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Ethics Case Study for ABC Incorporated and Questions

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This case, involving ABC Incorporated, contains various ethical issues confronted by members in business and industry. It has been written in dialogue and begins on the morning of April 10, 2015 at the company's audit committee meeting. The company has recently restated their financial statements and has assigned a special investigation committee to address the matter. The following individuals participated in the transactions in question or are involved in the investigation of the matter.

- **Lewis – Chairman of the Audit Committee**
- **George- Chair of the Special Investigation Committee** George, 52, is a CPA and is the newly appointed Director of the Company's Internal Audit Department. Prior to joining the company, he spent 6 years as the Director of Internal Audit with a company in a different industry after retiring as a partner with regional public accounting firm.
- **Daniel (Former CEO)** Daniel, 46, was the Chief Executive Officer ("CEO") of the Company from 2005 until his departure in February 2015. He had been the CEO of a competitor for over 10 years. In addition, Daniel worked for 9 years in charge of the internal audit department of a major retail chain. Daniel has a BBA in Accounting and an MBA in Finance.
- **Jan (CFO)** Jan, 39, joined the Company in 2000 and has held various financial accounting positions. In 2013 she was promoted to the position of Chief Financial Officer. Her previous professional experience includes two years as an accounting manager in a major public firm, and 9 years in public accounting, achieving the level of manager before leaving. In 1997 she obtained her CPA license. She has an undergraduate degree in accounting and is a member of the American Institute of Certified Public Accountants.
- **Gary (Controller)** Gary, 41, began his career with the company back in 2001. He has held various positions with the Company and is currently in the position of Controller. Prior to joining, Gary spent 4 years in public accounting providing tax and accounting services. He attended ABC College and received a BA in accounting. In 1995 he became a CPA and a member of the American Institute of Certified Public Accountants.
- **John (Accounting Manager)** John, 32, is the ABC's accounting manager. He only recently joined the company in 2012. Prior to joining the Company, he was with one of the company's largest competitors. John is a CPA with 7 years' experience in public accounting. He received an undergraduate degree in accounting and is a member of the American Institute of Certified Public Accountants.
- **Melanie (Senior Accountant)** Melanie, 26, was recently promoted to the position of senior accountant. She has been with the Company for 2 years. Previously she was with our accounting firm and worked on the team providing audit services to our Company. Melanie has recently received her CPA certificate and has joined the American Institute of Certified Public Accountants.

The chairman of the special investigation committee George has begun to address the audit committee:

THE MORNING OF APRIL 10, 2015

"Good morning. I would like to thank you for inviting me to speak at the Audit Committee meeting today. As some of you already know, my name is George and I am Chairman of the Special Investigation Committee assigned to assist ABC Incorporated with its internal investigation surrounding the recent restatement of the company's financial statements. In addition, the Securities and Exchange

Commission has begun their investigation and my Committee will be acting as a liaison. In light of these events, I have notified some of the accounting and financial personnel that were associated with the transactions in question that I would like to meet with them over the course of the next week. In the packages before you, I have included a short biography on each employee so that you may gain an understanding of each individual's professional experience. I will report my findings to the Committee after the meetings have concluded. Thank you."

THE AFTERNOON OF APRIL 18, 2015

In the late afternoon George and Lewis, Chairman of the Audit Committee, began talking.

"George, it has been eight days since you first spoke to the Audit Committee and tomorrow your Special Investigation Committee is scheduled to report back to them regarding the recent employee inquiries. Are there any important findings that I should know about before the meeting?"

"Well Lewis, why don't I just walk you through my last week of inquiries?"

"I began with the staff and worked my way up the organizational chart. My first conversation was held with Melanie. She was previously part of our audit engagement team. We courted her away from our auditors two years ago. We made a promise to her that the Company would pay for her masters' degree. Melanie was just promoted to a senior accountant position and works in accounts receivable. She reports directly to John, the accounting manager. I began my inquiry with Melanie by asking just one question."

"Melanie, if you thought the journal entry was false, why did you agree to record it?"

