Business and Professional Ethics for Directors Executives Accountants 8th edition Brooks Solutions Manual

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Business and Professional Ethics for Directors Executives Accountants 8th edition Brooks Solutions Manual

Business & Professional Ethics for Directors, Executives & Accountants, *8e*

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Chapter 2 – Ethics & Governance Scandals

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Chapter Questions

1. Do you think that the events recorded in this chapter are isolated instances of business malfeasance, or are they systemic through the business world?

   The events chronicled in this chapter range over an eighty-year period from 1929 to 2010. During that time there were horrendous business failures, frauds and debacles that cost investors, consumers, taxpayers, and the general public billions and billions of dollars, not only in the United States, but around the world. The scandals were worldwide, involving hundreds of companies, only some of whom are mentioned in this chapter. At the same time, however, throughout the world, there were millions of businesses that were supplying the goods and services needed by society, in an efficient and effective manner. They were operating within the law and ethical standards.

   The examples provided in this chapter, and throughout the textbook are aberrations. Most people and businesses, most of the time, act and behave in a responsible manner. They obey the law, ethical norms, and social standards of behavior. However, if executives, directors and accountants are not mindful of the ethical dangers that lurk in the business world, then they too can become part of this aberration that is so costly to society. These business exceptions challenge the integrity and humanity of everyone who has anything to do with business.

2. The events recorded in this chapter have given rise to legislative reforms concerning how business executives, directors, and accountants are to behave. There is a recurring pattern of questionable action followed by more stringent legislation, regulation, and enforcement. Is this a case of too little legislation being engaged too late to prevent additional business fiascos?

   No amount of legislation can ever prevent crimes from occurring. One key to preventing additional business fiascos from occurring is to create a business environment in which the focus of business is clear. The purpose of business is not to make a profit at any cost. Moreover, profit is the consequence of providing goods and services required by society, in an efficient and effective manner, while operating within the law and ethical standards. The more efficient and effective the operations, the more profits the business will generate. For far-sighted corporations, profits are not the goal; they are the consequence of action.

   Many of the fiascos discussed in this chapter relate to greedy business leaders who, perhaps through hubris, lost sight of the goal of business. By focusing on profits they began to compromise their ethical standards, and so began a downward spiral that resulted in fraud and bankruptcy.

3. Is there anything else that can be done to curtail this sort of egregious business behavior other than legislation?

   Yes, boards and directors and executives can be educated to understand that unethical behavior is bad for business, and that reputation, which determines success, depends on ethical behavior.

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Archie Carroll, for example, ("The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders," *Business Horizons*, July-August, 1991) has argued that businesses must first and always obey the law. Then they must be economically viable. They do this by operating in an efficient and effective manner. Next, they must behave with the highest ethical standards. Finally, businesses must give back to society. If businesses follow these four steps, as well as the lessons contained in this textbook, there will be less need for legislation to govern business behavior.

4. Many cases of financial malfeasance involve misrepresentation to mislead boards of directors and/or investors. Identify the instances of misrepresentation in the Enron, Arthur Andersen, and WorldCom cases discussed in this chapter. Who was to benefit, and who was being misled? Additional information on each case is included in Chapter 9 of the sixth edition of the text, which is available in the Digital Resources for the eighth edition (see www.cengagebrain.com).

Enron

Misrepresentation	Result	Who Benefited
Premature recognition of revenue using 'prepays'	Overstatement of revenue	These frauds resulted in net income and stock to increase, which benefited senior management that had lucrative stock options
Syndication of special purpose entities (SPEs)	Understatement of expenses	
Conflicts of interest by · Senior management · Board of directors	Financial rewards to the related parties	Financial rewards to: · Jeffery Skilling · the board members
False financial statements audited by Arthur Andersen	Fraudulent financial reporting	Senior management at Enron and partners at Arthur Andersen

Investors, regulators, employees and the general public were all mislead and harmed by this fraud.

Arthur Andersen

Misrepresentation	Result	Who Benefited
Culture focused on revenue production primarily through non-audit services	Compromise on audit quality	In the short-run, all the partners who shared in the profits derived from providing lucrative non-audit services to Enron
Removal of Carl Bass, quality control partner, from providing oversight on the Enron audit	Permitted David Duncan to accept the accounting policies of Enron	

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The partners and employees of Arthur Andersen lost their jobs when the accounting partnership collapsed; all of Arthur Andersen's clients had to find new accountants.

WorldCom

Misrepresentation	Result	Who Benefited
Capitalized expenses	Overstatement of net income	Ebbers, Sullivan, and all the other WorldCom executives and board members that held lucrative stock options
No oversight of the CEO	Ebbers could orchestrate the fraud	

Investors, regulators, employees and the general public were all mislead and harmed by this fraud.

5. Use the Jennings "Seven Signs" framework to analyze the Enron and WorldCom cases in this chapter.

Jennings 'Sign'	Enron	WorldCom
Pressure to meet goals, especially financial ones	Senior executives had lucrative stock options	Pressure after the collapse of Sprint takeover. Ebbers ordered Sullivan to 'hit the numbers'
Closed organizational culture	Conflicts of interests became acceptable business behaviors	This is detailed in Chapter 9 of the textbook
CEO with sycophants	Board ignored complaints from whistleblower	No one challenged Ebbers' authority
Weak board of directors	Powers Report and Senate Subcommittee Report blamed the board for a failure to provide oversight	This is detailed in Chapter 9 of the textbook
Nepotism and favoritism	None	None
Hubris	This is detailed in Chapter 9 of the textbook	Ebbers had unlimited power with no oversight
Ethical trade-offs	None	None

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6. Rank the three worst villains in the film *Wall Street: Money Never Sleeps* (2010). Explain your ranking.

    - Alan Loeb and Stephen Schiff, who wrote the screenplay, for simplifying a complex issue and attempting to make money by being the first to present a fictionalized account of the financial bailout associated with the subprime mortgage crisis.
    - Michael Douglas, the main actor, for reprising a role so that he could say, once again, 'Greed is good.'
    - The customers, who did not listen to the critics who panned the movie.

7. In each case discussed at some length in this chapter – Enron, Arthur Andersen, WorldCom, and Bernie Madoff – the problems were known to whistleblowers. Should those whistleblowers each have made more effort to be heard? How?

    Whistleblowers in these cases did not use all of the following steps:

    - Begin by talking to an immediate superior or relevant company official. At Enron and WorldCom this would probably have been someone in the accounting or internal audit departments; at Arthur Anderson, it would have been the partner in charge; and with Madoff it probably would have been someone in the accounting department.
    - Notify the audit committee of the board of directors.
    - Communicate with the external auditors.
    - Present a formal complaint to the Securities and Exchange Commission.
    - Failing all of the above, the whistleblower could go public as a last resource (after seeking appropriate legal counsel).

    In the Madoff case, the whistleblower was outside the company, and tried very hard to be heard, but his warnings fell on deaf regulatory ears. He could have gone public earlier, and perhaps a knowledgeable journalist could have caused some action with a public article. Alternatively, a letter to Elliott Spitzer might have done the trick.

8. The lack of corporate accountability, and an increased awareness of inequities and other questionable practices by corporations, led to the Occupy Movement. Identify and comment upon additional recent instances which have led to concerns over the legitimacy of corporate activities.

    - Manipulation of LIBOR rates – see discussion in Chapter 2
    - Over-leveraging of investment houses during the subprime lending scandal – see discussion in Chapter 8
    - Lack of integrity by credit rating agencies when valuing the subprime mortgages securitizations during the subprime lending scandal – see discussion Chapter 8
    - Many bribery scandals – see discussions in Chapter 2 and Chapter 8.

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9. It seems likely that the top executives of the major banks involved in the manipulation of the LIBOR rate were aware of the manipulations, and of the massive profits and losses caused by those manipulations. Why did they think that such manipulations could continue to be undetected, and/or unpunished?

   At least some senior bank officials were probably aware of the manipulative practices because they had gone on so long. Also, the problem appears to have been generally known to insiders, since a top U.S. official, Tim Geithner, Secretary of the Treasury, warned the head of the Bank of England that a clean-up was needed in a letter before the story surfaced in the press. The story came from a whistleblower who had been trying to stimulate action for some time, but no actions had been taken by major banks to curb their personnel who were involved in the manipulations.

10. The new anti-bribery prosecution regime involves serious charges and penalties for bribery in foreign countries during past times when many people were bribing in the normal course of international business, and penalties were not levied. Is it unreasonable to levy extremely high fines at the beginning of the new regime, and/or not to limit the period over which bribery can trigger those fines? Why and why not?

    Reasons supporting high fines at the start:

    - Sends a strong message to leave no doubt of the risks of bribery
    - Encourages ethical behavior on questionable actions before they become illegal
    - Low fines may be considered a cost of doing business, and produce no change in behavior.
    - Low fines could send a signal that the new anti-bribery regime is not considered high priority for investigators, so they may turn to more important areas.
    - New laws and/or more rigorous enforcement of existing laws do not happen without some public debate or notification.
    - More revenue for the government.

    Reasons against high fines at the start:

    - Unfair to levy high fines on unsuspecting companies
    - Companies need time to change policies and practices
    - Companies will lose business to competitors who bribe if the cost of bribery gets too high.

