# Money Problems: Issues in Accounting and Finance Ethics

Unsurprisingly, many ethical issues dilemma within business ethics concern *money,* and more specifically concern (1) providing accurate *information* about money and (2) using this information in ethically appropriate ways. In the last few decades, there have been numerous high-profile cases in which information was falsified, inappropriately withheld or revealed, or was used for inappropriate purposes. While many of these issues fall under the general heading of “accounting ethics” or “finance ethics,” these are not *simply* issues that should concern accountants, finance officers, bankers, or those who work for large, publicly traded companies. Instead, these issues are in some sense universal to business activity: insofar as businesses are concerned with profits and losses, monetary information will always play a significant role, and the potential misuse or manipulation of this information will continue to be a major ethical concern.

Perhaps because these issues often seem technical or arcane to most people, the ethical and legal violations associated with accounting and finance often escape punishment. However, as we will see, these issues can have huge impacts on people’s lives: by destroying the value of their retirement funds, by undermining governmental and nonprofit institutions, and by endangering the long-term livelihoods of the people employed at the companies in question.

## Cooking the Books: “Managed Earnings” and Ethics in Accounting

By law, publicly traded companies (in which investors can buy stock and receive dividends) must provide regular, accurate information about the financial situation of the company, including its revenues, expenses, retained earnings, and so on. Investors can then use this information to make decisions about whether to sell their stock in the company, buy more, or simply hold onto to what they currently own. These sorts of reporting requirements are not limited to publicly owned companies, however. Similar laws require that nonprofits and government agencies provide accurate information to the relevant authorities, that small businesses provide information to the banks or credit unions that provide them with loans, and so on. Again, “cheating” on these requirements has real consequences, since these financial reports are the main information that stakeholders rely on to make decisions about the future of the organization

**What does it mean to “manage earnings”? Why would someone do this?** Because of the high stakes of financial reporting, there can be a strong incentive for managers, directors, and CEOs to “smooth out the earnings” to make them appear to be more consistent they actually are, in order to present a healthy picture of the organization for stakeholders and to “make their numbers” (and to keep their jobs!). So, for example, rather than report a loss of $1 mil one quarter, and earnings of $2 mil the next, they might *prefer* to report earnings of $.5 mil for each quarter. While this can sometimes be done using legal means, abusive **earnings management** is prohibited both by the law and by codes of professional ethics. Depending on how it is done, however, it can be very difficult to detect.

It is important to note that while the urge to manage earnings can be selfish (a CEO simply wants to justify a salary increase), this need not be the case. In many cases, the leadership genuinely believes two things: (1) if a large loss is reported *right now,* things will go very badly for the organization, and many people will lose their jobs and (2) things are about to get better—revenues really will increase in the next months, expenses will go down, etc. The problem, of course, is that this optimism is often inaccurate, and falsified financial reporting can and does hurt people. These include stockholders who thought the company was in much better shape than it was, citizens who thought their government agency was well-prepared for the future, community credit unions that thought the small business would be able to repay its loan, and even employees (who would have been better served had problems been addressed earlier). In some cases, earnings are “managed” for years and years until the truth can no longer be hidden, and the organization suddenly falls apart (with very bad consequences for everyone involved).

**How can accounting fraud happen? Why is it so tough to catch?** People working in accounting might be pressured to “cook the books” in a variety of ways.

* **Revenue recognition fraud**. In very general terms, an organization should record something as revenue only after a sale or transaction has already taken place. One common sort of “earnings management” involves abusing this rule to count (potential) future sales as current revenue: recording “sales” to which customers haven’t yet agreed, that haven’t yet shipped, that are dependent on the customer receiving credit approval, for products that have already been returned, and so on. These tricks essentially “borrow” from expected future earnings to make current earnings look better.
* **Use of “cookie jar” reserves.** In revenue recognition fraud, organizations often try to inflate *current* revenue by taking away from *future* revenue. In other cases, however, they will establish “reserves” from good years that they can use to pay for (unrelated) expenses in future years. There is nothing wrong with saving money, of course; what makes this problematic is the fact that the goal is to *deceive* stakeholders as to revenue and expenses from year to year. It makes it look as if every year was a moderately good year, when in fact there were some very good years and some very bad years. Among other things, this deception may lead stakeholders to believe that things are a good deal less volatile (and good deal less risky) than they actually are.
* **“Big bath” restructuring charges.** When new leadership arrives at an organization, they often “restructure” by closing or relocating facilities or divisions, laying off employees and so on, which stakeholders expect will lead to short-term losses (e.g., severance payments to workers cost money, as does relocating, etc.). A “big bath” occurs when the organization *overstates* these losses by inappropriately counting *future* liabilities (for example, they may expect to pay $1 mil in unemployment payments next year, and inappropriately count this loss for the current year instead). Why do this? In short, because it allows the organization to overstate their performance in the years ahead—it will make it seem *as if* things have radically turned around (when in fact the company simply shifted their losses to the current period, and all of their gains to the subsequent period).
* **Acquisition accounting.** Another opportunity for fraud occurs when one company acquire another, and pays into a “reserve” account that *should* be used to pay only for the expected costs of this acquisition. Again, as in the case of restructuring, this can be abused by paying too much into the reserve initially (and taking a large loss in the current year, which they can blame on the cost of restructuring) and then using this to inflate future revenue (even though the business hasn’t actually improved in any meaningful sense).
* **Abuse of materiality.** Everyone recognizes that errors will occur, and that accounting records will never be *perfectly* accurate. However (for both moral and legal reasons), we do expect that they be accurate in the *material* (i.e., “important”) ways. Abuses of materiality occur when people *intentionally* misreport data and then (when caught by external auditors or regulatory agencies) say “this was just a mistake, and it’s not really a material one.” In many circumstances, this sort of lie can be very difficult for auditors to detect.