Melanie responded that "John gave me the journal entry. He told me to record a sale to our major customer. It was for two million dollars. I asked why we weren't recording this sale through the sales journal, and where the documents supporting the transactions were located. He said that, based upon his conversation with Gary, the Controller, documentation would arrive within the next several days. Company sales have really been down this year and recording such a material transaction with our major customer would have a significant impact on revenue. Well as you already know, we never received any support for the transaction. I knew the auditors would question the sale as I used to audit this Company. They asked the same questions I would have asked and wanted us to provide them with the original supporting documentation and inquired about our ability to override the internal controls. George, what was I suppose to do? Not record the transaction? John told me to record it, and he's the Accounting Manager."

I asked Melanie, "If you were uncomfortable talking to John, why didn't you speak to Gary, Jan or to the external auditors?"

Melanie explained to me that she didn't voice her concerns to anyone because she was afraid of losing her job and that she didn't want to approach John's superior and cause any additional waves since John just gave her a promotion. She also explained that the auditors were asking a lot of questions, but when they approached her, she told them that they needed to speak to her boss, John.

"Lewis, after my conversation with Melanie, I called John in to speak with him. I wanted to know why he would direct Melanie to record the sales transaction."

"John, as you are aware, we have restated the Company's most recent financial statements. The Securities and Exchange Commission is currently investigating all items associated with the restatement, the existence of specific sales transactions and challenging our revenue recognition policies. One transaction under investigation is the recording of a material sale made to our major customer. The Company is now aware that it was a fictitious transaction and that you had requested your staff, Melanie, to record it."

"George, that sale to our major customer was recorded based upon my conversation with my superior Gary. It all occurred on December 27th, the day I came back from vacation. Gary told me that he had received a call from Daniel, now our former CEO and that Daniel had just gotten off the telephone with Susan. She is the head of the Purchasing Department at our major customer. Gary said that Daniel told him that Susan's company was in desperate need of our products. They wanted to know if we could accept a verbal request for a two million dollar purchase and indicated that formal written documentation would be provided within a few days. Additionally, the customer asked Daniel to hold the products being purchased in our warehouse until they were ready to receive shipment. Daniel said that he and Susan had known each other for quite some time, and that he could accept her word. Daniel said that he would authorize the verbal transaction. Gary also said that Daniel appeared worried because the Company had been receiving a lot of pressure from Wall Street to hit the projected numbers. Daniel thought that if we waited to receive the required documentation from our major customer the sale might not be recorded until after year-end. If that happened, Company earnings would be down, stock prices would be adversely impacted, and bonuses would be substantially less because they are calculated as a percentage of net income. George, I have been with ABC for less than a year and I didn't want to question the authority of any of my superiors, so I directed one of my staff, Melanie, to make the entry."

"John, I know you are new to the Company, but when you finally realized that the transaction was false, why didn't you correct it? You have the authority to correct entries in the system. The sale was so materially false and misleading to the Company's books and records."

"George, I am not in the decision-making role for which I thought I was hired. When I finally discovered that the transaction was false, I knew that if I corrected the entry, my correction would have been reversed."

"Lewis, at this point I called the controller, Gary, in to be interviewed."

"Gary, we were just discussing that material year-end sale to our major customer. As you are already aware, it was false and subsequently reversed along with other transactions."

"Why did you direct John's department to record the false transaction?"

"George, initially, I was not sure if the transaction was false, but I did request that John's department record it. The transaction had never been properly recorded through our system, and we were told to override the internal controls. Subsequently we never received the promised supporting documentation and I became concerned. I voiced my concern to the CFO, Jan. Jan said that she had been apprised of the major customer transaction, but that she did not need to hear the details. “We need to meet our market expectations,” she said. In any event, false or not, I knew this was exactly what upper management wanted and I didn't want to have to deal with the ramifications if earnings were not met. Having a negative impact on bonuses could cost me my job. You cannot imagine the type of pressure that has been placed on our department."

"Thank you both for speaking so candidly with me. There have also been inquiries from the SEC regarding our revenue recognition policies on certain contracts, including a Telecommunications contract. Do either of you have any direct knowledge or participation in the recording of revenue involving the Telecommunications contract?"

"No, George. I recall Daniel, our former CEO, negotiating the terms in the contract. John and I had heard from Jan that he was taking a very active role in the contract negotiations because the deal was unusually large."

"Well, Daniel is no longer with the company, so perhaps I should make my additional inquiries with Jan. Again I would like to thank both of you for providing valuable insight into the various transactions in question. I may be contacting you if additional clarification is needed. On your way out, could you please ask Jan to join me?"

"Hello Jan. I would like to discuss some of the transactions that have been restated in the company's financial statements, in addition to the SEC investigation. Let us focus on two specific transactions, the year-end major customer sale and the Telecommunications contract. I believe your testimony to the SEC indicated that you are familiar with both."

"Yes George, I am."

"Jan, based upon my reading of the Telecommunications contract, it appeared that ABC was to provide a series of services to them over the course of the next 5 years. Let me simply start out with the question of who exactly made the determination to recognize revenue immediately when this contract clearly contained various multi-element arrangements with varying deliverables?"

"George, the decision to recognize revenue up front was made by Daniel. He said that he specifically reviewed the contract and that all criteria for revenue recognition had been met. Daniel has always been very technical, but I decided to do some research on my own. Based upon my review of the applicable accounting literature, the contract did contain arrangements with multiple components that should have been evaluated separately for revenue recognition purposes. My final assessment was that the recognition of revenue was being accelerated. Daniel is the CEO and it was his call. I did not feel the need to address it any further."

"Jan, please tell me about the year-end major customer sale. Your deposition stated that you knew it was false. Why didn't you correct the transaction?"

"How could I? Daniel authorized the transaction and he was the CEO and my boss. I thought I would approach him after the year-end audit was over and request that we reverse the transaction in the current year."

"Jan, why did you sign the representation letter dated February 25, 2015 to our auditors? You knew the financial statements were materially misstated because of these two transactions. Additionally, you must have also realized that you had misled them into believing that we were in compliance with our loan covenants?"

"George, we were in compliance. I gave the auditors our loan covenant calculations. It was exactly what they asked for and I believe that it was their job to test the validity of the numbers."

"Please Jan. We were only in compliance because of the materially false major customer sale and the premature recognition of revenue for the Telecommunications contract. The company only appeared to be in compliance. If the transactions were reversed, and they subsequently were, we were not in compliance."

"George, I would like to ask a question?"

"Certainly Jan."

"Doesn't the former CEO, Daniel, have any professional responsibility in this? He told me to sign the representation letter and he had direct knowledge of the false material transactions as well as the non-compliance with loan covenants."

"Yes, he does have professional responsibility in this matter, as do you. He directed you to sign a document with knowledge of the false material transactions. He never brought these items to the attention of the audit committee, but then again, neither did anyone in the department. In addition, ABC is a public company. We have regulatory requirements with the SEC. They were never contacted."

"George, I know I have a professional responsibility in all of this. Right now, I believe there really isn't anything else I can add."

"*and with that, Lewis, Jan left...and in quite a hurry I might add. I think tomorrow's meeting is going to be a long one.*"

THE MORNING OF APRIL 19, 2015 – AUDIT COMMITTEE MEETING

On the morning of April 19th after receiving a verbal report from George concerning his discussions with staff, the Audit Committee went into executive session to discuss the findings. Following this discussion, Lewis prepared a list of 16 points in the form of questions and answers that he disseminated to the Audit Committee for their review and approval.

The Audit Committee unanimously approved Lewis' summary and scheduled a separate meeting to deliberate the disciplinary measures they would take against each of the staff. The following is the summary that Lewis prepared:

1. **Were George, Jan, Gary, John and Melanie providing professional services to ABC Incorporated?**

   Yes. George used the CPA designation on his business cards and letterhead. Melanie, John, Jan and Gary had previously informed George that they were CPAs. Any oral or written representation to another individual regarding their status as a CPA is considered an action of informing others of the designation. For purposes of the *AICPA Code of Professional Conduct*, Melanie, John, Jan and Gary represented themselves as CPAs and thus are considered to be performing professional services.

