could count on, to their detriment.

       Have we sometimes "promised" to tell the truth and other times "almost warned" people that we weren't going to tell the truth? Telling the truth reveals our respect for the other person's decision making ability when he is provided the truth. We lie to people we think would misuse the truth in unfair or dangerous ways. Keeping the truth secret or deceiving people is only effective when those people believe we are providing them with the truth. Lies only work if we lie infrequently enough, to be believed and relied on when we do lie. There are lies of commission (lying intentionally) and lies of omission (lying by not telling the whole truth; the omitted information might influence decision-making). In accounting, a lie of commission might be lying about the financial position of a

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company by inflating revenues, assets, or capitalizing expenses; all of which are fraud. A lie of omission might be not fully disclosing information required by GAAP. Here, it is also unethical because the public has a right to know about all information that might influence their decision-making.

Honesty is about keeping promises to tell the truth. Accepting our promise to tell the truth puts someone in a relationship of trust with us. In the terms of Robert Fulghum in All I Really Need to Know, I Learned in Kindergarten, a promise is like riding the teeter-totter: Believing promises puts you at risk of a hard fall, but breaking promises leaves you alone and unable to play.

2. **Is it ever proper to not tell someone something that he or she has an expectation of knowing? If so, describe under what circumstances this might be the case. How does this square with rights theory?**

First, ask students if there is a difference between the expectations of knowing versus the right to knowing. For example, as college students their parents may have an expectation of knowing their grades; however, unless the students are dependents of their parents, the parents do not have a right to know the students' grades.

The conflict of not telling someone something that he may have a right to know is a choice between two rights. This situation may cause a person to tell a lie. For example, assume John works in payroll for PQR Inc. PQR has announced that it will be laying off 100 people from its workforce. Due to the need to prepare all the separation paperwork and final payroll for the employees being laid off, John knows who the 100 employees are. He has sworn to keep the list secret until management has told each of the employees. One of his co-workers is on the list. This co-worker comes to John and asks if she is on the list. She is a single mother and wants to start looking for another job if she needs to do so. How does John choose between his co-worker and the requirements of his job?

If John decides that his co-worker has the right to know the pending lay-off, he may be using the virtue of caring or empathy to justify his action. He will have chosen loyalty to his co-worker over loyalty to his employer. However, since confidentiality and trustworthiness are important principles for accountants, choosing loyalty to his co-worker over his employer could limit his career. Also, using rights theory, why does the co-worker have a right to know the impending lay-off result but not the other 99 employees? What if another employee has even more compelling concerns that John is unaware of? This is a good question to discuss justice. Equals should be treated equally and unequals, unequally. Does his co-worker have a higher claim (i.e., right) to know the truth than other workers? If John tells his co-worker because of her personal situation, should he make an effort to find out about that of other workers? What about a worker with a sick child or parent and lots of bills to pay? Where do we draw the line?

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11. **Is there a difference between cheating on a math test, lying about your age to purchase a cheaper ticket at a movie theater, and using someone else's ID to get a drink at a bar?**

    All are examples of lying and affect one's character through honesty and integrity. Many will use many rationalizations to justify the lying. Some may try to split hairs between what is wrong and what is more wrong – an ethical relativistic approach that should not be used. Just imagine a business that decides one improper financial reporting act is not as bad as another, so the former is allowed.

    Virtue ethics would want doing the right thing to become a habit. Deontology would emphasize the duty of doing the right thing and telling the truth, not just when it is convenient or does not intervene with personal desires of making a better grade without studying, paying more for a movie ticket or a minor obtaining an alcoholic beverage. Ethical behavior requires consistency of action and not a relativistic or situational perspective.

12. **Do you think it is ethical for an employer to use social media information as a factor when considering whether to hire an employee? What about monitoring social networking activities of employees while on the job? Be sure to use ethical reasoning in answering these questions.**

    Social media is one of the most popular forms of communication, particularly with Millennials. Anyone can connect with anyone else, or find information about others that may not otherwise be available. Thus, it should not be surprising if firms use social media to research potential job candidates. Firms may argue that social media is a public platform, unless the candidate makes it otherwise, and that it's their own choice to share the content that is available to anyone who searches for it.

    CareerBuilder found in a 2014 survey that 43% of hiring managers who research candidates said they had found information on social media that caused the firm not to hire the candidate. What qualifies as a valid reason to do so?

    A platform like LinkedIn allows a firm to fact-check a candidates' resume or CV. The firm may find out that a candidate lied on their application about qualifications, experiences or other information. This information may cause the firm not to hire the candidate. However, other social media platforms may include pictures, statuses, and likes about illegal activity, bullying, a criminal past, or posts that include racism, sexism, homophobia, or an unpopular political position. Much of the former may be considered speech. However, lying about qualifications and engaging in illegal activity are acceptable factors that might influence a firm's hiring decision. Personal opinions and free speech would be unethical to use in hiring decisions and may send the wrong message that a future employee should not feel free to speak out if she identifies wrongdoing.

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On the other hand, if the employee is seeking a job with a government entity, the standards may be stricter because of the need to take care not to express one's opinion on controversial matters that may pertain to the work of the agency, albeit not directly related to a specific matter before the agency. In this case it is important for the employee's statements not to appear to reflect the agency's position on the matter.

The firm would be using rights and utilitarianism theories in using social media to research candidates. The firm may think that it has a right to know if a job candidate is lying or engaging in illegal activities. From a utilitarian point of view, the firm wants an end result of hiring an honest job candidate who is not engaging in illegal activities. For example, what if the candidate was a child predator like Jared Fogle, the Subway spokesperson? [On November 19, 2015, Fogle was sentenced to more than 15 years in federal prison after pleading guilty to charges of child pornography and crossing state lines to pay for sex with minors.]

We believe candidates should know that in today world one's prospective employer may be searching the Internet for character-based information on candidates for positions. It is the candidate's personal responsibility to act appropriately and be cautious about what they say on the Internet. From a rights and virtue perspective, the firm should notify candidates that it will be researching their backgrounds on social media.

A firm may set policies for appropriate social media activities during the work day and on using company equipment for personal reasons. The firm wants a full day's work for its pay, and may consider using company time for personal social networking and posting as a form of theft. Setting a company policy on proper use of company computers, email accounts may include usage of the Internet and appropriate surfing of the net, online shopping and other personal activities. A bigger challenge for firms is regulating employees' usage of a personal smart phone during the work day.

An individual using company time or equipment to access social media for personal activities is acting out of egoism, or self-interest only. You wouldn't want a personal assistant texting or updating her Facebook status while working for you, so why should you do it when working for others? A firm setting clear guidelines expectations on personal activities on company time, if any, is employing utilitarian, deontological and virtues ethics reasoning. The policy might allow for exceptions such as monitoring the health of a sick child being watched by another.

13. **In a 2014 segment of *Shark Tank,* Trevor Hiltbrand, the founder of nootropic supplement maker Cerebral Success, sought funding from the "Sharks" to introduce a line of nootropic shots to be sold on college campuses in Five Hour Energy-style containers, but encountered some pushback from some of the Sharks who questioned the ethics of marketing to stressed-out, sleep-deprived college students anxious to get good grades. Should it matter if Hiltbrand was trying to capitalize on the need to gain a competitive edge in college by selling something that may not have received FDA approval?**

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Nootropics are an emerging class of drugs that are designed to enhance cognitive functions. Many supplements may also tout that they increase focus, alertness and well- being. Many nootropics supplements have had limited studies in humans, and could cause many side effects.

Many accounting students feel pressure in college to make top grades, particularly so that they will get the job offer from a top firm. This leads some to cheat or to use illegal drugs to enhance their focus and cognitive ability. Do you plan to carry over such behavior to the workplace? A legal supplement claiming to enhance cognitive ability would be an instant best seller. Many would be willing to use Cerebral Success out of an egoistic and short term viewpoint. This is when regulators like the FDA step in to protect consumers from the long-term side effects.

Was Hiltbrand really trying to help others or capitalize on the fears of those who choose to use a nootropic supplement? This is an interesting question to explore with students.

