BUSINESS ETHICS and Sarbanes Oxley (SoX)

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Outline

• OVERVIEW
• This model will briefly cover:
• Fundamentals of Business ethics as espoused by SOX (2002)
  - What is ethics?
  - What are ethical considerations managers, stockholders, auditors and other related parties should be aware of?

Vignettes (mini case studies) to emphasize key “ethical” considerations in SOX.
Learning Objectives and Skills

**Students will**

- Be able to explain the Fundamentals of Business Ethics
- To provide students with an understanding of the basic code of ethics with special emphasis on the principles laid down by the Sarbanes Oxley Act
- To help students understand what is proper ethical behavior in a business environment
- To learn about intercultural sensitivity when working in a multicultural environment.

**Skills developed**

- Ethics and Integrity
- Ethics and Conduct
- Working in cross-cultural teams and environments

SOX and business ethics

**BACKGROUND**

Following a number of corporate accounting scandals in the USA, the Congress passed the Sarbanes Oxley Act of 2002. The Sarbanes Oxley Act established new and enhanced standards for corporate accountability.

Section 406 of the Sarbanes Oxley Act “Code of Ethics for Senior Financial Officers” requires companies to have ethical standards.
SOX and business ethics

Standard 406 of SOX 2002 defines code of ethics as follows:
Standards that are reasonably necessary to promote:
• Honest conduct including the honest handling of actual or apparent conflicts of interest between personal and professional relationships
• Compliance with applicable laws and regulations

SOX and Business Ethics

• Objective
  • The Sarbanes Oxley Act (2002) provides many examples that can be used to enhance awareness of ethical considerations.
  • The objective of this module is to use guidelines provided by SOX (Section 406) to enhance awareness of proper ethical behavior.
    - This will be taught by means of mini cases that create situations which enable students to engage in “role playing” to enhance their awareness and understanding of accepted codes of behavior.

“Sure we cheated. You told us to make the answers as realistic as possible.”
Case 1

Jerry is a partner in an audit firm. Jack is the accountant of Widgets R Us, a company producing widgets. Jack and his managers provide Jerry with season tickets to watch the New York Tigers, his favorite baseball team.

**Key issues:**

1. Is there a violation of ethics in this situation?
2. If your answer is yes, to (1) above, why?

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An acceptance of a gift can be perceived by others as influencing the business judgment of the recipient.

The same applies to employees of a company. One cannot accept gifts as it would cause a perception that their decisions (discounts to customers etc) are improperly influenced.
Case 2
Widgets R Us informs Jerry, that, due to a cash flow problem, they do not have money to pay the audit fees. However, they pay the equivalent amount by giving Jerry stock in their company.

Issues
1. Is there a violation of ethics in this situation?
2. If your answer is yes, to (1) above, why?
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SOX and business ethics
1. There is a violation of ethics.
2. The reason is that there is a matter referred to as conflict of interest (conflict of interest is covered in section 206 of SOX). Now Jerry will benefit if the stock price of Widgets R Us increase. Jerry is vulnerable to pressure from Jack to authorize “adjustments” to the accounts that improve earnings.
Case 3
Joanne and Betty, sisters of Jerry, the partner of the audit firm auditing Widgets R Us, buys stock in Widgets R Us. They argue that there is no conflict of interest since Jerry does not benefit financially from their transactions.

Issues
1. Is there a violation of ethics?
2. If so, what (if any)?

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1. There is still a violation of ethics if the amount held by Jerry’s family is “substantial”.
2. Even though Jerry is not directly involved, this comes under the category of related third party transactions. Jerry is still vulnerable to pressure because his direct family will benefit from “adjustments” to the accounts that improve perceived performance and stock price.

This applies to employees of a company too. The holding by an employee or any member of his or her family of any substantial financial interest in any enterprise (customer or supplier) is not allowed.
Case 4
Jill is an employee of Widgets R Us. She is in charge of the computer store room. She borrows a computer, takes it home, and returns it when she is done using it. She is very careful and the computer is till in extremely good condition.

Issues.
1. Is there a violation of ethics?
2. Why?

1. There is a violation of ethics even though the computer is returned.
2. This comes under the category of *misuse of company assets by its custodians*. Employees are responsible for the security, authorized access to and the proper use of physical and nonphysical assets. Physical assets include equipment, inventory, money, documents and office supplies. Use by an employee of physical assets for which the employee might benefit is forbidden.
Case 5
Take the same example as before. Jill borrows a computer but gets the permission of her immediate superior.

Issues
1. Has the situation changed. Is it now ethical?
2. If not, why?