2. **Would Melanie be in violation of the Code for knowingly posting a materially false journal entry even though she was directed by her superior to record the entry?**

   Yes. Melanie should not have recorded the entry, but since she knowingly recorded a materially false entry to the books and records of ABC Incorporated and subordinated her judgment to her superior in possible violation of the

   - Integrity and Objectivity Rule (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by
     - paragraph .01a of the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010)
     - the "Obligation of a Member to His or Her Employer's External Accountant" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.030)
     - the "Subordination of Judgment" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.020).
   - General Standards Rule (AICPA, *Professional Standards*, ET sec. 2.300.001) items b and d)
   - Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001)
   - Acts Discreditable Rule (AICPA, *Professional Standards*, ET sec. 2.400.001) as supported by the "Negligence in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.040)

3. **What steps should Melanie have taken when she disagreed with her supervisor, John, concerning the posting of the false journal entry to the financial statements?**

Melanie should not have posted the entry and should not have subordinated her judgment. Instead, should have considered the impact the entry would have on the financial records and whether the financial statements and records could be materially misstated by posting the entry. If she determined that there could be a material misstatement, she should have then brought her concerns to her superior and if not resolved to the appropriate higher level(s) of management (for example, the controller, CFO, and/or audit committee). Any discussions should have been documented and summarized with her understanding of the facts, the accounting principles involved, the application of those accounting principles, and the parties with whom those matters were discussed. If after discussing her concerns with management, she concluded that appropriate action was not taken, Melanie should have considered what safeguards could be implemented so that she didn't subordinate her judgment. If Melanie concluded that no safeguards could eliminate or reduce the threats to an acceptable level or concluded that appropriate action was not taken, she should have considered discontinuing her relationship with the Company and should have evaluated her responsibility to inform the external auditors and the regulatory agencies by consulting her legal counsel.

[Citations: Integrity and Objectivity Rule (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by the "Subordination of Judgment" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.020), 'Obligation of a Member to His or Her Employer's External Accountant" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.030), and paragraph .01a of the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010). General Standards Rule (AICPA, *Professional Standards*, ET sec. 2.300.001) item b. Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001). Acts Discreditable Rule (AICPA, *Professional Standards*, ET sec. 2.400.001) as supported by the "Negligence in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.040)]

4. Would Daniel be in violation of the Code since he only *directed* or *permitted* his staff to record an entry that he knew was materially false?

If Daniel was a CPA and a member of the AICPA and/or a participating state society, Daniel would be subject to the provisions of the Code and may be in violation of Integrity and Objectivity, Accounting Principles and Acts Discreditable rules even though he just directed and permitted his staff to record a materially false and misleading entry in the company's records.

[Citations: Integrity and Objectivity Rule (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by the "Subordination of Judgment" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.020), and paragraph .01a of the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010). Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001) as supported by the "Responsibility for Affirming That Financial Statements Are in Conformity With the Applicable Financial Reporting Framework" interpretation (AICPA, Professional Standards, ET sec. 2.320.010). Acts Discreditable Rule (AICPA, *Professional Standards*, ET sec. 2.400.001) as supported by items a and b of the "Negligence in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.040)]

5. Were Gary and John in violation of the Code since they had authority to correct a materially false entry and keep the financial statements and records from being misleading?

Yes. Gary and John had a professional responsibility to correct materially false and misleading entries. They knowingly decided to not correct the entry while possessing the authority to do so. Both are in possible violation of the *Code of Professional Conduct*. In addition to their responsibility to reverse the transaction, they also have a professional responsibility as employees to prepare financial statements in conformity with GAAP and to consider informing the audit committee, regulatory agencies, and their employer's external accountants. Under different circumstances, if upper management did not have direct involvement in the false transactions, they should have also been informed. In addition, the Rules also prohibit a member from permitting their staff to record a materially false and misleading entry in the company's records.

[Integrity and Objectivity Rule (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by the "Subordination of Judgment" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.020), and paragraph .01b of the "Knowing

Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010). Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001) as supported by the "Responsibility for Affirming That Financial Statements Are in Conformity With the Applicable Financial Reporting Framework" interpretation (AICPA, Professional Standards, ET sec. 2.320.010). Acts Discreditable Rule (AICPA, *Professional Standards*, ET sec. 2.400.001) as supported by item c of the "Negligence in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.040).]

6. Would Jan be in violation of the Code since she signed a document that contains materially false or misleading information?

Yes. Jan knowingly signed a document that misrepresented facts to the auditors of the company. Under the *Code of Professional Conduct*, a member must be candid and is prohibited from knowingly misrepresenting or failing to disclose material facts to the company's auditors. In addition, she also has a responsibility, as an employee, to prepare financial statements in conformity with GAAP and to consider informing the audit committee, the company's external accountants, and regulatory agencies.

