

Accounting's Role in the Ethical Behavior of Management

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Abstract

Within business there are many debates over the ethical behavior that managers employ when making business decisions. There are many decisions made every day that question ethical codes of conduct. Though some actions may be legal, they may not necessarily be ethical. This paper delves deeper into this ethical debate of management's behavior within organizations. It explains how accounting is used to influence the ethical behavior of management. Even accounting standards and regulations do not encompass all ethical decision making within an organization. Some decisions are entirely based on ethics and what a company deems appropriate. This paper takes the ideas of earnings management and agency theory and determines how they affect the ethical decision making of management. This paper explores the background of accounting and how company culture, agency theory, and fraud affect the ethical behavior of management within a company.

Introduction: Background

Accounting is the language that binds the foundation of corporations in business. It is necessary in every business ranging from healthcare to the restaurant industry. If accounting did not exist, the ability to determine a company's wealth and money management would not be possible. No one would know the stability of a company and how well it is doing in relation to the economy. Without accounting, the stock market could not function. People invest in a company based on the numbers produced by companies on financial statements. If accounting did not exist, the financial statements would be nonexistent. There would be nothing for investors to rely on when investing money into a company. Therefore, there would be no need for stock markets, because investors would not invest in companies. The entire world's economy depends on published accounting information and the numbers that accountants produce daily.

Defining accounting better illustrates the purpose of accuracy. Accounting simply means the action or process of keeping financial accounts. *The Effect of the Concept of the Corporation on Accounting* also describes the function of accounting as "Provid[ing] information of a financial nature which may be used in the making of decisions" (Sprouse 1). Thus, no business could survive without accounting practices and principles set into place to provide the public with the information needed to make informed decisions. Accounting retrieves the financial information of a company and simplifies it into a set of financial statements more comprehensible and readily accessible to the general public. The information produced by the company in the form of published financial statements is used by a wide variety of outside users. The financial statements

are used predominately to illustrate the financial stability of a business for the current and potential shareholders.

Before delving into the theories and methodologies of present day accounting, it is appropriate first to take a look back in time. With new information systems and databases that have industrialized simultaneously with the birth of technology, it is difficult to believe that accounting actually started as early as the fourteenth century. Carol Wiley of AccountingEdu states, “In fact, the Italians of the 14th to 16th centuries are widely acknowledged as the fathers of modern accounting and were the first to commonly use Arabic, rather than Roman numerals for tracking business accounts.” Along with the creation of wonderful food, Italians should be credited for their exceptional work in the development of double entry bookkeeping. Double entry bookkeeping, or double entry accounting, is founded on the idea that every financial transaction has equal and opposite effects in at least two different accounts. This is better known as debits and credits. When used correctly, it satisfies the accounting equation: assets equal liabilities plus owner’s equity.

Although modern day accounting is still based on the double-entry accounting system that was invented by early Italians, it is now immensely different than it was centuries ago. Even though double entry bookkeeping was recorded as early as the fourteenth century, *The Securities and Exchange Commission* states:

Some sort of bookkeeping or recording is found almost as soon as men began to write. With the early formation of governments and the levying of taxes the necessity arose for reckoning and keeping records. In addition, the development of commerce in the ancient world called for some system of keeping records, and

a large number of business records dealing with such matters as sales, letting, hiring, money lending, and partnerships have been discovered. (Lamden 26)

It is astonishing to believe that even before the start of the fourteenth century, people knew and understood the importance of keeping records to measure the performance of a business. During this time, the information of businesses was kept private for the owner's use only. Keeping records during this time helped business owners know the financial situation of their company, which was an important part of everyday commerce. Soon after, the ideology of banking was created in Athens. In his book *The Securities and Exchange Commission*, Charles Lamden addresses the ideas of Arthur Woolf. He stated:

Having regard to the multifarious business carried on by bankers, it was essential for them to have their accounts carefully kept by themselves and a staff of clerks, chiefly freedmen and slaves; the details would be copied down from memoranda into Day Books and Ledgers, in which credit and debit accounts were shown on separate pages. (Lamden 27).

After banking was created, the development of accounting developed slowly until the 1970s. Even though there is always room for improvement, accounting is one topic that takes long periods of time for a new idea or standard to take effect. It is a system that could be changed, but it is also hard to accept change within an area of business that is so complex.

