Ethics in Accounting A Decision-Making Approach 1st edition Klein Solutions Manual

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Chapter 2
ETHICAL PRINCIPLES AND REASONING

Exercises

Legality Versus Ethicality

1. Determine whether the following are legal, ethical, both, or neither:
   a. After graduating from college, you now have the opportunity to work as an unpaid assistant to a famous Hollywood director during the production of his new film. You are excited to accept this opportunity because you will gain invaluable experience and connections in the movie industry. A friend, however, recently questioned whether your unpaid endeavor will violate minimum wage or other labor laws.
   b. A bank headquartered in Dallas, Texas recently hired three new employees from across the country to join its Real Estate Credit Analysis Department. At the time that the bank hired these employees, it knew that it would retain only one of these employees after "trying them out" for one month. The bank also knew that, under Texas law, employment contracts are terminable at will by an employer. The employees moved to Dallas and signed one-year apartment leases in the expectation that their jobs would be ongoing.
   c. When new consumer electronic devices are introduced for sale, an investment fund buys one at the earliest possible moment and then has engineers break it open. These engineers then advise the investment fund about the names of the suppliers who provide the component parts. The investment bank uses this information to increase its investments in these supplier companies in anticipation of them reporting greater sales.
   d. You use a prescription asthma inhaler when asthma attacks impair your breathing. It is against the law for you to share prescription items with others because only doctors can prescribe medicines and direct the use of medical devices. Nonetheless, when a companion recently suffered an asthma attack, you shared your inhaler with her.
   e. Metered parking spaces in the entertainment district of a Colorado ski resort town have posted signs that only permit "Two hour parking per day". The purpose of these signs is to give all tourists a reasonable opportunity to dine in the entertainment district, where parking spaces are scarce during the peak ski season. During the past summer, you wanted to eat while watching a soccer match at a sports bar in this district. Because the

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soccer match was expected to last over two hours, you parked in one space for two hours and then drove your car to park in an adjacent metered parking space for the remainder of the game.

SOLUTION for Exercise 2-1:

a. This arrangement is illegal, but ethical. All employees must be paid the minimum wage. Narrow exceptions exist for students who perform internships as part of an education program, but that exception does not apply to this college graduate. This arrangement, however, is ethical because the worker will gain invaluable experience and is not being exploited, while the director will get valuable assistance from a dedicated worker.
b. This arrangement is legal, but unethical. Employers may hire and fire employees at any time, under most circumstances, without notice. However, it is unethical to induce people to move across the country and sign long-term leases without informing them that they are likely to retain their positions for an extremely short duration.
c. This is legal and ethical. When a person buys property, they have the right to destroy it if they wish. This investment firm engaged in clever form of research and it is entitled to retain the rewards gained from lawfully obtaining superior information.
d. This is illegal but ethical. Enabling someone to breathe in an emergency situation justified violating the law against sharing prescription items.
e. This is illegal but ethical. The law was designed to protect tourist access during peak times. However, the policy underlying the law melts away, like the snow, during summer when the town is empty. By violating the law, a win-win-win resulted in which the customer was able to enjoy the entire game, the restaurant generated additional bar and food revenue, and the city got extra parking meter fees.

2. A CPA firm wants to gain a competitive recruiting advantage over its peers. Its lead recruiter has started giving $2,000 signing bonuses to brilliant 18-year-old high school graduates who plan to major in accounting during their upcoming college years. In return for these bonuses, students must agree that, if they decide to join the accounting profession upon graduation, they must accept employment with this CPA firm. This CPA is highly reputable and social media sites confirm that it pays its employees "top dollar." If bonus recipients attend information sessions for other CPA firms or interviews with other firms while in college, their offer of guaranteed employment with this firm terminates. Is this CPA firm's policy legal? Or ethical?