An interesting side story is a very positive review of Cerebral Success (4 ½ out of 5 stars) written on a website "Supplement Critique" that purports to have reviews from actual users of the product. Here is the statement on the website to guide those who might want to post a review of a product they have used:

> Thanks for Visiting SupplementCritique.com!
>
> I started this site because I was tired of the millions of fake review sites out there. Too many websites post reviews about products (specifically sports and health supplements), when they haven't even tried them! We aimed to change all of that, and **our mission is to provide you with unbiased reviews of supplements** in the health niche, from weight loss to male performance products.
>
> How do we prove that to you? Well, **we ACTUALLY physically test many of the products** we are reviewing, so you can be sure you're getting real, solid information about how they work.
>
> ***If you like, you can post your own review, but we do ask that you send us a picture of you holding a bottle of the product. We want to make sure our visitors are reading actual results from actual users, not just someone looking for a backlink to their website.***

14. According to Adam Smith's *The Wealth of Nations,* when it comes to government oversight in the free market and regulations, the less intervention, the better. Does the government play an important role in encouraging businesses to behave in an ethical manner? Explain the basis for your answer. What role do environmental laws have in a capitalistic system?

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The free market assumes that all players will be ethical and act in the best interest of the market, or community. However, the players are human, tempted by greed, that do not always act ethically or in the best interest of the markets and community. Then the government steps in with laws that set a minimum level of ethics and starts regulating the players. The basis for the government stepping in is utilitarianism and to protect the rights of the public.

Environmental laws consider sustainability and the ability of future generations to share in the benefits of a clean/green society. One could say it is motivated by social welfare, a utilitarian concept. That is, emphasizing the greatest good for future generations.

Besides setting a minimum standard for the environment, these laws also require the community sometimes to pay more for the environmental friendly alternative than would be chosen under cost benefit analysis only. These environmental laws require that the application of utilitarian analysis include the qualitative factors of sustainability and welfare of future generation, not just cost factors alone.

15. **According to the 2011 National Business Ethics Survey conducted by the Ethics Resource Center, *Generational Differences in Workplace Ethics,* a relatively high percentage of Millennials consider certain behaviors in the workplace ethical when compared with their earlier counterparts. These include:**

- **Use social networking to find out about the company's competitors (37%),**
- **"Friend" a client or customer on a social network (36%),**
- **Upload personal photos on a company network (26%),**
- **Keep copies of confidential documents (22%),**
- **Work less to compensate for cuts in benefits or pay (18%),**
- **Buy personal items using a company credit card (15%),**
- **Blog or tweet negatively about a company (14%), and**
- **Take a copy of work software home for personal use (13%).**

The report further concludes that younger workers are significantly more willing to ignore the presence of misconduct if they think that behavior will help save jobs.

a. Choose one or more behaviors and explain why Millennials might view the behavior as ethical.

Many of the behaviors are done out of egoism or the rationalization that "everyone is doing it" or "I'm doing this so I can do my job better." For example, "friending" a client or customer on a social network may seem innocent enough and a way to learn valuable information about these parties; however, it could be perceived as a way to gain such information prior to striking out on one's own and starting a new business. The problem with many of the enumerated behaviors is the perception that one's motives may not be in the best interests of the employer.

b**. Choose one or more behaviors and explain why you think it is unethical.**
Use ethical reasoning to support your points of view.

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Have the students discuss which of the above behaviors can be defended by virtue, deontology and utilitarian (both rule and act) theories. The students might pick to “friend” a client or customer on a social network as being a good end to help the company. This could lead to a discussion of professional versus personal social media; i.e., LinkedIn versus Facebook. As more companies are using social media to reach and stay connected with clients and customers, this behavior would be ethical if it was part of an employee’s job duties.

16. **How should an accounting professional go about determining whether a proposed action is in the public interest?**

Through the Securities and Exchange Act of 1934, the U.S. government effectively awarded a professional monopoly to CPAs, in return for their commitment to protect the public interest by acting as independent watchdogs over publicly traded corporations. Auditors serve as gatekeepers who protect the interests of stakeholders through monitoring activity within the organization and by providing a financial representation that is unbiased and accurate. The perspective of the auditor as a gatekeeper is consistent with the opinion of the Advisory Panel on Auditor Independence that states: In *United States v. Arthur Young & Co.* [1984] the Supreme Court of the United States described the independent audit as a “public watchdog” function and noted that “if investors were to view the auditor as an advocate for the corporate client, the value of the audit might well be lost”.

The AICPA Code of Professional Conduct has the public interest as its second principle. It defines the public interest to include “clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of CPAs to maintain the orderly functioning of commerce.” This principle calls for resolving conflicts between these stakeholder groups by recognizing the primacy of a CPA’s responsibility to the public as the way to best serve clients’ and employers’ interests. In discharging their professional responsibilities, CPAs may encounter conflicting pressures from each of these groups. According to the public interest principle, when conflicts arise the actions taken to resolve them should be based on integrity, guided by the precept that when CPAs fulfill their responsibilities to the public, clients' and employers' interests are best served.

17. **Distinguish between ethical rights and obligations from the perspective of accountants and auditors.**

Ethical rights describe how a person is entitled to be treated by another person. Ethical obligations are the duties to treat others in an ethical manner. Ask students what they think are their rights. Now which of those rights have an ethical basis? Have the students make a list of their ethical rights. If a student’s ethical right conflicts with the student’s ethical obligation, what should a student do?

From the perspective of accountants and auditors, obligations to the public are to act with integrity, be independent of clients both in fact and appearance, make objective decisions, and act in a responsible and trustworthy manner. The public has a right to receive accurate and reliable financial information to make informed decisions. Thus, the rights of stakeholders and

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the obligations of accountants and auditors to those stakeholders are the flip sides of the same issue.

18. **Using the concept of justice, evaluate how an auditor would assess the equality of interests in the financial reporting process.**

Justice as fairness is the basis of the objectivity principle in the AICPA Code that establishes a standard of providing unbiased financial information. In our discussion of ethical behavior in this and the following chapters, questions of fairness will be tied to making objective judgments. Auditors should render objective judgments about the fair presentation of financial results. In this regard, auditors should act as impartial arbiters of the truth, just as judges who make decisions in court cases should. The ethical principle of objectivity requires that such judgments be made impartially, unaffected by pressures that may exist to do otherwise. An objective auditor with knowledge about the failure to allow for the uncollectible receivables would not stand idly by and allow the financial statements to be materially misleading.

When we look at the traditional notion of justice as treating equals, equally, we can say that investors and creditors have a greater demand and need for accurate and reliable information than other users because they represent the public interest. Thus, the conceptual framework for financial reporting is geared toward the decision making needs of investors and creditors as the providers of financing while the needs of other users are of secondary concern.

19. **Why is it important for a CPA to promote professional services in an ethical manner? Do you believe it would be ethical for a CPA to advertise professional services using testimonials and endorsements? Why or why not?**

Professionalism and work ethic are important qualities of accounting professionals. Professionalism is generally defined as the strict adherence to courtesy, honesty, and responsibility when dealing with individuals or other companies in business and clients in public accounting. For CPAs, this means to act in accordance with personal and professional values such as trustworthiness, integrity, transparency, and the pursuit of excellence. A strong work ethic includes completing assignments in a timely manner, diligently, and with the highest quality possible. Ethics and professionalism in accounting also means to always place the public interest ahead of one's self-interests, the interests of an employer, and the client's interests. The public expects accounting and auditing professionals to be selfless in the pursuit of the public good.

Potential clients rely on the ethics and trustworthiness of accounting professionals. Clients make decisions whether to engage with potential accountants and auditors, at least in part, based on their advertising of professional services. Clients must be able to rely on the accuracy on the form and content of such communication including testimonials on behalf of accounting professionals.

In advertising professional services, a CPA must be honest and non-misleading. In using testimonials and endorsements, how does a potential client know if these are honest and non-misleading? Were the testimonials and endorsements paid or exaggerated? Would that affect

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one's opinion? What if the testimonials and endorsements are from paid actors, and not actual clients? As a profession that values objectivity and skepticism, objectivity and skepticism should be employed in determining how potential customers will react to advertising.

20. **Do you think it would be ethical for a CPA to have someone else do for her that which she is prohibited from doing by the AICPA Code of Professional Conduct? Why or why not? Do you think a CPA can justify allowing the unethical behavior of a supervisor by claiming, "It's not my job to police the behavior of others?"**

It would be unethical for a CPA to employ (whether paid or not) someone to perform an act that the CPA is prohibited from doing? It is using a proxy to do something that she knows is wrong. Having someone else do the wrong act does not change the wrongness of the act. The AICPA Code of Professional Conduct clearly holds CPAs to the standard of care that she should not permit others to do for her what she is prohibited from doing under the Code. To do so is an unprofessional act in violation of the Code.

If the CPA knows all the facts and determines that the supervisor is allowing or performing an unethical act, the CPA should try to stop that behavior. It may be impossible to change the behavior, but the CPA should question whether she wants to work for and with a supervisor and company that condones unethical behavior. Knowing that something is wrong obligates the ethical person to do something about. This applies in particular in accounting because of the public interest obligation.

