CENGAGE

BUSINESS AND PROFESSIONAL ETHICS

FOR DIRECTORS, EXECUTIVES & ACCOUNTANTS 9E

LEN BROOKS
PAUL DUNN

Business and Professional ETHICS

FOR DIRECTORS, EXECUTIVES & ACCOUNTANTS 9E

LEONARD J. BROOKS
Professor of Business Ethics & Accounting
Executive Director, Clarkson Centre for Business Ethics
Joseph L. Rotman School of Management
University of Toronto

PAUL DUNN
Professor of Business Ethics
Goodman School of Business
Brock University

Australia • Brazil • Mexico • Singapore • United Kingdom • United States

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***Business and Professional Ethics for Directors, Executives & Accountants,* 9th edition**

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Art Director: Chris Doughman

Cover Images:
ra2 studio – stock.adobe.com
iStockPhoto.com/AndreyPopov

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Library of Congress Control Number: 2019954967

Student Edition ISBN: 978-0-357-44188-6

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Printed in the United States of America
Print Number: 01 Print Year: 2020

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DEDICATION

Business and Professional Ethics for Directors, Executives & Accountants *is focused on deepening the understanding of how best to incorporate ethical values into governance, strategies, and actions to the benefit of us all.*

Our preparation of the Ninth Edition has been enriched by the contributions of many, but none more than our wives and families who have supported and encouraged us and to whom we dedicate this work. It is with great pride, thankfulness, and love that we acknowledge Jean and Kathy and our growing families.

Leonard J. Brooks, FCPA, FCA

Paul Dunn, CPA, CA

Toronto, Canada
December 2019

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ABOUT THE AUTHORS

Leonard J. Brooks is Professor of Business Ethics & Accounting at the Rotman School of Management of the University of Toronto. He is the Executive Director of the Rotman School's Clarkson Centre for Business Ethics, Director of the University's Professional Accounting Centre, and Director of its Master of Forensic Accounting Program (formerly the Diploma in Investigative & Forensic Accounting Program) at the University's Institute for Management & Innovation.

Professor Brooks served for fourteen years on the Editorial Board of the *Journal of Business Ethics* and continues to serve as a reviewer for that as well as other journals. He has published articles on ethics issues in the *Journal of Business Ethics*, *Accounting Organizations and Society*, and *Business & Society* and has authored or coauthored/edited the research monograph *Canadian Corporate Social Performance* and books or publications entitled *Business & Professional Ethics for Accountants*, *2e*; *Principles of Stakeholder Management: The Clarkson Principles*; and *Ethics & Governance: Developing and Maintaining an Ethical Corporate Culture*, *4e.*

Before joining the University of Toronto, Professor Brooks obtained his Chartered Accountant (C.A.) designation in Canada and subsequently became an audit manager and Director of Manpower for Touche Ross & Co. (now Deloitte LLP) in Toronto. He has served as a member, then Chairman, of the CAs' national Board of Examiners, and Chairman of their national Syllabus Committee. Professor Brooks became a Fellow of the Institute of Chartered Accountants of Ontario in 1982. He became a Chartered Professional Accountant (CPA) and a Fellow of the Chartered Professional Accountants (FCPA) of Ontario in 2012.

Paul Dunn is a Professor of Business Ethics at the Goodman School of Business, Brock University. Dr. Dunn has a doctorate in accounting from Boston University as well as two degrees in philosophy from the University of Toronto. He is a CPA who worked in downtown Toronto with Ernst & Young (as a chartered accountant), the Canadian Imperial Bank of Commerce (in the finance division), as well as in the private sector (in controllership).

Professor Dunn's research focuses on ethics, corporate governance, and corporate social responsibility. His research has appeared in a variety of scholarly journals, including the *Journal of Business Ethics*, the *Journal of Management*, *Business & Society*, and *Business Ethics Quarterly*. He is an Associate Editor for *Business and Society Review* and sits on the editorial boards of the *Journal of Business Ethics*, *Business & Society*, as well as the *Journal of Management and Governance*. The media in both Canada and internationally interview Paul Dunn regularly.

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5, 6	International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants, November 2001
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- The Liability Crisis in the United States: Impact on the Accounting Profession—A Statement of Position
- Trends in the Legal Liability of Accountants and Auditors and Legal Defenses Available

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- Enron's Questionable Transactions: Detailed Case
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- Bausch & Lomb's Hazardous Contact Lens Cleaner
- Chris Neary's Overcommitment to His Business
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- Maple Leaf Gardens Shenanigans
- Philip Services Corp . . . Into the Dumper
- Ritchies Auctioneers and the Ethics of Auctions
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DIGITAL RESOURCES FROM EARLIER EDITIONS

The Credibility Crisis—Enron, WorldCom, & SOX Chapter 9, 6th edition

- Chapter 9 text
- Key reports and letters:
    - The Powers Report by a specially formed subcommittee of Enron's Board, February 1, 2002 (Powers)
    - The Role of the Board of Directors in Enron's Collapse by the U.S. Senate's Permanent Subcommittee on Investigations—July 8, 2002 (Senate)

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  - The Accounting Treatment of Prepays by Robert Roach, Counsel and Chief Investigator, U.S. Senate's Permanent Subcommittee on Investigations—July 27, 2002 (Roach)
  - Sherron Watkins letter, sent on August 15, 2001, and her Senate Subcommittee testimony of February 14, 2002
- Sarbanes-Oxley Act of 2002
- Governance Reports and guidance
- SEC Reports, Press Releases, and Complaints, regarding Enron, Arthur Andersen, WorldCom, and Sunbeam Corporation

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PREFACE

CHALLENGES & OPPORTUNITIES

Expectations for appropriate business and professional accounting behavior have changed dramatically. Corporations now face *an era of heightened accountability* beyond shareholders to stakeholders who are intently *interested in how corporations achieve their objectives, not just what they achieve.* It is now recognized that corporate accountability has shifted from *accountability only to shareholders* to *accountability to stakeholders including shareholders*. The challenge is to make a profit ethically while respecting the interests of others including the environment, human rights, and contributing positively to society. Opportunities abound for those who face these challenges successfully. More is also expected of professional accountants, who are expected more than ever to serve society's best interests in increasingly complex and challenging business environments.

The era of heightened accountability has been forced by stakeholders who have recognized that errant corporate directors and managers and professional accountants have failed the public interests with catastrophic and lasting impacts. There is a broad understanding that *the last three major negative impacts on the world economy were ethical failures*, including the following:

- The *crisis of confidence in corporate governance and credibility in reporting* caused by the 2002 failures of Enron, Arthur Andersen, and WorldCom, leading to the crash of the stock market and the introduction of the *Sarbanes-Oxley Act of 2002* (SOX)
- *The Subprime Lending Crisis of 2007–2009* , where greed and unethical behavior led to a crash of the U.S. housing market and the collapse of investment values around the world and the enactment of the U.S. *Dodd-Frank Wall Street Reform and Consumer Protection Act* in 2010.
- The *LIBOR rate manipulation scandal* of 2012 in which the underpinning basis for interest rates was knowingly manipulated for the benefit of a few banks and their traders

In addition, there have been *many other ethical failures,* such as the Madoff Ponzi scheme; damage to the environment and to vulnerable members of society that have caused serious damage to the reputations of individuals, organizations, or professionals; and an understanding that higher expectations were warranted and that lower levels of performance were to be penalized. Farsighted businesspeople and professional accountants took note and began to systematically search for ethics risks and manage to prevent those risks from damaging their reputations and their ability to reach their objectives.