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SOLUTION for Exercise 2-2:
This policy is legal. Adults may enter into most forms of voluntary agreements. However, this arrangement is dubious from an ethical standpoint. On one hand, the student benefits from receiving cash for college and having a well-paying future employment opportunity. On the other hand, CPAs, as members of a profession, have a responsibility to exercise sensitive judgments that respect their employees' best interests. By foreclosing cash-starved students from even learning about career options that might be a better fit for them, the CPA firm is acting irresponsibly.

3. The University of Michigan Consumer Sentiment survey is a widely watched index that serves as a barometer of economic activity. Within seconds after this index's monthly public release, stock markets routinely move significantly. Unknown to the general public, the University of Michigan was collecting a minimum of a million dollars annually for releasing the headline results to select investment firms before the general public announcement occurred. Was this legal or ethical?

   SOLUTION for Exercise 2-3:
   At the time that the University of Michigan was doing this, the practice was legal. However, the SEC and some members of Congress were outraged, so some contemplated making the practice illegal.
   From an ethical standpoint, the university spent substantial time and money gathering this information. If the university had been a private sector company, it indisputably would have had the ethical right to reap the benefits of its substantial effort to create important, reliable information. However, in a sense, the information was so valuable, and world capital markets so depended upon it, that many viewed the university's actions as unethical. Aware of the government's threats to outlaw its conduct and the harm to its reputation, the university relented and stopped this practice.

   FOLLOW-UP: The information was released to the investment firms only two seconds early! In the era of high-speed computerized trading, two seconds is an eternity.

4. Under Chapter 7 bankruptcy rules, most debts are cancelled when an insolvent individual with a modest income successfully petitions for bankruptcy. A person is entitled to obtain a discharge from debts every seven years. After debt discharge, creditors are barred from exercising their right to ever enforce outstanding debts owed by bankrupt debtors. Is filing bankruptcy ethical?

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SOLUTION for Exercise 2-4:
As a general matter, it is never ethical to violate duties imposed by an agreement, including a contract in which one party extends credit to another. However, some would say that it is unethical to impose a severe debt burden on a borrower forever, especially if the borrower suffered a severe and unexpected disaster, such as overwhelming medical bills or a disability that impairs his or her ability to earn income.
The opportunity to obtain a "fresh start" in life through debt cancellation is firmly ingrained in our legal system. Our society, as expressed in its bankruptcy laws, has a longstanding principle of allowing most honorable borrowers to obtain debt discharge every seven years.

FOLLOW UP: The Bible states that "at the end of every seven years…a creditor shall release what he has lent to his neighbor." The US federal bankruptcy law likewise allows most honest borrowers to obtain to obtain complete debt cancellation every seven years. Should policies established in the Bible, or in any other religious document, influence the enactment of laws?

Ethical Absolutism and Relativism

5. To treat chickens more humanely, Californians voted by popular referendum to enact a law requiring minimum cage sizes for egg-laying chickens. Other large egg-producing states, such as Iowa, Nebraska, and Alabama, have not enacted such laws.
   a. Is the minimum size of an egg-laying hen's cage an ethical issue?
   b. Supporters of this law refer to themselves as "animal rights advocates." Should animals have rights? Which ones?
   c. Is the difference in laws between California and egg-producing states evidence of ethical relativism?
   d. California also enacted a law that provides that all eggs sold in California must be laid by hens living in cages that meet or exceed California's standards. Does California have the right to try to impose its ethical views on other states' citizens? Was California's motive for enacting this law solely attributable to ethical concerns?
   e. Because eggs are an inexpensive source of protein, an increase in the price of eggs would primarily affect low-income consumers. Does the fact that an increase in the price of eggs might harm low-income members of society affect your viewpoint?

