Accounting Ethics … and the Near Collapse of the World's Financial System

By Michael Pakaluk and Mark Cheffers

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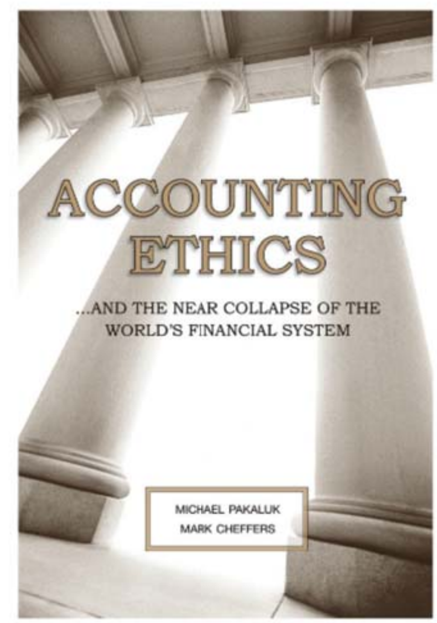
Reviewed by Vincent J. Love

Accounting Ethics … and the Near Collapse of the World's Financial System is not the usual recitation of the rules and interpretations contained in the codes and regulations of the AICPA, state societies, and state boards of accountancy. The book delves into the philosophical foundation of ethics to separate "doing the right thing" from the confining web of rules-based standards. It informs the reader of the concepts and foundation of the theories of ethics and explores a framework to measure the ethical character of personal actions outside of and above the rules. The authors accomplish this by giving the reader a basic understanding of the philosophical theories underlying ethical behavior buttressed by an exploration of the authors' perspective on unethical behavior that led to several well-known accounting and auditing failures. As in the authors' previous books on ethics, the result is a thought process that can be used to appropriately handle any ethical dilemma one might encounter in the profession. Every entry-level or experienced accountant or auditor performing professional services, whether in public practice, industry, or academia, should read this book.

The Case of AIG

The book has an interesting start: After a brief introduction, it jumps immediately into the AIG financial fraud, discussing the perceived breakdown of the ethical behavior of its officers. It explores an aspect of ethics usually not covered well in the books that restrict their focus to the rules included in the codes and standards. For example, it points out that "while it seems that auditing deficiencies must have existed, the facts and circumstances here point primarily to widespread lack of ethical behavior and professionalism among the internal CPAs throughout the AIG organization."

Chapters 2 and 3 give the reader an insider's view of what was happening at AIG, including copies of documents that shine a bright light on the reinsurance practices that were taking place long before they became known to the public. Here, the authors rightly wonder what happened to the ethics of more than 100 CPAs who at one time or another were on the AIG accounting staff. The authors demonstrate through a real example the endemic nature



of unethical behavior once it gains a foothold in an enterprise and begins to create "a culture of accounting corruption." They also set a basis for a later discussion relating unethical behavior to accounting irregularities.

Philosophy

In Part II, the book turns to a discussion of the philosophy of ethics, tracing its development from Plato and Socrates to Kant and beyond. By dealing with the questions "What is accounting ethics?" and, more broadly, "What is ethics?" the authors provide a backdrop for the evaluation of an individual's actions. These actions comprise four sequential stages—past influences, character, the nature of the act itself, and the effects of the act.

Chapter 4 explores "The Virtues," defining the virtues of an accountant as follows:

> The virtues of an accountant qua accountant are those traits, which are so ingrained that they have the aspect of second nature to the practitioner, which make an accountant a good professional and enable him or her to carry out attest or truth-telling work well (in the broadest and original sense of the term).

The authors point to six virtues identified in statements made by the modern founders of the profession that exemplify "attest or truth-telling well." They are—

- integrity
- pride
- tenacity in seeking the truth
- tenacity in stating the truth
- stubbornness
- simplicity.

Chapter 5 discusses the responsibility for actions taken. It includes the knowledge to understand and evaluate one's own professional actions, those of colleagues, and those of subordinates. Chapter 6, "Principles Versus Rules," delves into the nature of rules and principles and how the application of the rules can, in certain circumstances, possibly lead to a misapplication of the foundational principle. It discusses how this can occur in applying both accounting rules and ethics. This chapter is a good analysis of the problems that can result by letting the rules trump the principles rather than the other way around. The titles of the subsections in this chapter provide a good synopsis of its contents:

- What a Rule Is
- Rules Are Necessary But Not Sufficient
- The Incompleteness of Rules
- Rules in the Service of Principles
- Virtues as Safeguarding Principles
- The Insufficiency of Rules: An Example
- Rules in the Service of Principles: An Example
- A Relevant Legal Case.

The case discussed in this chapter is *U.S. v. Simon*, a controversial court decision that essentially found that even though financial statements may comply with GAAP and be reported on by auditors who comply with

GAAS, that alone may not result in the financial statements being fairly presented, because the rules require judgment in their application. And, as the authors state, "The ideals of disclosure and transparency, essential to an accountant's role, must be decisive, when merely following rules would yield a misleading result."