21. **Assume in the DigitPrint case that the venture capitalists do not provide additional financing to the company, even though the accrued expense adjustments have not been made. The company hires an audit firm to conduct an audit of its financial statements to take to a local bank for a loan. The auditors become aware of the unrecorded $1 million in accrued expenses. Liza Doolittle pressures them to delay recording the expenses until after the loan is secured. The auditors do not know whether Henry Higgins is aware of all the facts. Identify the stakeholders in this case. What alternatives are available to the auditors?**
Use the AICPA Code of Professional Conduct and Josephson's Six Pillars of Character to evaluate the ethics of the alternative courses of action.

The stakeholders in the DigitPrint case are the stockholders and employees of the company, the local bank, suppliers and customers of the company. The auditors may try to get Doolittle and Higgins to record the expenses; tell the board of directors of the situation; issue a qualified or adverse opinion if the expenses are not recorded; or they could do as Doolittle is pressuring them to do. Caving into the pressure from Doolittle would be unethical and would violate the AICPA principles of integrity, independence, responsibility, public interest and due care. Using these principles and the Six Pillars of Character, the auditors should meet with the board of directors to try and get support for the recording of the expenses. If that fails, then the auditors should issue a qualified or adverse opinion. This would be in keeping of the AICPA principles. Under the Six Pillars of Character, the auditors would be displaying trustworthiness, responsibility, fairness, and citizenship.

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22. **In the discussion of loyalty in this chapter, a statement is made that "your ethical obligation is to report what you have observed to your supervisor and let her take the appropriate action." We point out that you may want to take your concerns to others. The IMA Statement of Ethical Professional Practice includes a confidentiality standard that requires members to "keep information confidential except when disclosure is authorized or legally required."**

23. Do you think there are any circumstances when you should go outside the company to report financial wrongdoing? If so, to what person/organization would you go? Why? If not, why would you not take the information outside the company?

Questions 22 and 23 were inadvertently separated in production of the book so we answer them together.

Whistle blowing has had a bad name since before Rolf chose his duty to Nazi youth over his affection for the Von Trapp family in the "Sound of Music." Telling on someone to prevent serious harm to someone else is usually called tattling. Tattling often has the bad reputation due to its mean-spirited motivation. Telling to get someone out of trouble is usually the right thing to do. The difference in the two situations noted turns on motives for action. Whistle-blowing could stop something harmful which is about to happen or will continue happening. It does matter whether whistle-blowing can change the future and it does matter how important those changes are in the lives of those in peril. What matters is if the person tells to right a wrong and protect others; if so, it is an ethical action and warranted.

Whistle-blowing is different for accountants because it violates client trust and break promises the profession has made on behalf of each of its members. Accountants, as professionals, have access to truth and knowledge *because* we as a profession promise that clients can absolutely count on the accountants not to violate that trust by sharing secrets. If the profession did not promise confidentiality and our promise was in doubt, clients might purposefully keep secrets from their accountants because of fear of disclosure.

While there are situations where professional accountants have to go outside their chain of command, the profession's reputation for reliability is damaged whenever that promise of confidentiality is broken. Whistleblowing for a professional accountant is promise breaking. The best justification for breaking promises is what we call an emergency: time sensitive, future changing, no one else can do it and it has to be done in some situations. It is easier to imagine corporations in its personnel, operations and marketing departments doing dangerous and harmful things that must be stopped in a hurry than in the finance or accounting departments.

There are circumstances in accounting where future harm to people who deserve our protection (i.e., shareholders or the public) is so great that professional duty is superseded by duty to protect the public interest. In some of these circumstances, individual accountants are the only one person who can prevent or reduce that harm by acting. Accountants can't always trust their supervisors to do the right thing and follow up on what needs to be investigated.

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There are times that accountants are expected to report wrongdoing to the authorities as part of their ethical obligation, such as under the Dodd-Frank Financial Reform Act that will be discussed in Chapter 3. This would be the case if every effort has been made using internal means to correct for fraudulent financial statements to no avail. It may also be the case to prevent serious harm to others. Finally, it may be required by state law as well.

24. **Assume that a corporate officer or other executive asks you, as the accountant for the company, to omit or leave out certain financial figures from the balance sheet that may paint the business in a bad light to the public and investors. Because the request does not involve a direct manipulation of numbers or records, would you agree to go along with the request? What ethical considerations exist for you in deciding on a course of action?**

Would the omission of the information be misleading to investors and the public? If so, then the SEC would consider that information material and then should be disclosed. Many may consider the omission of information as a form of a lie. One may mislead by stating a lie or by keeping quiet about some information. Many religions consider one a sin of commission and one a sin of omission; since both are sins, they are both wrong. Omitting information goes to honesty, integrity and trustworthiness under the Six Pillars of Characters. Those values are also important using virtue or deontology reasoning.

What if a client asks you to leave out information about a multi-billion-dollar lawsuit for product tampering because it won't be resolved for at least years? Would you omit it because its effects are not in the short-term – i.e., within one year? The omission of the information (in the accounts or notes as required) – is misleading to investors and creditors who have a right to know that the company may have a very significant legal liability in two or more years. How will the company meet this obligation? Should it set aside the funds in a reserve account? These are all legitimate questions for users to ask, but they can't if the information is omitted.

25. **Sir Walter Scott (1771–1832), the Scottish novelist and poet, wrote: "Oh what a tangled web we weave, when first we practice to deceive." Comment on what you think Scott meant by this phrase.**

Lies often require stories which seem simple, but if examined, may call for further lies. In some cases, merely remembering a lie is more difficult than remembering the truth. Fiction is filled with stories of one lie leading to others. You might collect a list of those famous stories. This question provides an opportunity to remind students of the ethical slippery slope and once a lie is told, the person who tells it begins the slide and it is much more difficult to climb back up and regain the moral high ground. The concept of an 'ethical slippery slope' is one that defines behavior when a decision-maker first decides to deceive others by consciously covering up or lying about past behavior. This begins the slide down the proverbial ethical slippery slope where it becomes more difficult to reverse course because the decision maker is committed to the deceitful action; then since most people don't want others (i.e., superiors) to know about the initial, wrongful action over time cover up or lying slowly become untangled and the truth emerges.

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Betty Vinson was a victim of the ethical slippery slope. Once she agreed to go along with financial wrongdoing and enter false data into WorldCom's accounting system, it became very difficult for her to change direction as future requests were made for her to do the same.

26. **Assume you are interviewing for a position with an accounting firm and the recruiter asks you the following questions. Craft a response that you would feel comfortable giving for each one.**

- **Describe an experience in the workplace when your attitudes and beliefs were ethically challenged? Use a personal example if you have not experienced a workplace dilemma.**
- **What are the most important values that would drive your behavior as a new staff accountant in a CPA firm?**
- **Describe your ethical expectations of the culture in an accounting firm?**
- **What would you do if your position on an accounting issue differs from that of firm management?**

Selected points:

- I, as many students and recent grads, have been challenged ethically in being asked by a friend to share homework, tell what was on a test, or covering up who did what on a group project in order to get the best grade. These are conflicts of loyalty to a friend versus having integrity, and a short-term payoff versus long-term habits. I have tried to choose having the long-term habit of integrity and honesty.
- While some compromises are required in a workplace setting, an employee should understand that compromising ethics is not one allowed. As a new employee, I would not go against my ethical values. I would need to make sure that I knew all the facts so that I am judging or acting based on partial information.
- Most Americans tell white lies, often in the rationalization of being tactful. I cannot promise to never lie for you but I prefer to tell the truth as much as possible. For instance, if I answer a call from a client wishing to speak to you, and you tell me to say that you are gone for the day. I would probably tell the client that you unavailable to take the call at present and ask to take a message.
- A corporation may be considered a legal person, but it is collectively made up of individual employees. Many of those individuals may act ethically or unethically in any given situation. As an individual I am responsible to act ethically. An ethical corporation may not be able to guarantee that all of its employees will act ethically all the time, but it is required to have ethical policies and procedures in place so the actions of the corporation are ethical. I expect the CPA firm to have a culture of respect, honesty, integrity, and responsibility and realize it will demand the same of me.
- When differences on ethical issues with a supervisor arise at work, it's best to consult with a mentor or trusted advisor. It's always best to voice your values to others first in order to anticipate the reasons and rationalizations of others/superiors who are trying to get you to compromise your values.