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SOLUTION for Exercise 2-5:

a. Yes. Ethics involves separating "right" from "wrong." Many feel that the mistreatment of animals is distinctly wrong.
b. For discussion. It is worth noting that the same people who favor this animal protection law likely eat eggs or products with eggs as an ingredient. They may well eat chicken meat as well. Some would say that it is inconsistent to give chickens the "right" to a bigger living space, but then eat their eggs and slaughter them.
c. Perhaps. Some might say that a tension exists between farmers' rights to operate their businesses as they see fit, consumers' rights to the lowest cost products, and animals' rights to humane treatment. Most people, within constraints, share all three of these core beliefs. That is, all three principles are elements of ethical absolutism in all societies. However, Californians, by collective political action, have struck a balance among these considerations that differs from the balance struck in other states.
d. A cynic would suggest that Californians were motivated to impose the same standards on out-of-state producers to prevent them from gaining a production cost advantage. Eggs are a commodity and an out-of-state egg is a perfect substitute for an egg hatched in California.
e. For discussion.

FOLLOW UP: How much floor space should a hen's cage have? Prior to enactment of the law, the minimum size was 67 inches, or less than the size of an 8 by 11 sheet of notebook paper. The new law increases this space limit to 116 inches, or roughly the size of a legal size sheet of paper. Is this sufficient?

FOLLOW UP: Eggs only have approximately a .30 price elasticity of demand. What does that mean? (This means that demand is extremely price-inelastic.) Who is going to bear the economic impact of this law, consumers or farmers? Primarily consumers, because farmers largely can pass along the increased costs of production to buyers.

6. Wide variations exist around the world in the permissibility and implementation of the death penalty. Some countries ban it altogether, some countries permit it but rarely implement it, and some countries use it regularly. Even within the United States, similar differences exist, with some states banning it and some states allowing it.
   a. Is this an example of ethical absolutism or ethical relativism?
   b. What countries would you expect to apply the death penalty most frequently?

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SOLUTION for Exercise 2-6:
a. It appears to be a case of ethical relativism. However, supporters of ethical absolutism might argue that all countries abide by the same principle of justice for serious criminals, but that they merely differ in how they apply this notion of fair punishment.
b. According to Amnesty International, China, Iran, Saudi Arabia, Iraq, and the United States have the highest number of executions. China implements the death penalty at a dramatically higher rate than any other country. In China, committing certain non-violent crimes, such as drug trafficking and corruption by government officials, can result in the imposition of the death penalty.

Principles of Accounting Ethics

7. Which of the six principles in the AICPA Code of Professional Conduct is the most important?

   SOLUTION for Exercise 2-7: For discussion.

8. A CPA needs to satisfy state continuing education requirements each year to preserve her license to practice. Due to procrastination, she waited until the last minute to fulfill this requirement. She is a busy controller for a growing company and knows that the course administrators take attendance only at the start of the morning session and the start of the afternoon session. She goes to each sign-in period and then immediately leaves to go back to the office, skipping the program. What principles of the Code of Professional Conduct did she violate?

   SOLUTION for Exercise 2-8:
   The Responsibilities Principle requires a CPA to exercise sensitive moral judgment. This CPA's deception to save time certainly does not qualify as an appropriate moral judgment.
   The Public Interest Principle requires a CPA to have a commitment to professionalism. An important element of professionalism is a professional's demonstrated willingness to continually maintain and improve his or her skills. This CPA's procrastination and unwillingness to attend this Continuing Education session violated this ethical tenet.
   The Integrity Principle requires a person to comply with the spirit of a rule, not just its technical requirements. This CPA's technical satisfaction of the

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"check-in" requirements violates this ethical precept.
The Objectivity and Independence Principle focuses on the duty to act without bias. This principle does not appear to be relevant to this CPA's misconduct.
The final two principles focus on a person having the skill and ability to perform a task with due care and competence. By failing to reap the educational benefits of the Continuing Education program, this CPA may one day lack the due care to perform tasks discussed throughout the seminars. As a result, this CPA may eventually violate the fifth and sixth principles by virtue of a gap in her skill set.