This list, of course, is not complete: there will always be creative people who find new ways of tricking owners, shareholders, and other stakeholders into thinking their organization is in better financial shape than it really is. It is also important to note that these are simply rough descriptions, and the relevant laws are considerably more detailed. In the United States, for example, the SEC has adopted the **Generally Accepted Accounting Principles (GAAP).**

## Doing Your (Fiduciary) Duty: Ethics in Finance

Where issues in accounting ethics deal largely with ensuring the *accuracy* of information, issues in finance ethics concern how this information is *used* to make decisions about future investments. Again, while these issues can sometime seem remote to those who are not directly concerned with them, finance plays a huge role in both our professional and personal lives. The so-called “financial services industry” includes banks, insurance companies, mutual funds, (public or private) pension funds, as well as investment banks or “wealth management” firms. In the context of individual businesses and organizations, finance professionals are among those most directly responsible for ensuring long-run financial health and sustainability. As was the case with accounting, the unique role of finance professionals can lead to a number of ethical quandaries.

**“Fair and orderly markets.”** As a society, it is crucially important that our financial markets be both *fair* and *efficient.* So, for example, the home mortgage market (notably including Midwestern cities Chicago, Detroit, Minneapolis, Milwaukee, etc.) has historically been unfair to black Americans: banks would require they pay higher interest loans than otherwise similar white families, and would often deceive them about the terms of these loans. There have also been worries that the home-mortgage market hasn’t always been *orderly,* in that well-qualified applicants for loans couldn’t get them, and/or that banks were offering loans to those who could not realistically be expected to repay. When the government (or an organization) crafts its policies on finance, these two goals must always be kept in mind.

**What is a “fiduciary duty”? What can make fulfilling this duty difficulty?** In many cases, finance professionals are asked to act as **agents** or **fiduciaries** on behalf of a **principal.** This means that they are not making financial decisions “for themselves” but rather “for someone else.”This principal might be one of their customers, the shareholders or owners of their business, or even for the community as a whole (for certain sorts of government officials). **Fiduciary duties** are the (moral and legal) obligations to act on behalf of the principal, even when this does not coincide with one’s own self interest. The study of **agency relations,** and the moral problems raised for principals when they attempt to find trustworthy agents, is at the center of financial ethics. A few important concepts include the following:

* **Opportunism (“Shirking”).** By necessity, principals must trust finance professionals with private information. Opportunism occurs when the finance professionals use this for their own gain. (For example, a woman goes in to seek a loan for a new house, and the loan officer decides that *he* wants to buy the house.) Losses to opportunism by agents are called **agency costs.**
* **Moral Hazard.** Agents can take risks with their principal’s money or resources that they would not be willing to take with their own. For example, a person with health insurance might abuse this insurance by seeking unnecessary (and expensive) medical care. (In this case, the patient is sort of “agent” and the insurance company is the “principal”). This same sort of problem arises when *providers* (such as physicians) serve as agents of the patient (again, there is a motive for the physicians to recommend pricy tests and procedures that the patient would not want/need if they had all of the information).
* **Adverse Selection.** Principals are not always well-informed on what sorts of agents are the “right ones” to choose. Adverse selection occurs when/if the *worst* agents (those who most blatantly violate fiduciary duties, and who have information they can use to exploit the principal) are the ones most likely to be chosen. So, for example, a “loan shark” is the absolute worst agent for a low-income customer to work with, but (perversely) is often one of the only options available to her/him. A similar phenomenon has long plagued health insurance: the people most likely to sign up for health insurance (the very sick) are the very sort of people that the health insurance companies want to avoid. This leads to a vicious cycle where the “good” agents leave the market (because no one knows who they are, and they aren’t compensated adequately) and the bad agents come to saturate it.

