Ethics: Critical Thinking, Case Studies and Fraud

Authors:
Matthew X. Ryan, CFE, MBA
Francis X. Ryan, CPA, CGMA, MBA

Revised - March 2014

Copyright 2014 Matthew X. Ryan and Francis X. Ryan

Introduction

- Qualifications (Matt):
  - Financial Services & Risk Analysis
    - Public Accounting/Internal Audit
    - Alternative Investment (Hedge Fund) Accounting
    - Strategic & Operational Risk analysis (manufacturing, start-ups, financially-troubled companies, etc.)
  - Pennsylvania Army National Guard
    - Captain, Company Commander for Distribution/Logistics Company
    - Operation Iraqi Freedom (2008-2009), Executive Officer & Medical Logistics Officer
  - Non-profit Board experience
  - PICPA - Education Committee
  - Political Committees & State Senate Candidate Treasurer
- Education & Certifications
  - MBA - The Wharton School
  - B.S. Finance - Penn State University
  - Certified Fraud Examiner
Introduction

- Qualifications (Frank):
  - MBA, CPA, CGMA
  - Crisis Manager
  - Author, Series “Rebuilding America”
  - Marine Colonel (Retired)
    - Iraq and Afghanistan
    - Economic warfare & civil affairs
  - Former Chairman Audit Committee
    - Public Company and Not for Profit
  - Public Company Board Experience
  - Chairman, Not for Profit Board
  - Former Congressional Candidate

Course Outline

- Ethics
  - What are Ethics?
  - Why Study Ethics?
    - Critical Thinking Errors
- Ethics and Business
  - Professional Responsibility
  - AICPA Codification - Updated
  - CPA Vision
  - Seminal Events
Resources

- “4 Kinds of Fraud That Could Destroy Your Business” by Matt Garrett, August 2013
- AICPA Code of Professional Conduct:
  [http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx](http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx)

Protocol

- Discussion Parameters
  - Please do not interrupt each another
  - Listen to understand, not to agree
  - Criticize an opinion, not a person, if you disagree
  - Avoid giving personal information
  - Right of non-attribution of opinion
- Note: Course is not designed to give you a “correct” answer to all your ethical dilemmas.
  - Designed to get you to think about the dilemmas you may face so you can prepare for a response
What are Ethics?

- Is it what you do when no one is looking?
- Is it never making a mistake?
- Is it your core beliefs?
- Is it society’s beliefs?
- Is it something that can be taught?
- Is it something that changes over time?
- What is “it”?

What are Ethics?

- Moral principles that govern a person’s or group’s behavior.
- The moral correctness of specified conduct.
- Moral philosophy involving the concepts of what is right and wrong.
  - Frequently tied to our religious beliefs.
  - Usually learned as a child through family and other close influences.
  - Strongly influenced by culture.
Why Study Ethics?

- Are we more ethical today than 100 years ago?
- Are we less ethical?
- The same?

“It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed have grown enormously.”

- Alan Greenspan

Why Study Ethics?

- Reputation
- Business
  - Avoid public criticism, lawsuits, and…prison?
  - Increase profits
  - Avoid government intervention
- Enhance Critical Thinking Skills
  - Professional Skepticism
  - Make better decisions for ourselves, our firm, and society
  - Learn from the mistakes of others
Why Study Ethics?

- Reputation
  - Decades of good can be undone with a single act.
  - Inaction can be as damaging as committing the act.

“It takes many good deeds to build a good reputation, and only one to lose it.”
- Benjamin Franklin
Why Study Ethics?

- Business
  - Avoid public criticism, lawsuits, and...prison?
  - Increase profits (long-term)
  - Avoid government intervention
    - Costs associated with intervention?
    - Dodd-Frank, Sarbanes-Oxley, etc.

Why Study Ethics?

- Enhance Critical Thinking Skills
  - Professional Skepticism
  - Make better decisions for ourselves, our firm, and society
  - Learn from the mistakes of others
Why Study Ethics?

- Ethical Decision Making
  - What facts impact the decision?
    - Legal restrictions
    - Cultural influences
  - Who are the stakeholders?
    - How are each of them impacted?
  - What are possible alternatives?
  - What are common errors in analyzing the above?
    - Ethical decision making includes the ability to think critically with logic and compassion, but without bias.