This book presents an examination of how businesspeople and professional accountants can prepare themselves, their colleagues, and their organizations to identify important ethics challenges and opportunities and meet the heightened performance expectations they face. To succeed in the future, businesspeople and professional accountants will need to understand the key historical developments that have given rise to these heightened expectations and the techniques that are available and developing to shape future performance. There is now absolutely no excuse for a company to make ethical errors similar to those made by Wells Fargo (unethical incentives), VW (cheating on emissions tests), or Fox News (ignoring sexual abuse).

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The demise of Enron, Arthur Andersen, and WorldCom triggered SOX. The subprime lending scandal in 2007 led to the worldwide recession that has so significantly negatively affected economies, jobs, and the lives of us all. *These events were ethical failures that could have been prevented*. Unchecked until too late, they subsequently galvanized reforms in the accountability and governance of both corporations and professional accounting that have influenced business and professional ethics around the world. Undoubtedly, they will continue to bring new challenges and opportunities for directors, executives, managers, and professional accountants.

The reforms in accountability and governance frameworks have recognized that corporations and professional accountants have become increasingly more broadly accountable than previously understood. The *crisis of corporate governance and reporting credibility* that Enron began, Arthur Andersen fostered, WorldCom capped, and SOX sought to remedy heightened the awareness that corporations and the accounting profession must have the support of many stakeholder groups to achieve their strategic objectives. Following very quickly, the subprime lending fiasco from 2007 to 2009 further exacerbated the *crisis of confidence* by sensitizing the public and adding to ethical awareness and generating higher expectations for ethical behavior in order to sustain stakeholder support.

That support requires trust. Trust is based on the expectation that the corporation—really its board, executives, employees, and agents—and professional accountant will do the right thing and that their actions will respect the interests of the stakeholder groups. Earning and maintaining that trust requires changing the strategy, risk management, planning, operations, and decision making of the corporation to take account of the interests and expectations of stakeholder groups in addition to shareholders. A new accountability framework is required that focuses on indicators of performance related to stakeholder expectations for both internal and external reporting.

Governance must focus on this new, broader accountability framework in order to ensure that stakeholder trust objectives are met. Such a change will not happen by itself, and directors are in danger of not fulfilling their expectations to shareholders for risk management and due diligence if they ignore this duty. Some directors have understood the value of an excellent reputation and have been including risks to reputation in their risk management programs. Now that the linkage among ethics, reputation, and trust is clear and better understood, it is vital for corporations to upgrade their accountability and governance frameworks to ensure continued support. Shareholders and other stakeholders have come to expect more than they did pre-SOX—and the bar continues to rise.

Professional accountants can and should provide a critical facilitating element in the trust-oriented accountability and governance system. First, professional accountants can be important agents for ensuring trust. They are expected to serve in the public interest and must do so to preserve the trust placed in them by a society that expects them to behave as professionals. This expectation, which applies to professional accountants in public practice as well as those employed by corporations, requires a rededication to their role as a trusted fiduciary. Second, professional accountants are well placed to understand the role of trust in internal control and accountability frameworks and in the governance frameworks that provide direction and oversight to corporate activities. Third, good professional accountants are expected to display a level of professional skepticism and duty that should enable them to recognize the red flags of potential problems and report or remediate them.

Perhaps most important, these new governance and ethics expectations have reached the academic launching pads for new directors, executives, and professional accountants. The interest in newly created directors' governance education programs is startling. In 2004, the accreditation body for business schools worldwide published an Ethics Education Task Force Report that called for business students to be educated about (1) the

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responsibility of business in society, (2) ethical leadership, (3) ethical decision making, and (4) corporate governance and ethics.[1] Moreover, many jurisdictions are requiring compulsory ethics courses for accounting students before they are considered ready to write their qualifying exams for professional accounting designation. Accordingly, ethics and governance coverage is penetrating the curricula of far more business schools than in the past—which bodes well for the future.

Professional accounting bodies, stung by recent scandals, have also embraced this new era of ethical accountability by introducing a new international code of ethics that includes NOCLAR standards[2] that, when adopted worldwide, will fundamentally change the role of professional accountants. These new standards will require a professional accountant who discovers or suspects that his or her employer or client is not complying with laws or regulations to report this internally and then externally if no or insufficient action is taken. Because silence is not an option, there will be less chance of ethics problems staying secret. Consequently, it behooves companies to look for ethics risks systematically during their risk management programs. The new code of ethics also stresses that the primary purpose of professional accountants is to serve the public interest, and as a result, many professional accounting bodies have initiated compulsory ethics-related, professional development requirements for their graduates.

Understanding these trust expectations and the interrelationship to ethics and governance will resolve challenges and present opportunities for directors, executives, and professional accountants. It will facilitate the assessment of ethics risks, the protection of reputation, and the development of management safeguards such as a strong culture of integrity. More important, it will provide the essential foundation for ensuring the support of stakeholders for corporations and firms in the future.

PURPOSE OF THE BOOK

Business & Professional Ethics for Directors, Executives & Accountants provides a comprehensive background for understanding the crisis of credibility that business and the accounting profession now face and what can be done to restore the trust necessary for them to reach their strategic goals successfully.

Business and the accounting profession are now in an era of risk management because numerous scandals have undermined the credibility and reputation of corporations, firms, directors, executives, and accountants. Businesses and professionals cannot reach their strategic goals optimally in the medium and longer terms unless the ethics risks causing these scandals are recognized, avoided, mitigated, and monitored continuously. Governance systems must include ethical guidance, and decision making must consider the value systems that stakeholder groups respect; otherwise, stakeholders will not provide essential support because the corporate culture is unlikely to be a culture of integrity. Without a corporate culture of integrity, corporate directors and auditors cannot do their jobs effectively. Understanding how past scandals have led to the current era of governance and ethics risk management is essential so that past disasters can be avoided.

[1] The Association to Advance Collegiate Schools of Business, *AACSB Ethics Education Task Force Report*, June 2004, available at https://www.aacsb.edu/~/media/AACSB/Publications/research-reports/ethics-education.ashx

[2] The NOCLAR standards that are included in the 2018 *IESBA International Code of Ethics for Professional Accountants* are discussed in Chapter 6. Over 170 professional accounting bodies worldwide, including the AICPA, CPA Canada, and ICAEW, are members of the International Federation of Accountants (IFAC) and have pledged to harmonize their local codes to the IESBA Code in the near future.

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Students, executives, and board members must learn how to use ethical strategies, make ethical decisions, and integrate the latest information on ethics, governance scandals, legal liability, and professional accounting and auditing issues. They must understand why developing an ethical corporate culture is essential to maintaining stakeholder support and for auditors to audit financial statements. To keep learning interesting and to underscore the importance of ethical issues, this edition provides more than 140 cases, including classic frauds, bankruptcies, loss of reputation, and unprofessional practices, that provide excellent opportunities for developing an understanding of soft skills, including communications, persuasion, presentation, leadership, and a global mindset.

The crisis of corporate reporting credibility became so severe in mid-2002 that drastic measures were required to restore that credibility and relieve the gridlock that froze capital markets and dampened economies around the world. In fact, the financial disasters in 2002 accelerated and crystallized the impact of pressures for enhanced corporate accountability and a supportive governance framework that had been growing for years. As governance reform based on sound ethics takes hold around the world, there is an increasing need to understand the historical precursors involved, the responsibilities expected, and the techniques available for the satisfaction of those expectations.