In addition to these general sorts of problems, there are a number of more specific problems that have long plagued finance: clients are convinced to replace one product for another that is basically equivalent (and are charged for this); those applying for credit cards/loans are forced to sign away their right to sue, and so on. In large organizations, especially, it can often be difficult for finance professionals to determine whose interests take priority: the current owners, the (potential) future owners, the employees, the customers, the community as a whole, and so on.

## Two Case Studies

When considering accounting and financial ethics, it can be easy to get lost in the details, and forget why this all matters. Here are two examples to help tie this to the real world.

**Case 1: Enron and Arthur Anderson.** In 2001, Enron was one of the world’s largest companies (with a market cap of over $60 bil), and Arthur Anderson was one of the largest accounting firms. In an attempt to appear much more profitable than it was, Enron had been (for at least 5-10 years), engaged in large numbers of accounting tricks, including revenue recognition fraud, the illicit use of shell companies to hide their debt, “mark-to-market” accounting (which allowed them to count *future earnings* in the present), as well as other techniques. Andersen audited Enron, but was also served as a paid consultant for Enron on other areas of their business (which may have given them an incentive to be “lenient” on the audit). In any case, the leadership of Andersen decided not to reveal the accounting problems at Enron that individual Andersen auditors had uncovered. Later, when facing possible criminal charges for these actions, they made a concerted effort to destroy documents that provided evidence of this.

In early 2001, outside investigators (starting with financial journalists, but soon including the SEC and credit agencies) began picking up on irregularities in Enron, and it soon became obvious that Enron’s claims about revenues, earnings, etc., were largely bogus, and that Andersen had played along with the deception. By the end of the year, Enron’s share price went from over $80 to around $.10. Enron went bankrupt, and criminal charges were brought against the leadership of both Enron and Andersen. Within a year, Andersen lost its accounting license, and essentially went out of business as well. In the end, this hurt a large number of people:

* 4,000 Enron employees and 85,000 Andersen employees lost their jobs. Since Enron’s retirement scheme largely consisted on Enron stock, many of their 15,000 workers suffered additional substantial financial losses.
* Enron was a publicly owned company whose major shareholders included many mutual funds, pensions, and insurance companies (and indirectly, a very large number of working-class and middle-class people who had contributed to their employer’s retirement plans). These people all suffered financial losses, as did the (numerous) creditors to which Enron owed money before it declared bankruptcy.
* This scandal led to a heightened distrust in financial markets, accountants and auditors, and even government regulators (who had failed to catch the problem in time).

In response to the Enron scandal, the US passed the **Sarbanes-Oxley (SOX)** act, which aimed to ensure the independence of auditors (both internally and externally), improve the detail and accuracy of financial statements, hold senior executives (such as CFOs and CEOs) *individually* responsible for fraud and other wrongdoing.

**Case 2: Eau Claire (WI) Country Treasurers Office.** Between 2001 and 2013, the country treasurer (an elected official) and the office manager colluded to steal around $1.4 mil in property tax payments. Annual audits failed to catch them, at least in part because the “lost” money never showed up in the system—by working together, the two embezzlers managed to make it so that the lost money never showed up. The fraud was uncovered only when the treasurer retired, and the new treasurer noticed evidence of theft. There are several related problems here:

* Like many other counties (though certainly not all of them), Eau Claire elects the country treasurer. Historically, this was because of worries that the treasurer could yield their tax collection power for political purposes (though it would be very difficult to do this now). Unfortunately, the practice of electing treasurers (as opposed to having the city manager/mayor simply hire them) might also helps shield incompetent and/or corrupt officials from detection and punishment, even when they do things that their coworkers or supervisors find suspicious (as seems to have been the case in Eau Claire).
* Cases such as this often lead to decreased trust in government, and can cause voters to (understandably) vote against tax increases that might be stolen by corrupt officials. Paradoxically, though, increased funding stresses may be part of the “root problem” here, since the best way to guard against fraud is to make sure that there is a “division of labor” among multiple employees to ensure that no one person (or small group of people) can do something like this.

## Review Questions

1. Why do you think “managing earnings” is such a common practice for many businesses and organizations? Why is it so difficult for regulators to catch? Finally, if *you* were an individual working for an organization that did this, what do you think you (realistically) could do?
2. Think of a time that *you* have had to use an **agent** of some type. How, if at all, could you ensure that this person would act on your behalf, and what did you learn from this experience? To what extent were the problems/issues described above relevant to your experience?

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