Since the creation of the FASB in 1978, accounting has developed rapidly. With the introduction of modern technology, many unfathomable ideas have become a reality

for accounting practice. Technology has made accounting much easier and much more efficient. Along the years, databases and storage systems have been developed, making records much easier to keep physically safe. Information database systems have almost completely replaced all paper system accounting in businesses. The risk of losing files and financial information to fire or flood is less likely to happen now that electronic storage is possible. However, electronic storage is not the only way files are kept. Files are typically stored in a physical location for seven years as backup in case a database fails.

All of this new technology, however, makes unethical behavior and fraudulent activity much easier to commit because it is harder to trace within a business. Some accountants, known as auditors, audit companies and form an opinion about their financial statements. The role of an auditor is to enter a company as an independent outsider and determine whether the financial statements are fairly stated based on the numbers and reports produced by management. This helps shareholders make a decision whether or not to invest in a company if an auditor has deemed the company's financial statements fairly stated. However, some things that occur in a business setting may not be fraud technically speaking, but they could be deemed unethical. Ethical representation is a large, yet under examined topic, within accounting.

The concept of ethical decision making is important in every person's life. Often, employees are asked to make an ethical decision either within their job or personal lives. A code of ethics is not law. It is not something that everyone must follow in order not to have any negative repercussions. Ethics determine the way people live their lives. One may make an unethical decision to lie to his or her parent or significant other. This is not

deemed unlawful, but instead unethical. Ethical decision making is also made within a business setting every day. A business person may decide to lie or inflate numbers to a client in order to get a sale. This also may not be deemed unlawful, but most would argue that this type of behavior is wrong and ultimately unethical. This brings up the discussion on the meaning of ethical decision making.

There are many ways to define ethics. Some definitions range from what society deems acceptable to how a decision relates to a religious or moral belief. According to an article by Andre, Claire, and Meyer, ethics can be described in two ways. First, ethics can be described as: “Well-founded standards of right and wrong that prescribe what humans ought to do, usually in terms of rights, obligations, benefits to society, fairness, or specific virtues.” It can also be described as: “The study and development of one's ethical standards.” So why is this discussion so important in today's society? The mere mention of ethics typically implies the connotation of religious beliefs and morals. There is neither one set of religion nor one set moral standards across the world. This makes it very difficult to determine someone's ethical viewpoint.

In business, ethical decision making is very important. It is used simultaneously with the term accountability. A company has an honorable responsibility to hold itself accountable to make ethical decisions so it does not deceive the public regarding its financial stability. D.R. Sheldon states: “Whether transnational or domestic, corporations and government seem to be mired in a crisis of accountability. This crisis includes diseases of inefficiency, lack of competitiveness, moral and ethical lapses, and intentional fraud for self-gain” (Sheldon 1). This accountability crisis should be addressed with an

in-depth study of accounting's role in the ethical behavior of management and what a company can do to evaluate the stability of their ethical standards.

Those investing in the stock market wish for the managers of a company to make ethical decisions because they often invest copious amounts of money solely based on year-end audits. Many citizens do not wish to learn the trade of accounting because of its rigorous work load. Therefore, they leave the work to those who can handle the long hours of studying and the many tests needed to become certified in certain areas. One would want an accountant, as an unbiased eye looking in, to be extremely ethical. *The International Journal of Management* states that an accountant's job is,

One of the hardest and most disciplined jobs all over the world and due to the type and nature of services presented should have specific validity and trust. The continuance of this credit and improving it depends upon theoretical and practical adherence of profession members to their behavioral and ethical regulations.

(Asoodeh, Meymandi, and Rajabdoory 136)

It is an accountant's job to give an opinion on whether or not management is correctly following Generally Accepted Accounting Principles (GAAP) when depicting the financial information of a company. This is done during an audit of a company. The auditor (accountant) will determine whether or not a company has correctly followed GAAP and if the financial statements are free from material misstatement. This is known as an audit opinion.

There is a large amount of pressure for management to make ethical decisions in every decision made for a company. However, sometimes this is not entirely the case. As many have seen and heard, there are sometimes cases in which a manager acted

unethically on his or her own behalf in an attempt to better him or herself. While this practice is considered wrong and frowned upon, it still continues to happen. There are many systems in place to try and stop these unethical practices from happening, but the brilliance of unethical managers sometimes surpasses the intelligence of those searching for misconduct. An example could be people who embezzle money out of a company for years before anyone even realizes the money is gone. Often, these people know about more loopholes within a company than the management does. These people will use this as leverage and commit a fraud without being easily detected.