Part II concludes with a chapter that discusses alternative approaches in ethics. It briefly addresses pluralism and relativism in ethics, situation ethics, conventionalism, scientism, emotivism, utilitarianism, Kantianism, Nietzscheanism, and the "threat-safeguard" approach. While reading these chapters that are steeped in the philosophy of ethics, one needs to keep in mind that this book is used as a text to teach ethics to accounting students; like many in the profession, they have little educational background in this discipline. An understanding of the philosophical underpinning of ethics is necessary to faithfully comply with the ethical principles embodied in the various codes and regulations, so this would be useful to practitioners as well as students.

Ethics in Practice

In Part III, the authors address "The Meaning of Accounting Professionalism." Here, they discuss the interrelationship of ethics, professionalism, and accounting that results in "accounting ethics." This part of the book explores the question "Is accounting a profession?" from the perspective of sociological, philosophical, and historical approaches. It contains an overview of the history behind the Code of Professional Conduct, how the code was developed, the distinct stresses that bore on its development, and the determinants that gave rise to our current standards.

Part IV provides some of the most interesting analyses of ethics in practice. It contains chapters on three major business failures—Enron, WorldCom, and Lehman Brothers. The Enron chapter is subtitled, "Rules Trumping Principles," and the authors hone in on Andersen's independence, integrity, and professionalism, giving their perspective on why Andersen lost its way. They talk about Andersen's role in the noneconomic hedge transactions and then further develop their position on rules versus principles and how it came into play at Enron. The authors use excerpts from the testimony of the Enron accountants to buttress their opinions and to address greed and the underlying motivation for Andersen's actions.

The chapter on WorldCom is subtitled, "Complicity of Internal Accountants." As with all financial statement failures, they begin with the enterprise's officers and accountants breaching the ethical standards or accounting for the form rather than the substance of the transaction. All three of the chapters in Part IV, and the ones related to AIG in the first portion of the book, correctly focus initially and primarily on the enterprises' executive officers and internal CPAs and their misconduct. They examine the asserted ethical failures in independence and due diligence of the auditors of WorldCom—Andersen. All of the analyses of ethical failures throughout the book are accompanied by a thorough, concise recitation of the surrounding facts and circumstances.

The chapter on Lehman Brothers includes a fairly evenhanded analysis of the issues. It gives an understandable and concise description of the "Repo 105" transaction and compares the accounting for these instruments to the standards, particularly the rules in SFAS 140 that were applicable at the time. The authors also recognize that the accounting complied with a strict reading of the rules embodied in the standards, and Lehman had a policy manual that explained the concept and the applicable rules. It is interesting to note that this case is still being litigated; subsequent to the book being published, the trial court ruled on a motion to dismiss, which significantly limited the claims against the external auditors, while allowing the claims against Lehman to go forward.

One of the issues addressed in the chapter is a letter from a reputable U.K.-based law firm giving an opinion on the legality of the sale aspect of the Repo 105 transaction. The court found that such an opinion letter from a noted British law firm was not a "red flag." This letter was important because it concluded that the Repo 105 transsaction transaction was a sale under British law. Lehman, as described in the book, initiated these transactions through its U.K. operations because it believed the transactions constituted legal sales under U.K. law even if they received different treatment in the United States. This use of a favorable regulatory environment is sometimes referred to as "regulatory arbitrage."

Since this case is still pending, no conclusions are affirmatively expressed. The authors present cogent arguments surrounding the substance of this maneuver to lower the enterprise's debt-to-equity ratio and the strict application (or misinterpretation) of the rules; at this point, these are just well-articulated arguments. [The author of this review notes that he is a retired partner of the audit firm involved.]

The penultimate chapter, "Cases from Practice," takes actual situations confronted by accountants, lays out the fact pattern, and asks what should be done. This is followed by other information that the accountant acquires from searching for an answer after the fact, or a synopsis of possible answers. The reader is then directed to a page in the book that gives a suggested resolution and related discussion. All 10 exercises raise interesting, real-life ethics application issues. This is a great source of material for in-firm ethics education programs.

The book's concluding chapter asks, "What Can Be Done?" It spells out what actions can be taken by practitioners at every level to enhance their ethical behavior and grow as true professionals. This is an excellent primer on how to emulate the behavior of other practitioners who demonstrate ethical qualities, and it offers exercises that can be used to increase one's ethical skills.

I would highly recommend this book to students wanting to join the profession and to all accountants, no matter what area they practice in. It will give the reader a greater appreciation of the importance of ethical behavior, how to react to ethical dilemmas, and most importantly, how to think outside the rules and to focus on the substance of the underlying circumstances and the spirit of the overarching principle. ❑

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