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studies require replication and refinement and why most findings are open to legitimate differences of interpretation. If you are an impartial scientist and your research turns up an ambiguous but worrisome finding about your new drug, perhaps what seems like a slightly increased risk of heart attack or stroke, you might say, "This is troubling; let's investigate further. Is this increased risk a fluke, was it due to the drug, or were the patients unusually vulnerable?"

However, if you are motivated to show that your new drug is effective and better than older drugs, you will be inclined to downplay your misgivings and resolve the ambiguity in the company's favor. "It's nothing. There's no need to look further." "Those patients were already quite sick, anyway." "Let's assume the drug is safe until proven otherwise." This was the reasoning of the Merck-funded investigators who had been studying the company's multibillion-dollar painkiller drug Vioxx before evidence of the drug's risks was produced by independent scientists.[16]

You will also be motivated to seek only confirming evidence for your hypothesis and your sponsor's wishes. In 1998, a team of scientists reported in the distinguished medical journal the *Lancet* that they had found a positive correlation between autism and childhood vaccines. Naturally, this study generated enormous alarm among parents and caused many to stop vaccinating their children. Six years later, ten of the thirteen scientists involved in this study retracted that particular result and revealed that the lead author, Andrew Wakefield, had had a conflict of interest he had failed to disclose to the journal: He was conducting research on behalf of lawyers representing parents of autistic children. Wakefield had been paid more than $800,000 to determine whether there were grounds for pursuing legal action, and he gave the study's "yes" answer to the lawyers before publication. "We judge that all this information would have been material to our decision-making about the paper's suitability, credibility, and validity for publication," wrote Richard Horton, editor of the *Lancet*.[17]

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Wakefield, however, did not sign the retraction and could not see a problem. "Conflict of interest," he wrote in his defense, "is created when involvement in one project potentially could, or actively does, interfere with the objective and dispassionate assessment of the processes or outcomes of another project. We cannot accept that the knowledge that affected children were later to pursue litigation, following their clinical referral and investigation, influenced the content or tone of [our earlier] paper. . . . We emphasise that this was not a scientific paper but a clinical report."[18] Oh. It wasn't a scientific paper, anyway.

Of course we do not know Andrew Wakefield's real motives or thoughts about his research. But we suspect that he, like Stanley Berent in our opening story, convinced himself that he was acting honorably, that he was doing good work, and that he was uninfluenced by having been paid $800,000 by the lawyers. Unlike truly independent scientists, however, he had no incentive to look for disconfirming evidence of a correlation between vaccines and autism, and every incentive to overlook other explanations. In fact, five major studies have found no causal relationship between autism and the preservative in the vaccines (which was discontinued in 2001, with no attendant decrease in autism rates). The correlation is coincidental, a result of the fact that autism is typically diagnosed in children at the same age they are vaccinated.[19]

The Gift that Keeps on Giving

Physicians, like scientists, want to believe their integrity cannot be compromised. Yet every time physicians accept a fee or other incentive for performing certain tests and procedures, for channeling some of their patients into clinical trials, or for prescribing a new, expensive drug that is not better or safer than an older one, they are balancing their patients' welfare against their own financial concerns.

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Their blind spot helps them tip the balance in their own favor, and then justify it: "If a pharmaceutical company wants to give us pens, notepads, calendars, lunches, honoraria, or small consulting fees, why not? We can't be bought by trinkets and pizzas." According to surveys, physicians regard small gifts as being ethically more acceptable than large gifts. The American Medical Association agrees, approving of gift-taking from pharmaceutical representatives as long as no single gift is worth much more than $100. The evidence shows, however, that most physicians are influenced even more by small gifts than by big ones.[20] Drug companies know this, which might have something to do with their increased spending on marketing to physicians, from $12.1 billion in 1999 to $22 billion in 2003. That's a lot of trinkets.