This brings forth the argument of what should be considered unethical in a business setting and what should be permitted. There are many topics in accounting that could be considered ethical debates. Many people have different views on whether or not a manager's behavior is always ethical. Some of these topics include but are not limited to company culture, agency theory, and different types of fraud. Over the years there have been many standards and regulations implemented to keep business activities legal and ethical. However, determining the ethical behavior of management is very difficult because there is no set ethical standard around the world. Every culture and country is different; therefore, every business within a culture will be different. No two companies will ever be exactly the same.

I: Company Culture

A company is only as respectable as it appears to the general public. Therefore, the reputation of a company is imperative to its success. When determining reputation, many look to the core culture and ethics that are established from within each company. A company's culture involves many different aspects that blend together to create the framework for success regardless of the organization's size. Culture can be defined in many ways, but is often referred to as the beliefs and customs of a group of people. Every individual business is its own group of people; therefore, every business has its own unique culture. This can vary depending on the country or type of economy in which the business is located. That is also important when considering entering into business transactions with different countries. Culture is an important aspect to many people around the world and should be researched before making any business decisions. Ahmed Riahi-Belkaoui states, "Culture is an important variable affecting a country's accounting environment" (Riahi-Belkaoui 9). Sometimes the company's culture is created at the start of a business and is held to the same regard until the company dissolves. Other times, the culture changes with the changing of management and employees. Every person in a business brings in his or her own style and attitude. One manager could have the same ethics and moral standards in mind as the company deems important to its success. Other managers could have ideas in mind to change the ethics and value of the company in order to benefit them further.

The notion of company culture is extremely important to the success of the business, but unfortunately, is not a universal ideology that is set in stone upon creation

of a business. Every business has its own company culture, and therefore, has its own ethical standards. While some companies may have similar ethical standards, no two companies will ever be the same because, just like people, every business is significantly unique. A company's culture ultimately drives important decisions. If a business's culture is founded upon ethical decision making and always doing the right thing, then that company is almost certainly going to make decisions based on this culture and more than likely create financial statements that most accurately reflect the true financial standing of the company. "The cultural relativism model assumes that culture, through its elements and dimensions, dictates the type of organizational structure" (Riahi-Belkaoui 6). The organizational structure of a business is vital to how the company runs the day-to-day business. Simply changing the company's culture could possibly change the entire outlook of a business and create an organization that people deem unethical.

Company culture is used in many ways within an organization. It can be used to determine the attitude within the workplace, all the way to the different types of functions hosted, such as Christmas parties or social events. One way this culture is created, is through the hiring process of management. As stated earlier, management often tends to influence company culture. This stems from the influence it has over its employees. Management sets the standards in which a company operates and the employees comply and follow the standards set forth by the company. This presents the debate about labor markets.

There are two different types of labor markets for top management personnel: external and internal. A company can hire externally and bring someone in from outside the company, or they can promote an employee from within the company. This is better

known as internally promoting. Internal versus external hiring of management is a very large, yet overlooked ethical debate within businesses. Many believe that hiring an executive externally is more successful because that person can have an outside view as well as the view of the company. However, others believe that internally promoting an executive is more beneficial.

When hiring externally, the incoming manager typically has no previous relationships with any of the employees. Relationships within a business setting are very important. This lack of relationship potentially can put a strain on the workplace atmosphere. Relationships also take time to develop, which means it will take time for the employees to gain a sense of rapport with the new executive. Giving a new manager the time it takes to settle in and become familiarized with the company could take away significant time that is needed for other things within the company. Promoting from within would not have these problems. With promoting internally, the new executive more than likely already has existing relationships with the employees. This allows the manager to settle in quickly and begin operations within the company.

Another issue that may arise is the new manager's ethical background. If an employee is hired internally, he or she is more likely to carry on the ideals and ethical background that he or she has developed through working for the company. Whereas hiring externally, there is not any good indication as to whether or not the incoming manager will hold the company's morals and ethics to a high regard. They could potentially mold the company culture into something other than what the company deems ethical or moral. This outside person does not understand the cultural norms and ethical codes of conduct that the company has established. This creates an opportunity within

management and the company as a whole because the outside person may not even believe or have the same ethical values of the organization.

The major ethical debate, however, lies with the influence the financial statements have on the manager's decision making process. In a perfect situation, the published financial statements should not affect the decisions of management. They should instead be focused on the internal control of the company and how well the company is doing from within. Management of a company should not focus on meeting desired net income projections on the financial statements. These statements are published externally for the use of the shareholders. They should ultimately have no impact on how management makes operating decisions. When hiring from the external labor market, however, this is not always the case.

When hiring from the external labor market, Agency Theory suggests that businesses typically add in a bonus package for the new manager to convince the person to change jobs. (Cohen and Holder-Webb) Most people would not be willing to change their jobs unless some sort of incentive was in place. This is why businesses give bonus packages to incoming managers who are hired from the external labor market. This bonus incentive creates a competitive external labor market. In their article "Theory of Perpetual Management Accounting Innovation Lag in Hierarchical Organizations," Benjamin Foster and Terry Ward state: "A competitive external labor market simultaneously determines pay rates and labor allocation. In contrast, administrative rules and customs govern pay rates and labor allocation in an internal labor market" (Foster and Ward 404). Therefore, in order to get people to agree to change jobs in a competitive labor market, there must be some sort of enticement to convince them to work there.

Typically, the new manager's bonus is based off of the company's published net income. If the manager meets certain projections for net income on the audited financial statements, he or she will receive a bonus in addition to regular pay. These bonus incentives tend to create greed within a company's management. This greed gives the manager a rationalization for doing whatever it takes to meet projected numbers in order to receive a bonus. In *Rethinking the Influence of Agency Theory in the Accounting Academy*, Cohen and Holder-Webb state:

The popular and business press emphasized greed throughout its coverage of recent accounting scandals. However, if one searches beneath the surface of these events, there appears to be a common theme that permeates almost all of the egregious scandals: inventive and occasionally desperate attempts to meet earnings forecasts and keep the numbers up at all costs. (Cohen and Holder-Webb 19)

Accounting standards are established to ensure that management of a company does not commit fraudulent activities in order to get the published financial statements to meet earnings projections. However, the problem lies in the legal ways that management attempts to meet earnings projections. This is where the ethical debate arises.

Some believe that as long as the managers of a company are following accounting standards, they are acting ethically on behalf of the company. Others believe that there are unethical, but legal, practices that managers partake in that should not be allowed within businesses. Auditors tend not to think that these practices are unethical. If the financial statements agree with GAAP, the auditors are typically not concerned. However, some believe that the practices such as earnings management are unethical and

should not be allowed in a business because to participate in these activities could potentially misstate inventory and net income. Earnings Management can be described as income increasing or decreasing accounting choices that companies use to manipulate the published financial statement numbers. (Peltier-Rivest and Swirsky) This could be considered unethical by the people who use the financial statements to make decisions. If managers are hired from the external labor market, then they are much more likely to engage in earnings management in order to boost the company's earnings in order to receive their bonuses. This is better explained in *Positive Accounting Theory*, which states, "A lot of executives apparently believe that if they can figure out a way to boost reported earnings their stock prices will go up even if the higher earnings do not represent any underlying economic change. In other words, the executives think they are smart and the market is dumb" (Watts and Zimmerman 75). This idea of earnings management is the way that management plans to increase the perceived revenue generated by the company on the published financial statements. In turn, the managers will meet their quotas to receive their bonuses, and the stock price will also go up because investors believe that the company is growing at a positive rate. One way to create this effect to drive up stock prices is to change the way the company accounts for inventory. If the company switches its method from FIFO to LIFO for inventory costing, then it affects future taxes, and that affects future cash flows. It usually decreases taxes and increases net cash flow. Another way to participate in earnings management is the way a company records depreciation. There are many different methods that follow GAAP, such as straight-line method, or double-declining balance. The company can participate in

earnings management and change the way it records depreciation to change the net income.

Earnings management is not illegal. In fact, there are many companies that participate in earnings management. This process follows GAAP and, therefore, is legal. The real issue within accounting is whether or not it is ethical. Some accountants believe that it is unethical because it is inflating earnings in order for management to meet earnings. Others believe that because it follows GAAP there is nothing wrong with it. There are multiple reasons why a manager will engage in earnings management. One major reason involves a company's debt covenants. In *Earnings Management in Healthy Firms*, Peltier-Rivest and Swirsky state, "The debt covenant hypothesis predicts that when a healthy firm is close to violating an accounting-based debt covenant restriction, its managers are expected to make income-increasing accounting choices to relax the debt covenant restriction and lower the expected costs of technical default" (Peltier- Rivest and Swirsky 23). Managers will also engage in earnings management because of bonus incentives. Managers that are hired externally receive a bonus if they meet certain published net income projections. If the managers do not meet the projections, they will not receive a bonus. Externally hired managers are more likely to make income-increasing accounting choices that will affect the financial statements because tend to be focused on the published numbers. Managers of any company should not be focused on the externally published information of a company. Instead, they should be focused on the internal accounting that is in place within their company.

While hiring from the external labor market causes many problems that accounting principles cannot prevent, hiring from an internal labor market could be the

potential solution. Many companies give promotions as incentives for their employees to stay with the company. It also gives the employees a better sense of belonging within a company. There are multiple positive reasons for hiring from the internal labor market. One major incentive for a company to hire from within is the difference in pay. A manager promoted from within typically does not receive a bonus package as an incentive for becoming manager because he or she is more concerned with intrinsic benefits from the company, such as making the company more profitable. This means that the company, in turn, saves money by promoting from within. They typically do not pay an incoming manager as much if he or she was hired from the internal labor market as opposed to the external labor market. This also gives the employees more incentive to work harder in hopes of receiving a promotion.

While there are many wonderful reasons for hiring from the internal labor market, there is one reason that surpasses all others. Hiring from the internal labor market creates a strong company culture and organizational environment. A lack of a bonus incentive in management tends to create a business environment that makes ethical decisions. While following along with GAAP, management is focused on the quality of their work and the internal accounting that occurs within the business. They are not focused on the published financial statements like management hired from an external labor force. This creates ethical decision making from management. It also allows the ethical code of conduct of the company to be upheld throughout management. If management is created from inside the company, the people know exactly what is expected of them. The ethical code of conduct displayed by management is the same as the entire company. This creates a strong organizational structure within the company. Focusing on the internal structure of

the company and the internal accounting procedures performed will allow the company to make ethical decisions. Promoting from within keeps management of a company from focusing solely on the published financial statements. The managers promoted from within do not wish to participate in earnings management because they have no need to try to inflate earnings within a company. They are focused on the internal accounting processes that occur as opposed to putting too much emphasis on the published financial statements. Hiring from the internal labor market cuts out many ethical issues that even accounting standards cannot prevent.

II: Agency Theory

In addition to the unethical behavior of earnings management created by hiring management from an external labor market, managers that focus on externally published financial statements unknowingly participate in agency theory. In the 21st volume of *Issues in Accounting Education*, the problem of agency theory is described more in depth. The Agency theory model is defined as, “The [Agency Theory] model assumes a separation of ownership and control, information asymmetry arising from that interested behavior on the part of the contracting parties” (Cohen and Holder-Webb 23). Another simpler definition of agency theory comes from the *Business and Society Review*, which states that, “The agency theory of the firm ... focuses on the relationship between the principal (owner/stockholder) and the agent (manager)” (Culpan and Trussel 62).

The basics of the theory indicate that there are involved parties that have contradicting ideas. In the case of most businesses, there are typically two different parties: the shareholders and the managers. The shareholders are the party interested in the published financial statements. However, they are interested in the statements for a different reason than the externally hired manager. They are interested in seeing the stock price go up to ensure that the company is profitable. Managers hired from an external labor market are also interested in the published financial statements, but for personal reasons. They are focused on getting the incentive bonus for reaching projected earnings for the year. This creates an ethical dilemma. The shareholders trust managers to make ethical decisions when reaching published financial information. They trust that the managers do everything in the interest of the shareholders to create a profitable company.

However, managers are often times solely focused on their own gains. They will try to manipulate the numbers to receive their bonus. This includes using earnings management to reach a desired net income for the published statements.

Culpan and Trussel also state, “The agent has certain obligations, which are to be fulfilled for the principal by virtue of their economic contract. ‘The underlying mechanism with which this relationship is articulated is in terms of a contract between the principal and the agent; thus, the firm is seen as a nexus of contracts between principals and agents’” (Culpan and Trussel 62). The idea that the agent will always act in a desirable way for the principal is hard to determine. The ideal scenario would be that managers would make decisions that would ultimately minimize agency costs while also increasing the wealth of the stockholders. This is very hard to accomplish though. Managers are typically so worried about meeting projected earnings to receive a bonus that they do not take into consideration the best interests of the shareholders. This is what creates the ethical agency theory debate within accounting.

By hiring from an internal labor market, a business can focus more on creating the right relationship between the manager and the shareholders. Instead of worrying about the published numbers for their own personal gain, the managers can instead focus on the needs of the shareholders. This creates a healthy relationship within the company and leaves little room for ethical mistakes. The managers’ actions reflect that of ethical decision making in regard to the decisions made that directly affect the shareholders. The shareholders are more satisfied because they have a manager they can trust to make decisions with their best interests in mind. Managers are also more satisfied because they have a better chance of continuing as managers if the shareholders are happy.

This creates a positive environment that allows all involved parties to interact together in a positive manner.

III: Foundations of Fraud

Another ethical debate concerning accounting practices is fraudulent activities among management of a company. While this activity is known to be unethical in every way possible, it is often hard to stop it from happening. Fraud is an unfortunate part of everyday life. In today's society, fraud is a major topic of discussion because it does not only happen in the business world. For example, identity theft is on the rise and there are many systems in place to stop it from happening. However, these practices do not always stop fraud. Citizens are continuously reporting identity theft or fraudulent charges on credit cards. Just like identity theft, fraudulent activities within the business world immeasurably affect citizens of our country. There are many systems in place to stop these wrongdoings, but there are still many things that could be done. Before delving into fraud, first consider the definition. According to *The Accountant's Guide to Fraud Detection and Control*, fraud is defined as "A deception deliberately practiced in order to secure unfair or unlawful gain" (Coggins et al. 40).

Fraud has occurred for many years. There truly is no way to completely predict when fraud will happen; however, there are times when the opportunity is higher than others. When investigating fraud, it is essential to consider the "fraud triangle." The fraud triangle is taught in most accounting classes. It is an easier way of understanding why people would commit fraud. The fraud triangle is a triad of ideas that make for the ideal time to commit fraud within a company. The first category is the incentive or pressure to commit fraud. People are not going to commit fraud just because they feel like it that day. There must be a reason behind their thoughts and actions. For people to commit an illegal

act such as fraud, they must have some kind of incentive or pressure to complete the act. For example, if the fraud is committed by management, there is likely pressure for the management to meet third party expectations. If the company is expected to meet a certain number, there may be an incentive for management to manipulate the numbers in order to meet expectations. If they do not meet expectations, they could lose bonuses and the stock price could possibly drop. There is also a chance that the financial stability or profitability of the company is threatened. This could also pressure management into manipulating some numbers so that the company looks relatively stable to investors and possible new clients.

Another possible risk factor relating to incentives and pressures is possibly management's personal financial situation. If managers are in a threatening situation with their personal finances, they could feel a pressure to possibly manipulate numbers in order to keep the stock prices up. If they are successful it could ensure the company's success and their own as well. The second part of the fraud triangle is opportunity. There must be an opportunity for people to commit fraud. If they know without a doubt that they will get caught then they would not even attempt the action. However, if there is an opportunity for them to commit fraud and go unnoticed, this greatly increases the chances of the fraud occurring. For example, one major opportunity is when there is deficient internal control within an organization. An organizations internal control is one key factor to determining the day to day operations within a business. If the internal control is lacking, there is a great possibility that even a simple fraudulent activity could go unnoticed.

Another opportunity is the ineffective monitoring of management. If management is not monitored and is given free range, they could possibly get away with illegal activities that better themselves or the company. This is a prime example of why it is crucial for management to report to the Board of Directors. This simple action could help prevent fraud in a company and help ensure that the management acts in the best interest of the company.

The final part of the fraud triangle is rationalization. In order to commit fraud, people must rationalize that their actions are excusable. One thing to look at when determining possible rationalizations is a history of violations of securities or allegations of fraud. This is a sign that someone may commit fraud in the future. Another sign is the ineffective communication of ethical standards or selection of inappropriate ethical standards. If management is not communicating to the people the correct ethical standards of the company, an employee may be more likely to commit a fraudulent activity. This is why communication within a business is very important. It allows people to know what is expected of them and prevents people from doing things the company deems unethical.

Another rationalization could be that employees believe they are simply “borrowing” the assets from the company. The assets could be money or something else the company values as assets, but the employee may believe that taking them with the idea in mind to replace them at a later date is not stealing or illegal. When these three topics coincide, it creates the perfect opportunity for fraudulent activity to occur.

There are a few things to consider when investigating fraud: the victim, descriptive details of the act thought to be fraudulent, the victim’s loss, possible

perpetrators, evidence that the perpetrator acted with intent, and evidence that the perpetrator profited from the act (Coggins et al. 40). When investigating fraud, one must also take into consideration that the perpetrators do everything they can in order to make their acts unrecognizable. No one will ever truly be able to understand why fraud occurs or who commits it simply because those people will go to great extents to hide their illegal acts. This is why it is very difficult to determine different types of fraud. However, there are said to be three different classifications of fraud: fraud that has been prosecuted, fraud that has been discovered but not yet prosecuted, and fraud that has not been discovered (Coggins et al. 33). The only truly known fraud is the fraud that has already been prosecuted. This is the only type that is observable. While not all fraud is the same, studying the types of fraud that have been committed in the past could potentially help guard against it from happening again in the future. Even though there are systems in place to protect against fraud, there will never be a fail proof way to eliminate it completely. The fraud perpetrators who are being caught are the people who are careless and not very competent to pull off such illegal acts. The more competent people who dedicate countless hours to devising the perfectly foolproof plans are the perpetrators who are still not being caught. This is why it is so important to create a company environment that protects against fraud.

There is no way to rid a business completely of people who could potentially commit fraud because there is no set list of qualities that a perpetrator possesses. People who commit fraudulent activities do not fit into certain stereotypes. These people tend to be those who are least expected. Obviously, personal appearance is not a good indicator of what to look for when determining a perpetrator. A person's lifestyle or a sudden

lifestyle change is a major indicator. “Many white-collar criminals cannot resist spending their ill-gotten gains, and few in our experience save their money. Although some spend conservatively, many others spend extravagantly” (Coggins et al. 44). Detecting fraud in the early stages is a key factor in ensuring large amounts of money are not embezzled from a business. Many large fraud schemes that are easily remembered left many people and companies out of millions of dollars. Studying past fraud schemes can help companies learn about what types of fraud are more easily committed and which schemes are harder to detect. This can give the companies a better understanding of how to protect themselves against fraudulent activities.

Fraud has greatly evolved throughout the years. Fraud that occurred thirty years ago may seem quite simple in today’s society. The development of technology, information systems, and databases, has created an environment for fraud to spread. It is now much harder to detect fraud within an organization. There was one major case of fraud that is easily remembered that caused many regulations to be passed to prevent future cases of fraud. It is known as the Enron scandal. Culpan and Trussel state:

Enron was one of the world’s energy, commodities, and services companies. It marketed electricity and natural gas, delivered energy and other physical commodities, and provided financial and risk management services. In 2000, its revenues were \$100 billion, it was the fifth largest firm in the Fortune 500, and it had 19,000 employees. (Culpan and Trussel 60)

So with all this success, how did one of the largest firms in the country end so abruptly? First, take a look at the start of the fraudulent activities. Enron established as a company in 1985. It started out small like every other business, but during the next sixteen years, it

grew from a concentric firm to a diversified firm dealing with many different commodities. Their commodities ranged from energy production, distribution, trading, to broadband trading. While impressing everyone by their massive growth in 2000, they were audited by a prestigious auditing firm, Arthur Anderson. This firm was considered one of the big eight auditing firms. It was given unmodified audit opinions making the public believe that this company was phenomenal. An unmodified audit opinion simply means that the audit company was stating that the published financial statements were free from material misstatement. This means that if any errors existed, they were not material in effect to the finances of the company. This gave the investors a flawed opinion of Enron. It seemed the company was breaking down so many barriers and reporting record stock prices.

While the company was breaking down many growth barriers, their operating performance was poor and declining. Their debt levels were increasing and it was questionable whether or not they were going to be able to meet their obligations. Despite all these negative performance measures, their liquidity ratios were remaining constant. The stock price kept increasing because more and more people were interested in this rapidly growing company. However, with all the rapid growth, the managers of Enron stretched the company too thin. They kept diversifying into new business opportunities, creating managerial and financial problems that management could not overcome. Even though the managers knew they could not keep up with the constant growth of the company, they became too greedy and did not want the company to go under. They created an elaborate plan that started out small that included many accounting malfunctions. The Securities and Exchange Commission launched an investigation that

discovered the massive fraud that had occurred for years. In addition to Enron committing fraud, Arthur Anderson failed to report all the improper accounting practices that Enron was committing. The firm did not want to report the improper accounting practices of the company because they were also charging them tens of millions of dollars in other consulting fees separate from the yearly audit.

Not long after Enron was uncovered, many scandals came into light because of improper accounting practices. This is when Congress passed the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act in 2002. This act created reform to protect investors against fraud in a public company. It made it illegal for auditors to provide many non-audit services to their clients. It also passed a law that management of a company must sign the financial statements of a company to ensure that the information is correct. By passing this act, it created little wiggle room for management of businesses. They now have to sign documents stating that they are free from misstatement and fraud. This creates a more ethical environment in which managers oversee a company. Even though it protects against illegal fraudulent activities, it does not protect against unethical behaviors exhibited by managers hired by external labor markets as discussed earlier. These managers have to follow all rules and regulations, but there is still room for unethical decisions to be made.

There are many other examples of major fraud schemes that have occurred. However, Enron is one of the most widely talked and known about fraud scheme in history. Some others include, Bernard Madoff, who was exposed in December 2008, created an elaborate Ponzi scheme to make 65 Billion dollars off unknowing people. This was the largest individual fraud scheme in history to the date. Another fraud scheme was

a company known as WorldCom. Their fraud scheme was so corrupt; it caused the telecom company to go bankrupt, which wiped out 103.9 billion dollars in assets.

Another fraud scheme was Tyco International. The CEO and CFO embezzled more than 150 million dollars in unearned bonuses and loans until they were discovered in 2002.

These are just a few of the many large fraud schemes that have occurred over the years.

There have also been numerous small fraud schemes committed by everyday people in companies around the world.

Conclusion

Ethical decision making is an everyday part of life. This is why it is such an important topic. It is not only important in day to day decisions, but also in significant decisions made in businesses. These decisions can affect many people; therefore, they need to be held to a high ethical standard to deter anyone from making unethical decisions within a business. Accounting plays a major role in the ethical decision making of every company. It determines by what standard of ethics the management of a company conducts business. Accounting standards and regulations are important to the way management controls a company. Before many accounting standards were in place, managers made decisions within a company that were extremely unethical and jeopardized many jobs and life earnings of those who invested in a company's stock. With new standards in place, managers of companies are required to do his or her job a certain way. However, even though standards are involved, some managers make decisions that have questionable ethical significance. This is why every business should have a code of ethical conduct to attempt to deter unethical decision making within a company.

Codes of conduct attempt to create a company culture within a business that always achieves ethical decision making. Company culture is an important aspect to any business. It is absolutely necessary for all companies to have their own unique culture. This culture is what sets the culture for all the decisions that are made within the company. If the company culture is not strong and ethically sound, the management of that company may make decisions that are not ethical. The unethical decisions may be legal, but there may be speculation as to whether or not they are ethical. This is a large

debate within accounting today. There are many things that managers do within a business that may be deemed legal but unethical by some. Some of these debates are centered on earnings management and what managers do to better themselves instead of the company. Another act companies participate in is Agency Theory and whether they hire managers from the external or internal labor markets. Despite the debates, accounting still plays a large role in the ethical decision making of managers. It determines the standards they are to follow, and whether or not some activity within a company is fraudulent. These accounting standards determine how a company runs and sometimes even how they choose their management. With more advanced accounting standards, there could be even better protection against activities that are committed but deemed unethical. Until then, however, accounting standards will continue to determine the ethical behavior of management. Many practices within accounting such as earnings management might always be a large debate topic with an absolute right or wrong never accepted.

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