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Major Case 1 Adelphia Communications Corporation

On July 24, 2009, the U.S. Court of Appeals for the District of Columbia upheld the finding of the SEC that Gregory M. Dearlove, a certified public accountant and formerly a partner with the accounting firm Deloitte & Touche LLP, engaged in improper professional conduct within the meaning of Rule of Practice 102(e). Dearlove served as the engagement partner on Deloitte's audit of the financial statements of Adelphia Communications Corporation, a public company, for the fiscal year ended December 31, 2000. The SEC confirmed its original ruling that Adelphia's financial statements were not in accordance with generally accepted accounting principles, and that Dearlove violated generally accepted auditing standards. The administrative law judge (ALJ) also found that Dearlove was a cause of Adelphia's violations of the reporting and record-keeping provisions of the Exchange Act. The ALJ permanently denied Dearlove the privilege of appearing or practicing in any capacity before the commission.

The opinion for the court was filed by Judge Douglas H. Ginsburg of the U.S. Court of Appeals for the D.C. Circuit Court. The opinion states that the SEC concluded that Dearlove engaged repeatedly in unreasonable conduct resulting in violations of applicable accounting principles and standards while serving as Deloitte's engagement partner in charge of the 2000 audit of Adelphia. Dearlove had argued that the SEC committed an error of law, misapplied the applicable accounting principles and standards, and denied him due process. Because the SEC made no error of law, and substantial evidence supports its findings of fact, the court denied the petition.

Background Issues

John Rigas had founded Adelphia, the Greek word for brothers, in 1952, and Rigas and his children were the controlling shareholders in 2000. By the year 2000, Adelphia was one of the largest cable television companies in the United States. It had doubled the number of cable subscribers that it served by acquiring several other cable companies in late 1999. Although its assets were growing, Adelphia's debt grew substantially as well. The SEC found that, prior to 2000, Adelphia, its subsidiaries, and some Rigas-affiliated entities entered as coborrowers into a series of credit agreements. By 1999, Adelphia and the entities had obtained $1.05 billion in credit; in 2000, they tripled their available credit and drew down essentially all the funds available under the agreements.

Deloitte audited Adelphia's financial statements from 1980 through 2002, with Dearlove as the engagement partner. Dearlove and the Deloitte team described the 2000 audit, like many prior audits of Adelphia, as posing "much greater than normal risk" because Adelphia engaged in numerous transactions with subsidiaries and affiliated entities, many of which were owned by members of the Rigas family.

Deloitte issued its year 2000 independent auditor's report of Adelphia—signed by Dearlove—on March 29, 2001. In January 2002, in the wake of the Enron scandal, the SEC released a

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statement regarding the disclosure of related-party transactions. In March, Adelphia disclosed its obligations as co-debtor with the Rigas entities. Its share price declined from $30 in January 2002 to $0.30 in June, when it was delisted by the National Association of Securities Dealers (NASDAQ). In September 2002, the U.S. Department of Justice (DOJ) brought criminal fraud charges against Adelphia officials, including members of the Rigas family, and Adelphia agreed to pay $715 million into a victims' restitution fund as part of a settlement with the government. In April 2005 the SEC brought and settled civil actions against Adelphia, members of the Rigas family, and Deloitte.

SEC Charges

In September 2005, the SEC charged Dearlove with improper conduct resulting in a violation of applicable professional standards, including his approval of Adelphia's method of accounting for transactions between itself and one or more Rigas entities (i.e., related-party transactions). The matter was referred to the ALJ, who presided at an administrative trial-type hearing to resolve the dispute between the SEC and Adelphia. The ALJ determined Dearlove had engaged in one instance of "highly unreasonable" conduct and repeated instances of "unreasonable" conduct, and permanently denied Dearlove the right to practice before the SEC. Upon review of the ALJ's decision, the SEC held Dearlove had engaged in repeated instances of unreasonable conduct as defined under Rule 102 and denied him the right to practice before the SEC, but provided him the opportunity to apply for reinstatement after four years. Dearlove petitioned for review of that decision, which was denied by the U.S. Court of Appeals.

SEC Rule 102(e) provides the SEC may "deny, temporarily or permanently, the privilege of appearing or practicing before [the SEC] in any way to any person who is found by the Commission . . . to have engaged in unethical or improper professional conduct." The rule defines three classes of "improper professional conduct" for accountants: (1) "Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards," (2) "a single instance of highly unreasonable conduct that results in a violation of applicable professional standards," and (3) "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." The court supported the SEC's determination that Dearlove repeatedly engaged in unreasonable conduct.

While most of the alleged fraud at Adelphia took its form in hidden debt, the trial was also notable for examples of the eye-popping personal luxury that has marked other white-collar trials such as at Tyco.

In the court case, prosecutor Christopher Clark led off his closing argument by saying John Rigas had ordered two Christmas trees flown to New York, at a cost of $6,000, for his daughter. Rigas also ordered up 17 company cars and the company purchase of 3,600 acres of timberland at a cost of $26 million to preserve the pristine view outside his Coudersport, Pennsylvania, home. Timothy Rigas, the CFO, had become so concerned that he limited his father to withdrawals of $1 million per month.

Deloitte's Audit

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Deloitte served as the independent auditor for Adelphia, one of its largest audit clients, from 1980 through 2002. The audits were complex. Several of Adelphia's subsidiaries filed their own Form 10-K annual reports with the SEC. For several years, Deloitte had concluded that the Adelphia engagement posed a "much greater than normal" risk of fraud, misstatement, or error; this was the highest risk category that Deloitte recognized. Risk factors that Deloitte specifically identified in reaching this assessment for the 2000 audit included the following:

- Adelphia operated in a volatile industry, expanded rapidly, and had a large number of decentralized operating entities with a complex reporting structure.
- Adelphia carried substantial debt and was near the limit of its financial resources, making it critical that the company comply with debt covenants.
- Management of Adelphia was concentrated in a small group without compensating controls.
- Adelphia management lacked technical accounting expertise but nevertheless appeared willing to accept unusually high levels of risk, tended to interpret accounting standards aggressively, and was reluctant to record adjustments proposed by auditors.
- Adelphia engaged in significant related-party transactions with affiliated entities that Deloitte would not be auditing.

To help manage the audit risk, Deloitte planned, among other things, to increase Deloitte's management involvement at all stages of the audit "to ensure that the appropriate work is planned and its performance is properly supervised." It also proposed to heighten professional skepticism "to ensure that accounting estimates, related-party transactions, and transactions in the normal course of business appear reasonable and are appropriately identified and disclosed."

On March 29, 2001, Deloitte issued its independent auditor's report, signed by Dearlove, which stated that it had conducted its audit in accordance with GAAS and that such audit provided a reasonable basis for its opinion that Adelphia's 2000 financial statements fairly presented Adelphia's financial position in conformity with GAAP.

Charges against Rigas Family and Deloitte

In the wake of Adelphia's decline, the DOJ brought criminal fraud charges against several members of the Rigas family and other Adelphia officials. The DOJ declined to file criminal charges against Adelphia as part of a settlement in which Adelphia agreed to pay $715 million in stock and cash to a victims' restitution fund once the company emerged from bankruptcy.

The SEC brought several actions related to the decline of Adelphia. On April 25, 2005, Adelphia, John Rigas, and Rigas's three sons settled a civil injunctive action in which the respondents, without admitting or denying the allegations against them, were enjoined from committing or causing further violations of the anti-fraud, reporting, record-keeping, and internal controls provisions of the federal securities laws. The next day, the commission instituted and settled administrative proceedings against Deloitte under Rule 102(e). Without admitting or denying the commission's allegations, Deloitte consented to the entry of findings that it engaged in repeated instances of unreasonable conduct with respect to the audit of Adelphia's 2000 financial statements. Deloitte also consented to a finding that it caused Adelphia's violations of

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those provisions of the Securities and Exchange Act that require issuers to file annual reports, make and keep accurate books and records, and devise and maintain a system of sufficient internal controls. Deloitte agreed to pay a $25 million penalty and to implement various prophylactic policies and procedures. The commission also settled a civil action, based on the same conduct, in which Deloitte agreed to pay another $25 million penalty. Senior manager William Caswell consented to commission findings that he committed repeated instances of unreasonable conduct and agreed to a bar from appearing or practicing as an accountant before the commission with a right to apply for reinstatement after two years.

Violation of GAAS: General, Fieldwork, and Reporting Standards

In determining whether to discipline an accountant under Rule 102(e)(1)(iv), the commission has consistently measured auditors' conduct by their adherence to or deviation from GAAS. Certain audit conditions require auditors to increase their professional care and skepticism, as when the audit presents a risk of material misstatement or fraud. When an audit includes review of related-party transactions, auditors must tailor their examinations to obtain satisfaction concerning the purpose, nature, and extent of those transactions on the financial statements. Unless and until an auditor obtains an understanding of the business purpose of material related- party transactions, the audit is not complete. These standards can overlap somewhat, and one GAAS failure may contribute to another.