    Conclusion – High fines are probably reasonable

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11. At GM and Takata, whose improper actions finally came to light, a whistleblower raised objections to the actions before or very early in the production process. Why were their concerns ignored and risks taken? In VW's case, why didn't a whistleblower come forward? What aspects of governance were lacking in each company?

    At GM and Takata the whistleblower's concerns were not taken very seriously. Neither company had a whistleblowing program that brought complaints to the senior officers and directors of the company. The culture in both companies was also not encouraging to whistleblowers. In GM, the dominant pressure was to keep costs low, so changes that would increase costs were ignored. The potential harm, cost and reputational loss involved was simply not taken into account in the decision making. Analysis of stakeholder impacts was not undertaken. In addition, at GM, and the approvals required for safety testing and remediation were not scrutinized or reported upward, so a low level official was able to cover the matter up until customer outcries brought the faulty switch problem to light. At Takata, the prevailing culture was not to question or criticize more senior employees or executives who made strategic and operational decisions. This meant that early remediation of the air bag problem did not happen. Needless to say, the top executives at GM and Takata did not encourage whistleblowing or "safety first" thinking at the time.

    At VW, the pride of VW engineers was at stake because their competitors had been able to design their cars to pass environmental tests, but VW's had not. The VW marketing people had even incorporated the winning of environmental awards into the VW marketing campaign, although the awards had been falsely won. Because there was a lot at stake, VW engineers resorted to a cheating process that they had used twice before, even though they had been caught twice. Whistleblowers, recognizing that there was a huge amount at stake, did not want to expose their colleagues by whistleblowing and risk the stigma and reputational loss that would follow. Whistleblowing was not encouraged by top management in any case, and a whistleblower protection program with reporting to the Board was not in place. The engineers seem to have been blind to the potential downside problem that could occur, which was a failure of proper decision making to include medium- and long-term stakeholder impacts.

12. The CEOs of Valeant Pharmaceuticals and Turing Pharmaceuticals took the view that they could jack up the price of their drugs by huge percentages because they could, and they failed to consider seriously enough whether they should. Whose fault was this? In a well-functioning corporate governance system, what measures should be in place to control such actions?

    The CEOs of Valeant and Turing had, for some time, gotten away with the strategy of buying fully developed drugs for which alternatives didn't exist and jacking up their prices to sky-high levels, and this would have continued except for the public outcry and political scrutiny that arose. In addition, the Boards of Directors of each company actively encouraged this business model, probably believing that maximization of profit was OK at any cost. The Board of Valeant actually structured CEO Pearson's remuneration to include huge performance stock unit (PSU) incentives if Pearson were able to dramatically expand Valeant's profits, and therefore incented

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him to press on with an unsustainable business model. Therefore both the CEOs and the Board of both companies were at fault.

In a well-functioning company, there should be a continuing assessment by the Board of the ethicality and sustainability of the company's business model, and a review by the Compensation Subcommittee of the Board of the executive incentive remuneration scheme to see that it does not motivate difficulties such as in the cases of these two companies.

13. What are the reactions and outcomes that can be attributed to the leaked Panama Papers?

The Panama Papers release shocked the public and regulators, and galvanized both into action. The public outcry against leaders and others who were evading taxation in the countries they lived or earned their wealth resulted in the resignation of several heads of state, and great pressure being brought to bear on tax collection officials and programs to recover unpaid taxes and to close off exposed loopholes in tax law. In addition, the exposure of individuals who look advantage of questionable methods to hide their wealth produced a chilling effect on the use of such techniques, and several countries were able to encourage repatriation of offshore wealth be offering amnesty, or low-tax programs. The Panama Papers also exposed possible means for money laundering, which were followed up and curtailed. The extent of disclosures was so vast, that a full investigation of possible secret arrangements will continue for many years.

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Case Solutions

1. Enron's Questionable Transactions (Chapter 2, pages 108-112)

What this case has to offer

The Enron Debacle is the icon for massive fraud allowed by failure of the company's governance system and the conflicted interests of its executives, auditors and lawyers. It precipitated the loss of credibility and trust in financial markets and corporate governance and accountability that ultimately led to reform of corporate governance and accountability, and of the accounting profession, through the Sarbanes-Oxley Act of 2002. It is a case that all businesspeople and professional accountants should be familiar with and understand.

Teaching suggestions

I use the PowerPoint slides on my website for instructors. First, I set up the topic of governance; second, I use "Enron Affair" to review the important elements of the case; and finally I use "Enron Debrief" to debrief, and review the rest of the material in Chapter 2 and models used in the course.

If you refer to the "Enron Affair" PowerPoint, you will see the order I have found to be very engaging and successful. I ask the audience to assume the role of a member of the Board of Directors, and then I challenge them throughout the case discussion with the following questions:

- What is your role as a Board member?
- What questions should you ask?
- Why didn't the Enron Board ask those questions?

Depending on the audience (non-accounting or accounting), I review less or more of the details of the fraudulent transactions. My PowerPoint provides a basic set. The key is to reveal enough that all audiences understand:

- Basic governance structure and roles of the Board, executives, professional accountants and lawyers, as well company policy (particularly on conflicts of interest) and compliance systems.
- What a Special Purpose Entity (SPE) is, the operation of the 3% rule for accounting for transactions, and how income, assets and liabilities could be manipulated using it.
- How and by whom the basic frauds were committed.
- The motivation for the frauds.
- Where the money went.
- What the impact of manipulation was on Enron's financial reports, and the investing public.
- How the governance system was short-circuited – ***see overheads.***

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- The role of an ethical or unethical corporate culture in preventing or abetting fraud.
- Why whistle-blowing is important.
- What Arthur Andersen contributed.
- What the banks contributed by facilitating the SPE transactions?
- How the Sarbanes-Oxley (SOX) Act arose.
- What changes SOX originated.
- How ethics risk management can help.

Discussion of Ethical Issues

The following questions are presented in the text for discussion of the significant issues raised in the Enron case:

1. Which segment of its operations got Enron into difficulties?

   Wholesale services was the segment where most of the manipulation went on. See Enron PowerPoint (PPT) 6 for a breakdown of the relative profitability (IBIT) of Enron's divisions.

2. How were profits made in that segment of operations (i.e. what was the business model)?

   See PPTs 5 and 7 for a word version of activities – note how hard it is to understand. Transparency was not in the interest of Enron's perpetrators.

3. Did Enron's directors understand how profits were being made in this segment? Why not?

   Apparently they did not. They should have queried how almost 50% (See PPT 16 for the proportion of manipulated income) of Enron's profits could have come from SPEs whose operations had no economic substance, or that asset sales and repurchase transactions between Enron and the SPEs were circular. You can't make money off yourself. Also, there were apparently 1,000-3,000 SPEs created, and a good Director should wonder why so many were needed.

4. Enron's directors realized that Enron's conflict of interests policy would be violated by Fastow's proposed SPE management and operating arrangements because they proposed alternative oversight measures. What was wrong with their alternatives?

   The Board's alternative controls were left to Fastow to institute, oversee and presumably report upon to the Board. He was the principal fraudster, and there was no internal audit follow-up (Arthur Andersen had taken the internal audit role as a subcontractor), nor did the Board demand feedback. No whistleblower concerns reached the independent member of the Board. Like mushrooms, independent Board members were left in the dark.

5. Ken Lay was the Chair of the Board and the CEO for much of the time. How did this probably contribute to the lack of proper governance?

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"Kenny Boy" did not serve as a useful foil or overseer of his own CEO actions, as a good independent Chair of the Board should. The inherent conflict of interests in being CEO and Chair has led to increasing separation of these functions as a measure of good governance, and some jurisdictions are requiring it. For example, Lay's handling of the Sherron Watkins whistle-blowing letter showed either brilliance or evidence of incompetence on conflict of interest matters. He asked the lawyers who advised on creation of the SPEs if what they had done was all right.

6. What aspects of the Enron governance system failed to work properly, and why?

   See PPTs 24-38 from Session 2 of Author's Course file.

7. Why didn't more whistleblowers come forward, and why didn't some make a significant difference? How could whistleblowers have been encouraged?

   See PPT 37. If you were contemplating coming forward, and you knew that Enron's culture was unethical (see examples) and the bosses knew it, would you come forward? – Not likely, because the risk was too high that you would be fired or not welcomed. There would have to be changes in the culture and systems to encourage whistleblowers to come forward, such as measures to make the culture ethical (see text discussion, and a protected whistleblower program. As a result of this apparent flaw, SOX/SEC has subsequently mandated that all SEC registrant companies have a whistleblower system that reports to the Audit Committee.

8. What should the internal auditors have done that might have assisted the directors?

   They should have been alert for flaws in Enron's conflict of interest policies, and any lack of compliance. When a policy was/is set aside by the Board, internal audit should have been advised or should have realized this by screening the relevant minutes. Also they should have been looking for any transactions with questionable economic substance. Their reports should go the Board of Directors as well as management.

9. What conflict of interests situations can you identify in:

   - *SPE activities*
   - *Arthur Andersen's activities*
   - *Executive activities.*

   The Enron Debacle shows conflicts of self-interest (personal gain of executives, employees, auditors, lawyers, bankers and directors) vs. shareholder (as many were misled and lost significantly) and other stakeholder interests (as the company objectives were not met and jobs etc., were lost. Each type of conflict has many examples.