The reason Big Pharma spends so much on small gifts is well known to marketers, lobbyists, and social psychologists: Being given a gift evokes an implicit desire to reciprocate. The Fuller Brush salespeople understood this principle decades ago, when they pioneered the foot-in-the-door technique: Give a housewife a little brush as a gift, and she won't slam the door in your face. And once she hasn't slammed the door in your face, she will be more inclined to invite you in, and eventually to buy your expensive brushes. Robert Cialdini, who has spent many years studying influence and persuasion techniques, systematically observed Hare Krishna advocates raise money at airports.[21] Asking weary travelers for a donation wasn't working; the Krishnas just made the travelers mad at them. And so the Krishnas came up with a better idea: They would approach target travelers and press a flower into their hands or pin the flower to their jackets. If the target refused the flower and tried to give it back, the Krishna would demur and say, "It is our gift to you." Only then did the Krishna ask for a donation. This time the request was likely to be accepted, because the gift of the flower had established a feeling of indebtedness and obligation in the traveler. How to repay the

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gift? With a small donation . . . and perhaps the purchase of a charming, overpriced edition of the Bhagavad Gita.

Were the travelers aware of the power of reciprocity to affect their behavior? Not at all. But once reciprocity kicks in, self-justification will follow: "I've always wanted a copy of the Bhagavad Gita; what is it, exactly?" The power of the flower is unconscious. "It's only a flower," the traveler says. "It's only a pizza," the medical resident says. "It's only a small donation that we need to have this educational symposium," the physician says. Yet the power of the flower is one reason that the amount of contact doctors have with pharmaceutical representatives is positively correlated with the cost of the drugs the doctors later prescribe. "That rep has been awfully persuasive about that new drug; I might as well try it; my patients might do well on it." Once you take the gift, no matter how small, the process starts. You will feel the urge to give something back, even if it's only, at first, your attention, your willingness to listen, your sympathy for the giver. Eventually, you will become more willing to give your prescription, your ruling, your vote. Your behavior changes, but, thanks to blind spots and self-justification, your view of your intellectual and professional integrity remains the same.

Carl Elliott, a bioethicist and philosopher who also has an MD, has written extensively about the ways that small gifts entrap their recipients. His brother Hal, a psychiatrist, told him how he ended up on the speakers bureau of a large pharmaceutical company: First they asked him to give a talk about depression to a community group. Why not, he thought; it would be a public service. Next they asked him to speak on the same subject at a hospital. Next they began making suggestions about the content of his talk, urging him to speak not about depression, but about antidepressants. Then they told him they could get him on a national speaking circuit, "where the real money is." Then they asked him to lecture about their own new antidepressant. Looking back, Hal told his brother:

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It's kind of like you're a woman at a party, and your boss says to you, "Look, do me a favor: be nice to this guy over there." And you see the guy is not bad-looking, and you're unattached, so you say, "Why not? I can be nice." Soon you find yourself on the way to a Bangkok brothel in the cargo hold of an unmarked plane. And you say, "Whoa, this is not what I agreed to." But then you have to ask yourself: "When did the prostitution actually start? Wasn't it at that party?"[22]

Nowadays, even professional ethicists are going to the party: The watchdogs are being tamed by the foxes they were trained to catch. Pharmaceutical and biotechnology industries are offering consulting fees, contracts, and honoraria to bioethicists, the very people who write about, among other things, the dangers of conflicts of interest between physicians and drug companies. Carl Elliott has described his colleagues' justifications for taking the money. "Defenders of corporate consultation often bristle at the suggestion that accepting money from industry compromises their impartiality or makes them any less objective a moral critic," he writes. "'Objectivity is a myth,' [bioethicist Evan] DeRenzo told me, marshaling arguments from feminist philosophy to bolster her cause. 'I don't think there is a person alive who is engaged in an activity who has absolutely no interest in how it will turn out.'" There's a clever dissonance-reducing claim for you—"perfect objectivity is impossible anyway, so I might as well accept that consulting fee."

Thomas Donaldson, director of the ethics program at the Wharton School, justified this practice by comparing ethics consultants to independent accounting firms that a company might hire to audit their finances. Why not audit their ethics? This stab at self-justification didn't get past Carl Elliott either. "Ethical analysis does not look anything like a financial audit," he says. An accountant's transgression can be detected and verified, but how do you detect the transgressions of an ethics consultant? "How do you tell the differ-

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A Slip of the Brain

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ence between an ethics consultant who has changed her mind for legitimate reasons and one who has changed her mind for money? How do you distinguish between a consultant who has been hired for his integrity and one who has been hired because he supports what the company plans to do?"[23] Still, Elliott says wryly, perhaps we can be grateful that the AMA's Council on Ethical and Judicial Affairs designed an initiative to educate doctors about the ethical problems involved in accepting gifts from the drug industry. That initiative was funded by $590,000 in gifts from Eli Lilly and Company; GlaxoSmithKline, Inc.; Pfizer, Inc.; U. S. Pharmaceutical Group; AstraZeneca Pharmaceuticals; Bayer Corporation; Procter & Gamble; and Wyeth-Ayerst Pharmaceutical.