Applying Ethics to Accounting Problems

9. You enjoyed your job in the real estate accounting department of Forever Twelve, Inc., a large publicly traded retail clothing chain, until recently.

   Last month, your company signed a 10-year nonrenewable lease with a major regional shopping mall. As part of the deal, Forever Twelve, Inc. agreed to invest $500,000 to immediately upgrade the interior of the store. This upgrade will include installing LED lighting, marble floors with gold inlays, bathrooms, and dressing rooms. In return, the mall's landlord agreed to give your company an "incentive payment" equal to 40% of the value of the upgrades, payable immediately.

   According to construction industry estimates, these upgrades have an average useful life of 15 years. You remember from your business law course that these items are classified as "fixtures" and must remain affixed to the property when a tenant vacates the premises.

   The head of the Real Estate Accounting Department has told you to record the 40% incentive payment as an immediate $200,000 revenue. Then, you are supposed to "depreciate the net out-of pocket cost" of $300,000 on a straight-line basis over 15 years.

   You have no background at all in real estate accounting, so you asked your boss two questions: "Isn't the $200,000 a cost rebate rather than income?," and "Are you sure that 15 years is the correct depreciation period?" In response, your boss told you, "Look, this company is aggressive in its accounting and aggressive in firing people. Just do it."
   You did a little research, but could not definitively find the answers to your questions.

   a. Do you doubt the accuracy of the accounting policy posed by your boss? Why?
   b. Under the AICPA Code, what principles would you violate if you follow the accounting directive of your boss?

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SOLUTION for Exercise 2-9:

a. Yes, for three reasons.

First, the "incentive payment" is merely a cost reimbursement, not income. If a company merely makes an expenditure and another party reimburses it for a portion of its cost, it cannot record that cash inflow as revenue. Revenue is earned through the delivery of goods and services. Surely, if the mall had simply paid this amount directly to the construction contractor, your employer would not have had a "revenue."

Second, your company's net cash outflow, over the long run, is $300,000. Under the approach proposed by your boss, the company would have $200,000 of revenue and $300,000 of depreciation expense. Therefore, over the long run, the company's profits would be reduced by only $100,000. That result does not make sense.

Third, although the physical improvements will last 15 years, your employer will only have the use of these improvements over the 10-year lease period. Under GAAP, to be conservative, these leasehold improvements must be expensed over the shorter of the 10-year lease term or the improvement's 15-year physical useful life. Thus, the proper write-off period is 10 years.

b. All of the Code of Conduct's Principles are relevant to your actions. The Responsibilities Principle requires you to act in ways that maintain the public's confidence in financial statements. Your employer's viewpoint seemingly yields an illogical outcome, which would impair the public's confidence.

The Public Interest Principle requires you to act for the good of the broader community. As a publicly-traded company, stockholders must receive accurate information. The very inaccuracies in this account distort the company's results and overstate its short-run and long-run profitability.

The Integrity Principle requires you to act with candor and not subordinate your beliefs to those of your boss. You strongly doubt that the company's viewpoint is correct and must not accommodate your boss.

The Objectivity and Independence Principle requires you to maintain objectivity. Your instincts correctly guide you to doubt that the company's proposed accounting is accurate.

The Due Care Principle requires you to observe technical standards. You have not been able to identify the appropriate technical guidance. As a result, you should pursue better guidance from your boss or from an outside adviser.

Finally, the Scope and Nature of Services Principle requires you to act with competence and diligence. The proposed accounting treatment for this transaction does not seem to be based on competent analysis or adequate

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diligence to document that it complies with GAAP.

Kohlberg's Stages of Moral Development

10. As the head of Zendog Corporation's Tax Department, you faced an interesting dilemma. Due to substance abuse problems, an officer-shareholder of this closely held company had become disruptive and untrustworthy. To alleviate this problem, the company terminated this officer's employment contract and repurchased his shares at a premium price above market value.