- It is still not ethical. Jill may be friendly with the boss directly in charge of her. In general use of assets for which an employee is custodian, must be justified and approved by two levels of management above the employee concerned.
Case 6
Jack realizes that a major product line of Widgets R Us is going to become obsolete. He tells some friends who have stock in Widgets R Us. The friends, fearing that the stock price will decline, immediately sell their stock.

Issues
1. Is this ethical?
2. If not, why?

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This is characterized under insider trading which prevents employees from profiting from inside information of the company. Even though Jack did not personally profit from disclosing the information and hence, did not violate the law, his action is still a violation of business ethics.
SOX and Business ethics

Case 7
Take the same example as before. Assume that this time Jack tells friends who do not have stock in the company about the potential bad news. Neither Jack nor his friends profit in anyway from this information.

Issues
1. Has Jack violated business ethics given that nobody profited from the information?
2. If so, why?

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Even though nobody profited from Jack releasing this information, it is still considered a violation of business ethics. An over-riding principle is that no employees in the organization should communicate externally about the company’s prospects with respect to performance and company policies nor disclose unpublished price sensitive information without authorization.
Case 8
Jerry, the CEO of Widgets R Us contributes $100,000 to the Republican party from company funds since he believes in all the policies of the party. He also believes that if the Republican party wins Congress and the Presidency, their economic policies will greatly benefit his company. Jerry finds nothing in state laws that prevent him from making contributions. He also spoke to the shareholders who had no objections.

Issues
1. Is his action ethical?
2. If not, why not?

In this case, Jerry’s action cannot be considered unethical. With respect to the law, the US foreign Corrupt Practices Act allows contributions provided shareholder approval is obtained. Contributions to congressmen are in accordance with the law if state laws permit corporate contributions. The contribution must be made adhering to applicable state and local laws. The US Pharmaceutical Operating Committee is responsible for oversight and assuming that such contributions are in compliance with all applicable laws.
Case 9
Jerry is a very devoted Republican. During the election campaign, in addition to contributing, he requests his employees to contribute to a fund that will be donated to the Republican party.

Issues
1. Is the action by Jerry ethical?
2. If not, why?

The action by Jerry is not unethical. It does not violate any code of ethics. In addition, it does not violate any laws. The Federal Election Campaign Act allows requesting of donations provided there is no coercion in any form in respect to participation in the fund (called the Political Action Committee Fund).
Case 10
Joe has worked for many years at Widgets R Us. He is loyal to the company. He is in charge of developing a new product line of widgets which, when brought to market will definitely increase the earnings of the company. He now realizes that stocks in Widgets R Us are a good investment and buys a number of shares.

Issues
1. Is this ethical?
2. If not, why not?

This action is not ethical. No employee can deal in stock of the company if he or she is in possession of unpublished price sensitive information.
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Let us now consider some issues from the audit firm's point of view. Consider the following cases and give your opinion.

Case 11
Jack is the audit partner for Widgets R Us. Jack's boss, the chief partner feels that Widgets R Us is an important client. He has a compensation structure where Jack is rewarded for retaining the client (i.e., client deciding to stay with the audit firm).

Issues
1. Is this form of compensation structure meet ethical standards?
2. If not, why?

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• Prior to the Sarbanes Oxley Act of 2002, there was no legislation which said this was unethical as long as the partner acted judiciously and honestly.
• The issue of compensation structure has long been a bone of contention.
• However, the ethical standards under SOX do not address this. Hence, despite the contention, this compensation structure cannot be considered to be unethical.
SOX and business ethics

• **Case 12**
  Jerry the owner of Widgets R Us, with his top managers ask the audit firm to provide consulting services in areas relating to book keeping, designing and setting up accounting systems, tax and management consulting. This is in addition to the auditing services.

**Issues**
1. Is this ethical based on the new standards?
2. If not, why?

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This was a big issue especially after the Enron scandal. Arthur Andersen (AA) the auditor, provided consulting services to Enron for which they received $75 million and then conducted the audit (fees $25 million).

Prior to the Enron scandal, there was nothing in any guidelines regarding the provision of consulting service. However, now certain kinds of consulting services cannot be provided. These are the services described in case 12.
Case 13
Jack the owner of Widgets R Us, with his top managers ask the audit firm to provide tax consulting services. This is in addition to the auditing services. Jack feels that there is no association between tax and auditing and hence should not violate any standards.

Issues
1. Is this ethical based on the new standards?
2. If not, why?