Telling the story of ongoing pressures for more trusted governance and of the contributions of key financial scandals is important to the development of an appropriate understanding of the post-SOX world for directors, executives, and accountants, and of the heightened ethical expectations arising from the subprime lending crisis. Ethical failures have cost us all dearly. In response, governance has recently incorporated the need for a risk management process—a process that must now be broadened to involve awareness of factors that can erode the support of stakeholder groups.

The reputation of corporations is recognized as being connected with the degree to which stakeholders trust that corporations will do the right thing. In other words, there is now *a concern for both what a corporation does and how it is done*. At certain times in the past, the emphasis was so strongly on achieving profit that little attention was given to how the profit was earned. Now that the support of stakeholders is recognized as critical to success, an important second objective of the book is to provide an understanding how to create a corporate *culture of integrity*—one that builds stakeholders' ethical expectations into corporate behavior, accountability, and governance. Extending this discussion to the new era for professional accountants and reviewing their potential roles is a third objective.

Directors, executives, and accountants need to understand how to make ethical decisions they can defend to stakeholders. Codes of conduct cannot cover all situations, so organizational cultures need to be developed and decision processes utilized that are based on sound ethical decision-making frameworks. *Business and Professional Ethics for Directors, Executives & Accountants* covers these topics as well as the development of an *ethics risk management process*, strategies for dealing with and reporting to stakeholders, and strategies for ensuring ethical behavior in the workplace and during the management of crises.

In a nutshell, *Business and Professional Ethics for Directors, Executives & Accountants* examines the background and nature of the heightened stakeholder-accountability era of corporate and professional accountability and governance, and provides insights into the development of sound patterns of behavior on the part of directors, executives, and accountants. Successful management of ethical risks and the development of ethical competitive advantages depend upon the mastery of the subjects discussed. Professional accountants must understand the issues covered as a foundation for the fulfillment of their role as fiduciaries and experts in accountability and governance.

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APPLICABILITY

Business and Professional Ethics for Directors, Executives & Accountants is intended as a sourcebook for directors, executives, and professional accountants on accountability and governance, on appropriate decision making and behavior, and on ethics risk management in the new era of heightened corporate accountability. Blending text, readings, and cases, it can be used as or for the following:

- A stand-alone book in courses in business and/or professional ethics and/or in governance.
- An adjunct to traditional strategy, governance, or accounting texts to provide access to interesting, real-world dilemmas. The material in the book has been used very successfully with MBA and Executive MBA students as well as accounting students.
- Custom selections from the text, cases, and readings can be tailored to specific course requirements.
- Independent study.

The book has been organized into relatively freestanding chapters to facilitate custom publishing of a selection of chapters and/or cases. For example, material in Chapter 2 could be used to introduce governance and provide a historical path to current thinking on reputational issues and stakeholder support. The history of ethics and governance scandals since 2001, which appears in Chapter 2, has been well used to start off Executive MBA programs. Similarly, directors and executives or MBA students wishing to focus on conflict of interests could benefit from Chapters 2, 5, and 7, plus cases from other chapters. Chapters 1 and 4 provide a fundamental platform for understanding current business ethics expectations and defensible approaches to ethical decision making for business students beginning their studies. Chapter 8, which covers the subprime lending fiasco, provides an essential understanding of the current business challenge gripping us all worldwide. Professional accounting students should be familiar with all chapters.

The coverage provided is largely North American in orientation. Examples, readings, and cases are drawn with that perspective in mind. Basic ethical problems and principles are the same throughout North America since they are shaped by the same concerns, markets, and similar institutional structures and legal strictures. Where points of difference are noteworthy, they are dealt with specifically.

Increasing globalization is also recognized by the inclusion of significant worldwide changes introduced by the International Federation of Accountants in their revisions of global standards for ethical behavior of professional accountants, such as their new NOCLAR and Independence standards. In addition, the reimagination of professional accounting that is under way in the United Kingdom and Canada is covered because both developments respond to common drivers of change, such as the globalization of capital markets and major frauds that are being experienced around the world. Several cases covering problems of large European companies and doing business abroad are included to provide a global perspective and an understanding of how different cultures call for somewhat different ethical behavior.

Because of the prominence of American capital markets and the significant impact of the American practices of the Big Four professional accounting firms, North American governance frameworks for both business and professional accountants around the world will serve as a benchmark for developments in other jurisdictions. In addition, domestic and foreign expectations for behavior will be increasingly intertwined because the practices of multinational corporations or firms will be increasingly scrutinized globally by stakeholders active in major consumer and capital markets and in regulatory arenas around the world.

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AUTHORS' APPROACH

To the greatest extent possible, *Business and Professional Ethics for Directors, Executives & Accountants* focuses on the development of a practical understanding of the ethical issues driving recent unethical events, the resulting development of emerging accountability and governance frameworks, and the practical skills required to deal with them effectively. Of necessity, this means providing a learning experience embedded with real-life cases and examples. At the same time, these real-life problems are interpreted through exposure to classic positions and articles that have had a lasting impact on business ethics in general and accounting ethics in particular. The authors' experiences as directors, executives, and professional accountants, plus substantial experience in the teaching of and consulting on business and accounting ethics, management control, and similar governance-related subjects, contribute significantly to the development of the issues and discussions offered.

ORGANIZATION OF THE BOOK, & DIGITAL RESOURCES WEBSITE

The book is arranged in eight chapters that include 148 cases, of which eight are new to this edition, as well as four readings and appendices. Additional cases, appendices, readings, and material on the Enron fiasco are available with your Cengage Unlimited subscription at **www.cengage.com**.

		CASES	READINGS & APPENDICES
Chapter 1	Ethics Expectations	22	1
Chapter 2	Ethics & Governance Scandals	9	
Chapter 3	Ethical Behavior—Philosophers' Contributions	8	
Chapter 4	Practical Ethical Decision Making	7	
Chapter 5	Corporate Ethical Governance & Accountability	29	1
Chapter 6	Professional Accounting in the Public Interest	39	
Chapter 7	Managing Ethics Risks & Opportunities	26	4
Chapter 8	Subprime Lending Fiasco—Ethics Issues	8	
		148	3

The first two chapters provide an understanding of concerns that have been driving the development of current ethics expectations:

- Chapter 1 provides an overview of the book as it deals with the origins of concerns traditionally felt by a range of stakeholder groups and how these concerns have produced a broadened and heightened stakeholder-oriented accountability expectation.
- Chapter 2 provides a historical perspective on the ethics and governance scandals that stimulated changes in ethics expectations for accountability and governance reform and how these changes have been crystallized in law or generally accepted standards of performance. Both chapters provide a useful foundation for the rest of the book.

The next two chapters facilitate how a director, executive, employee, or professional accountant should respond to the emerging ethical expectations by taking decisions and actions that will be considered both right and defensible particularly when codes of conduct do not precisely fit the circumstances. It presents concepts developed over the centuries by philosophers as well as recently developed, practical frameworks for their application:

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- Chapter 3 covers important contributions by several philosophers to provide a background from which to reason ethically.
- Chapter 4 presents several practical approaches to ethical decision making—the core of ethical behavior—that facilitate the development of strategy as well as day-to-day decisions business people must face.