A Slip of the Brain

> Al Campanis was a very nice man, even a sweet man, but also a flawed man who made one colossal mistake in his 81 years on earth—a mistake that would come to define him forevermore.
>
> —sports writer Mike Littwin, on Campanis's death in 1998

On April 6, 1987, *Nightline* devoted its whole show to the fortieth anniversary of Jackie Robinson's Major League debut. Ted Koppel interviewed Al Campanis, general manager of the Los Angeles Dodgers, who had been part of the Dodger organization since 1943 and who had been Robinson's teammate on the Montreal Royals in 1946. That year, he punched a bigoted player who had insulted Robinson and, subsequently, championed the admission of black players into Major League Baseball. And then, in talking with Koppel, Campanis put his brain on automatic drive. Koppel asked him, as an old friend of Jackie Robinson's, why there were no black managers, general managers, or owners in baseball. Campanis was, at first, evasive—you have to pay your dues by working in the minors;

drunk guy's data. But what if he hadn't been drunk? What if he had some other kind of impairment that had nothing to do with drinking? Would I have invented another excuse or logical argument to justify excluding his data? As we will see in chapter 7, "Creativity and Dishonesty," creativity can help us justify following our selfish motives while still thinking of ourselves as honest people.

I decided to do two things. First, I reran the experiment to double-check the results, which worked out beautifully. Then I decided it was okay to create standards for excluding participants from an experiment (that is, we wouldn't test drunks or people who couldn't understand the instructions). But the rules for exclusion have to be made up front, before the experiment takes place, and definitely not after looking at the data.

What did I learn? When I was deciding to exclude the drunk man's data, I honestly believed I was doing so in the name of science—as if I were heroically fighting to clear the data so that the truth could emerge. It didn't occur to me that I might be doing it for my own self-interest, but I clearly had another motivation: to find the results I was expecting. More generally, I learned—again—about the importance of establishing rules that can safeguard ourselves from ourselves.

Disclosure: A Panacea?

So what is the best way to deal with conflicts of interest? For most people, "full disclosure" springs to mind. Following the same logic as "sunshine policies," the basic assumption underlying disclosure is that as long as people publicly declare exactly what they are doing, all will be well. If professionals

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were to simply make their incentives clear and known to their clients, so the thinking goes, the clients can then decide for themselves how much to rely on their (biased) advice and then make more informed decisions.

If full disclosure were the rule of the land, doctors would inform their patients when they own the equipment required for the treatments they recommend. Or when they are paid to consult for the manufacturer of the drugs that they are about to prescribe. Financial advisers would inform their clients about all the different fees, payments, and commissions they get from various vendors and investment houses. With that information in hand, consumers should be able to appropriately discount the opinions of those professionals and make better decisions. In theory, disclosure seems to be a fantastic solution; it both exonerates the professionals who are acknowledging their conflicts of interest and it provides their clients with a better sense of where their information is coming from.

HOWEVER, IT TURNS out that disclosure is not always an effective cure for conflicts of interest. In fact, disclosure can sometimes make things worse. To explain how, allow me to run you through a study conducted by Daylian Cain (a professor at Yale University), George Loewenstein (a professor at Carnegie Mellon University), and Don Moore (a professor at the University of California, Berkeley). In this experiment, participants played a game in one of two roles. (By the way, what researchers call a "game" is not what any reasonable kid would consider a game.) Some of the participants played the role of estimators: their task was to guess the total amount

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of money in a large jar full of loose change as accurately as possible. These players were paid according to how close their guess was to the real value of the money in the jar. The closer their estimates were, the more money they received, and it didn't matter if they missed by overestimating or underestimating the true value.

The other participants played the role of advisers, and their task was to advise the estimators on their guesses. (Think of someone akin to your stock adviser, but with a much simpler task.) There were two interesting differences between the estimators and the advisers. The first was that whereas the estimators were shown the jar from a distance for a few seconds, the advisers had more time to examine it, and they were also told that the amount of money in the jar was between $10 and $30. That gave the advisers an informational edge. It made them relative experts in the field of estimating the jar's value, and it gave the estimators a very good reason to rely on their advisers' reports when formulating their guesses (comparable to the way we rely on experts in many areas of life).