    When a company enters into a treasury stock buyback of its own shares, the amount disbursed to a shareholder is viewed as an ownership distribution, not as an expense. However, an argument can be made that at least a purchase of the buyback was a necessary expense because the buyback was a necessary cost of keeping the company running smoothly.

    You have to decide whether to deduct some or all of this payment as a deductible tax expense on the company's corporate tax return. You have had various thoughts, listed here. Using Kohlberg's model, identify the stage of moral development associated with each of the following viewpoints you have considered:

    a. It is in inappropriate to deduct this payment because doing so would violate our tax laws.
    b. It is appropriate to deduct this payment because the tax rules governing stock buybacks did not contemplate circumstances such as this one in which the purpose of the buyback was to get rid of an officer-shareholder whose corporate decisions were harming company profitability.
    c. It is proper to claim this deduction because the risk of IRS detection is infinitely small.
    d. Because the applicable tax rules are uncertain in this unique situation, a good faith argument can be made in favor of claiming the deduction, and the IRS is unlikely to ever impose severe penalties if the claimed deduction is detected and challenged.
    e. I am uncertain about the right decision, and I have to respect the wishes of senior management, all of whom want me to claim this deduction.
    f. I am going to claim this deduction, and if the IRS denies our right to this deduction, I am going to have our general counsel fight for it in federal tax court because the broad policies of the matching principle permit deduction of this payment as an ordinary and necessary expense.

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SOLUTION for Exercise 2-10:

a. Stage Four, because this reasoning reflects a concern for following the law
b. Stage Six, because this reasoning reflects a belief that laws do not have to be complied with if justice so dictates
c. Stage One, because the tax accountant is only concerned with the risk of punishment, not with doing the "right" thing or following the law
d. Stage Two, because the tax accountant is assessing the risk of punishment and is focused on the "good faith" nature, or mitigating circumstances of intent, that will minimize the magnitude of any punishment
e. Stage Three, because this reasoning reflects a desire to please peers
f. Stage Five, because this reasoning reflects a belief that laws can and should be changed through orderly legislative and judicial processes

11. NBC medical television reporter, Dr. Nancy Snyderman, agreed to a voluntary quarantine after returning from an area of Africa where there was an Ebola epidemic. There was no evidence that she was infected with Ebola, but she announced on national television that, as an act of prudence, she would voluntarily quarantine herself at home for 21 days. If a person has contracted Ebola, this is the typical incubation period for patients to manifest Ebola symptoms, such as a high fever, fatigue, and vomiting.

    Despite her public assurances, Dr. Snyderman violated her quarantine by venturing outside her home to pick up food from a favorite restaurant. Ebola potentially can be contracted from contact with an infected person's bodily fluids, such as sweat or saliva. If Ebola is contracted, patients face a major risk of death.

    a. What level of moral development did Dr. Snyderman exhibit when she publicly announced her self-imposed quarantine?
    b. What level of moral development did Dr. Snyderman exhibit when she violated her self-imposed quarantine?
    c. Was it ethical for Dr. Snyderman to venture outside her home in violation of her self-imposed quarantine? Is it relevant that Dr. Synderman did not break any laws by venturing out of her home?
    d. Assume that privacy laws prevent doctors from disclosing the names of patients who may have contracted a serious, contagious disease. If a doctor nonetheless discloses the identity of such a patient to enable others to get potentially life-saving treatment, what level of moral development would the doctor be exhibiting?
    e. Do you venture outside your home when you have a contagious respiratory disease, such as flu? If so, although the magnitude of the harm that such an action may cause are quite different from the potential harm

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caused by venturing outside with Ebola, is your conduct in principle any different than Dr. Snyderman's?

f. What are the odds that a contagious person infected with flu will infect others? Do you know those odds when you venture outside with flu? Is there a probability of infecting others that you believe is acceptable?