   An interesting additional discussion, is how each conflict of interest situation developed, and

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why the professionals and directors lost sight of their need for independence, and what the professional accountants and banker thought that their mandate really was.

10. How much time should a director of Enron have been spending on Enron matters each month? How many large company boards should a director serve on?

    This depends on the complexity of the company's operations, the competence and trust placed in its management and governance systems, and the competence and skills of the Board member. On a company of significant size, a Director may have to spend 4-5 days per month to discharge their duties properly. On this basis, allowing for personal business, a person who serves only as a director could only serve on 3-4 Boards.

11. How would you characterize Enron's corporate culture? How did it contribute to the disaster?

    Enron's corporate culture was unethical (see PPTs 17 and onward). It was fraught with conflicts of interest, unethical and also illegal and acts, poor examples were set by directors and executives, and the directors, professional accountants and lawyers involved were self-interested instead of in the sustainable interest of shareholders and other stakeholders. If the process of allowing the satisfaction individual self-interest of the company's directors, personnel and agents, they ignored their fiduciary duty to the shareholders and other stakeholders. The Board members who were independent of management and not conflicted, were in the dark. Measures to make a corporate ethical culture are discussed in the text and Chapter PPTs. This set introduces ethics risk management and other governance and accountability paradigm changes.

Subsequent Events

May 25, 2006

From Sunseri, Gina, and Rottman, Sylvie (May 25, 2006). "Enron Verdict: Ken Lay Guilty on All Counts, Skilling on 19 Counts." *ABC News*, http://abcnews.go.com/Business/LegalCenter/story?id=2003728&page=1 :

> "Lay, 64, was convicted on all six counts against him, including conspiracy to commit securities and wire fraud. He faces a maximum of 45 years in prison. Lay also faces 120 years in prison in a separate case.
>
> "Lay posted a $5 million bond secured with family-owned properties at a hearing following the verdict. He was ordered to stay in the Southern District of Texas or Colorado.
>
> "'I firmly believe I'm innocent of the charges against me," Lay said following the hearing. "We believe that God in fact is in control and indeed he does work all things for good for those who love the lord.'

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"Skilling, 52, was convicted on 19 counts of conspiracy and fraud. Combined with his conviction on one count of insider trading, he faces a maximum of 185 years in prison. Skilling was acquitted of nine other charges relating to insider trading.

"'Obviously, I'm disappointed," Skilling told reporters outside the courthouse. "But that's the way the system works.'

"'I think we fought a good fight — some things work, some things don't,' he said…"

"In a separate, nonjury bank fraud trial related to Lay's personal banking, U.S. District Judge Sim Lake found the Enron founder guilty of bank fraud and making false statements to banks. Lake had withheld his verdict in the Lay bank fraud case until the Lay-Skilling jury announced its verdict. Lay faces up to 120 years in prison in that case."

Useful Articles, Links and Videos

C-Span (October 25, 2010). "Q&A with Bethany Mclean, author of *All the Devils are Here* and *Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* [video]." http://www.c-spanvideo.org/program/296214-1

Gibney, Alex (2006) Film "Enron: The Smartest Guys in the Room" [film preview, video footage and Enron timeline], available at http://www.pbs.org/independentlens/enron/index.html#

Rose, Charlie (January 21, 2002). "A Conversation about Enron's Declaration of Bankruptcy"[including a series of one-on-one discussions and panels with for journalists, the then SEC chairman, political critics and US senators discussing the Enron scandal from its beginnings]. https://charlierose.com/videos/9768

Time [Enron scandal webpage containing many links to stories] at http://www.time.com/time/2002/enron/

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2. *Arthur Andersen's Troubles* (Chapter 2, pages 112-120)

What this case has to offer

Arthur Andersen (AA) will forever be a key part of the Enron SOX chain that accelerated changes in the accountability and governance paradigm for corporations and the accounting profession. In fact, AA's problems were systemic as their root was in the firm's flawed governance system where the desire for profit was allowed to outweigh the firm's fiduciary interests to client shareholders and the public interest. The case presents excellent opportunities to review conflict of interest issues, the need for inclusion of ethics in an organization's strategy, operations and compliance processes, and for illustrating how the expectations of the public can dramatically affect an organization. AA's disappearance dramatically illustrates how risk managers had been in the habit placed too low a value on losing the ability to operate – known as "franchise risk"; post-Enron and AA that valuation has changed upward considerably.

Teaching suggestions

I use the PowerPoints in my Author's Course download for Session 2 (PPTs 23-36) to discuss the case. The key issues are:

- What happened and who did it?
- The 3% Special Purpose Entity (SPE) accounting rule and how it led to manipulation.
- How following the 3% rule precisely, and ignoring the overall principle that there must be external validity (an independent outside buyer/seller) to allow the recording of profit, led to manipulation.
- What the flaw was in AA's governance system that permitted the Enron, WorldCom, Waste Management and Sunbeam fiascos?
- Other matters raised in the questions below.

Discussion of ethical issues

The following questions reveal the key points of the case:

1. What did Arthur Andersen contribute to the Enron disaster?

   AA failed to protect the interest of current and future shareholders, and stakeholders that relied upon the financial reports and integrity of the company. AA failed to form a reliable part of the Enron governance system, thereby leaving the directors and other stakeholders at risk. See the list of AA's apparent mistakes in the case.

2. What Arthur Andersen decisions were faulty?

   See list of AA's apparent mistakes in the text, as well as the section on AA's internal control flaw.

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3. What was the prime motivation behind the decisions of Arthur Andersen's audit partners on the Enron, WorldCom, Waste Management, and Sunbeam audits – the public interest or something else? Cite examples that reveal this motivation.

   It was revenue generation and retention. They served their self-interest rather than the public interest by not acting upon the memos from their quality control personnel, and not challenging the manipulative practices and structures at Enron.

4. Why should an auditor make decisions in the public interest rather than in the interest of management or current shareholders?

   An auditor is the agent of the shareholders, and is elected annually at the Annual general Meeting of Shareholders by the shareholders. As such, the auditor must make sure that audited annual financial statements comply with Generally Accepted Accounting Principles (GAAP), and GAAP are designed to produce statements that do not favor the interests of current shareholders or executives and mislead future shareholders and other stakeholders such as governments, taxing authorities and the like. GAAP is therefore designed to produce statements that are in the public interest, and the auditor is the agent who should ensure GAAP is properly applied. An auditor who does not protect the public interest can face reputational and legal consequences because the expectations of the public have not been met.

5. Why didn't the Arthur Andersen partners responsible for quality control stop the flawed decisions of the audit partners?

   They tried via memos, but the firm's governance structure had earlier determined that the audit partner in charge could override them. Clearly, AA's governing body made the wrong decision.

6. Should all of Arthur Andersen have suffered for the actions or inactions of fewer than 100 people? Which of Arthur Andersen's personnel should have been prosecuted?

   I don't think so, because it seems unfair to the many innocent partners, staff and audit client stakeholders that lost value because of the resulting discontinuity. I further do not believe that society was well-served by the loss of one of the Big 5, thus concentrating the choices for independent audit work in the future. On the other hand, the disappearance of AA sent a significant signal to the rest of the audit world. I would have preferred larger fine and imprisonment for AA's decision makers who determined and carried out the policy of audit partner primacy, plus a very large fine and sanctions (no new SEC clients for 3 months) for the continuing firm. I would also consider carefully whether non-partner audit personnel had a responsibility for whistle-blowing, and would signal how this should be done in the future.

7. Under what circumstances should audit firms shred or destroy audit working papers?

   Given the developments in the AA Case, audit working papers should not be destroyed before

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they could be of assistance and/or relevant in any legal, tax or other dispute. This means that the auditor should retain paper or digital versions for a very long time. In some jurisdictions, the statute of limitations might come into play at the end of seven or ten years, but may not where fraud is concerned. An audit firm may chose not to follow the statutory limits because they might wish to be able to respond to protect themselves for a longer period. Public expectations that affect reputations are not bound by legal limits.

8. Answer the "Lingering Questions" in the case (p. 119 in the text).

See the answer to Question 6 above. I do not think that the Big 4 firms could be shrunk to the Big 3 in the future because it would not be seen to be in the public interest. I think that other AA partners will be brought to trial, but not many. Perhaps only the head of the firm, the lawyer involved and the partners-in-charge of the firm and the region or function will be brought before the courts. Finally, I am sure that a similar tragedy will occur again – probably after the pain of ignoring the public interest abates again as it has from earlier scandals in earlier decades. Our memory fades as generations retire, and unless the education system plays a stronger role with students in the future, ethics lessons will be forgotten again.

Subsequent events

July 15, 2003:

From Feeley, Jef (July 15, 2003). "Andersen Worldwide settles Enron Suits." *Financial Post*, FP9:

> "The network of foreign accounting firms once linked to Arthur Andersen LLP will pay US$40-million to resolves lawsuits stemming from Enron Corp.'s collapse…
>
> "Andersen Worldwide Société Cooperative is seeking to erase liability in suits filed by Enron investors and workers over the accounting firm's role in helping Enron hide more thanUS$1-billion in losses… The accord doesn't cover Arthur Andersen LLP, Enron's auditor for more than a decade… Andersen Worldwide also agreed to pay US$20-miooion to Enron's bankruptcy creditors.
>
> The settlement is a small fraction of the US$29-billion that shareholders and former workers say they lost in Enron's meltdown."

May 31, 2005:

In the case of *Arthur Andersen, LLP v. United States (04-368)*, 544 U.S. 696 (2005) 374 F.3d 281. [May 31, 2005]. https://www.law.cornell.edu/supct/html/04-368.ZS.html

The Supreme Court of the United States unanimously reversed AA's conviction due to serious flaws in the jury instructions.

As of 2008, there were over 100 civil lawsuits pending against AA.

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Useful Articles, Links and Videos

C-Span and Washington Journal (January 21, 2002). "Arthur Andersen and Enron [video]." http://www.c-spanvideo.org/program/168280-2

"Participating by remote connection from Chicago, Mr. Greising discusses the Arthur Andersen accounting corporation and the Enron bankruptcy."

C-Span and Department of Justice Briefing Room (Mar. 14, 2002). "Arthur Andersen Indictments [video]" http://www.c-spanvideo.org/program/169155-1

"The deputy attorney general announced that a federal grand jury has indicted the accounting firm Arthur Andersen with obstruction of justice."

C-Span and Washington Journal (Mar. 28, 2002). "Accounting Regulation [video]." http://www.c-spanvideo.org/program/169358-5

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Oppel, Richard and Eichenwald, Kurt (January 16, 2002). "Enron's Collapse: The Overview; Arthur Andersen Fires an Executive for Enron Orders." *The New York Times*, http://select.nytimes.com/gst/abstract.html?res=F50A1EF9385C0C758DDDA80894DA404482

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3. *WorldCom: The Final Catalyst* (Chapter 2, pages 120-127)

What this case has to offer

When WorldCom announced massive overstatements of profit in June 2002, it completely shattered the trust in corporate accountability and governance that President Bush and others had been trying to rebuild. Sarbanes and Oxley combined their separate efforts in the U.S. Congress and Senate, and the Sarbanes-Oxley Act emerged in late July 2002, thus triggering a change in corporate accountability and governance, and well as the accounting profession. The WorldCom case involves simple manipulations, but once again offers lessons about the need for an ethical corporate culture, whistleblower protection, avoiding an over-dominant CEO, no independent Chair of the Board, and incompetence of Directors. The prosecution and dissolution of AA was so far along by June/July 2002, that their role in not finding the problems earlier was overshadowed by the emergence of SOX.

Teaching suggestions

I review the events after Enron and up to SOX, and I indicate how it galvanized the development of SOX. I then deal with the questions listed below.

Discussion of ethical issues

The following questions were presented for discussion of the significant issues raised in the case:

1. Describe the mechanisms that WorldCom's management used to transfer profit from other time periods to inflate the current period.

   Details are in the case, but the major mechanisms use included:

   - Capitalization of current costs to move them to future periods
   - Reduction of current costs by drawing down reserves

2. Why did Arthur Andersen go along with each of these mechanisms?

   AA may not have known about the manipulations, or at least some of them. Cynthia Cooper, Vice-president for Internal Audit was apparently the first to identify the irregularities. According to the SEC quotations in the case, WorldCom went to some lengths to conceal the manipulations from AA. However, this raises the question of how effective AA's audit work was because the manipulations were significant. Moreover, if AA knew of some of the manipulations, then is it another case of AA wishing not to confront management and preferring to protect future fee revenue.

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3. How should WorldCom's board of directors have prevented the manipulations that management used?

   An ethical corporate culture should have been developed that would have encouraged the personnel who were ordered to manipulate to whistle blow. If scrutiny and analysis by internal and external auditors were known to have been tighter, then perhaps the manipulation attempts would not have been attempted. Moreover, if WorldCom had not been so dominated by Bernard Ebbers (i.e., if an independent Chair of the Board and appropriate whistleblowing mechanisms had been in place) then he might not have tried to manipulate, and/or other might have reported the attempt. Ebbers might not have attempted the manipulation if the Board had not allowed him to borrow $408 million and spend it in ways that required rising WorldCom stock prices and/or cash.

4. Bernie Ebbers was not an accountant, so he needed the cooperation of accountants to make his manipulations work. Why did WorldCom's accountants go along?

   Because they thought they could get away with it for a while and that when profits returned that "adjustments" would be restored. They might have thought that everyone was manipulating and that smoothed earnings were 'good". They did not see their duty as protecting the shareholders' interests or the public interest.

5. Why would a board of directors approve giving its Chair and CEO loans of over $408 million?

   The Board did not recognize the risk that Ebbers would misuse the funds borrowed. To some extent the Board was at fault for allowing a loan arrangement for Ebbers where he could draw down amounts on his own without a reporting mechanism to the Board and for subsequent approval as amounts rose beyond reasonable levels, and they did not check on the specific use of the money and the value of that usage as collateral.. They trusted Ebbers who had built the company up from its early roots. They did allow him to borrow money for the purpose of buying the largest ranch in Canada, which was also unusual.

6. How can a Board ensure that whistleblowers will come forward to tell them about questionable activities?

   A protected whistleblower mechanism is vital, and its use must be encouraged by top management. Even then, there is no guarantee. In the end, an ethical corporate culture is essential to the promotion of whistle blowing and ethical behavior in general. This topic is discussed further in Chapter 3.

Useful Articles, Links and Videos

WorldCom Fraud Info Center [Website no longer active in 2017.]
http://www.worldcomfraudinfocenter.com/information.php

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Faber, David (September 9, 2003). "The Rise and Fraud of WorldCom: Former CEO Ebbers talks in CNBC's 'The Big Lie [article].'" *CNBC TV*, http://www.nbcnews.com/id/3072795/ns/business-cnbc_tv/t/rise-fraud-worldcom/

The CNBC news show, "The Big Lie: Inside the Rise and Fraud of WorldCom," January 2005 http://video.google.com/videoplay?docid=6560803301631269691#

This 55 minute CNBC news documentary exposes the extent of the WorldCom fraud. Viewers will gain insight into the actions, decisions, and deception of several key participants, including the then-chairmen of AT&T and Sprint as well as the WorldCom capacity planner who constructed the growth model.

"WorldCom Chief Guilty [video]" (March 16, 2005). *CBS News*, http://www.cbsnews.com/video/watch/?id=680422n

Bayot, Jennifer and Farzad, Roben (August 12, 2005). "Ex-World Com Officer Sentenced to 5 Years in Accounting Fraud." *The New York Times*, http://www.nytimes.com/2005/08/12/business/12worldcom.html

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4. *Bernie Madoff Scandal – The King of the Ponzi Schemes* (Chapter 2, pages 127-136)

What this case has to offer

Bernie Madoff's investment scandal is the most recent high-profile corporate fraud in the U.S. As stated in the case, the story of how Mr. Madoff began his scheme, what he actually did, who suspected he was a fraudster and warned the SEC, why the SEC failed to find wrongdoing, who knew, and who did nothing, is a fascinating story of ethical misbehavior, greed, innocence, incompetence, and misunderstanding of duty. As in previous scandals (Enron, WorldCom, etc.), managers, auditors, regulators, and other stakeholders failed to stop the fraud that went on for a long time.

This case raises questions about the role of the SEC in regulating and overseeing hedge funds, as well as the effectiveness of currently existing legislation in protecting investors of hedge funds.

Teaching suggestions

I start this case by asking students what a Ponzi scheme is. According to the SEC:

> "A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity." (U.S. Securities and Exchange Commission (SEC). 2011)

I continue explaining students that this is one of the oldest known forms of securities fraud. Following, I ask students what are the potential red flags to identify a Ponzi scheme and whether or not these flags where evident in Madoff's operation, for example:

- High investment returns with little or no risk (i.e. "guaranteed" returns).
- Overly consistent returns regardless of overall market conditions.
- Unregistered investments.
- Unlicensed sellers or a network of investment companies.
- Secretive and/or complex strategies.
- Poor disclosure or obscure account statements.
- Difficulty receiving payments.

Finally, I close the case highlighting that, as it was the case with other corporate scandals, several parties failed to detect and act on the potential signs of fraud.

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Discussion of ethical issues

1. Is Madoff's sentence too long?

The 150 years sentence was the maximum possible penalty for Bernie Madoff's crimes. A week before the sentencing took place, Judge Denny Chin received a letter from Mr. Madoff's lawyer, Ira Lee Sorkin (Weiser 2011), asking for a prison term substantially below the 150-year maximum. The lawyer listed several reasons, including Mr. Madoff's confessing to his sons, knowing he would be turned in, his "full acceptance" of responsibility for his crimes, and his efforts to assist in the recovery of lost assets. Furthermore, the lawyer asked a chance for Mr. Madoff to be free before his death.

In response, Judge Chin stated that he understood Mr. Sorkin's plea. "It's a fair argument that you want to give someone some possibility of seeing the light of day," the judge said in an interview, "so that they have some hope, and something to live for." Nevertheless, Judge Chin's reasoned that "In the end, I just thought he didn't deserve it," he said. "The benefits of giving him hope were far outweighed by all of the other considerations."

Judge Chin explained in a series of interviews that 20 or 25 years would have effectively been a life sentence, and that any additional years would have been purely symbolic. Yet symbolism was important, given the enormity of Mr. Madoff's crimes. The judge weighted the fraud's unprecedented scale, its duration over two decades and its thousands of victims. At that point, the judge said, symbolism "carried more weight."