The second difference concerned the rule for paying the advisers. In the control condition, the advisers were paid according to the accuracy of the estimators' guesses, so no conflicts of interest were involved. In the conflict-of-interest condition, the advisers were paid more as the estimators overguessed the value of the coins in the jar to a larger degree. So if the estimators overguessed by $1, it was good for the advisers—but it was even better if they overguessed by $3 or $4. The higher the overestimation, the less the estimator made but the more the adviser pocketed.

So what happened in the control condition and in the

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conflict-of-interest condition? You guessed it: in the control condition, advisers suggested an average value of $16.50, while in the conflict-of-interest condition, the advisers suggested an estimate that was over $20. They basically goosed the estimated value by almost $4. Now, you can look at the positive side of this result and tell yourself, "Well, at least the advice was not $36 or some other very high number." But if that is what went through your mind, you should consider two things: first, that the adviser could not give clearly exaggerated advice because, after all, the estimator did see the jar. If the value had been dramatically too high, the estimator would have dismissed the suggestion altogether. Second, remember that most people cheat just enough to still feel good about themselves. In that sense, the fudge factor was an extra $4 (or about 25 percent of the amount).

The importance of this experiment, however, showed up in the third condition—the conflict-of-interest-plus-disclosure condition. Here the payment for the adviser was the same as it was in the conflict-of-interest condition. But this time the adviser had to tell the estimator that he or she (the adviser) would receive more money when the estimator overguessed. The sunshine policy in action! That way, the estimator could presumably take the adviser's biased incentives into account and discount the advice of the adviser appropriately. Such a discount of the advice would certainly help the estimator, but what about the effect of the disclosure on the advisers? Would the need to disclose eliminate their biased advice? Would disclosing their bias stretch the fudge factor? Would they now feel more comfortable exaggerating their advice to an even greater degree? And the billion-dollar question is this: which of these two effects would prove to be larger? Would the discount that the estimator applied to the adviser's advice be smaller or larger than the extra exaggeration of the adviser?

The results? In the conflict-of-interest-plus-disclosure condition, the advisers increased their estimates by another $4 (from $20.16 to $24.16). And what did the estimators do? As you can probably guess, they did discount the estimates, but only by $2. In other words, although the estimators did take the advisers' disclosure into consideration when formulating their estimates, they didn't subtract nearly enough. Like the rest of us, the estimators didn't sufficiently recognize the extent and power of their advisers' conflicts of interest.

The main takeaway is this: disclosure created even greater bias in advice. With disclosure the estimators made less money and the advisers made more. Now, I am not sure that disclosure will always make things worse for clients, but it is clear that disclosure and sunshine policies will not always make things better.

So What Should We Do?

Now that we understand conflicts of interest a bit better, it should be clear what serious problems they cause. Not only are they ubiquitous, but we don't seem to fully appreciate their degree of influence on ourselves and on others. So where do we go from here?

One straightforward recommendation is to try to eradicate conflicts of interest altogether, which of course is easier said than done. In the medical domain, that would mean, for example, that we would not allow doctors to treat or test their own patients using equipment that they own. Instead,

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CHAPTER NINE

Auditing Ethics

LEARNING OBJECTIVES

By the end of this chapter you should be able to:

1. Understand the role and responsibilities of the independent auditor.
2. Explain the important values, standards, and virtues in auditing as described in the professional codes of conduct in the profession and their role in shaping the ethics of auditing.
3. Explain the role of heuristics and biases in determining auditor decisions.
4. Understand the auditor's role related to ethics in the areas of financial statement disclosure and earnings management.
5. Explain the role of the auditor in the corporate governance process.