SOLUTION for Exercise 2-11:

a. Dr. Snyderman sought approval from her peers and the viewing public when she announced her self-imposed quarantine. This reflects moral development at Stage 4 of Level 2.
b. Dr. Snyderman acted without regard to the well-being of others because she believed at the time that she could do so without suffering any punishment. Her act was entirely self-focused and reflected moral development at Stage 1. In hindsight, she suffered a huge reputational loss because she suffered great humiliation from the media and public when this story became public.
c. On a cost-benefit basis, she potentially risked the lives of numerous others solely so she could enjoy food from a certain restaurant. Her actions were highly unethical. It is irrelevant that she did not break any laws. It is impossible for society to regulate all conduct through its legal system.
d. The doctor's civil disobedience would exhibit moral development at Stage 6 of Level 3.
e. It is similarly unethical. The relative cost-benefit ratio may shift, but the costs to others of catching your disease is almost surely greater than the enjoyment you gain from venturing out.
f. The precise odds cannot be calculated. Children are more infectious than adults. Influenza is most contagious on the second and third days after contracting it. Adults remain contagious for about ten days, while children remain contagious for about 14 days.

FOLLOW UP: Are there differences between Dr. Snyderman's actions and your actions in venturing out among others when you are infected? What factors make it more acceptable, or less acceptable, for you to venture outside with the flu than for Dr. Snyderman to venture outside? Obviously, the magnitude of the consequences is far greater if one spreads Ebola. On the other hand, a 21-day quarantine impairs a person's lifestyle much more than a day or two's voluntary quarantine does due to the flu.

12. In the 1960s, most civil rights attorneys were men and most nurses were women. Do these facts support Kohlberg's views on higher-level moral development or Gilligan's views?

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SOLUTION for Exercise 2-12:
It tends to support Gilligan's views. Gilligan suggests that men tend to emphasize rights and justice at higher levels of moral development, but women tend to emphasize the ethics of caring for others less fortunate and entering into interpersonal relationships. However, over time, more and more women have become lawyers and selected careers that emphasize justice, such as working as criminal prosecutors, judges, and civil rights attorneys. As a result, gender data concerning career choices provides weak, if any, evidence concerning gender-based differences in advanced moral development.

Comprehensive Problems

13. In *Star Wars*, Grand Master Luke Skywalker modified the Jedi Code as follows upon reestablishing the Jedi Order in the Galaxy:

Jedi are the guardians of peace in the galaxy.

Jedi use their powers to defend and to protect.

Jedi respect all life, in any form.

Jedi serve others rather than ruling over them, for the good of the galaxy.

Jedi seek to improve themselves through knowledge and training.

Match each of these five axioms to a counterpart principle in the AICPA Code of Professional Conduct, selecting from among the Responsibilities Principle, the Public Interest Principle, and the Due Care Principle.

SOLUTION for Exercise 2-13: According to the first, second, and fourth axioms, Jedis are "guardians of peace in the galaxy" who must "defend and protect" for "the good of the galaxy." All three of these axioms correspond to the Public Interest Principle, which states that accountants must "serve the public interest [and] honor the public trust."

The third axiom, which states that Jedis must always respect others, is similar to the Responsibilities Principle, which states that accountants "should exercise sensitive professional and moral judgments in all their activities."

Finally, the Jedis' duty to "improve themselves through knowledge and training" directly corresponds to the Due Care Principle, which states that accountants should "strive continually to improve competence and the quality of services."

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14. You never thought you would be selected for an internship, but you did succeed. You, along with your classmate Olya Kvalevcka, were spending the summer together, completing the final weeks of your coveted internships with PrizeWaterhome, CPAs. The only problem was that the firm intimated that, due to a slowdown in business, it would only give a permanent job offer to one of you.