The Judge decided that 150 years would send a loud, decisive message. He felt that Mr. Madoff's "conduct was so egregious," he said, "I should do everything I possibly could to punish him." Moreover, any sentence of less than 150 years could be seen as showing him mercy. "Frankly, that was not the message I wanted to be sent," the judge said.

Following the Judge's criteria, the sentence was not too long but just tough in accordance to the U.S. laws.

2. Some SEC personnel were derelict in their duty. What should happen to them?

Arguably, the SEC personnel that failed in their duties should be punished; however, it is difficult to determine the extent of the SEC's negligence in investigating this fraud.

SEC Chairman Christopher Cox stated that the agency would follow up on its own failure to investigate this case. The SEC had been tipped as early as 1999 that Madoff was running a Ponzi scheme. The SEC sent examiners to the firm twice, including an enforcement team, but came up with nothing. Moreover, since no subpoena power was requested, the SEC conducted its investigations with documents provided by Madoff, and he kept providing false records.

After an extensive investigation, the Office of Investigation (OIG) of the SEC concluded:

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"The OIG did not find that the failure of the SEC to uncover Madoff's Ponzi scheme was related to the misconduct of a particular individual or individuals, and found no inappropriate influence from senior-level officials. We also did not find that any improper professional, social or financial relationship on the part of any former or current SEC employee impacted the examinations or investigations." (U.S. Securities and Exchange Commission (SEC). 2009)

Overall, the investigation uncovered that this case was a failure of the SEC's policies, procedures and internal controls but, according to the OIG, it appears not to be the direct result of professional negligence of the investigators. The fact that most investigators were lawyers, fresh out of law school without a sufficient understanding of the capital markets seems to bear this assessment out. As well, the failure to have a central registry/oversight of complaints by a senior, fully-knowledgeable person points to a systemic failure. Moreover, the failure to check on Madoff's answers to interview questions demonstrates a ridiculous lack of appreciation for sound evidence-gathering and verification. On the other hand, Markopolos' testimony before members of the U.S. Congress seems to indicate that some individuals within the agency choose not to investigate the fraud in depth.

3. Are the reforms undertaken by the SEC ("The Securities and Exchange Commission Post-Madoff Reforms" (last update October 16, 2014),http://www.sec.gov/spotlight/secpostmadoffreforms.htm) tough enough, and sufficiently encompassing?

   The reforms undertaken by the SEC include:

   - Revitalizing the Enforcement Division
   - Revamping the handling of complaints and tips
   - Encouraging greater cooperation by 'insiders'
   - Enhancing safeguards for investors' assets
   - Improving risk assessment capabilities
   - Conducting risk-based examinations of financial firms
   - Improving fraud detection procedures for examiners
   - Recruiting staff with specialized experience
   - Expanding and targeting training
   - Improving internal controls
   - Advocating for a whistleblower program
   - Seeking more resources
   - Integrating broker-dealer and investment adviser examinations
   - Enhancing the licensing, education and oversight regime for 'back-office" personnel

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These reforms seem to address some of the biggest problems uncovered after Madoff's scandal; nevertheless, only time will tell if these measures are effective in preventing similar frauds.

4. Does it matter that Madoff's auditor, Friehling, was his brother-in-law?

It matters because it is a clear conflict of interest. Auditing Standards and professional accountants Codes of Ethics require auditors to be free of conflicts of interests in order to be objective. In the case of an audit engagement, it is in the public interest that the auditor be independent of the entity subject to the audit. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

Independence issues were central to prior corporate scandals and were addressed in the independence rules included in the *Sarbanes Oxley Act of 2002*; however, these rules would not necessarily apply to the audit of Madoff's funds as these companies were not a public company. Investors should be mindful of the potential problems of a lack of proper audit by a qualified auditor, and they should always make sure their interests are properly protected. In this case, investors failed to inquire.

5. Does it matter that Friehling did no audit work?

Not conducting any audit work was in clear violation of the auditing standards that require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit. Moreover, it is the auditor's responsibility to:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control;
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks; and,
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

As a result of the fraud, the Public Company Accounting Oversight Board (PCAOB) has been given the additional responsibility to supervise the audits of registered securities dealers in the U.S.

6. Comment on the efficacy of self-regulation in the form of Federal Industry Regulatory Authority (FINRA), and in respect of the audit profession. What are the possible solutions to this?

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Professional self-regulation is the regulation of a profession by its members. A central purpose of professional self-regulation is protection of the public from harm. Professional self-regulation should encourage professional conduct and competence, fairness, transparency, accountability, and public participation. Individual members are personally accountable for their practice through adherence to codes and standards.

A fundamental problem with self-regulation is maintaining independence from the interest of individuals or firms influencing the decisions of professional standard setters and enforcers. FINRA was not strong enough or sufficiently independent from Bernie Madoff to investigate the fraud.

The self-regulation of the accounting profession, and particularly in regard to audit standards, was put to test after the scandals that led to the passage of the *Sarbanes Oxley Act of 2002.* In essence, the US government decided that self-regulation was not enough to protect the public interest and created the Public Company Accounting Oversight Board (PCAOB), this organization is:

> "…a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection." (PCAOB 2013-2017)

7. Answer Markopolos' questions: "How can we go forward without assurance that others will not shirk their civic duty? We can ask ourselves would the result have been different if those others had raised their voices and what does that say about self-regulated markets?"

   There is no straight forward answer to these questions. In principle, it is an individual decision to act in accordance to ethical principles. In this case, it seems that there were many people who could have raised the flag about the fraud, for example Madoff's employees and auditors, the SEC investigators, and a number of investment professionals that did not believe in Madoff's investment strategy. If these individuals had raised their voices earlier, the fraud could have been uncovered sooner. Of course, the regulator (the SEC) would have to be ready and able to investigate thoroughly, diligently and with proper professional scepticism.

8. How could Markopolos and the other whistleblowers have gotten action on their concerns earlier than they did?

   Being a whistleblower is not an easy task. In this case, Markopolos contacted the SEC, which is the top authority in charge of investor protection in the U.S. Moreover, Markopolos had strong suggestive evidence to back up his claims. Beyond going to the SEC, he and other whistleblowers could have "gone public", talking to the media about these issues.

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Media attention can help to direct the public's attention towards fraud cases; however, it can encounter fierce criticisms, for example, Bethany McLean, a 31-year-old Fortune magazine reporter challenged Enron's accounting practices, asking how the company made its money. Enron's CEO, Jeffrey Skilling, called McLean unethical and hung up on her. The chairman, Kenneth Lay, called Fortune's managing editor to complain. The CFO, Andrew Fastow, flew to New York to tell McLean and her editors that Enron was in great shape.

9. Did Markopolos act ethically at all times?

Arguably, Markopolos was driven not only by the public interest, but also by its personal interest as Madoff's competitor. Markopolos was a former chief investment officer at Rampart Investment Management in Boston. His investigation began in 1999, when a colleague learned of Madoff's investment returns and urged Markopolos to replicate his strategy. Markopolos soon concluded that the numbers did not add up. Markopolos confronted bosses who urged him to match Madoff's results, investors who did not want to hear the truth, and SEC's officials who either did not listen or could not understand his arguments. Moreover, Markopolos initially thought he might be eligible for a sizable reward if the fraud involved insider trading, but that turned out not to be the case. Nevertheless, it seems like Markopolos acted ethically in blowing the whistle about the fraud.

10. What were the most surprising aspects of Markopolos' verbal testimony on YouTube at "Madoff Fraud Allegations & Financial Markets Regulation: Harry Markopolos [testimony] [video]." ([uploaded] February 4, 2009). http://www.youtube.com/watch?v=uw_Tgu0txS0 and https://www.youtube.com/watch?v=uw_Tgu0txS0

Markopolos' statement highlights that:

- The SEC repeatedly ignored Markopolos' detailed warnings.
- The SEC's personnel appear to be incapable of understanding the financial transactions involved.
- The SEC is staffed by people without professional investigative or audit experience.
- The fraud could have been stopped earlier when Madoff's investments reached $7 billion.
- SEC officials at the Boston office were ignored by their superiors and their colleagues at the New York office.
- The SEC appears to be afraid of investigating high-level cases.

11. Did those who invested with Madoff have a responsibility to ensure that he was a legitimate and registered investment advisor? If not, what did they base their investment decision on?

It seems like the decision to invest in Madoff's fund was a result of affinity, greed and trust in other investment advisors recommending Madoff's fund. Individuals should do some research

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before investing in public or private firms. Furthermore, if an individual relies on an investment advisor, the advisor should perform a more thorough examination before issuing a recommendation involving, for example, analysis of portfolio composition, portfolio stress testing, risk management, and asset verification.

An article by CBS News on the Madoff scandal, also featured in the Show 60 Minutes (see "The Man Who Figured Out Madoff's Scheme," 2009, below), cites Markopolos explaining an affinity scheme, saying that "Bernie was Jewish, so he ran it on the Jewish community in the United States. But that wouldn't get him enough customers, 'cause he always needed new money to keep the scheme going."

The article continues: "Madoff extended his reach from New York to Palm Beach, Florida, where he enlisted hundreds of wealthy clients, many of them recruited from his own country clubs. And he also made connections that gave him entree to Europe, and the hedge funds capital of America, Greenwich, Conn."