Critical Thinking Errors

- Appeals to Pity
- Argumentum ad Populum
- Argumentum ad Hominem
- Reductio ad Absurdum
- Mollification
- Argument from Authority
- The Gambler’s Fallacy
- Sunk Cost Fallacy
- Appeals to Tradition
- Appeals to the New

*Above list partially adapted from Chapter 4 in “Business Law: The Ethical, Global, and E-Commerce Environment” 15th Edition, Miller/Barnes/Bowers/ Langvardt, 2012*
Critical Thinking Errors

► Appeals to Pity
  ► Appeal to the compassion of society towards the “innocent”
  ► The elderly, children, veterans
  ► Politics and the media
    ► Veterans benefits
    ► Military spending
    ► Education
    ► Social Security/Medicare
  ► Have you ever been encouraged to do something unethical because the result would aid the “innocent”?

Critical Thinking Errors

► Argumentum ad Populum
  ► “Argument to the people”
  ► Is the majority always right?
    ► “Bandwagon Fallacy”
  ► Ethical decisions may not be the popular decision.
    ► Revenue Recognition issues
    ► Many energy firms in the late 1990s (including Enron) booked revenue as a merchant instead of an agent
      ► Grossly inflated revenue figures
      ► BUT: energy firms did it to remain competitive
Critical Thinking Errors

► Argumentum ad Hominem
  ► “Argument against the man”
  ► Attack the motives/qualifications of the individual, not the actual decision or point-of-view.
  ► Politics and the media
  ► Bethany McLean & Enron
    ► McLean was a journalist for Fortune magazine
    ► In 2001, she questioned the valuation of Enron and how they even made money
    ► Jeff Skilling publicly attacked her as “unethical” because she had obviously “not done her research”
      ► NEVER Addressed her actual question

Critical Thinking Errors

► Reductio ad Absurdum
  ► “Slippery Slope Fallacy”
  ► Politics and the media
  ► Marketing

► Mollification
  ► Downplaying past bad conduct or decisions by blaming problems on external circumstances.
    ► “They were not ordinary times”
    ► Everyone else was doing it
Critical Thinking Errors

- **Argument from Authority**
  - Related to *Argumentum ad Hominem*
  - Position vs. qualifications vs. experience
  - Does Warren Buffett always make good investment decisions?
    - Or does his name give him leverage in today’s investment negotiations? (Bank of America investment)
  - What about “The Buffett Rule”?  
  - Meredith Whitney and financial projections.
- Are people with experience or in positions of authority always ethical?

---

Critical Thinking Errors

- **The Gambler’s Fallacy**
  - Independent events affect future outcomes.
  - Not getting caught in the past does not mean you won’t get caught in the future.
  - How long did Bernie Madoff escape questions about his investment firm?
Critical Thinking Errors

▶ Sunk Cost Fallacy
  ▶ Common in business and government projects.
  ▶ Doesn’t have to be related to financial costs.
  ▶ If you made one unethical decision, do you make another to cover it up?
    ▶ If you made a mistake with a client, how do you react?
    ▶ Ponzi schemes

Critical Thinking Errors

▶ Appeals to Tradition
  ▶ This is how we’ve always done things.
  ▶ Are traditions always ethical?
  ▶ Are the acceptable behaviors from 100 years ago still acceptable today?

▶ Appeals to the New
  ▶ It’s new, it must be better.
  ▶ But what are the second and third-order effects of this “new way”? Do we know the ramifications?
    ▶ Financial Leverage & Derivatives
Professional Responsibility

- To whom are we responsible?
  - Owners?
  - Employees?
  - Suppliers?
  - Regulators?
  - Ourselves?
  - Public?

Who is the Public?

“A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession’s public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.” ET Section 53 Art II
AICPA Code of Conduct

“As professionals, certified public accountants perform an essential role in society. Consistent with that role, members of the American Institute of Certified Public Accountants have responsibilities to all those who use their professional services. Members also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public’s confidence, and carry out the profession’s special responsibilities for self-governance. The collective efforts of all members are required to maintain and enhance the traditions of the profession.” ET Section 52 Art 1

Standards of Financial Ethics

- Independence of thought
- Objectivity
- Integrity
- Due Care
- Attuned to broad business issues - FUTURE

http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx
Independence - Public Practice

“For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.” ET Section 55, Art IV

Independence of Thought - Others

“Although members not in public practice cannot maintain the appearance of independence, they nevertheless have the responsibility to maintain objectivity in rendering professional services. Members employed by others to prepare financial statements or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as members in public practice and must be scrupulous in their application of generally accepted accounting principles and candid in all their dealings with members in public practice.” ET Section 55, Art IV
Objectivity

“Objectivity is a state of mind, a quality that lends value to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.” ET Section 55, Section IV

Integrity

“Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: “Am I doing what a person of integrity would do? Have I retained my integrity?” Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.” ET Section 54, Art III
Due Care

“A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member’s ability.”