Dearlove asked the court to compare the reasonableness of his conduct to a standard used by New York state courts in professional negligence cases, that the standard for determining negligence by an accountant should be based on whether the respondent "use[d] the same degree of skill and care that other [accountants] in the community would reasonably use in the same situation." Dearlove believed that his actions should be judged in the context of the large, complex Adelphia audit and to determine whether he exercised the degree of skill and care, including professional skepticism, that a reasonable engagement partner would have used in similar circumstances. Dearlove contended that this analysis "necessarily includes . . . conclusions previously reached by other professionals," a reference to the Adelphia audits that Deloitte conducted from 1994 through 1999. Dearlove asserted that he could place some reliance on audit precedent. Moreover, in his view, the fact that prior auditors reached the same conclusions was "compelling evidence" that Dearlove acted reasonably. The court rejected any suggestion that the conduct of prior auditors should be a substitute for the standards established by GAAS, ruling that "these standards apply to audits of all sizes and all levels of complexity and describe the conduct that the accounting profession itself has established as reasonable, provid[ing] a measure of audit quality and the objectives to be achieved in an audit." The court, therefore, declined to create a separate standard of professional conduct for auditors that depends in each case on the behavior of a particular auditor's predecessors.

The SEC found that prior Deloitte audits offered little support for the conclusions reached in the 2000 audit. The record did not describe how the audits of prior financial statements were performed or what evidential matter supported those audit conclusions. Moreover, Dearlove's expert, while arguing that partner rotation does not require the new auditor to perform a "de novo audit of the client," nevertheless explained that an engagement partner "would perform . . . new audit procedures or GAAP research and consultation . . . to address changed conditions or

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professional standards." In 2000, Dearlove was presented with markedly different circumstances from those presented to prior teams: Since 1999, Adelphia had tripled its coborrowed debt, doubled its revenues and operating expenses, and acquired more cable subscribers. The changes implicated areas of the Adelphia audit that Deloitte had specifically identified as posing high risk—namely, its rapid expansion, substantial debt load, and significant related-party transactions. Therefore, the court rejected Dearlove's argument that the similarity of prior audit conclusions lent reasonableness to his own audit and found no reason to reject GAAS as the standard by which we judge all audits.

Violation of Accounting and Reporting Standards

Having determined that Dearlove's conduct was unreasonable, the SEC turned to the applicable professional accounting and reporting standards. The GAAS required that when an audit posed greater than normal risk—as Dearlove had determined the Adelphia audit did—there must be "more extensive supervision by the auditor with final responsibility for the engagement during both the planning and conduct of the engagement." The SEC found no evidence in the audit workpapers or elsewhere in the record that Dearlove gave any consideration to the propriety of at least three separate transactions: (1) offsetting of receivables and payables, (2) reporting of coborrowed debt, and (3) direct placement of stock transactions.

Offsetting Receivables and Payables

Accounting Principles Board Opinion No. 10 states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." Rule 5-02 of the commission's Regulation S-X requires that issuers "state separately" amounts payable and receivable. Interpretation 39, Offsetting of Amounts Related to Certain Contracts, defines a right of setoff as "a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt of another party by applying against the debt an amount that the other party owes to the debtor. The Interpretation is consistent with Rule 5-02.

The court had concluded that Adelphia's presentation of a net figure for its related-party payables and receivables violated GAAP. Because Adelphia netted the accounts payable and receivable of its various subsidiaries against the accounts payable and receivable of various Rigas entities on a global basis, it did not comport with Interpretation 39's basic requirement that netting is appropriate only when two unrelated parties are involved.

The SEC held Adelphia violated GAAP because its netting involved more than two parties: "Adelphia netted the accounts payable and receivable of its various subsidiaries against the accounts payable and receivable of various Rigas Entities on a global basis . . . [and] netting is appropriate only when two parties are involved."

The SEC analyzed the record and determined that Dearlove's conduct was unreasonable in the circumstances and that it resulted in a violation of professional standards—both GAAS and GAAP. Because GAAS focuses upon an auditor's performance and requires him to exercise due professional care, the commission rejected Dearlove's attempt to fault the SEC for marshaling

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the same evidence to show that his conduct was unreasonable and that he failed to exercise due professional care in performing the audit.

Coborrowed Debt

Between 1996 and 2000, several Adelphia subsidiaries and some of the Rigas entities had entered as coborrowers into a series of three credit agreements with a consortium of banks. Although the agreements differed in the amount of credit available, their terms were substantially the same: each borrower provided collateral for the loan; each could draw funds under the loan agreement; and each was jointly and severally liable for the entire amount of funds drawn down under the agreement, regardless of which entity drew down the amount. By year-end 2000, the total amount of coborrowed funds drawn under the credit agreements was $3.751 billion, more than triple the $1.025 billion borrowed at year-end 1999. Of this amount, Adelphia subsidiaries had drawn approximately $2.1 billion, and Rigas entities had drawn $1.6 billion.

Generally, an issuer must accrue on its balance sheet a debt for which it is the primary obligor. However, when an issuer deems itself to be merely contingently liable for a debt, *Statement of Financial Accounting Standards (SFAS) 5* provides the appropriate accounting and reporting treatment for that liability. *SFAS 5* establishes a three-tiered system for determining the appropriate accounting treatment of a contingent liability, based on the likelihood that the issuer will suffer a loss—that is, be required to pay the debt for which it is contingently liable. If a loss is *probable* (i.e., likely) and its amount can be reasonably estimated, the liability should be accrued on the issuer's financial statements as if the issuer were the primary obligor for the debt. If the likelihood of loss is only *reasonably possible* (defined as more than remote but less than likely), or if the loss is probable but not estimable, the issuer need not accrue the loss but should disclose the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. The issuer still must disclose the "nature and amount" of the liability, even if the likelihood of loss is only *remote* (slight). From 1997 through 1999, Adelphia had included in the liabilities recorded on its balance sheet the amount that its own subsidiaries had borrowed, but it did not consider itself the primary obligor for the amount that the Rigas entities had borrowed and therefore did not include that amount on its balance sheet. Instead, Adelphia accounted for the amounts borrowed by the Rigas entities by making the following disclosure in the footnotes to its financial statements:

Certain subsidiaries of Adelphia are coborrowers with Managed Partnerships (i.e., Rigas entities) under credit facilities for borrowings of up to [the total amount of all coborrowed debt available to Adelphia and the Rigas entities that year]. Each of the coborrowers is liable for all borrowings under this credit agreement, although the lenders have no recourse against Adelphia other than against Adelphia's interest in such subsidiaries.

Deloitte had approved this treatment in the audits it conducted from 1997 to 1999.

Dearlove knew that Adelphia considered the Rigas entities's debt to be a contingent liability for which its chances of suffering a loss were merely remote, making accrual on the balance sheet unnecessary pursuant to *SFAS 5.* Deloitte created no workpapers documenting its examination of Adelphia's decision. However, from the record, it appears that Deloitte considered the matter and

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focused its review on the likelihood, as defined by *SFAS 5,* that Adelphia would have to pay Rigas entities's share of coborrowed debt.

Dearlove also believed that, although the Rigas family was not legally obligated to contribute funds in the event of a default by the coborrowers, the family would be economically compelled to protect their Adelphia holdings by stepping in to prevent a default by the entities. Dearlove did not, however, conduct any inquiry into whether the family would, in fact, use their personal assets to prevent a default by Adelphia. Dearlove estimated the value of the Rigas family's holdings of Adelphia stock by multiplying the number of shares the Rigases owned by the price per Class A share, resulting in a figure of approximately $2.3 billion, which he concluded was by itself ample to cover the debt and conclude his *SFAS 5* analysis. However, Dearlove did not determine if these Rigas family assets were already encumbered by other debt; he saw no financial statements or other proof of the family's financial condition other than local media reports that the Rigases "were billionaires." Dearlove testified that he "never asked them: Are you worth $2 billion, $3 billion, or $10 billion?" Dearlove also did not consider whether disposing of some or all of the family's stock in Adelphia might result in a downward spiral in the stock's value or in a change in their control of the company, in the event of a default by the entities under the coborrowing agreements.