THE ROLE AND RESPONSIBILITIES OF THE AUDITOR

An auditor is hired by the shareholders of the company (usually through the audit committee) to conduct an audit. During the audit process, the auditor gathers evidence about whether the financial statements of the company are prepared in accordance with the applicable financial reporting framework (the accounting standards). At the end of the audit process, an audit opinion is issued with the auditor's statement that the financial statements have been prepared by the company in accordance with the applicable financial reporting framework or that they have not complied with this reporting requirement. Outsiders use audited financial statements and the auditor's word (the opinion) as a primary source of information about the company. Stakeholders rely on the information to make decisions related to the company so if auditors fail to perform their professional responsibility, outsiders receive bad information and may make bad choices. Bad choices related to a company include: granting a company a loan when you would not have done so if the "true" financial picture had been known; buying stock in a company when you would not have bought the stock if the "true" financial picture had been known; or failing to sell stock ssp

when you would have had the "true" financial picture been known. All these consequences affect the cash flow of the individuals involved. For this reason, it is important that the decisions made by the auditor demonstrate both the technical proficiency and the ethical sensibility that outsiders expect.

Technical proficiency for auditors involves knowledge about the accounting standards and knowledge about the auditing standards. We have spoken about the rules accountants must follow related to the accounting standards in previous chapters. In this chapter we will focus on the technical rules in the auditing standards that guide the auditor in performing on audit.

The auditing standards specify the technical rules auditors must follow when they conduct an audit. There are two main sets of auditing standards in the world. The international auditing standards are written by the International Auditing and Assurance Standards Board (IAASB, 2013), a part of the International Federation of Accounting (IFAC). The US auditing standards for public companies are written by the Public Company Accounting Oversight Board (PCAOB, 2013). The standards from the IAASB and the PCAOB are listed in the Appendix to this chapter. An auditor would demonstrate technical proficiency during an audit by following the auditing standards. Let's consider how the auditor would demonstrate ethical awareness during an audit.

VALUES, STANDARDS, AND VIRTUES IN THE PROFESSIONAL CODES OF CONDUCT

Ethical awareness by the auditor begins by following the professional codes of conduct. Chapter Six discussed professional ethics codes as a resource for decision making. There are two professional codes of conduct that apply to auditors today: the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct sets the ethics standards for the accounting profession in the USA, and the Code of Ethics for Professional Accountants written by the International Ethics Standards Board for Accountants (IESBA) sets the ethics standard for the accounting profession outside the United States. Let us look at each of these ethics codes briefly.

The AICPA code of professional conduct is composed of two sections, a section that describes the basic conceptual framework of the profession's rules and regulations, and another section that expresses the particular rules that govern the professional practice of the accountant. Most of these rules apply to every member of the profession, but some rules are restricted to members in public practice only.

The AICPA code of professional conduct requires the accountant to comply with the following principles:

- **The Public Interest** A member should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
- **Integrity** To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

The Role of the Accounting Profession in the Financial Crisis of 2007–2008

The financial crisis that started in 2007 and accelerated in 2008 ushered in a period of reflection about how the United States could have been pushed into a recession brought on by excessive risk taking and a mortgage meltdown. Some have blamed moral hazard as a major contributing factor. *Moral hazard* occurs where one party is responsible for the interests of another, but has an incentive to put its own interests first. Research by Atif Mian and Amir Sufi of the University of Chicago's business school provides hard evidence that securitization of mortgages fostered moral hazard among mortgage originators, which led them to issue loans to uncreditworthy borrowers. They were motivated to do so by moral hazard effects, in that the securitized assets were sold off to unsuspecting investors and so the risk of default transferred to these parties, not the originating banks.

For two and a half years, the U.S. Senate focused on the role of financial institutions in the financial crisis of 2007–2008 that started with the failure of Lehman Brothers. A bankruptcy examiner's report issued on April 12, 2011, shed light on the role of auditing firms in the financial meltdown. The report was written by Jenner & Block Chairman Anton Valukas. The details of Lehman's financial activities that vaulted the company into bankruptcy are too complicated to discuss in detail, but we provide a summary in Exhibit 4.1.

EXHIBIT 4.1 Lehman's Financial Transactions and Accounting Disclosures

Despite the profession's efforts to control for risk and improve corporate culture, the United States experienced its worst recession that began in 2007 in part due to risky financial activities and improper accounting practices. It started when the investment banking firm of Lehman Brothers failed because it was unable to retain the confidence of its lenders and counterparts and because it did not have sufficient liquidity to meet its current obligations. Lehman engaged in a series of business decisions and transactions using a device known as "Repo 105" that had left it with heavy concentrations of illiquid assets with deteriorating values such as residential and commercial real estate.

Confidence eroded when Lehman reportedly had two consecutive quarters of huge reported losses, $2.8 billion in the second quarter of 2008 and $3.9 billion in the third quarter of that year.