"It was in Greenwich that Bernie Madoff made some of his biggest deals with large investment firms that were willing to feed him billions of dollars of their clients' money to manage. And in return, Bernie Madoff agreed to pay the so-called feeder funds a fortune in annual fees. The largest of the feeder funds was the Fairfield Greenwich Group…"

Boies, Schiller & Flexner LLP, "…one of the most prominent law firms in the US, is representing Fairfield Greenwich investors, who lost nearly $7 billion when Madoff went under. They are suing the firm for gross negligence, claiming it failed to investigate Madoff thoroughly or monitor his activities as it promised to do in its marketing materials."

12. Should investors who make a lot of money (1% per month while markets are falling) say "Thank you very much", or should they query the unusually large rate of return they are receiving?

The SEC guidance recommends that when individuals consider their next investment opportunity, they should start with these five questions:

- Is the seller licensed?
- Is the investment registered?
- How do the risks compare with the potential rewards?
- Do I understand the investment?
- Where can I turn for help?

Also, the SEC explains in its guidance (see U.S. Securities and Exchange Commission (SEC) 2011) to be aware of red flags such as:

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"High investment returns with little or no risk. Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any "guaranteed" investment opportunity.

"Overly consistent returns. Investments tend to go up and down over time, especially those seeking high returns. Be suspect of an investment that continues to generate regular, positive returns regardless of overall market conditions."

13. Should investors who made money from "investing" with Madoff be forced to give up their gains to compensate those who lost monies?

U.S. bankruptcy laws authorize a trustee to recover money that was distributed as part of a fraud and share it among the victims. The purpose of these provisions is to balance the losses among the various investors, but how that balance is supposed to be struck is not clear. Under New York State law, which can be invoked for Madoff recoveries, a trustee can seek redemptions going back six years.

In practice, it will be very difficult to force investors to return any money made from their investments with Madoff. Investors may wind up suing each other, as well as the hedge funds and banks that brought them into Mr. Madoff's funds and the auditors who worked for those hedge funds.

14. Is this simply a case of "buyer beware"?

This is a case involving a massive fraud and negligence of various government agencies in charge of investor protection. It is not just a case of "buyer beware," and it should be a clear call for reforms targeted to avoid similar cases.

Several people lost their life savings and some even lost their lives in connection with this fraud. A man that invested his savings with Madoff, mentioned by Judge Denny Chin, died of a heart attack two weeks after the fraud was uncovered. Thierry de la Villehuchet, CEO of Access International Advisors, a money-management operation who placed investors' funds in Madoff's investments, stabbed himself to death with a box cutter after taking sleeping pills after losing $1.4 billion in the scheme. Mark Madoff, Bernie Madoff's eldest son and defendant in a number of lawsuits launched by the trustees of his father's investors, hanged himself two years after the fraud by a dog leash on a metal ceiling beam in his Manhattan loft apartment.

Useful Articles, Links and Videos

Berenson, Alex (December 19, 2008). "Even Winners May Lose With Madoff." *The New York Times* http://www.nytimes.com/2008/12/19/business/19ponzi.html

"The Man Who Figured Out Madoff's Scheme: Tells 60 Minutes Many Suspected Madoff Fraud; Says SEC Is Incapable of Finding Fraud." (March 1, 2009). *Wired New York,* http://www.wirednewyork.com/forum/showthread.php?t=19951&page=4

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5. *Wal-Mart Bribery in Mexico* (Chapter 2, pages 137-138)

What this case has to offer

This case shows how executives can thwart the strategic objectives of the company's owners for their own enrichment, or for corporate goals that seem to make sense in the short term, but not in the longer term. Wal-Mart has been under pressure for unfair business practices, unfair treatment of labor, and the destruction of small competition and local economies. As a result, their new developments have often been opposed resulting in delays or extra unnecessary costs. At the same time, leaders of the owning family, the Walton's, have been applauded for their contributions to sustainability and other causes. Wal-Mart had developed anti-bribery codes and training programs in line with corporate social responsibility (CSR) objectives, but this case shows how the lofty intent was actively ignored by senior executives at head office and in Mexico who used bribes and protected bribe payers, subverted investigations, and kept the Board of Directors in the dark. Ultimately a *New York Times* article (see the text) revealed the problem, and triggered reputational repairs as well as preparations for defence against charges under the *U.S. Foreign Corrupt Practices Act (FCPA).* The Waltons' credibility and of Wal-Mart suffered significant damage, confirming the allegations of unfair practices, treatment, etc. that the company strove to avoid.

It is an excellent case that illustrates:

- The impact of bribery/unethical acts on a company and its owners, including the actions of highly sensitive stakeholders such as the news media, investors, and government agencies.
- How bribes are used and the use of agents ("gestores") to make them.
- How executives can circumvent company policy.
- How whistleblowers can be vilified.
- How excellent senior offices who oppose can decide to leave the company out of frustration and apparently do so without letting the Board of Directors know what is happening.
- How a risk management program can be subverted if directors are too trusting and whistleblowers are not encouraged.
- The role of an ethical corporate culture in strengthening corporate policies and in encouraging whistleblowers to come forward so that the Board can hear about ethics risks.

Teaching suggestions

I would suggest introducing the Wal-Mart Bribery Case by providing a brief overview about the company, its owners, size, challenges, criticisms, and interested stakeholders. That will provide a

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background to set up and understand the learning experiences mentioned in the first paragraph above. Alternatively, students can be asked questions on each of these issues to provide the background.

After the background is established, the class can be asked to provide the relevant details of the case, and ultimately the answers to the questions posed at the end of the case.

Discussion of ethical issues

1. Where were Wal-Mart's questionable payments made, and where did this result in serious damage to the company and its executives? Why?

   Wal-Mart's questionable payments were made in Mexico, but the reputational fall-out, prosecution under the FCPA, and damage to profit occurred in the U.S. The negative reactions and consequences were caused by the awareness and interest of stakeholders in the U.S. and around the world including the press and media, investors and other stakeholders even though those in Mexico were not apparently concerned.

2. The 'gestores' payments were made to third parties, who then bribed local officials. How would a company ensure that its third party vendors are operating within the law?

   A company should include its agents (the gestores) in its policies, protocols, training and annual sign-offs because their actions ultimately impact the company. As well, the company's internal audit/risk management examinations should cover third party actions, and the reports should be made available to the Audit Committee and/or Risk Management Committee of the Board of Directors. A company cannot sit back and expect all of its agents to do the right thing.

3. Some of Wal-Mart's senior executives knew about the bribes, but did not take any effective actions to curtail this activity. What steps should the Board of Directors take to ensure that systems and internal controls are in place so that they are informed about questionable managerial activities and actions?

   The Board should ensure that company policies and systems are robust and comprehensive, and that the internal controls, that ensure compliance, are operating properly. This usually involves periodic examination by internal auditors and or risk management investigators, with reports to the senior executive responsible for the activity, and to the relevant board committee. Whistleblowers are a necessary aspect of the control mechanism, so they must be encouraged, supported, and their reports reported to the relevant Board Committee. The Board must take active responsibility for the oversight of these functions – they cannot rely entirely on senior management to do their job in these areas. The relevant Board Committee should hear from the senior executive overseeing these areas quarterly and should review a summary quarterly report with access to the specific reports when called for. Reports to the Board as a whole should be made by specific committees on a quarterly basis to raise the profile, awareness and importance of these functions.

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4. Wal-Mart Mexico seemed to have a culture of the goal justifying the means. How can the Board of Directors ensure that the operational activities of the company do not subvert proper governance objectives?

   The Board should be concerned about how the company makes it profits, not just how much. This means that the Board should consider whether senior executives have the right perspective on ethical and responsible action both before they are hired and on a continuing basis thereafter. This is known as ensuring the "right tone at the top." The role of reference checks and investigations before hiring are critical. In addition, ongoing examinations of actions by internal auditors and risk management teams, as well as continuous reviews of whistleblower complaints and resolutions, and of web-postings are necessary. All concerns must be followed up, and prompt significant disciplinary action must be evident.

Useful Articles, Links and Videos

Wal-Mart Hit by Mexican Bribery Claims [video] – *Bloomberg Television* [April 23, 2012], accessed at http://www.bloomberg.com/video/91194862-wal-mart-hit-by-mexican-bribery-claims.html on September 22, 2016.

In this report introduced by Erik Schatzker on Bloomberg Television's "InsideTrack", Sara Eisen reports on that Wal-Mart is investigating allegations of bribery of Mexican officials by its Mexican subsidiary to speed the opening of stores in that country. In damage-control mode, Wal-Mart is dealing with more allegations that senior executives may have tried to cover up the bribes by shutting down the company's own investigation.

"Not just Wal-Mart: Dozens of U.S. companies face bribery suspicions," Stephen Gandel, *Fortune*, April 26, 2012, accessed at http://fortune.com/2012/04/26/not-just-wal-mart-dozens-of-u-s-companies-face-bribery-suspicions/ on September 23, 2016.

The author writes that "at least 81 public companies [are] under investigation by the Securities and Exchange Commission or the Department of Justice for running afoul of the Foreign Corrupt Practices Act, which makes bribery in foreign countries punishable in the U.S. In addition, a growing number of companies have started placing disclosures in their financial documents that say their employees may at times violate the U.S.'s overseas bribery law, despite the company's best efforts to prevent it."