Dearlove testified that, at the end of the 2000 audit, he spoke to senior manager Caswell for about 15 minutes regarding the requirements of *SFAS 5*. During this meeting, they concluded that "the assets of the cable systems and the Adelphia common stock that the Rigases owned exceeded the amount of debt that was on the coborrowed entities, and the overhang . . . exceeded the coborrowing by hundreds of millions if not billions of dollars." Dearlove testified that, although other assets could have been included in an *SFAS 5* analysis, these two assets alone were sufficient to allow the auditors to conclude that Adelphia's contingent liability was remote. Deloitte therefore approved Adelphia's decision to exclude Rigas entities's $1.6 billion in coborrowed debt from its balance sheet and to instead disclose the debt in a footnote to the financial statements.

When it reviewed the adequacy of the note disclosure that Adelphia planned to use (which was identical to the language it had used in previous years), the audit team initially believed the disclosure should be revised. During the 2000 quarterly reviews, audit manager Ivan Hofmann and others had repeatedly encouraged Adelphia management to disclose the specific dollar amount of Rigas entities' coborrowings, but Adelphia continually ignored Deloitte's suggestions. Although Deloitte was unaware of it at the time, Adelphia management was working purposefully to obfuscate the disclosure of Rigas entities's coborrowed debt.

In November 2000, at a third-quarter wrap-up meeting attended by Dearlove, Caswell, and Hofmann, Adelphia management (including Adelphia's vice president of finance, James Brown) agreed to make disclosures regarding the amounts borrowed by the Rigas entities under the coborrowing agreements. Caswell and Hofmann subsequently suggested improvements to the note disclosure in written comments on at least six drafts of the 10-K; they proposed adding language that would distinguish the amount of borrowings by Adelphia subsidiaries and Rigas entities, such as the following: "A total of $—— related to such credit agreements is included in

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the company's consolidated balance sheet at December 31, 2000. The [Rigas] entities have outstanding borrowings of $—— as of December 31, 2000, under such facilities."

At the end of March 2001, as Deloitte was concluding its audit of the 2000 financials, Brown—despite his agreement in November 2000 to disclose the amount of Rigas entities's borrowing—informed the audit team that he did not think that the additional disclosure was necessary. Instead, Brown proposed adding a phrase explaining that each of the coborrowers "may borrow up to the entire amount available under the credit facility." Brown argued that his proposed language was more accurate than Deloitte's proposal because the lines of credit could fluctuate and, as a result, it would be better to disclose Adelphia's maximum possible exposure. Caswell agreed to take Brown's language back to the engagement team, but he told Brown that he did not agree with Brown and did not think that Deloitte would accept his proposed language.

Notwithstanding Caswell's reaction, Brown soon afterward presented his proposed language to the audit team, including Dearlove, Caswell, and Hofmann, during the audit exit meeting on March 30, 2001. Brown claimed that his proposed disclosure language had been discussed with, and approved by, Adelphia's outside counsel. Although Dearlove characterized the disclosure issue as "really one of the more minor points that [the audit team was] trying to reconcile at that point," the ALJ did not accept this testimony. Dearlove testified that he was "concerned" about "making it clear to the reader how much Adelphia could be guaranteeing," and that Brown's language was "more conservative" but "wasn't necessarily what we were attempting to help clarify." Dearlove also testified that he told Brown, "I don't understand how that [proposed change] enhances the note" but that, after "an exchange back and forth relative to that," Dearlove "couldn't persuade him as to what he wanted." Nevertheless, Dearlove told Brown that he agreed with the proposal and approved the change. Caswell and Hofmann also indicated their agreement.

Adelphia's note disclosure of the coborrowed debt, as it appeared in its 2000 Form 10-K with Brown's added language, read as follows:

Certain subsidiaries of Adelphia are coborrowers with Managed Entities under credit facilities for borrowings of up to $3,751,250,000. Each of the coborrowers is liable for all borrowings under the credit agreements, and may borrow up to the entire amount of the available credit under the facility. The lenders have no recourse against Adelphia other than against Adelphia's interest in such subsidiaries.

Adequacy of the Note Disclosure of Adelphia's Contingent Liability

The SEC also considered whether Adelphia's footnote disclosure of Rigas entities' coborrowings was appropriate under GAAP. Adelphia disclosed the total amount of credit available to the coborrowers ("up to" $3.75 billion) without indicating whether any portion of that available credit had actually been drawn down, much less that all of it had. This disclosure was inadequate to inform the investing public that Adelphia was already primarily liable for $2.1 billion and a guarantor for the remaining $1.6 billion that had been borrowed by Rigas entities. Therefore, it did not comply with the requirement in *SFAS 5* to disclose the amount of the contingent liability.

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The SEC concluded that Dearlove acted unreasonably in his audit of Adelphia's note disclosure, resulting in several violations of GAAS. In high-risk audit environments such as that presented by the Adelphia engagement, GAAS specifically recommend "increased recognition of the need to corroborate management explanations or representations concerning material matters—such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity" when audit risk increases. The accounting for Adelphia's coborrowed debt implicated the extensive related-party transactions and high debt load that were part of the basis for Deloitte's high-risk assessment for the Adelphia audit. Management's insistence on its own accounting interpretation was precisely the behavior identified by the audit plan as presenting a much higher than normal risk of misstatement in the audit.

Moreover, Dearlove knew that the audit team believed that the footnote disclosure in previous years was inadequate and had urged additional disclosure that would have made clear the extent of Rigas entities's actual borrowings and Adelphia's resulting potential liability. Dearlove did not think that Brown's language helped achieve Deloitte's goal of clarifying the extent of Rigas entities's debt and Adelphia's obligation as guarantor. Yet Dearlove accepted Brown's language without probing his reasons for the change, without understanding Adelphia's reasons for rejecting Deloitte's language, and without discussing the issue with the concurring or risk review partners assigned to the audit. This unquestioning acceptance of Brown's proposed disclosure language was a clear—and at least unreasonable—departure from the requirements of GAAS to apply greater than normal skepticism and additional audit procedures in order to corroborate management representations in a high-risk environment. Dearlove's conduct resulted in violations of applicable professional standards.

Dearlove asserted that disclosure of the amount that Rigas entities could theoretically borrow (up to $3.75 billion) was more conservative than disclosure of the $1.6 billion that it had actually borrowed. The SEC concluded that the footnote disclosure was materially misleading to investors: "Materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." If "there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision," the information is material. A reasonable investor would think it significant that the footnote disclosure spoke only in terms of potential debt when, in fact, the entire line of credit had been borrowed and $1.6 billion of it was excluded from Adelphia's balance sheet but potentially payable by Adelphia. It was especially important for this information to appear in Adelphia's financial statements because investors had no access to the financial statements of the privately held Rigas entities. The SEC rejected Dearlove's argument that Adelphia's note complied with *SFAS 5*'s requirement to disclose the amount of debt that Adelphia guaranteed.

Debt Reclassification

After the end of the second, third, and fourth quarters of 2000, Adelphia's accounting department transferred the reporting of approximately $296 million of debt from the books of Adelphia's subsidiaries to the books of various Rigas entities. In exchange, Adelphia eliminated from its books receivables owed to it by the respective Rigas entities in the amount of debt transferred. The three transfers were in the amounts of $36 million, approximately $222 million, and more than $38 million, respectively. In each instance, the transaction took place after the end of the

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quarter, and each transfer involved a post-closing journal entry that was retroactive to the last day of the quarter.

A checklist prepared by Deloitte in anticipation of the 2000 audit showed that Deloitte was aware of a significant number of related-party transactions that had arisen outside the normal course of business and that past audits had indicated a significant number of misstatements or correcting entries made by Adelphia, particularly at or near year-end. An audit overview memorandum recognized as a risk area that "Adelphia records numerous post-closing adjusting journal entries" and provided as an audit response, "[Deloitte] engagement team to review post- closing journal entries recorded and review with appropriate personnel. Conclude as to reasonableness of entries posted." An audit planning memorandum provided that "professional skepticism will be heightened to ensure that . . . related party transactions . . . are appropriately identified and disclosed" and that auditors should "increase professional skepticism in [areas] where significant related party transactions could occur."

Dearlove testified that Deloitte had identified the Rigas family's control of both Adelphia and Rigas entities as posing a special risk. Dearlove also testified that he believed that it was important to know whose debt was whose, concerning Adelphia and Rigas entities. He testified that he was "generally aware the debt was audited," but that he did not review the debt workpapers directly. He also testified: "I don't recall [debt] being [a] particularly sensitive area, .
. . I don't recall issues raised to me of difficulties we had. I don't recall any particular conversation I had with the team" concerning the audit of the debt. The record does not show that Dearlove knew of the three journal entries involving debt reclassification at the time of the audit.