The business decisions that had brought Lehman to its crisis of confidence may have been in error but were deemed by the bankruptcy examiner to be largely within the business judgment rule. But the decision not to disclose the effects of those judgments created a valid claim against the senior officers who oversaw and certified misleading financial statements. Legal claims of failing to meet professional responsibilities were charged against Lehman's CEO, Richard Fuld, and its CFOs, Christopher O'Meara, Erin M. Callan, and Ian Lowitt. A valid claim also existed against its external auditor, Ernst & Young, for its failure to question and challenge improper or inadequate disclosures in those financial statements, among other things.

Lehman had used an accounting device (known within Lehman as "Repo 105") to manage its balance sheet by temporarily removing approximately $50 billion of assets from the balance sheet at the end of the first and second quarters of 2008.

In an ordinary "repo," Lehman raised cash by selling assets with a simultaneous obligation to repurchase them the next day or several days later; such transactions were accounted for as financings, and the assets remained on Lehman's balance sheet. In a Repo 105 transaction, Lehman did exactly the same thing, but because the assets were 105 percent or more of the cash received, accounting rules permitted the transactions to be treated as sales rather than financings, so that the assets could be removed from the balance sheet. With Repo 105

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transactions, Lehman's reported net leverage was 12.1 at the end of the second quarter of 2008, but if Lehman had used ordinary repos, net leverage would have been reported at 13.9.

Lehman did not disclose its use—or the significant magnitude of its use—of Repo 105 to the federal government, to the rating agencies, to its investors, or to its own board of directors. Ernst & Young was aware of its use but did not question it or the nondisclosure of the Repo 105 accounting transactions. It took Lehman until September 2008, several months into the financial meltdown, to publicly disclose the liquidity issues. On September 10, 2008, the company announced that it was projecting a $3.9 billion loss for the third quarter of 2008. By the close of trading on September 12, its stock price had declined to $3.65 a share, a 94 percent drop from the $62.19 price on January 2, 2008.

Over the weekend of September 12–14, 2008, a series of meetings were held by U.S. Treasury Secretary Henry Paulson, president of the Federal Reserve Bank of New York Timothy Geithner, SEC chairman Christopher Cox, and the chief executives of leading financial institutions. The government made a decision that many believe ushered in the financial crisis. It refused to fund a solution to the Lehman problem, stating that it did not have the legal authority to make a direct capital investment in Lehman, and Lehman's assets were insufficient to support a loan large enough to avoid its collapse.

As an alternative to government intervention, Lehman approached Barclays, a British bank, and it appeared a deal had been reached on September 14 that would save Lehman from collapse, but later that day, the deal fell apart when it was learned that the Financial Services Authority, the United Kingdom's bank regulator, refused to waive U.K.-shareholder-approval requirements. Clearly, that would take too long. Meanwhile, Lehman could no longer fund its operations. The bank collapsed on September 15, when it filed for bankruptcy protection. The filing remains the largest bankruptcy filing in U.S. history, with Lehman holding over $600 billion in assets.

At the Senate Banking Committee hearings on the Lehman failure and subsequent financial crisis, Valukas spoke about the general principle that auditors play a critical role in the proper functioning of public companies and financial markets. He said:

> Boards of directors and audit committees are entitled to rely on external auditors to serve as watchdogs—to be important gatekeepers who provide an independent check on management. And the investing public is entitled to believe that a "clean" report from an independent auditor stands for something. The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure to avoid rocking the boat. I found that [valid] claims exist against Lehman's external auditor in connection with Lehman's issuance of materially misleading financial reports.

Reflecting on the years of investigations after business and audit failures and important changes in the landscape of audit regulations, we would like to think the profession has learned its lesson. Yet, the recent trend of expanding the scope and nature of consulting services provided to audit clients gives us great pause. At times we have had to shake our heads in bewilderment at some of the arrangements. A good example is what Ernst & Young did when it lobbied congressional staff on behalf of two audit clients. The SEC charged the firm with violations of auditor independence rules that require firms to maintain their objectivity and impartiality with clients. The firm agreed to pay more than $4 million to settle the charges in 2014. While the investigations of the profession previously discussed raised the question "Where were the auditors?" In this case we have to ask "What were they thinking?"