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6. *LIBOR Manipulations Cause Widespread Impacts* (Chapter 2, pages 138-140)

What this case has to offer

The LIBOR Manipulations Case, which describes an important scandal in easily understood terms, exposes the problem of banks that rely upon public goodwill and trust to operate successfully, abusing that trust to enhance the financial position or profits of the banks and/or their employees at the expense of the public. In fact, the manipulated rates caused harm to bank customers, and others who borrowed (i.e., house mortgages, etc.) or lent funds to the banks *all around the world* because many contracts are based on these. It is not surprising that banks are often mistrusted by the public.

In addition, it is surprising to see how long the manipulation went unchecked, and it is easy to speculate that the top bankers and regulators knew of the practices, and let them continue. Although some executives lost their jobs and their bonuses when their banks were charged, some did not. The size of the fines levied is staggering. Going forward, gentle treatment is very unlikely, so top executives and boards of directors need to be more vigilant with regard to such practices.

The emails quoted show the cultural acceptance of manipulation within the banks, and the fact that prowess at such falsification was a source of personal pride. The same thing was evident among the risk assessors at the rating agencies during prior to the financial scandal of 2008. They knew they we acting unethically and/or illegally, but were doing so cheerfully, and without concern.

Teaching suggestions

I would suggest beginning the case discussion by asking a class member to provide an overview of the case facts. Then I would ask the class how important they thought reputation and trust were to banks. This should trigger a discussion to the effect that they were very important because banks don't sell durable goods like autos, they sell trust.

Then I would ask the class:

- If they were on the board of directors, how they would ensure that the bank's reputation and public trust should be protected?
- Why had the boards of directors of the banks not done so?
- How could the traders come to consider their cheating with obvious pride?

Finally, I would deal with the questions at the end of the case.

Discussion of ethical issues

1. Which groups were most at fault for the LIBOR manipulations: brokers, traders, bank executives, bank boards of directors, or regulators? Why?

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I would argue that the boards and the regulators were most at fault because theirs is the residual responsibility for corporate performance. They owe a responsibility to society at large, and to investors and other stakeholders for bad actions. It may have been that they were not aware enough of the potential problems, or that their policies were not effective, or that they were not well enforced. Those policies should have informed and kept everyone else from engaging in unethical or illegal acts.

2. What should the regulatory bodies do with the fines paid by these banks? Reduce tax rates for the general public? Use the funds to re-educate investment bankers?

   Arguably both should be done, practicality is important, and further practical uses could emerge as well.

3. Robert Diamond continues to receive his £2 million pension annually. Should he suffer financially by having to forfeit this pension because the LIBOR scandal occurred while he was CEO of Barclays?

   It is possible to argue this question either way. If, for example, he did not know of the scandal, then loss of his job could be penalty enough. If he did know, and took no action, then further personal loss could be argued. Other issues to consider would include: Did he benefit directly? How much?

Useful Articles, Links and Videos

What's Behind the Libor Scandal? – *Bloomberg Television* [July 3, 2012], accessed at http://www.bloomberg.com/video/what-s-behind-the-libor-scandal-HOu3xR9sStGNPparj5DT4w.html on September 23, 2014.

Sara Eisen on Bloomberg Television's explains the "London Interbank Offered Rate," or LIBOR.

Topic: New developments: LIBOR scandal

"Lloyds not off hook yet after $370 million Libor fines," Matt Scuffham and Huw Jones, *Reuters*, July 28, 2014, accessed at http://www.reuters.com/article/2014/07/28/us-lloyds-libor-idUSKBN0FX13H20140728 on July 31, 2014.

Lloyd's was not yet fined and so does not appear in the text's list of players fined over the LIBOR scandal (see Chapter 2, page 86). The article says that Lloyds' penalty is the seventh penalty "but … the first penalty for attempting to fix so-called "repo" rates to reduce fees for a taxpayer-backed scheme set up by the Bank of England to support British banks during the 2008 financial crisis." They report that Bank of England Governor Mark Carney wrote that "the attempted manipulation could lead to criminal action against those involved."

"This New Libor 'Scandal' Will Cause a Terrifying Financial Crisis," Jesse Colombo, *Forbes*, March 6, 2014, accessed at http://www.forbes.com/sites/jessecolombo/2014/06/03/this-new-libor-scandal-will-cause-a-terrifying-financial-crisis/ on July 31, 2014.

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Five-year-long low LIBOR rates, the author asserts, has helped to "fuel a massive economic bubble around the entire world that will end in a devastating financial crisis that will be even worse than the Global Financial Crisis" and cause trillions of dollars of losses—a thousand times worse than losses associated with the LIBOR-fixing scandal.

"First day of business for new LIBOR administrator: ICE Benchmark Administration Ltd take responsibility for administrating LIBOR," Her Majesty's Treasury and The Rt Hon Sajid Javid MP [Financial Secretary to the Treasurer], February 3, 2014, accessed at https://www.gov.uk/government/news/first-day-of-business-for-new-libor-administrator on July 31, 2014.

As part of the LIBOR reform, this government announcement outlines the transfer of the administration of the LIBOR to the NYSE Euronext Rate Administration Limited, the acquisition of the latter by the Intercontinental Exchange (ICE) Group, and the renaming of the organization to the ICE Benchmark Administration Limited.

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7. *General Motors Ignores Obvious Ignition Faults* (Chapter 2, pages 140-142)

What this case has to offer

The case explores how GM made millions of cars with faulty ignition switches that malfunctioned, killing some people and injuring others, even though the fault was known before production began. Was the fault really with the ignition switch or with a corporate culture focussed on cost, not safety, and where committees were "responsible," but no individuals were accountable?

Teaching suggestions

Most students do not understand what happens to power steering and power braking when a car's motor stops working, so I begin by clarifying what the faulty switch causes. This approach grabs student attention very powerfully, and paves the way for an animated discussion of how cheap the fix would have been, and how unethical the impact of the focus on cost control was compared to a focus on safety. This exposes the flaws on GM's corporate culture, and paves the way for a discussion of the questions posed.

This case provides the opportunity to discuss: the technical failures (the ignition switch, the loss of braking, power steering, etc.); individual culpability (who knew of the problem and did nothing to stop production); the problems in a corporation so large that no individuals were accountable, where failings ranged from a lack of a safety culture and reporting mechanisms to problems with engineering processes, policies and training, compliance, auditing, and oversight, and recordkeeping.

Discussion of ethical issues

1. Why didn't GM act effectively on suspicions that their ignition switches were faulty?

   GM personnel, who identified the problem, either did not understand the significance of it, or were not instructed to bring safety problems to their superiors for assessment and disposition. It appears that one engineer (DeGiorgio) had too much responsibility in the sign-off on the faulty ignition switch, and/or GM procedures/policies were inadequate or too loosely adhered to or enforced. Because DeGiorgio did not speak up, it appears that no one else was aware of the problem or the deviation from policy when DeGiorgio later altered the part but did not change the part number. Later on, DeGiorgio commented that the emphasis at GM was on cost. In contrast, in the Cadillac division, the fault was discovered before any faulty switches were deployed, and a corrected part was created.

2. Who was at fault for the deaths and injuries involved, and why?

   Fault cascades with this case, because it comes at many levels:

   - DeGiorgio, for failing to bring attention to the faulty switch, and for redesigning the switch (2006) but failing to change the part number (against policy).

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- Personnel aware of the problem for failing to act and take responsibility, particularly those aware of the switch failing to meet specifications, but still allowing it to go into production.

- Lack of individual and committee accountability. The Valukas report (Valukas 68) says that "…interviews [for the report] showed a troubling disavowal of responsibility made possible by a proliferation of committees." The report continues, "… [B]ecause a committee was "responsible," no single person bore responsibility or was individually accountable." (Valukas 68-69).

While people make mistakes, employees might argue that the corporation was also at fault for failing to have a robust system of quality control and for failing to have a corporate culture that identifies, learns from, and corrects problems. The Valukas Report's headings in its recommendations section include the following (Valukas, 2014, p. viii): organizational structure; cultural emphasis on safety; individual accountability; communication between and within groups; communication with NHSTA; role of lawyers; interactions with suppliers; data storage, retrieval and analysis; engineering processes and databases; product investigation process; policies and training; compliance, auditing, and oversight; recordkeeping.

3. Should a company be able to escape liability for harming individuals by declaring bankruptcy?

No. After bailouts of 2008-2009, public outcry was loud against GM's attempt to close the books on its liabilities. If we consider the 6-Question Approach or examine hypernorm values to assess whether escaping liability is ethical, we can stop at the issue of fairness. It is not fair that the company gets a fresh start when victims' lives will never be the same again.

4. Should any GM personnel go to jail over the ignition switch failures? If so, who?

Yes (see Question 2): those responsible, despite the fact that they were not accountable. Engineers are given a great deal of responsibility that must be taken seriously. In the U.S. and Canada, professional engineers, through legislation, are governed by state and provincial regulatory societies that licence, certify, and regulate engineers in order to protect the public. They are subject to professional code requirements to protect the public that may have been violated at GM. However, unlicensed engineers who are not subject to professional codes or regulatory authorities can work as employees for companies.

5. Would you trust GM enough to buy one of their cars in the future?

No. Given the problems exposed by the Valukas Report, the company would need to prove that it has a different and better, safety-oriented corporate culture. Because the company is so large and the majority of personnel are not likely to change, inertia is against positive, rapid improvement.