Chapters 5 and 6 examine how corporations and professional accountants can develop sound ethical accountability, governance, and management systems that respond to emerging ethics expectations:

- Chapter 5 covers those issues, expectations, and ethical culture-promoting systems that directors and executives should understand in order to discharge their duties successfully in the modern era.
- Chapter 6 deals with the roles and functions of professional accountants in the new accountability system for corporations, as agents of ethical accountability, as experts in the development of ethical accountability and governance mechanisms, and as professionals who should be demonstrating professional skepticism and compliance with the new 2018 *IEBSA International Code of Ethics for Professional Accountants* that includes NOCLAR and independence rules that will fundamentally change the role of professional accountants worldwide. Chapters 5 and 6 both cover the identification, assessment, and management of *conflicts of interest* and other key elements of a modern ethics-oriented governance system.

The final two chapters deal with a set of extremely important issues that directors, executives, and professional accountants need to understand and develop a facility with in order to avoid serious pitfalls and to take unique opportunities that others will miss. The last chapters of the book provide overviews of the most pressing and formative ethical and economic problems of our lifetimes and offer guidance as to the lessons that we all should learn:

- Chapter 7 deals with the supercritical areas of ethics risk and opportunity management, effective stakeholder management, sustainability and corporate social responsibility performance and reporting, workplace ethics, whistleblower programs and ethics inquiry services, motivation and avoidance of fraud and white-collar crime, bribery and the challenges of international operations including cultural networking practices such as *guanxi*, and ethical crisis management.
- Chapter 8 reviews the subprime lending fiasco and presents an ethical analysis of this latest ethical disaster to influence the world negatively. Lessons drawn from the ethical analysis are presented to provide a platform for discussion and learning so that future problems can be avoided. In its own way, this chapter provides a summary application of the material covered in earlier chapters.

Each chapter presents an interesting selection of cases and a useful list of references. The combination of text, 148 cases, four readings and appendices provides a much richer learning experience than books that present just cases, or text plus a limited number of cases and no seminal readings.

In addition, numerous references are made in the margin where a website link/reference or a downloadable file is available on the *Business and Professional Ethics for Directors, Executives & Accountants* (*BPE*) Digital Resources website at **www.cengage.com**.

This website is updated continuously with new information, notes, and website links of interest. The BPE Digital Resources website also houses cases and relevant chapter material from earlier editions to provide a resource for students and instructors, including the following:

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- Cases deleted from past editions (see list in the Table of Contents on page xiv)
- *Chapter 9: The Credibility Crisis: Enron, WorldCom, & SOX* from the sixth edition.
- Readings:
  - The Liability Crisis in the United States: Impact on the Accounting Profession—A Statement of Position
  - A Lawyer's Perspective on an Accountant's Professional Obligations
- Additional References and Seminal Reports

IMPROVEMENTS TO THE NINTH EDITION

Building on the strong foundation developed in the earlier eight editions, this new edition has been thoroughly updated. Major improvements include the following:

- Learning objectives are now featured at the beginning of each chapter.
- Chapter 1, "Ethics Expectations," has been updated to reflect the revisions made to the other chapters of the textbook including discussions about sexual abuse (#MeToo movement), critical environmental pressures, reimaging of the professional of accounting as well as the new NOCLAR and Independence Standards, the new Business Roundtable Statement calling for expanded corporate accountability, expanded ESG investing, updated risk management information, and recent key business scandals.
- Chapter 2, "Ethics & Governance Scandals," has been updated to provide a timeline, analysis, and summary of the significant ethics and governance scandals, events, and responses in three time frames: prior to 1970, 1970 to 1990, and 1990 to the present. A key case has been added covering Deutsche Bank's disastrous corporate culture that led to closing down its investment banking division, which accounted for roughly 20% of its business.
- Chapter 3 "Ethical Behavior—Philosophers' Contributions," has been updated with the addition of a case on industrial spying.
- Chapter 4 "Practical Ethical Decision Making," has been updated to consolidate and clarify practical and defensible approaches to ethical decision making.
- In Chapter 5, "Corporate Ethical Governance & Accountability," updates include new information on the Business Roundtable Statement, declaring that corporations have responsibilities to all of their stakeholders; on Benefit and B Corporations; and on the heightened need for an ethical corporate culture with several recent examples.
- Chapter 6, "Professional Accounting in the Public Interest," has been significantly revised to include a new framework for professionalism, an extensive discussion of the new NOCLAR Rules that will change professional responsibilities significantly, how the profession is being reimagined, a new approach to the calculation of transfer prices, and three new cases covering Carillion's bankruptcy, KPMG's ethical missteps with PCAOB information and cheating on ethics exams, and the NOCLAR solutions to Toshiba's accounting frauds.

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- Chapter 7, “Managing Ethics Risk & Opportunities,” has been revised to include a discussion of the new COSO Enterprise Risk Management framework; integration of environmental, social, and governance investing and reporting with examples including audited versions; a historical discussion of sexual harassment, the #MeToo movement, and the recent tipping point achieved due to high-profile convictions; additional material on forensic accounting and money laundering; and crisis management. Three new cases have been added: Barclays Bank: How Not to Deal with Whistleblowing, Danske Bank’s Money-Laundering Scandal, and QuadrigaCX—Cryptocurrency Exchange Fiasco, which deals with audit and forensic accounting matters.
- Chapter 8 “Subprime Lending Fiasco—Ethics Issues,” has been updated to take account of recent analyses and the prosecutions of investment banks and their officers.
- Eight new cases have been added to this edition, including the following:

Chapter	**Case Title**
2	Deutsche Bank—A Cultural Disaster
3	Spy Versus Spy: Corporate Espionage in the Canadian Airline Industry
6	Carillion Bankruptcy: A Nightmare That Challenged the Foundations of the U.K. Accounting Profession
6	NOCLAR Solutions to Toshiba’s Accounting Scandals & Confrontations with Auditors
6	KPMG’s Ethical Red Flags—Advance PCAOB Information and Cheating on Ethics Exams
7	Barclays Bank: How Not to Deal with Whistleblowing
7	Danske Bank’s Money-Laundering Scandal
7	QuadrigaCX—Cryptocurrency Exchange Fiasco

Importantly, the *BPE* website, www.cengage.com, is constantly expanding to include helpful references such as video clips of major events and brief summaries of key books on ethical matters.

As noted above, a *BPE Digital Resources website* has been created at www.cengage.com to provide access to readings and references identified in the margin of the book, as well as cases and chapter material from past editions.

In addition, the *BPE Instructor’s Manual*, which is available online, has been augmented to provide sample examinations and the discussion of successful, innovative usage of the book by satisfied instructors. PowerPoints are available for instructors through *the BPE Instructor’s Manual* website.

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3. Once you have registered and logged in for the first time, go to the "Search for Books or Materials" bar and enter the author or ISBN for your textbook. When the title of your text appears, click on it and you will be taken to the companion site. There you can choose among the various folders provided on the Student side of the site. NOTE: If you are currently using more than one Cengage textbook, the same user name and password will give you access to all the companion sites for your Cengage titles. After you have entered the information for each title, all the titles you are using will appear listed in the pull-down menu in the "Search for Books or Materials" bar. Whenever you return to Cengage you can click on the title of the site you wish to visit and go directly there.

ACKNOWLEDGMENTS

By Len Brooks

I have been fortunate to receive excellent suggestions for improving this and earlier versions of *Business & Professional Ethics* from Graham Tucker, Alex Milburn, Bill Langdon, Peter Jackson, Michael Deck, Curtis Verschoor, Lyall Work, and John Grant. But, as in the past, I want to acknowledge specifically the searching and insightful contributions by David Selley and particularly Ross Skinner. In addition, I want to thank Miguel Minutti and Lee Benson, whose research enriched many of the book's cases and discussions. These contributors should rest easy, however, as I did not accept all their suggestions and therefore take responsibility for any errors or omissions.

To my former colleague, Max Clarkson, I owe a debt of gratitude for providing the initial platform and encouragement for development and exercise of my ideas in the classroom and as a consultant and the stimulation to search for new ideas to contribute to our discipline.

To the Canadian Centre for Ethics & Corporate Policy, I owe appreciation for their willingness to agree to reciprocal use in this edition of material written for *Ethics & Governance: Developing & Maintaining an Ethical Corporate Culture,* 4th edition, which I wrote with David Selley and which the EthicsCentre published in 2012.

To my mother and my father, who was a CA, CGA, CMA, and CPA, I owe my understanding of values and my interest in pursuing them.

To my wife, Jean, for her continued support and, for their forbearance, my children, Catherine, Len, Heather, and John; their spouses or significant others Christina, Gabe, Rob, and Julia; and my grandchildren Bianca, Willow, Mya, Owen, and Lara, I owe my love and respect.

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By Paul Dunn

To my colleagues who constantly help me explore the numerous aspects of business ethics.

To the many students and instructors who have provided useful comments.

To my three children and their partners and my five grandchildren, who have encouraged me to explore alternative approaches and analyses to life.

Finally, to my wife, Kathy, for her constant love and support.

THE END OF THE BEGINNING

Amid the tragedy created by many scandals, both large and small, a silver lining has emerged: the acceleration and crystallization of stakeholder-oriented accountability and ethical governance frameworks for corporations, new tipping points for sexual abuse in the workplace and for international cooperation on enforcement with regard to financial crimes, and a reimagining of professional accounting with an increased focus on serving the public interest. Awareness of these developments and what they require to generate and maintain stakeholder support provides the foundation for the roles, responsibilities, and future success of directors, executives, and professional accountants. We have entered an era wherein appropriate values upheld and applied hold the key to ethical behavior, reputation, and sustained success. *Business and Professional Ethics for Directors, Executives & Accountants* provides an orderly development of the issues and skills involved and the understanding necessary to use them effectively—hopefully for the benefit of the business community, the accounting profession, and society as a whole.

Leonard J. Brooks, FCPA, FCA
Professor of Business Ethics & Accounting
Executive Director, The Clarkson Centre for Business Ethics
Joseph L. Rotman School of Management
University of Toronto

Paul Dunn, CPA, CA
Professor of Business Ethics
Goodman School of Business
Brock University

December 2019

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OVERVIEW OF THE BOOK

The disasters at Enron, Arthur Andersen, and WorldCom and more recently the subprime lending crisis have fundamentally changed expectations for the behavior of directors, executives, and professional accountants. Good risk management practices must now incorporate ethics risk management, accountability, and governance practices that ensure that the reputations of individuals, corporations, and firms are protected and that the support of stakeholders is strong enough to facilitate success. Leaving the development of ethical boundaries to trial and error—risking bad practice—is no longer acceptable.

Corporations and business professionals are now part of a new post-SOX era of broadened stakeholder-oriented accountability and governance. Directors, executives, and professional accountants now realize that this necessitates considering the impacts and risks of their decisions on their reputations and on the public interest—certainly on more than the traditional short-term set of shareholder interests. Some businesspeople and professionals will want to go beyond developing a good defensive accountability and governance system to develop a competitive advantage where customers, employees, and others will be attracted by distinctly higher levels of trust based on commonly respected values such as honesty, fairness, compassion, integrity, predictability, and responsibility.

Unless directors, executives, and professional accountants develop effective accountability, governance, and risk management processes that incorporate ethics,

- directors will be unable to fulfil their due diligence requirements,
- executives will be unable to develop sound competitive business models and protect their emerging legal liability,
- professional accountants will be unable to fulfill their role as fiduciaries and as leaders in the development of accountability and governance system, and
- corporations and the accounting profession as we know them will be further discredited and regulated.

Business and Professional Ethics for Directors, Executives & Accountants provides an understanding of why ethics has become a critical success factor, the nature and importance of key financial failures and legislative changes, how ethical behavior can be guided, how ethical decision making can be improved and made defensible, and how directors, executives and accountants can deal with the special problems that occur in an ever-changing business environment.

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1

Ethics Expectations

PURPOSE OF THE CHAPTER

Business and the professions function within a framework created by the expectations of the public. Scandals have traditionally triggered a “sea change” of new expectations for business governance and the accounting profession around the world. Enron, WorldCom, Arthur Andersen, the subprime lending fiasco, the Madoff Ponzi scheme, huge bribery prosecutions of Daimler and Siemens, manipulation of interest rates by major banks, the flouting of laws by Deutsche Bank and money-laundering regulations by Danske Bank, shocking disregard for fairness and safety, and the violation of environmental protection laws have reinforced the need for new standards and have pushed expectations to even higher levels. Not surprisingly, the newest behavioral expectations are based on an acceleration of business and professional ethics trends that have been long in the making. As a result, business and professional ethics have become key determinants of corporate and personal success and the focal points of research and corporate change.

This chapter explores the changes that the ethics trends have brought to the expectations framework as well as the developments that have arisen in response to those changes. It also begins to consider what the changes in expectations mean for the directors, executives, and professional accountants. As such, this chapter provides an introduction and overview of the book. Unless businesspeople understand the historical genesis of current expectations, they are likely to repeat the unfortunate errors of earlier executives and directors.

After reading this chapter, you will understand:

- what current ethics expectations are
- why they have developed
- the importance of accountability to stakeholders
- how current ethics expectations may affect:
  - business governance, planning, decision making, behavior, performance, and reporting
  - professional accounting standards, practices, and service in the public interest
  - personal behavior.

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THE ETHICS ENVIRONMENT FOR BUSINESS: THE BATTLE FOR CREDIBILITY, REPUTATION, & COMPETITIVE ADVANTAGE

During the last thirty-five years, there has been an increasing expectation that business exists to serve the needs of both shareholders and society. Many people have a "stake" or interest in a business, its activities, and impacts. If the interests of these stakeholders are not respected, then action that is often painful to shareholders, officers, and directors usually occurs. In fact, it is unlikely that businesses or professions can achieve their long-run strategic objectives without the support of key stakeholders, such as shareholders, employees, customers, creditors, suppliers, governments, host communities, and activists.

The support for a business—and business in general—depends on the credibility that stakeholders place in corporate commitments, the company's reputation, and the strength of its competitive advantage. All of these depend on the trust that stakeholders place in a company's activities. Trust, in turn, depends on the values underlying corporate activities.

Stakeholders increasingly expect that a company's activities will respect their values and interests. To a large extent, this respect for stakeholder values and interests determines a corporation's ethical standing and success. Consequently, corporate directors are expected to govern their company ethically, meaning they are to see that their executives, employees, and agents act ethically. Moreover, the corporation is increasingly expected to be accountable to stakeholders in a transparent or ethical manner. Performance assessment now extends beyond what is achieved to encompass how ethically those results were achieved.

As a result, the governance and accountability regime for business and the professions has become far more concerned with stakeholder interests and ethical matters than in the past. Directors, executives, and professional accountants, who serve the often-conflicting interests of shareholders directly and the public indirectly, must be aware of the public's new expectations for business and other similar organizations and must manage their risks accordingly. More than just to serve intellectual curiosity, this awareness must be combined with traditional values and incorporated into a framework for ethical decision making and action. Otherwise, as was the case with the Enron, Carillion, Deutsche Bank, Wells Fargo, and subprime lending debacles, the credibility, reputation, and competitive advantage of capital markets and the organization, the management, the professional, and the profession will suffer. What has produced this change in public expectations for business governance, behavior, and accountability? Several factors appear to share causal responsibility, as indicated in Table 1.1.

Environmental Concerns

Nothing galvanized early public opinion about the nature of good corporate behavior more than the realization that the public's physical well-being and the well-being of some workers was being threatened by corporate activity. Initially, concern about air pollution centered on smokestack and exhaust pipe smog, which caused respiratory irritation and disorders. These problems were, however, relatively localized so that when the neighboring population became sufficiently irate, local politicians were able and generally willing to draft controlling regulation, although effective enforcement was by no means ensured.

Two other problems associated with air pollution that were slower to be recognized were acid rain, which neutered lakes and defoliated trees, and the dissipation of the earth's ozone layer. In the first case, the sulfur in exhaust gases combined with rain and fell to the ground far away from the source, often in other legal jurisdictions. Consequently, the reaction by politicians in the source jurisdiction was predictably slow, and many arguments were raised about who was responsible and whether the damage was real or not. Ultimately, however, the level of awareness of the problem became sufficiently widespread to support international treaties and more stringent local regulations.

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TABLE 1.1 Factors Affecting Public Expectations for Business Behavior

Unbridled greed	Subprime lending fiasco, CEO overcompensation, price gouging
Physical	Quality of air and water, safety
Moral	Desire for fairness and equity at home and abroad, sexual abuse
Bad judgments	Operating mistakes, executive compensation, cover-up of failed environmental engineering, unethical incentive schemes
Activist stakeholders	Ethical investors, consumers, environmentalists, #MeToo movement
Environmental reality	Environmental degeneration, need for sustainability
Economic	Weakness, pressure to survive, pressure to falsify
Competition	Global pressures, substandard environmental engineering
Financial malfeasance	Numerous scandals, victims, greed
Governance failures	Recognition that good governance and ethics risk assessment matter
Accountability	Desire for transparency, corporate social responsibility, sustainability (GRI)
Synergy	Publicity, successful changes, rise of ethical investing
Institutional reinforcement and recognition	• New laws: environment, whistleblowing, recalls, *U.S. Sentencing Guidelines,* OECD antibribery regime, antibribery laws, *Sarbanes-Oxley Act* (SOX) reforms, *Dodd-Frank Wall Street Reform and Consumer Protection Act,* mandatory risk management*, Business Roundtable Statement* • Professional accounting reform, globalization of standards (IFAC, IFRS), NOCLAR rules • New worldwide enforcement regime: antibribery, money laundering

The dissipation of the earth's ozone layer and its role in global warming has been more recently recognized as a serious threat to our physical well-being. The release into the atmosphere of chlorofluorocarbon (CFC), once the most common residential and industrial refrigerant, allows CFC molecules to use up molecules of ozone. At the same time, cutting down rain forests in Brazil, a main source for replenishing ozone, has contributed further to the depletion of the ozone layer around our planet. This layer was our major barrier from the sun's ultraviolet rays, which cause skin cancer and damage our eyes.

The timing of the recognition of water pollution as a problem worthy of action has paralleled the concern about our depleted ozone layer, partly because of our limited ability to measure minute concentrations of toxins and our inability to understand the precise nature of the risk of waterborne metals and dioxins. Corporations asserted that they did not have the technical solutions to the elimination of air and water pollution at reasonable cost and therefore could not do so and remain competitive. However, once the short- and long-term threats to personal safety were understood, the public, led by special interest groups, began to pressure companies as well as governments directly to improve safety standards for corporate emissions.

Government reaction, often prompted by disasters, has been significant at all levels. Locally, no-smoking regulations have been enacted and local ordinances tightened. Environmental regulation has been the subject of international treaties. Environmental protection acts in the United States and Canada have been put in place that feature significant fines of up to $1 million to $2 million per day for a corporation convicted of environmental malfeasance. In addition, personal fines and/or jail terms for officers and directors have focused the attention of executives on programs to ensure compliance with environmental standards. Nothing energized executives in the United States and Canada more than the statement of a judge in regard to the promulgation of the *U.S. Sentencing Guidelines* on November 1, 1991. He said that the "demonstrated presence of an effective program

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of environmental protection would constitute an adequate 'due diligence' defense which could reduce the level of fine from $2 million/day to $50,000/day." Although this reaction may be viewed as defensive, the "due diligence" movement should be viewed as the *codification phase* of the movement toward corporate environmental responsibility.

More recently, the growing concern for local and global environmental sustainability has led to competitive and activist pressures for companies to report publicly on their environmental impacts using sustainability frameworks such as the Global Reporting Initiative's GRI Standards. In addition,[1] the huge fines, lawsuit settlements, and loss of reputation and the support of the public by offending companies such as BP for its oil spill and Volkswagen for cheating on emission standards have reinforced the need for other companies to take preventive action rather than pay an astronomical price for environmental negligence.

Corporations and governments must respond to the necessity for environmental action. The United Nations released a series of reports that *document an acceleration in environmental degradation and advocate the need for a 45% cut in emissions by 2030*.[2] Past inaction has come at a high cost, and continued inaction on environmental protection is unconscionable. Children, parents, executives, governments, and central banks are taking note, and the movement on environmental matters will become significantly more rapid. Large corporations and investors are reducing their investment in the carbon economy and shifting their interests into more environmentally neutral investments.

Moral Sensitivity

Beginning in the 1980s and 1990s, there has been a significant increase in the sensitivity to the lack of fairness and to discrepancies in equitable treatment normally afforded to individuals and groups in society. Increased recognition of the plight of several groups was responsible for this heightened social conscience, including the feminist movement, the mentally and physically challenged, Native people, and minorities. To some degree, the public was prepared to entertain the concerns of these groups because unfortunate events had brought the realization that some special interest groups were worth listening to, as environmentalists, consumer advocates, and antiapartheid supporters had shown. Also, for most of the period from 1960 onward, disposable incomes and leisure time have been sufficiently high to allow members of the public to focus on issues beyond earning their livelihood. In addition, as a result of advances in satellite communications that have allowed virtually "live" coverage of worldwide problems, the thinking of the North American public has become less inner directed and parochial and more sensitive to problems featured by wide-ranging investigative reporters.

Evidence of public pressure for more fairness and equity is readily available. The desire for equity in employment has resulted in laws, regulations, compliance conditions in contracts, and affirmative action programs in corporations. Pay equity programs have begun to appear to readjust the discrepancy between the pay scales for men and women. Consumer protection legislation has tightened to the point that the old philosophy of "buyer beware," which tended to protect the large corporation, has become "vendor beware," which favors the individual consumer. Employee drug tests have been much more carefully handled to minimize the prospect of false findings. All of these are examples in which public pressure has brought about institutional changes through legislatures or courts for more fairness and equity and less discrimination and therefore will be virtually impossible to reverse. Indeed, the trend is unmistakable.

Moral sensitivity is evident to international issues as well as domestic. The campaign to boycott buying from corporations that engage in child or sweatshop labor in foreign countries

[1] See the Global Reporting Initiative's website at https://www.globalreporting.org.

[2] See United Nations, *The Report of the Secretary-General on the 2019 Climate Action Summit and the Way Forward in 2020*, December 11, 2019, accessed December 13, 2019, at https://www.un.org/en/climatechange/reports.shtml.

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provides ample testimony to this and has resulted in the creation of codes of ethical practice for suppliers and compliance mechanisms to ensure they are followed. Organizations such as the Social Accountability International and AccountAbility have developed workplace policies, standards, workplace auditor training programs, and reporting frameworks.

The most significant recent change in moral sensitivity has been the recognition by the general public and corporate community of the seriousness of sexual violence and abuse against women in the workplace. The #MeToo movement has, in 2017–2019, finally been able to bring to justice several serial predators, such as Harvey Weinstein, Bill Cosby, and Roger Ailes, as well as major corporations, such as McDonald's have fired senior officials even for so-called consensual relationships with persons reporting to them. The ensuing shock waves have activated the public and in turn governance measures to prevent what has been pretty much an unchecked exploitation of women. The legal sentences of up to ten years in jail for the eighty-year-old Bill Cosby and the settlements paid to the high-profile victims of up to $20 million each are staggering. The movie *Bombshell* further reinforces the stigma associated with this exploitation and will surely keep penalties high in the future.

Bad Judgments & Activist Stakeholders

Directors, executives, and managers are human, and they make mistakes. Sometimes the public or specific groups take offense at these instances of bad judgment and take action to make the directors and management aware that they do not approve. For example, Wells Fargo instituted an unethical incentive scheme for retail bank employees to create new accounts without customer approval and then scandalously fired 5,000 workers who couldn't meet quotas. It resulted in the loss of many, many customers, including the State of California. There is also the 2015 Volkswagen decision to cheat on emissions tests and then cover it up, stirring the anger of many consumers and environmentalists and resulting in the loss of many new and returning customers with a resulting dramatic fall in share price. In earlier times, the decision by Shell UK to scuttle the Brent Spar oil storage vessel in a deep part of the ocean rather than take it apart onshore led to demonstrations in support of Greenpeace, which tried to stop the scuttling, and to the boycott of Shell gas stations in Europe. Nestlé products were boycotted in North America and Europe to stop the free distribution of baby formula powder to African mothers who were mixing it with contaminated water, thereby killing their babies. Nike and other companies' products were boycotted through the efforts of concerned individuals and groups to stop the use of sweatshop and child labor, particularly in foreign countries. The recall of Firestone tires was ignited by the media, beginning with a television show in Houston, Texas. North American corporations were extravagantly overpaying their executives—including several above $100 million per annum—or not reducing executive pay when profits declined, so CalPERS, the California Public Employees' Pension Fund, called for the establishment of compensation committees consisting of a majority of independent directors. Activist stakeholders were clearly able to make a difference—which most people thought was for the best.

Two other kinds of activists also made their appearance in the late 1980s and early 1990s: ethical consumers and ethical investors. Ethical consumers were interested in buying products and services that were made in ethically acceptable manners. Consequently, books such as *Shopping for a Better World*, *The Ethical Shopper's Guide to Canadian Supermarket Products*, and *Conscious Consumption* were published in the United States, Canada, and the United Kingdom. They provided ratings of companies, their affiliates, and their suppliers on different performance dimensions, such as hiring and treatment of women, environmental management and performance, charity, progressive staff policies, labor relations, consumer relations, and candor at answering questions. Ethical consumers were then able to "vote with their checkbooks."

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Ethical investors took the view that their investments should not only make a reasonable return but should do so in an ethical manner as well. Originally pioneered by large pension funds such as CalPERS and the New York City Employees Pension Fund, as well as several church investment funds, the movement has been augmented since the early 1990s by several ethical mutual funds. These ethical mutual funds employ screens that are intended to knock out companies from consideration that are involved in so-called harmful activities—such as producing tobacco products, armaments, or atomic energy or misusing animals for testing. Alternatively, individuals or mutual funds can invest in companies or in indices of companies that have been screened by an ethical consulting service such as Domini Social Investments (http://www.domini.com) or MSCI (http://www.msci.com/esg-integration). Morgan Stanley Capital International (MSCI), for example, provides several indices of companies ranked high in sustainability, social responsibility, or environmental performance. A similar index, the Sustainalytics (http://www.sustainalytics.com) Jantzi Social Index (JSI), is available for the top sixty Canadian stocks as well as screening ESG (environmental, social, and governance) factors for Canadian, U.S., and European stocks. In addition, the FTSE4Good Index (http://www.ftse.com/products/indices/FTSE4Good) has been created for companies listed on the London Stock Exchange. The performance of these indices compares very well to those for nonscreened stocks in each country.[3] A current list of ethical mutual funds and an update on socially responsible investing (SRI) can be found at the websites of the Forum for Sustainable and Responsible Investment (http://charts.ussif.org/mfpc) in the United States and the Responsible Investment Association in Canada (http://riacanada.ca). Many consultants offer screening services to investors on a fee-for-service basis. The entire field of ethically screened investing has grown dramatically, reportedly up at a compound rate of 70% over the five-year period to 2019.[4]

These developments signal that business decisions are being judged against different standards than before, by groups that have billions of dollars at their disposal. For additional information, contact the Investor Responsibility Research Centre at http://www.irrcinstitute.org and similar websites.

Economic & Competitive Pressures

Although the public's expectations have been affected directly by the factors already discussed, a number of underlying or secondary factors are also at work. For example, in general, the pace of economic activity slowed during the late 1980s and early 1990s and just before and after the millennium. Corporations and the individuals in them had to wrestle with "no growth," or shrinking volume scenarios, instead of the expansion that had been the norm. In the 1990s, growing pressure from global competitors and the drive for improved, costly technology shrank profit margins. Absence of growth and shrinking margins led to downsizing to maintain overall profitability and desirability to capital markets. Whether to maintain their jobs, volume-incentive-based earnings, or their company, some people resorted to questionable ethical practices, including falsification of transactions and other records, and the exploitation of the environment or workers. The result has been part of the reason for triggering cases of environmental and/or financial malfeasance with significant costs to reputation and finances.

The development of global markets has led to the manufacture and sourcing of products throughout the world. The accompanying restructuring has been viewed as enabling greater productivity and lower costs with lower rates of domestic employment. Therefore, the pressure on employed individuals to maintain their jobs may not abate as production

[3] See, for example, the commentary on Performance & SRI at https://www.ussif.org/performance.

[4] David Berman, "Renewable Energy Stockholders Reap Rewards," *The Globe and Mail*, December 14, 2019, B9.

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increases. Nor, given greater competition, will greater volume necessarily increase profit, so the pressure on corporations will not abate to levels experienced in the past. In addition, corporations will be unable to rely on a cyclical return to profitability to restore the risk of unethical behavior to former levels. Consequently, to counteract growing workplace pressures, companies have increasingly instituted better governance mechanisms, including improved ethical behavior guidance and better management of ethics risks, particularly when developing incentive schemes.

Financial Scandals: The Expectations Gap & the Credibility Gap

There is no doubt that the public has been surprised, stunned, dismayed, and devastated by financial fiascos. The list of classic examples would include Enron, WorldCom, Adelphia, Tyco, HealthSouth, Parmalat, Royal Ahold, Barings Bank, Livent, Bre-X, Madoff, Carillion, Sino-Forest, Deutsche Bank, the U.S. subprime lending disaster, and the collusion and manipulation of financial markets by major banks as well as the slightly older U.S. savings and loan (S&L) bankruptcies and bailouts, and the bankruptcies of several real estate companies.