Statement of Financial Accounting Standards (SFAS) 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, permits a debtor to derecognize a liability "if and only if it has been extinguished." *SFAS 125* provides that a liability is extinguished if either (1) the debtor pays the creditor and is relieved of its obligation for the liability, or (2) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

When the Adelphia subsidiaries posted the debt in question to their books, they acknowledged their primary liability for the amounts posted. They could not remove the debt properly from their books without first satisfying the requirements of *SFAS 125* that either the Adelphia subsidiaries repaid the debt to the creditor during the relevant reporting periods or a creditor had released the subsidiaries from their liability for repayment. The evidence does not show, and Dearlove did not contend, that either of these events occurred. Adelphia's attempt to extinguish the debt unilaterally merely by shifting the reporting to Rigas entities violated GAAP and rendered its financial statements materially misleading by making Adelphia's debt appear less than it was.

Dearlove did not dispute that "certain debt which had been posted to Adelphia was later posted to a Rigas entity." However, focusing on the statement in the initial decision that "once Adelphia's subsidiaries had posted this debt to their books they became primary obligors for the amounts posted," Dearlove argued that *SFAS 125* does not define the circumstances under which

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an entity recognizes debt that may be derecognized only under the *SFAS 125* criteria. He claimed that the initial decision of the commission improperly "assumed without analysis" that the posting of debt in a ledger is such a circumstance. Dearlove argued that the application of *SFAS 125* is complex where entities are jointly and severally liable for an obligation, and it did not apply where an entity is secondarily or contingently rather than primarily liable. He asserted that Adelphia was arguably not required to recognize debt in cases where co-borrowed funds were intended to be used by other co-borrowers. He stopped short, however, of saying that the funds at issue were so intended, and our review of the record yields nothing to support such a contention. The record did not establish that all the reclassified debt was c-borrowed debt, and the ALJ correctly concluded that the impropriety of Adelphia's debt reclassification was unaffected by the question whether the debt was co-borrowed. In addition, Dearlove cited no authority to support his contention that *SFAS 125* is applicable only where primary obligors were required to recognize a liability, and we are aware of none.

The crucial question for the *SFAS 125* analysis is whether the debt was extinguished in one of the enumerated ways. If the debt was not extinguished as provided in *SFAS 125,* the debtor may not derecognize it. The SEC found that the debts were recognized when booked and that, because there was no evidence that the debts were extinguished under *SFAS 125,* the accounting treatment violated GAAP.

With respect to the direct placement of stock transactions, on at least four occasions corresponding with public offerings by Adelphia, Adelphia removed a portion of Co-Borrowing Credit Facility Debt from its books as part of sham transactions in which a Rigas Entity non-co-borrower received Adelphia securities and a Rigas Entity co-borrower "assumed" debt of Adelphia. In each instance, Adelphia claimed in Commission filings and other public statements that Adelphia had applied some or all of the proceeds from these securities transactions actually to pay down debt, when — in fact — these transactions were shams with no bona fide proceeds, and resulted only in the transfer of Adelphia's debt to the books of Rigas Entity co-borrowers.

The commission also found that Dearlove's conduct in his audit of Adelphia's accounting for debt was at least unreasonable, resulting in several GAAS violations. As explained, Dearlove knew that Adelphia had a large number of decentralized operating entities with a complex reporting structure, carried substantial debt, and engaged in significant related-party transactions with affiliated entities that Deloitte would not be auditing. He also knew that Adelphia management tended to interpret accounting standards aggressively. Moreover, the audit plan specifically required that post-closing journal entries be examined in particular detail and that the audit team draw conclusions as to their reasonableness. Dearlove knew that these factors, together with others, led Deloitte to identify the Adelphia audit as posing a "much greater than normal" risk of fraud, misstatement, or error. In addition, Dearlove knew that Adelphia management netted its affiliate accounts payable and receivable and sought to reduce the amount of related-party receivables that it reported.

In this context, GAAS required Dearlove to consider the "much greater than normal" risk of the audit in determining the extent of procedures, assigning staff, and requiring appropriate levels of supervision. In addition, he was required to "direct the efforts of assistants who [were] involved in accomplishing the objectives of the audit and [to] determin[e] whether those objectives were

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accomplished." He was required to exercise "an attitude that includes a questioning mind and a critical assessment of audit evidence," "to obtain sufficient competent evidential matter to provide . . . a reasonable basis for forming a conclusion," and, after identifying related-party transactions, to "apply the procedures he consider[ed] necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements."

The reclassified debt involved post-closing journal entries of a magnitude significant enough to require the auditors to confront management and request an explanation, as required by Deloitte's audit planning documents. After discussing the entries with appropriate Adelphia personnel, Deloitte should have documented management's explanation and Deloitte's conclusions as to whether the accounting treatment was reasonable in the audit workpapers. The record did not show that any of these steps was taken. The failure to take them was, at the very least, unreasonable.

The SEC concluded that Dearlove had acted at least unreasonably in signing an unqualified audit opinion (i.e., unmodified) stating that Deloitte had conducted its audit in accordance with GAAS and that such audit provided a reasonable basis for its opinion that Adelphia's 2000 financial statements fairly presented Adelphia's financial position in conformity with GAAP.

Postscript

On April 21, 2005, it was announced that Time Warner and Comcast were buying bankrupt cable company Adelphia Communications in a $17.6 billion cash-and-stock deal. As a result of a settlement of actions against Adelphia and members of the Rigas family for securities fraud and other violations, and a related criminal forfeiture action, the U.S. Department of Justice and the U.S. Securities and Exchange Commission obtained a recovery consisting of cash of approximately $729 million. The funds were distributed to eligible claimants who suffered a financial loss as a direct result of the circumstances surrounding the Adelphia fraud.

Deloitte did not fare well in the investor lawsuits. On April 5, 2010, Deloitte & Touche LLP agreed to pay up to $210 million as part of a larger $455 million amount. Also, a number of banks, including Bank of America, Citigroup, JPMorgan Chase, Wachovia, and 35 others, agreed to pay to settle an investor lawsuit. Earlier, in 2005, Deloitte had paid the SEC $50 million to settle claims that it had incorrectly audited Adelphia's 2000 financials. Not surprisingly, the defendants, Deloitte and the banks, admitted no wrongdoing, but Deloitte spokesperson Deborah Harrington said, "Deloitte & Touche believes it has no liability for the fraud by Adelphia and its former management. Deloitte & Touche also believes, however, that it was in the best interests of the firm and its clients to settle this action rather than to continue to face the expense and uncertainty of protracted litigation."

As usual, the lawyers made out well in this case, landing a 21 percent share of the settlement (or about $94 million).

This is a good case to have students review the SEC complaint against Deloitte and expand the scope of the case to enhance its usage as an end-of-course project. Here is the link to the complaint: https://www.sec.gov/litigation/complaints/complr17627.htm.

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Instructors may want to add a fifth question if Chapter 6 is assigned in the course. Optional Question

Do you believe that Deloitte violated its ethical and professional responsibilities in the audit of Adelphia by being liable for negligence, gross negligence, or fraud? Explain the reasons for your answer using the discussion in Chapter 6 for support.

Case Questions

1. **Dearlove and Deloitte had identified the audit as posing much greater risk than normal. Describe the risk factors in the case that most likely would have led to this conclusion.**

For several years, Deloitte had concluded that the Adelphia engagement posed a "much greater than normal" risk of fraud, misstatement, or error; this was the highest risk category that Deloitte recognized. Risk factors that Deloitte specifically identified in reaching this assessment for the 2000 audit included the following:

- Adelphia operated in a volatile industry, expanded rapidly, and had a large number of decentralized operating entities with a complex reporting structure;
- Adelphia carried substantial debt and was near the limit of its financial resources, making it critical that the company comply with debt covenants;
- Management of Adelphia was concentrated in a small group without compensating controls;
- Adelphia management lacked technical accounting expertise but nevertheless appeared willing to accept unusually high levels of risk, tended to interpret accounting standards aggressively, and was reluctant to record adjustments proposed by auditors; and
- Adelphia engaged in significant related party transactions with affiliated entities that Deloitte would not be auditing.

To help manage the audit risk, Deloitte planned, among other things, to increase Deloitte's management involvement at all stages of the audit and to heighten professional skepticism. One has to wonder why Deloitte felt management's involvement needed to be ratcheted up when it was management's behavior that was being reviewed and an integral part of the overall assessment of the internal control environment.