ET Section 56, Art V

AICPA Codification

- Ethics Codification Project
  - Appendix 2: AICPA Code of Professional Conduct
  - Objective to create a more user-friendly, intuitively arranged code
  - Incorporates conceptual framework approach
    - Threats and safeguards
    - Conceptual framework applies only when no guidance in the code exists
    - One framework for Members in Business
    - One framework for Members in Public Practice
    - Additional framework for independence that focuses on members in public practice who perform attest services for clients
AICPA Codification

- Substantive Changes
  - Self-Review Threat
  - Ethical Conflicts
  - Attest Clients
  - Director Positions
  - False, Misleading, or Deceptive Acts
  - Attest Engagement Performed with Former Partner
  - Use of AICPA Awarded Designation

AICPA Codification

- New Coding
  - 0.100: Overview of Professional Conduct
  - 0.200: Structure and Application of the AICPA Code
  - 0.300: Principles of Professional Conduct
  - 0.500: Nonauthoritative Guidance
  - 0.600: New, Revised, and Pending Interpretations
  - 0.700: Deleted Standards
  - Part 1: Members in Public Practice
  - Part 2: Members in Business (Industry)
  - Part 3: Other Members
Disciplinary Actions - AICPA

- See the Appendix 3 for Disciplinary Cases
- Names have been changed to protect those impacted by these actions.

http://www.aicpa.org/ForThePublic/DisciplinaryActions/Pages/default.aspx

CPA Vision

- Core Purpose: CPA’s ....making sense of a changing and complex world
- Vision Statement: CPA’s are trusted professionals who enable people and organizations to shape their future.
CPA Vision

- CPA’s add value:
  - Communicating the total picture with clarity and objectivity
  - Translating complex information into critical knowledge
  - Anticipating and creating opportunities
  - Designing pathways that transform vision into reality

---

CPA Vision

- Communicating the total picture with clarity and objectivity:

![Graph showing the relationship between temperature and joint failures.](image)
CPA Vision

- Communicating the total picture with clarity and objectivity

Dilemma

- Is there a difference between ethical conduct and legal conduct?
- Is ethical conduct the same as morality?
- Can you teach Ethics?
- Can a society’s boundaries of ethical behavior become distorted?
- What do you do and how should you act if society’s boundaries go unchecked?
Seminal Event

- A seminal event is one in which your actions at the time will have a significant effect on your life.
- How you respond will materially alter the rest of your life.
- Your actions can be viewed as a crossroads
- Your response will follow you your entire life.
  - Charlotte and Jonathan
  - Meghan Vogel

Causes of Ethical Dilemmas

- Extreme fatigue
- Unwillingness to confront a dishonest person
- Need for income
- Job security
- Broadsided - just did not see it coming
- Others?
What Are Our Challenges?

- Set the “tone at the top” through ethical behavior
  - Corporate Values, Credos - Appendix 1: Johnson & Johnson Credo
- Know and respect professional standards
- Understand proper disclosure and financial reporting considerations
- Know proper and value-oriented responses to ethical dilemmas
- Understand how to identify different types of fraud in the workplace and in financial statements
  - Professional Skepticism

What Must I Do?

- Remember key reference points from Code of Professional Responsibility
  - Responsibility is to the public
  - Independence
  - Objectivity
  - Integrity
  - Due Care
Where to go for help?

- AICPA Ethics Hotline - 888-777-7077
  - Option 6
  - Option 2
- Ethics@aicpa.org
- State Association of CPA's
- Ethics Decision Tree
- www.aicpa.org/audcommctr

Where to go for help?

- “There are known knowns; there are things we know that we know. There are known unknowns; that is to say, there are things that we now know we don’t know. But there are also unknown unknowns - there are things we do not know we don’t know.”
  - former SECDEF Donald Rumsfeld
- Bottom line: there are ethical dilemmas that you may never see coming
- Stay connected with your fellow CPAs and professionals, ask questions/advice
Ethics

- Ethics is a higher standard of conduct which guides an individual and an organization in their interactions. It is a matter of conscience about what is right or wrong in the interaction we have with one another.

Points to Remember

- Tone at the top affects an organization’s attitudes towards ethics
- You will be affected as a CPA by the conduct of other CPA's - responsibility for self-governance
- How will you respond when you have a seminal event?
  - PRACTICE how you will respond
- Your conduct and actions will follow you your entire life - so do the right thing
Thank you for your participation in today’s program.

Matthew X. Ryan, CFE, MBA
mxryan@gmail.com
412-215-2983 (cell)

Francis X. Ryan, CPA, CGMA, MBA
FRYAN1951@gmail.com
717-891-2707 (cell)