In Section 206 SOX specifically prohibits the type of services Arthur Anderson the audit firm provided to Enron. These include the services discussed earlier. However, tax consulting is not prohibited. Hence, by default, this cannot be considered violation of ethical standards under SOX.
**Case 13**

The Jack and the other managers of Widgets R Us are responsible for hiring and firing the auditor.

**Issues**

1. Is this considered ethical? In other words, do you see anything wrong with this?
2. If so, what is the violation (if any)?

Under the new ethical guidelines provided under section 406 of SOX, managers cannot be responsible for hiring and firing of auditors. It is the owners (stockholders) who should be responsible. Managers work directly with the auditor during the conduct of an audit. If managers are allowed to fire auditors, then a scenario is created where the auditor may be “beholden” to the managers and may be more vulnerable to pressure.
Case 14
The audit firm of Jack are paid by the managers of Widgets R Us. Their fees are determined by and negotiated with the managers.

Issues
1. Do you see any ethical problems here?
2. If so, what (if any)?

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The same issues apply here as in the previous case. If managers are allowed to negotiate and determine audit fees, then they can put pressure on partners to “pass” accounting entries that increase earnings to enable them to increase their bonuses. SOX does not allow this under the new standard of ethics. Rather, stockholders have to determine audit fees and approve the audit fees in their general meetings. Since auditors do not work with stockholders, this reduces the perceived threat to them.
Case 15
Jerry the partner of the audit firm has been responsible for supervising the audit of Widgets R Us for the last ten years.

Issues
1. Is there any form of ethical violation here?
2. If so, what is the violation?

Prior to the ethical standards issued by SOX with regard to section 406 in particular, this was not an issue. In fact, it was considered to be beneficial since the partner could be considered an expert on the company and its industry.

After the ethical standards issued by SOX, this is now considered a violation of ethical standards. Section 203 in particular requires partners to “rotate” every five years. This reduces the chances of “familiarity” with managers. Section 203 even goes so far as to recommend that the audit firm itself should be rotated though this is still under discussion.
SOX and Business Ethics

Conclusion
In summary, the SOX act provides a code of ethics. In the previous slides we discuss key violations of ethics in the USA. In America violation of the ethical standards discussed may result in penalties but not necessarily jail time. However, it is important to note that in some European countries “ethical standards” are in fact the law (e.g., Germany) and violation of the same ethical codes could result in prison time. It also has to be noted that violating ethical standards such as accepting bribes could, under SOX, result in imprisonment. However, in many Asian and African countries (while in theory it is illegal) bribes are the norm and accepted way of doing business when parties are not known to each other. These differences have to be borne in mind. In the next section of this module we focus on intercultural sensitivities.

SOX and Business Ethics

- Cross cultural sensitivity: Why is it important?
  Cross cultural sensitivity is important because proper ethical conduct involves understanding the cultural sensitivities of people from other countries and acting in a manner that does not hurt or offend others.

- Cross cultural sensitivity: What does it mean?
  Culture is the acceptable way of thinking and doing things in that part of the world where you were born. Cross cultural sensitivity involves understanding the differences between cultures and adjusting behavior to show respect to foreign cultures.
SOX and Business Ethics (continued)

• **Case one**
  Mary and Barbara are close friends at High School. While they are walking together through a shopping mall, they see a group of visitors from India all dressed in Indian attire. Mary laughs and jokes how odd they look to Barbara. Barbara thinks it is funny too.

  *Comment*

SOX and Business Ethics

• Cross cultural sensitivity involves understanding that people from other cultures dress differently. The point to be made here to Mary and Barbara is that to the “foreigners” perhaps they look funny too.
SOX and Business ethics

• Case 2
After high school, Mary and Barbara go the same college and then decide to spend a semester studying in Munich, Germany. Mary and Barbara live in a type of student hostel where mostly students from abroad are housed. They spend most of their time hanging out with other American students with whom they feel more comfortable.

Comment

This is a “trap” most people fall into. People feel comfortable mixing with their “own kind” due to similarity in language and culture. Unfortunately, foreigners see this as arrogance. This creates a subconscious prejudice. This prejudice affects relationships including business relationships. Foreign people appear to be “less friendly” and more difficult to negotiate with. When Mary and Barbara are living in Germany, they should read about Germany and the Germans, and perhaps take a beginner’s course in German. Living with German friends and spending more of their free time with new German friends would foster goodwill and affect both personal and future business relationships. For example, when dealing with China, having even a rudimentary understanding of Mandarin would “open doors” due to their respect that you have made an attempt to learn their language (and culture). This applies universally.
SOX and Business Ethics

• