S9-4 Ethical Decision Making: A Real-Life Example

LO 9-2, 9-7

Assume you work as a staff member in a large accounting department for a multinational public company. Your job requires you to review documents relating to the company's equipment purchases. Upon verifying that purchases are properly approved, you prepare journal entries to record the equipment purchases in the accounting system. Typically, you handle equipment purchases costing $100,000 or less.

This morning, you were contacted by the executive assistant to the chief financial officer (CFO). She says that the CFO has asked to see you immediately in his office. Although your boss's boss has attended a few meetings where the CFO was present, you have never met the CFO during your three years with the company. Needless to say, you are anxious about the meeting.

Upon entering the CFO's office, you are warmly greeted with a smile and friendly handshake. The CFO compliments you on the great work that you've been doing for the company. You soon feel a little more comfortable, particularly when the CFO mentions that he has a special project for you. He states that he and the CEO have negotiated significant new arrangements with the company's equipment suppliers, which require the company to make advance payments for equipment to be purchased in the future. The CFO says that, for various reasons that he didn't want to discuss, he will be processing the payments through the operating division of the company rather than the equipment accounting group. Given that the payments will be made through the operating division, they will initially be classified as operating expenses of the company. He indicates that clearly these advance payments for property and equipment should be recorded as assets, so he will be contacting you at the end of every quarter to make an adjusting journal entry to capitalize the amounts inappropriately classified as operating expenses. He advises you that a new account, called Prepaid Equipment, has been established for this purpose. He quickly wraps up the meeting by telling you that it is important that you not talk about the special project with anyone. You assume he doesn't want others to become jealous of your new important responsibility.

A few weeks later, at the end of the first quarter, you receive a voicemail from the CFO stating, "The adjustment that we discussed is $771,000,000 for this quarter." Before deleting the message, you replay it to make sure you heard it right. Your company generates over $8 billion in revenues and incurs $6 billion in operating expenses every quarter, but you've never made a journal entry for that much money. So, just to be sure there's not a mistake, you send an e-mail to the CFO confirming the amount. He phones you back immediately to abruptly inform you, "There's no mistake. That's the number." Feeling embarrassed that you may have annoyed the CFO, you quietly make the adjusting journal entry.

For each of the remaining three quarters in that year and for the first quarter in the following year, you continue to make these end-of-quarter adjustments. The "magic number," as the CFO liked to call it, was $560,000,000 for Q2, $742,745,000 for Q3, $941,000,000 for Q4, and $818,204,000 for Q1 of the following year. During this time, you've had several meetings and lunches with the CFO where he provides you the magic number, sometimes supported with nothing more than a Post-it note with the number written on it. He frequently compliments you on your good work and promises that you'll soon be in line for a big promotion.

Despite the CFO's compliments and promises, you are growing increasingly uncomfortable with the journal entries that you've been making. Typically, whenever an ordinary equipment purchase involves an advance payment, the purchase is completed a few weeks later. At that time, the amount of the advance is removed from an Equipment Deposit account and transferred to the appropriate equipment account. This hasn't been the case with the CFO's special project. Instead, the Prepaid Equipment account has continued to grow, now standing at over $3.8 billion. There's been no discussion about how or when this balance will be reduced, and no depreciation has been recorded for it.

Just as you begin to reflect on the effect the adjustments have had on your company's fixed assets, operating expenses, and operating income, you receive a call from the vice president for internal audit. She needs to talk with you this afternoon about "a peculiar trend in the company's fixed asset turnover ratio and some suspicious journal entries that you've been making."

Required:

1. Complete the following table to determine what the company's accounting records would have looked like had you not made the journal entries as part of the CFO's special project. Comment on how the decision to capitalize amounts, which were initially recorded as operating expenses, has affected the level of income from operations in each quarter.

	Q1 Year 1 (March 31)		Q2 Year 1 (June 30)		Q3 Year 1 (September 30)		Q4 Year 1 (December 31)		Q1 Year 2 (March 31)	
(amounts in millions of U.S. dollars)	With the Entries	Without the Entries	With the Entries	Without the Entries	With the Entries	Without the Entries	With the Entries	Without the Entries	With the Entries	Without the Entries
Property and Equipment, Net	$38,614	$	$35,982	$	$38,151	$	$38,809	$	$39,155	$
Sales Revenues	8,825	8,825	8,910	8,910	8,966	8,966	8,478	8,478	8,120	8,120
Operating Expenses	7,628		8,526		7,786		7,725		7,277	
Income from Operations	1,197		384		1,180		753		843	

2. Using the publicly reported numbers (which include the special journal entries that you recorded), compute the fixed asset turnover ratio (rounded to two decimal places) for the periods ended Q2–Q4 of year 1 and Q1 of year 2. What does the trend in this ratio suggest to you? Is this consistent with the changes in operating income reported by the company?
3. Before your meeting with the vice president for internal audit, you think about the above computations and the variety of peculiar circumstances surrounding the "special project" for the CFO. What in particular might have raised your suspicion about the real nature of your work?
4. Your meeting with internal audit was short and unpleasant. The vice president indicated that she had discussed her findings with the CFO before meeting with you. The CFO claimed that he too had noticed the peculiar trend in the fixed assets turnover ratio, but that he hadn't had a chance to investigate it further. He urged internal audit to get to the bottom of things, suggesting that perhaps someone might be making unapproved journal entries. Internal audit had identified you as the source of the journal entries and had been unable to find any documents that approved or substantiated the entries. She ended the meeting by advising you to find a good lawyer. Given your current circumstances, describe how you would have acted earlier had you been able to foresee where it might lead you.
5. In the real case on which this one is based, the internal auditors agonized over the question of whether they had actually uncovered a fraud or whether they were jumping to the wrong conclusion. *The Wall Street Journal* mentioned this on October 30, 2002, by stating, "it was clear . . . that their findings would be devastating for the company. They worried about whether their revelations would result in layoffs. Plus, they feared that they would somehow end up being blamed for the mess." Beyond the personal consequences mentioned in this quote, describe other potential ways in which the findings of the internal auditors would likely be devastating for the publicly traded company and those associated with it.

WorldCom
Verizon

Epilogue: This case is based on a fraud committed at WorldCom (now part of Verizon). The case draws its numbers, the nature of the unsupported journal entries, and the CFO's role in carrying out the fraud from a report issued by WorldCom's bankruptcy examiner. Year 1 in this case was actually 2001 and year 2 was 2002. This case excludes other fraudulent activities that contributed to WorldCom's $11 billion fraud. The 63-year-old CEO was sentenced to 25 years in prison for planning and executing the biggest fraud in the history of American business. The CFO, who cooperated in the investigation of the CEO, was sentenced to five years in prison.