    While waiting in a partner's office, you happened to see Olya's resume on his desk. The resume was sitting plainly in front you, so you began to kill time looking at it. Upon reading it, you noticed that Olya had misrepresented several things about herself. She stated that she was the Beta Alpha Psi vice-president, but she was only the vice-president in charge of guest speakers, not the overall vice-president. She also said that she was Professor Salcedo's Teaching Assistant, but you knew that this was false because you were Professor Salcedo's Teaching Assistant…and he only employs one! Finally, her resume says that she was selected as the "top student in Intermediate Financial Accounting" and you have never heard of that award.

    You could barely sleep last night, thinking about whether you should tell someone in authority at PrizeWaterhome about these lies. What should you do?

SOLUTION for Exercise 2-14:
Step 1: Consider all of the evidence to be sure that you are factually correct. Is it a material deception to say that you are a "vice-president," even if you are one of several vice-presidents, each with differing responsibilities?

Is it possible that Professor Salcedo did in fact employ Olya as a Teaching Assistant? Could he possibly have employed her for a different class he teaches at your university or during a different academic term? Is it possible that he teaches a class at a different university as well, or conducts executive education classes for the university that are not part of the established academic curriculum?

Are you sure that there is no award for "top student" in a certain class? Is it possible that her particular instructor for that class created such an award, even if it is not a recognized university award?

Step 2: Assess the alternatives.

- You can report some or all of these facts to a Human Resources manager at the firm.
- You can report some or all of these facts to a partner at the firm.
- Before you speak to someone in authority at the firm, you can first speak

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with Olya to find out if her statements are true.

- Before you speak with someone in authority at the firm, you can first speak with Olya to see if she would like to disclose or correct these misstatements to the firm.
- You could refrain from saying anything to anyone.

Step 3: Review the ethical issues.

Assuming that Olya lied, you need to decide if you have a moral duty to report her to the CPA firm.

Step 4: Evaluate the consequences.

If you do nothing, your chances of getting the job offer are, apparently, about 50%.

If your report your allegations of Olya's misconduct to someone in authority, you face several risks:

- You may be mistaken. If so, when Olya refutes your accusations, you will appear to be careless, vindictive, and overly competitive, which surely would lead the firm to deny you a job offer.
- You are correct. However, you might nonetheless be considered to be petty and a "rat." This could also lead the firm to deny you a job offer.
- You are correct. If so, the firm might appreciate your courage in presenting these facts to them and give you the job offer. You likely should couch your statements in a manner that speaks of "ethics," "duty," and the "need for complete honesty and integrity" in the accounting profession. You also should express your hesitancy to come forward out of a concern that others would consider you to be self-serving. Reinforce that you came forward with information because you believe it was "the right thing."

15. Three shots rang out, striking Al and his son Jeff. Neither died…yet. It'd be just a matter of time.

    As the sight of splattered crimson dominated the senses, all I could think of was, "What journal entries might be needed?"

    The facts, as I later came to discover them:

    Al Parsons and his equal partner, brother Lou, for over 30 years successfully had operated the Celebrity Loan Company on a quiet street in Beverly Hills, California. Catering to the famous but financially troubled, Celebrity Loan Company quickly became known as "pawnbroker to the stars."

    Al and his son Jeff were shot on December 11, Year 1. Al died within 20

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minutes, while Jerry languished in Mercy Hospital until his eventual demise on January 10, Year 2. The culprit was a disgruntled patron of Celebrity Loan Company.

Al's medical bills were modest, but Jerry's medical bills eventually reached $688,000 at the time of his death. On December 31, Jeff's medical bills were $200,000.

Celebrity Loan Company's financial problems were just beginning.

Lou submitted the medical claims for Jeff to the company's insurer, but the claim properly was denied by the insurance company on December 17, Year 1. The insurer's reason was that the Loan Company's accident insurance policy expressly stated that "all claims that appropriately are, or should be, covered by workers' compensation insurance are hereby not recoverable under this policy agreement." The insurance claims representative was correct. Jeff's injuries clearly fell within the scope of workers' compensation insurance because these injuries occurred on the job in Jeff's employment capacity.