[Citations: Integrity and Objectivity Rule (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by the "Subordination of Judgment" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.020), "Obligation of a Member to His or Her Employer's External Accountant" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.030), and paragraph .01c of the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010). Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001). Acts Discreditable Rule (AICPA, *Professional Standards*, ET sec. 2.400.001) as supported by item c of the "Negligence in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.040).]

7. Is Daniel in violation of the Code since he did not sign the document containing materially false and misleading information?

Daniel, the former CEO, permitted his employee, Jan, to sign a representation letter that did not disclose the false material transactions of which he had direct knowledge. Daniel has a fiduciary responsibility to the company and may be in violation of federal and state laws. If Daniel were a CPA and member of the AICPA, he would be in violation of the Code. Under the *Code of Professional Conduct,* Daniel is prohibited from permitting or directing another to sign such a document. In addition, Daniel has an obligation to the company's external auditors and should consider informing the audit committee, and regulatory agencies regarding the disclosure of known material facts.

[Citations: Integrity and Objectivity Rule (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by "Obligation of a Member to His or Her Employer's External Accountant" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.030), and paragraph .01c of the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010). Acts Discreditable Rule (AICPA, *Professional Standards*, ET sec. 2.400.001) as supported by the "Negligence in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.040)]

8. Did Melanie, John, Gary and Jan have a professional obligation to disclose misrepresented facts to the company's external auditors?

Yes. All of the staff, as CPAs and members of the AICPA, have a responsibility under "Obligation of a Member to His or Her Employer's External Accountant" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.030) to be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts to the company's external accountants. Additionally, Jan knowingly signed a document that represented to the Company's external auditors that the Company's financial statements were free of material misstatements though material errors existed. Under the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010) and item c of the "Negligence in the Preparation of Financial Statements or Records" interpretation, a member is prohibited from signing such a false and misleading document.

9. **Were Gary and John required to exercise due professional care and to obtain sufficient relevant data as support for the basis of their conclusions and recommendations when recording the entries of the Company?**

   Yes. The General Standards Rule (AICPA, *Professional Standards*, ET sec. 2.300.001) requires members of the AICPA to exercise due professional care in the performance of professional services and to obtain sufficient relevant data to support the recording of transactions. Gary and John were required to obtain written documentation and were not following company procedure or the internal control policies of the Company. They should have exercised due professional care and only directed the transactions to be recorded only when the proper documentation was obtained.]

10. **Is Jan in violation of the Code if she states that the financial statements and other financial data of the company are presented in conformity with generally accepted accounting principles ("GAAP") when she knows there is a material departure from GAAP on the statements and data taken as a whole?**

    Yes. By signing the auditor's representation letter, Jan falsely represented that she was not aware of any material modifications that should be made to the financial statements. Because she has knowledge that the financial statements and data were materially misstated, as a member under the Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001), Jan cannot:

    - express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles, or
    - state that she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

11. **Could Jan have used her professional judgment to depart from GAAP?**

    Though the financial statements contained a departure from GAAP, if Jan could have demonstrated that, due to unusual circumstances the financial statements or data would otherwise have been misleading, and then Jan may have been able to justify the departure from GAAP. Otherwise, she may be in violation of the Accounting Principles Rule (AICPA, *Professional Standards*, ET sec. 2.320.001).

12. **What responsibilities under the Code did Jan and Daniel have with respect to requirements of governmental bodies, commissions or other regulatory agencies?**

    Members are required to follow the requirements of governmental bodies, commissions and regulatory agencies. As Jan is a CPA and a member of the AICPA, the Code required her to comply with SEC regulations under the "Governmental Bodies, Commissions, or Other Regulatory Agencies" interpretation (AICPA, Professional Standards, ET sec. 2.400.050). Daniel would similarly been subject to the Code if he were a CPA and a member. The financial statements contained false material transactions for which Jan was aware. If a material event or change has occurred and has not been previously reported to the SEC, it is required that a current report be filed.

ABC Incorporated - Organizational Chart

ABC Incorporated

Below is the organization chart for ABC Incorporated. Code violations by an employee are listed under their name.