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6. Was Mary Barra paid enough for the job she was required to do?

   At an annual salary of "just" $1.6M, Mary Barra seemed underpaid compared to male CEOs, but when the stock awards of $13.7M are factored in, her salary was competitive with other "Big 3" auto CEOs (Brustein)

Useful Articles, Links and Videos

Brustein, Joshua. "Mary Barra's GM Pay Could Top $14 Million, Putting Her in the Big Three." 10 February 2014. *Bloomberg.* 19 October 2016. http://www.bloomberg.com/news/articles/2014-02-10/mary-barras-gm-pay-could-top-14-million-putting-her-in-the-big-three.

Colvin, Geoff. "How CEO Mary Barra is using the ignition-switch scandal to change GM's culture." 18 September 2015. *Fortune.* 19 October 2016. http://fortune.com/2015/09/18/mary-barra-gm-culture/ . [Includes imbedded videos, "GM pays $900 million to settle ignition claims.]

Valukas, Anton R. "Report to board of directors of General Motors Company regarding ignition switch recalls." 2014. 19 October 2016. http://www.npr.org/news/documents/2014/valukas-report-on-gm-redacted.pdf .

Wikipedia. "Regulation and licensure in engineering." 24 August 2016. *Wikipedia.* 19 I+October 2016. https://en.wikipedia.org/wiki/Regulation_and_licensure_in_engineering .

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8. *VW Cheats on Emissions Tests* (Chapter 2, pages 143-144)

What this case has to offer

This case describes the almost incredible gamble VW engineers took to cheat on vehicle emission tests by using built-in software to defeat the test equipment and win awards when, in fact, their "clean diesels" were emitting nearly forty times the allowable limits.

Teaching suggestions

It is useful to raise the student's interest by drawing their attention to the fact that VW had cheated on emissions tests twice before, and had been caught both times, and yet they tried it again. After discussing the defeat software functionality, I deal with the case questions.

1. Why would VW engineers think they could get away with a defeat device when the technique had been caught twice before?

   VW engineers thought they could get away with the deceit, because they weren't counting on anyone to challenge or compare the results of the Environmental Protection Agency (EPA) or California Air Resources Board (CARB) tests. But an independent, non-profit research group, called the International Council on Clean Transportation (ICCT), did just that. Only because its on-road test results did not jibe with the in-lab test results of CARB or even the less-stringent EPA results, the ICCT approached CARB and the EPA to point out the discrepancies—namely emissions 9 to 38 times the acceptable limits, and the EPA contacted VW. Ironically, the ICCT was trying to show that diesel cars were now running cleaner than gasoline vehicles. (Vincent 2015)

   "The cars were passing the California Air Resources Board (CARB) tests and the Environmental Protection Agency's (EPA's) less-stringent tests in the lab. But when "…the International Council on Clean Transportation (ICCT) … set out [in 2014] to prove diesel vehicles were now cleaner than other cars… their road tests in California…uncovered massive disparities from the Environmental Protection Agency's (EPA) lab tests, sparking the current scandal." (Vincent 2015) [Note: The ICTT commissioned researchers at West Virginia University to conduct the tests. (Lienert and Gardner 2015)]

2. If they thought they would be caught, why did they try the defeat device?

   It may be that the engineers reasoned that when the emission control devices were turned off, car performance would be improved in the form of more torque or better gas mileage. (Gates, et al. 2016) Better driving performance and fewer fill-ups would be strongly effective marketing tools—in addition to the bonus of supposedly low emissions--to increase the diesel VWs' consumer appeal and, therefore, the sale of more vehicles.

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But it is more likely, according to the *New York Times* exposé, that VW employees decided to cheat in about 2004 when they realized they could not meet CARB or EPA emission limits legally. (Gates, et al. 2016)

Notwithstanding the *New York Times'* comments, it is likely that VW engineers realized that the performance of their cars would be so eroded by the software setting necessary to meet the emissions limits, that their engineering prowess and the marketability of their cars would be damaged severely. The decision to use defeat software would have been seen to solve both problems.

3. Why didn't one of the several design engineers and test engineers and technicians involved blow the whistle to top management, or and/or the regulators?

   It is important to look at the reward system and corporate culture at VW: were engineers and others being rewarded for clean cars or for selling more cars? Once the decision to cheat had been made in about 2004, because the cars couldn't meet the EPA and CARB emission limits, was the company "in too deep"? That is, was the deception so large and damning, that executives thought it had to be hidden? Or was arrogance the impetus for the deception: a hacker's triumph of sorts? Or a denial that German cars were no longer the world's best? If rewards system did not reward honesty or continuous improvement (learning from mistakes), and if there were no mechanism—e.g., code of conduct, compliance officer, mechanism to whistleblow--and employees profited by the deception, there may have been no compelling reason to come forward. Also, once a decision to cheat was taken, in an unethical corporate culture, a significant stigma would attach to anyone who exposed the deceit.

4. VW has a governance system, where the Supervisory Board is different from North American Boards of Directors. a) How is it different from North American governance models?

   In North America, corporations are overseen by a Board of Directors elected by shareholders at least once per year. VW has two boards: a Management Board, and a Supervisory Board. The Supervisory Board seats are split evenly between representatives of the union and of shareholders, with the Chair being independent and voting when needed to break ties. The Supervisory Board should oversee the management board and each should be independent of each other; *however, the supervisory board lacks independence and authority* (Milne 2015), since half of supervisory board seats go to German workers, and the most others go to insiders related to or associated with major owners (Milne 2015), so they are not independent. Only 12% of VW stock is publicly held.

   Milne (2015) continues, saying: "In most German companies, the chairman would discuss sensitive matters with the shareholder side first, agreeing a common position before bringing it before the full board. At VW, particularly under former chairman Ferdinand Piëch, who was in charge from 2002 until [2015], things worked in reverse. 'Piëch would first talk to the works council and agree a position. Then he would bring it to the shareholder side,' says a former

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director…This created an atmosphere where sensitive matters were resolved far from the boardroom and without management oversight. 'The board was really just for show,' says a former senior VW executive. 'They lacked the ability to ask any deep technical questions — and you see that in the current scandal.'" (Milne 2015)

4b) The VW governance system does not appear to have had a whistleblower encouragement and reporting system. Could the differences in governance have contributed to the decision to cheat, and to keeping it a secret? If so, how?

Yes. Without independence and an established reporting and investigative mechanism, there is little incentive for non-board workers to whistleblow to try to sway non-independent boards. Even if whistleblowers came forward, Milne (2015) continues, saying, "'It is hard to exaggerate what kind of atmosphere this created,' says a former supervisory board member. 'It was very difficult to do anything that hurt workers…But beyond that it just killed the board as a place of proper discussion.'"

5. Describe how VW would have to change to institute a culture of integrity.

At a minimum, the Supervisory Board would require independence (and more outsiders) and technical, financial expertise and governance expertise to allow fulsome discussion of those topics.

6. How would VW ensure that their policy on environmental protection be upheld?

The compensation system could reward meeting or improving environmental protection policy targets. Responsibility for reaching those targets could be part of performance contracts so that someone is accountable and responsible for meeting them. In addition, internal auditors, and/or those involved in enterprise risk identification and assessment should be reviewing VW policies and for situations where policies were not being followed. Sanctions should be meted out for those who fail to meet important policies and put the enterprise at risk.

7. Should VW engineers, managers and the CEO be sent to jail? Why and why not?

Those shown responsible or taking part in the cover up should be held responsible. The defence would likely be that they were acting in the manner expected of them and so they saw no wrong in their actions.

8. Would you buy a VW? Why and why not?

Consumers who intended to purchase or did purchase VWs for better mileage than gas-fuelled cars might still decide to purchase VWs, reasoning that better gas mileage was worth some environmental points, even though the emission of nitrogen oxides was worse than reported. Some consumers, solely price-driven, may have purchased VWs particularly because of the sale prices seen after the scandal broke. Those consumers feeling duped by a manufacturer that

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claimed to be efficient and clean, as well as environmentally-conscientious consumers, would likely avoid VW.

Useful Articles, Links and Videos

Gates, Guilbert, Jack Ewing, Karl Russell, and Derek Watkins. "Explaining Volkswagen's Emissions Scandal." *New York Times.* Updated September 12, 2016. http://www.nytimes.com/interactive/2015/business/international/vw-diesel-emissions-scandal-explained.html?_r=0 (accessed October 20, 2016).

Lienert, Paul, and Timothy Gardner. "Volkswagen's 'clean diesel' strategy unraveled by outside emissions tests." *Reuters.* September 21, 2015. http://www.reuters.com/article/us-usa-volkswagen-emission-idUSKCN0RL2EI20150922 (accessed October 20, 2016).

Milne, Richard. "Volkswagen: System failure: VW's culture has been blamed for fostering dysfunction but the company's politics may hinder change." *Financial Times.* November 4, 2015. https://www.ft.com/content/47f233f0-816b-11e5-a01c-8650859a4767 (accessed October 21, 2016).

Vincent, Michael. "Volkswagen emissions scam: Man who uncovered VW fraud wants other carmakers under spotlight." *ABC [Australian Broadcasting Corporation] News.* September 22, 2015. http://www.abc.net.au/news/2015-09-23/man-who-uncovered-vw-emissions-scam-wants-wider-probe/6797082 (accessed October 20, 2016).

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