The Loan Company did not carry workers' compensation insurance on Jeff because its accountant inaccurately told Lou that workers' compensation insurance was not needed for a child employed in the family business. Lou and his accountant have been friends for many years. Lou's accountant, a CPA, admits that he told Lou that workers' compensation insurance was unnecessary, and he was wrong. The accountant points out, though, that he gave this advice while chatting during a break from their weekly poker game.

As business partners, Al and Lou had entered into an agreement, called a buy-sell agreement to establish the price that the surviving partner would be required to pay to the other's estate on his death. The buy-sell agreement between the two equal partners sets the buyout price as follows:

> *"Upon the death of one partner, the surviving partner agrees to purchase the deceased partner's interest for an amount equal to 100% of the deceased partner's Capital Account, as stated in the Company's balance sheet as of the close of the month in which one partner dies. This balance sheet shall be prepared in accordance with generally accepted accounting principles."*

The partnership agreement elsewhere defines the phrase "Capital Account" to mean a particular partner's share of the loan company's owners' equity.

Lou received the company's December 31, Year 1 financial statement from the accountant on February 12, Year 2, and paid the buyout price for Al's partnership share shortly thereafter. The balance sheet, as prepared by

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the accountant, did not reflect any reduction in owners' equity for the liability owed to the hospital for Jeff's medical bills incurred by Jeff while on the job.

Later on, Lou got expert financial advice that the company accountant should have reflected the company's liability for Jeff's medical bills on the company's December 31, Year 1 balance sheet, but the accountant failed to do so.

As a result of the accountant's alleged error, Lou clams that he paid too much money to buy out his partner. Lou now wants the accountant to reimburse him for the amount of this overpayment.

a. When the accountant advised Lou about whether Celebrity Loan Company was required to maintain a workers' compensation policy, both parties were at a poker game. Did the accountant have a duty to give accurate advice on this topic?

b. Assume that the accountant was not an expert in workers' compensation insurance issues, but he wanted to help out Lou, who was his client and friend. Did the accountant violate any Principles of the AICPA's Code of Professional Conduct? Which ones?

c. Assume that the accountant gave this advice to Lou and never billed Lou for the accountant's services. Would your answers above be different?

d. Do you believe that the accountant has an ethical duty to reimburse Lou?

e. How much do you believe that the accountant should pay to Lou?

SOLUTION for Exercise 2-15:

a. An accountant always has a duty to give accurate advice. If the social setting in which the question was posed was unsuitable for the rendition of professional advice, the accountant should have deferred answering the question until the parties could meet in an office setting.

b. Yes. Under the Responsibility Principle of the Code of Conduct, a CPA must demonstrate a commitment to professionalism. Giving serious business advice at a poker game is questionable. Under the Due Care and Scope and Nature of Services Principles, a CPA has to exercise proper care and limit the scope of his services to topics about which he is competent. The accountant admittedly had no expertise in this area and should not have rendered any advice to his client.

c. No. Accountants often answer quick emails or phone calls and do not explicitly charge for quick inquiries. From a broader perspective, they factor these minor "no charge' situations into their billing rate for their other services. The fact that there was no express charge for this advice is irrelevant.

d. Yes. When a person acts carelessly, he has an ethical and legal responsibility to accept the consequences of his actions.

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e. As of year-end, Year 1, it was probable and estimable that the Loan Company was going to be liable for Jeff's medical bills. The liability existed at year-end. Moreover, by the time that the accountant prepared the year-end balance sheet, Jeff had died and the amount of his medical bills was known to be $688,000. As a result, the Loan Company's accountant should have accrued a $688,000 liability, which would have reduced owners' equity by this same $688,000 amount. Consequently, the deceased brother's one-half share of the owners' equity, and the resulting price paid by surviving brother Lou, was too high by $344,000. Lou is entitled to receive the $344,000 amount that he overpaid.

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