As a result of these repeated shocks, the public has become cynical about the financial integrity of corporations, so much so that the term *expectations gap* has been coined to describe the difference between what the public thinks it is getting in audited financial statements and what it is actually getting. The public outrage over repeated financial fiascos has led, in both the United States and Canada, to tighter regulation, higher fines, and investigations into the integrity, independence, and role of the accounting and auditing profession and, more recently, of executives and directors.

On a broader basis, continuing financial malfeasance has led to a *crisis of confidence* over corporate reporting and governance. This lack of credibility has spread from financial stewardship to encompass other spheres of corporate activity and has become known as the *credibility gap*. Audit committees and ethics committees, both peopled by a majority of outside directors; the widespread creation of corporate codes of conduct; the increase of corporate reporting designed to promote the integrity of the corporation; and increasing fines and regulation all testify to the importance being assigned to this crisis.

No longer is it presumed that "whatever company 'X'[5] does is in the best interests of the country." Fiascos related to the environment or to dealings with employees, customers, shareholders, or creditors have put the onus on corporations to manage their affairs more ethically and to demonstrate that they have done so.

Devastated by the sequence of U.S. disasters in 2001 and 2002 involving Enron, Arthur Andersen, and WorldCom, public confidence evaporated in the business community, its financial reporting, and the accounting profession. In the ensuing crisis of confidence, capital markets were reeling. President George W. Bush and other business leaders strove to restore lost confidence, but their efforts were largely in vain. Finally, in record time, the U.S. Congress and Senate passed the *Sarbanes-Oxley Act of 2002* (SOX) on July 30, 2002. That act ignited reform of both corporate governance and the accounting profession, first in the United States, then indirectly in Canada and around the world. Further details are provided in the next chapter and in the Web archive for this book at **www.cengage.com**.

It is noteworthy that a second wave of reform for corporate governance and in the accounting profession came to a head in 2017–2019. The pressure, caused by numerous ill-advised actions, for corporations to embrace broader objectives inclusive of stakeholder

[5] "Whatever is good for General Motors is good for the country" was a commonly used statement before 2000.

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interests reached a significant tipping point. In addition, several scandals, such as Sino-Forest and Carillion, as well as the potential adoption of big data and data analysis techniques, called for a reimagining of professional accounting.

Governance Failures & Risk Assessment

The Enron, Arthur Andersen, and WorldCom series of disasters in 2001–2002 made it clear that current existing modes governing companies and reporting on their activities were not sufficient to protect investors' interests and, more broadly, the public interest in orderly markets and corporate activities.

Corporate directors have been expected to ensure that their corporations act in the interests of investors and within the range of activity deemed suitable by the societies in which they operate. But in the Enron, WorldCom, and other cases, the oversight by company directors failed to contain the greed of executives, managers, and other employees. These and other companies were out of control, and unacceptable practices resulted. To quote the U.S. Senate's report on the *Role of the Board of Directors in the Collapse of Enron*:

> (1) **Fiduciary Failure.** The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees, and business associates.
>
> Source: U.S. Senate's Permanent Subcommittee on Investigations, *Role of the Board of Directors in the Collapse of Enron*, 2002, 3.

Clearly, the public was fed up with directors, executives, and others enriching themselves at the public's expense. It was evident that directors and executives were not identifying, assessing, and managing ethics risks in the same manner or depth that they were for other business risks. But the Enron, Arthur Andersen, and WorldCom cases resulted in the bankruptcy of two of the world's largest companies and the disappearance of one of the world's most respected professional accounting firms within a year. This sudden reversal of fortunes, caused by the failure to govern ethics risks, changed the calculus of risk management profoundly. The probability of catastrophic failure caused by unidentified and/or unmanaged ethics risks was undeniably real and much higher than anyone expected.

Governance reform was perceived as necessary to protect the public interest. Where directors had been expected to assess and make sure that the risks faced by their corporation were properly managed, specific ethics risks were now seen to be a key aspect of the process. Governance reform to ensure that this would happen was overdue.

Increased Accountability & Transparency Desired

The lack of trust in corporate processes and activities also spawned the desire for increased accountability and transparency on corporate matters by investors and particularly by other stakeholders. Companies around the world have responded by publishing more information on their websites and freestanding reports on their corporate social responsibility (CSR) performance, including such subjects as environmental, health and safety, philanthropic, and other social as well as governance impacts (ESG). Although some information in these reports is skewed toward management objectives, the advent of external

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verification and the reaction to misinformation are gradually improving the information content involved. The trend is definitely toward increased nonfinancial reporting to match the public's growing expectations and several nonfinancial reporting frameworks, like the GRI, emerged.

In addition, the realization that *unbridled greed* by executives and/or dominant shareholders lay behind many of the financial scandals that have damaged both investors and other stakeholders has reinforced the desire for more accountability for and transparency of corporate actions. For example, the subprime lending fiasco (see Chapter 8) spawned the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which mandated clear disclosures of risks inherent in complex financial instruments, Similarly, examples of outrageous executive compensation and bonuses, even when companies were doing poorly, resulted in a vigorous backlash leading companies to offer shareholders more information on remuneration plans and an opportunity to have a nonbinding but helpful "say-on-pay" input to the pay-setting process. Likewise, companies like General Motors and investment banks that received bailouts during the subprime lending crisis found that incredibly large bonuses paid to senior personnel were subject to monitoring, approval, and rollbacks. Similarly, the sharp backlash received by executives of drug companies that hiked lifesaving drug prices by over 1,000%, indicated that such actions to benefit shareholders were no longer defensible when that action disadvantaged other stakeholders. Contrary to the way executives are often portrayed in the movies, unbridled greed is no longer considered good.

Synergy among Factors & Institutional Reinforcement

Linkages among the factors affecting public expectations for ethical performance have already been identified but not the extent to which these linkages reinforce each other and add to the public's desire for action. Few days go by in which the daily newspapers, radio, and television do not feature a financial fiasco, a product safety issue, an environmental problem, or an article on gender equity or discrimination. On occasion, public furor and expectations are jolted by a glaring revelation of lack of personal and corporate integrity, such as in April 2016 when the Panama Papers leak of secret offshore arrangements occurred that documented tax avoidance, hidden wealth, the potential extent of money laundering, and significant potential corruption. In the aggregate, the result is a cumulative heightening of the public's awareness of the need for controls on unethical corporate behavior. In addition, there are many examples emerging where business executives did not make the right decision and where ethical consumers or investors acted and were successful in making companies change their practices or improve their governance structures to ensure that future decision processes were more wholesome. The entire ethical consumer and SRI movement has been strengthened by the knowledge that acting on their concerns can make companies and society better, not poorer.

In turn, the public's awareness impacts politicians who react by preparing new laws or the tightening of regulations. In effect, the many issues reaching the public's consciousness result in institutional reinforcement and codification in the laws of the land. The multiplicity of ethical problems receiving exposure is focusing thought on the need for more ethical action, much like a snowball gathering speed as it goes downhill.

One of the most important examples of reactive legislation is the *U.S. Sentencing Guidelines of 1991*. As previously noted, it stimulated significant interest by directors and executives everywhere in North America in whether their companies were providing enough guidance to their personnel about proper behavior. The consequences for not doing so prior to the introduction of the guidelines had been minor since directors and

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