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4. What would you do if you were Billy? Consider the following:
   - How can you get it done effectively and efficiently?
   - What do you need to say and to whom?
   - What can you expect the pushback to be and how might you counteract any reasons and rationalizations?

Case 4-5 Han, Kang & Lee, LLC

Joe Kang is an owner and audit partner for Han, Kang & Lee, LLC. As the audit on Frost Systems was reaching its concluding stages on January 31, 2016, Kang met with Kate Boller, the CFO, to discuss the inventory measurement of one its highly valued products as of December 31, 2015. Kang told Boller that a write-down of 20 percent had to be made because the net realizable value of the inventory was 20 percent less than the original cost recorded on its books. That meant the earnings for the year would be reduced by $2 million and the client would show a loss for the year. In a heated exchange with Boller, Kang was told to use the January 31, 2016, value, which reflected a full recovery of the market amount. Boller suggested that subsequent values were acceptable under GAAP. Besides, she said, that was the method the previous auditors had used. She went on to explain that the market value for this product was known to be volatile and a smoothing effect was justified in the accounting procedures.

Kang was under a great deal of pressure from the other partners of the firm to keep Boller happy. It seems Frost Systems was about to embark on a variety of projects, on which it was considering having the firm provide consulting assistance, advice, and recommendations. The revenue from these arrangements could turn out to be twice the audit fees. Kang called a meeting of the other partners. While the three of them had different points of view on the issue, the final vote was 2-1 to accept the client's accounting.

Questions

1. Do you think the client's accounting approach to the market valuation of the inventory was acceptable under GAAP? Include in your discussion a brief explanation of why fair value measurements are difficult.
2. Evaluate the professional judgment used by Kang and the firm in assessing the client's accounting and reaching its own decision to accept it.
3. Would independence be impaired if the firm were offered, and accepted, the consulting arrangements? Consider whether any threats to independence would exist and, if so, how they might be reduced to an acceptable level.
4. What would you do at this point if you were Joe Kang and why?

Case 4-6 Tax Shelters

You are a tax manager and work for CPA firm that that performs audits, advisory services, and tax planning for wealthy clients in a large Midwestern city. You just joined the tax department after five years as a tax auditor for the county government. During the first six months in tax, you found out that the firm is aggressively promoting tax shelter products to top management officials of audit clients. Basically the company developed a product and then looked for someone in management to sell it to, rather than the more conventional method whereby an officer might approach the firm asking it to identify ways to shelter income.

The way these products work is the firm would offer an opinion letter to the taxpayer to provide cover in case the IRS questioned the reasonableness of the transaction. The opinion would say that the firm "reasonably relied on a m m

committee hires, evaluate, fires (if appropriate), and determines the fees of the external auditor with minimal input from senior management?

6. How might financial incentives in the form of client services unconsciously introduce auditor bias into the independent audit function? Are there any solutions to the conflict?
7. Do you believe the internal audit activity should be independent? Explain.
8. Do you believe that the SEC should prohibit auditors from providing *all* nonaudit services for audit clients? Use ethical reasoning to support your answer.
9. Assume that a CPA serves as an audit client's business consultant and performs each of the following services for the client. Identify the threats to independence. Do you believe any safeguards can be employed to reduce the threat to an acceptable level? Explain.
   a. Advising on how to structure its business transactions to obtain specific accounting treatment under GAAP.
   b. Advising and directing the client in the accounting treatment that the client employed for numerous complex accounting, apart from its audit of the client's financial statements.
   c. Selecting the audit client's most senior accounting personnel by directly interviewing applicants for those positions.
10. What are the dangers of creeping commercialism in the accounting profession?
11. Can a CPA auditor be independent without being objective? Can a CPA auditor be objective without being independent? Explain.
12. What is the problem with an auditor overrelying on management's representations on the financial statements?
13. Andy Simmons is a CPA with his own accounting and tax practice. He occasionally does an audit for small business clients. One day an audit client shows Andy a letter from the local Property Tax Assessor's office. It seems the client inquired about the process to be followed to appeal the 20 percent increase in his property taxes. He already wrote an appeal letter and was denied. The letter said that most folks who appeal those decisions hire a CPA to represent them before the administrative board in property tax assessment hearings. If your client asks you to represent him in the appeal process, can you do so under the AICPA Code? Explain.
14. You're struggling in your new accounting practice to tap into a potential client base. You have tried traditional advertising and marketing tools to no avail. Your friend tells you to use social media as a tool to reach potential customers. You're not sure about it. Your concern is one of ethics. The last thing you want to do is violate the ethical standards of the accounting profession. Identify the ethical issues that should be of concern to you in deciding whether and how to use social media for advertising and solicitation of new clients.
15. You have decided to leave your CPA firm. Using the AICPA rules as a guide, answer the following questions: (1) Can you post some negative comments about your former employer on Twitter? (2) Can you call your former clients and tell them that you are leaving? (3) Can you take their files with you when you go?
16. You previously worked for the Department of Revenue, a governmental agency in your town. You cut all ties with the agency after you left two years ago to start your own tax accounting business. One day you receive a call from the agency asking you to conduct a tax audit of taxpayers in the town. You do not conduct a financial statement audit of any of these clients. Assume the proposed arrangement is to pay you 25 percent of additional amounts collected following your audits of property tax returns plus 50 percent of all first-year tax penalties. What ethical issues exist for you in deciding whether to accept the engagement? Would you accept it? Explain.