Deloitte had specifically identified areas posing high risk including Adelphia's rapid expansion, substantial debt load, and significant related party transactions. The high risk areas are demonstrated by three separate transactions: (1) Offsetting receivables and payables; (2) Reporting co-borrowed debt; and (3) Direct placement of stock transactions.

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2. **Classify each of the accounting issues in the case into the financial shenanigans identified by Schilit in Chapter 7. Are there any accounting procedures that do not fit into one of the shenanigans? If not, make up a category to describe such procedures in a general way as did Schilit. Comment on the earnings management effects as well.**

The Adelphia case has three accounting transactions not in compliance with GAAP. The offsetting receivables and payables is a form of shenanigan number 5, failing to record or improperly reducing liabilities. This failure to account for offsetting receivables and payables means that interest expense may be understated. The reporting of co-borrowed debt is a form of shenanigan number 5, failing to record or improperly reducing liabilities. This failure to record co-borrowed debt also indicates that interest expense may be understated. Adelphia also failed to adequately disclose relevant information about these arrangements in a note especially given the agreement with Deloitte. Instead, it watered down the disclosure and made it more innocuous. Little is said in the case about the problems with the direct placement of stock transactions and it seems this may be more of an operational rather than financial "shenanigan." The transactions were classified by the SEC as "sham" transactions. A review of the SEC complaint in the case indicates the following.

On at least four occasions corresponding with public offerings by Adelphia, Adelphia removed a portion of Co-Borrowing Credit Facility Debt from its books as part of sham transactions in which a Rigas Entity non-co-borrower received Adelphia securities and a Rigas Entity co-borrower "assumed" debt of Adelphia. In each instance, Adelphia claimed in Commission filings and other public statements that Adelphia had applied some or all of the proceeds from these securities transactions actually to pay down debt, when, in fact, these transactions were shams with no bona fide proceeds, and resulted only in the transfer of Adelphia's debt to the books of Rigas Entity co-borrowers.

Schilit's shenanigans do not expressly address failed note disclosures although they emanate from the improper accounting. Perhaps an eighth shenanigan on "failure to properly disclose notes related to material transactions" would better capture those kinds of shenanigans. This is important because earnings management techniques come in all forms and sizes and failed note disclosures can mask income smoothing and other methods of earnings management. However, most of Adelphia's shenanigans were motivated by the desire to mask related party transactions and the extent of debt due by Adelphia to creditors.

A key issue in the case is the proper reporting of the coborrowed debt and related party transactions. A review of the contingent liability rules seems to indicate that the disclosures were inadequate for a reasonably possible loss. It does not appear a liability should have been recorded based on a probable outcome. The coborrowed debt and related party transactions could be put into an eighth shenanigan on disclosure fraud: failing to adequately disclose relevant details about contingent events and related-party transactions.

3. **Describe each of the auditing standards and procedures the auditors failed to adhere to given the facts of the case. How did the failure of the auditors to follow**

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them violate Deloitte's ethical standards as evidenced by the deficiencies in the work of Dearlove and other members of the audit engagement team?

The generally accepted auditing standards require the auditors to plan the audit adequately and to properly supervise any assistants. Auditors must exercise due professional care in performing an audit and preparing a report. They must maintain an attitude of professional skepticism, which includes a questioning mind and a critical assessment of audit evidence. They must obtain sufficient competent evidential matter to afford a reasonable basis for an opinion with respect to the financial statements under review. Auditors are expected to develop procedures to identify fraud in the financial statements, especially those related to material misstatements.

Specifically, in the area of the offsetting or netting of receivables and payables, the SEC found no evidence in the audit workpapers that Deloitte gave any consideration to the propriety of Adelphia's netting during the year 2000 audit or that the audit team conducted any analysis of FASB Interpretation 39, Offsetting of Amounts Related to Certain Contracts (FIN 39), requirements. There is no evidence that Dearlove made any attempt to determine the gross amounts of Adelphia's related party accounts payables and receivables. In this area the SEC found that Dearlove did not obtain sufficient competent evidential material to support his conclusion that Adelphia's netting was properly done; he did not exercise appropriate skepticism despite circumstances requiring heightened scrutiny; and he did not properly supervise the audit team to ensure that significant related party transactions, like this netting, were afforded appropriate review. Sufficient audit evidence was lacking in some cases and the auditors allowed themselves to be influenced by client management on a number of issues. The ethical standards of integrity and objectivity, due care including professional skepticism, and following GAAP and GAAS were violated as evidenced by how the auditors went about gathering evidence on transactions and developing workpaper information.

In the area of coborrowed debt, the SEC found that Deloitte and Dearlove created no workpapers documenting its examination of Adelphia's decision. There is no evidence that Dearlove or the audit team conducted an analysis of Adelphia's potential for liability under the credit agreements; nor is there evidence that Dearlove directed the audit team to conduct such an analysis. Instead, Dearlove's conclusion was based on a series of assumptions about the Rigas Entities' and the Rigas family's willingness and ability to pay the coborrowing Rigas Entities' debt -- assumptions that were either untested or inadequately tested. Each of Dearlove's failures to meaningfully review Adelphia's chances of suffering a loss on the coborrowings resulted in a violation of the professional standards. The review of coborrowed debt did not meet the GAAS to exercise due professional care and professional skepticism, adequately plan the audit, and obtain sufficient competent evidential matter to afford a reasonable basis for his opinion that Adelphia's chances of incurring a loss were remote.

In the area of the adequacy of the note disclosure of Adelphia's contingent liability, the SEC found that: Dearlove and Deloitte failed to exercise the level of professional care called for by the high-risk account; failed to employ professional skepticism in analyzing the note

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disclosure; and failed to apply audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements.

These failures by Deloitte and Dearlove violated ethical standards. As cited in the SEC complaint these standards (and pre-revised AICPA Code rule numbers) include the following: independence (rule 101), objectivity and skepticism (rule 102), due care and competence (rule 201), compliance with auditing standards (rule 202), accounting principles (rule 203), and acts discreditable (rule 501).

4. Analyze the actions of Deloitte and Dearlove from an ethical reasoning perspective.

Reviewing the professional/ethical standards, Deloitte and Dearlove: had a duty and obligation of due care in conducting the audit; to approach the audit with a healthy dose of skepticism; and to identify risks of possible problems with the clients' business model or the existence of material misstatements in the financial statements. The auditors failed on all accounts.

The actions by Deloitte and Dearlove were motivated by egoism and the clients' best interests, not the interests of the shareholders and creditors. The auditors failed in their public interest obligations. The actions of Rigas management were designed to promote their interests regardless of the cost and ethics of accounting and financial reporting techniques. Using rule-utilitarianism, GAAP and GAAS must be followed regardless of any utilitarian benefits that may exist for the company by developing its own (self-interest) way of accounting and financial reporting for the related party transactions, co-borrowed debt, and receivable-payable offsets. From a justice perspective, the audit was biased towards the interests of the Rigas family. In treating equals, equally and unequals, unequally, the fact is the shareholders and creditors had a greater claim to accurate and reliable financial statements and their rights should have been stressed above all else. Using virtue theory, honesty requires that the statements should be truthful and fully disclose all relevant information on related parties' transactions. The accounting and reporting of other transactions should be consistent with diligence, responsibility, and transparency. Impartiality requires that Deloitte should not be biased towards the Rigas family. Perhaps the auditors feared losing a major client and allowed client interests and pressures on the auditor to rule the day. This would be a stage 3 reasoning approach to moral decision- making.

Instructors may want to add a fourth question if Chapter 6 is assigned in the course.

Optional Question

Do you believe that Deloitte violated its ethical and professional responsibilities in the audit of Adelphia by being liable for negligence, gross negligence, or fraud? Explain the reasons for your answer using the discussion in Chapter 6 for support.

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Negligence is a violation of a legal duty to exercise a degree of care that an ordinary prudent person would exercise under similar circumstances. For a CPA, negligence is failure to perform a duty in accordance with applicable standards; it may be viewed as failure to exercise due professional care. Gross negligence is the lack of even slight care, indicative of a reckless disregard for one's professional responsibilities. Fraud is defined as misrepresentation by a person of a material fact known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured.

In the Adelphia case, Deloitte and Dearlove violated ethical and professional responsibilities and were liable for negligence. The audit was performed without exercise of due professional care and with reckless disregard for GAAS and proper financial reporting. Deloitte was found guilty of fraud in a case brought by the U.S. Department of Justice and the SEC. It does seem quite clear that fraud existed and Adelphi was a willing participant because it knew of the co-borrowed debt and contingent liability, improper reporting of related party transactions, and receivable-payable offset, but the firm did little to insist that proper accounting and financial reporting occurred in these instances.

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