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17. You were engaged to file the 2015 individual and corporate tax returns for a client. The client provided her records and other tax information on March 1, 2016, to help prepare the 2015 tax return. Your client paid you $12,000 in advance to prepare those returns. On April 1 after repeated requests to return her records, you informed the client that her tax returns for 2015 would be completed by April 15, and all of the records would be returned at that time. However, you failed to complete the return. The client paid another accountant $15,000 to complete the returns after the deadline and incurred tax penalties. Do you believe that you violated any of the rules of conduct in the AICPA Code? Did you violate any ethical standards beyond the Code? Explain.
18. In January 2008, it was discovered that William Borchard, who handled due diligence for clients of PwC interested in mergers and acquisitions, divulged controversial plans to Gregory Raben, an auditor at the firm, and Raben used the information to buy stock ahead of a series of corporate takeovers. The SEC found the two guilty of insider trading, a violation of the law. Assume none of the clients were audit clients. What are the ethical issues involved in engaging in such transactions? Were any of the AICPA rules of conduct violated? Explain.
19. Assume that the CPA firm of Packers & Vikings audits Chi Bears Systems. The controller of Chi Bears, a CPA, happens to be a tax expert. During the current tax season, Packers & Vikings gets far behind in reviewing processed tax returns. It does not want to approach clients and ask permission to file for an extension to the April 15 deadline so the firm approaches the controller and offers him a temporary position as a consultant for the tax season. Was it ethical for the firm to make the offer? Would it be ethically acceptable for the controller to accept the position? Explain.
20. Assume you are the senior in charge of the audit of a client in New York who offers you two tickets to the Super Bowl between the New York Giants and the Denver Broncos. The opportunity to see the Manning brothers square off against each other is appealing. How would you decide whether to accept the tickets for the game?
21. In recent years the move by accounting firms to offshore tax and consulting work has grown and expanded into audit work. What are the ethical concerns that might be raised about the practice of electronically transmitting audit information to offshore centers like those in India that provide accounting professionals to audit U.S. corporations' financial statements?
22. According to SOX rules that mandate auditor rotation, the lead audit partner on an engagement is prohibited from providing those services for a client for greater than five consecutive years. The purpose of the rule is to encourage professional skepticism. Discuss the costs and benefits of auditor rotation as you see it. Do you think audit firms should be rotated periodically?
23. In August 2008, EY agreed to pay more than $2.9 million to the SEC to settle charges that it violated ethics rules by co-producing a series of audio CDs with a man who was also a director at three of EY's audit clients. According to the SEC, EY collaborated with Mark C. Thompson between 2002 and 2004 to produce a series of audio CDs called *The Ernst & Young Thought Leaders Series.* Thompson served on the boards at several of EY's clients during the period when the CDs were produced. What threats to independence existed in the relationship between EY and Thompson? From an ethical perspective, would it have mattered if it was not an audit client but one for whom advisory services only were performed?
24. On May 20, 2014, the SEC settled an investigation of James T. Adams, the former chief risk officer at Deloitte, for causing violations of the auditor independence rules. It seems that Adams accepted tens of thousands of casino markers while he was the advisory partner on a Deloitte casino gaming client. Review the facts of the case and explain how Adams's actions compromised his independence under the AICPA Code.
25. Is accounting a trustworthy profession? How would you know whether it is or is not?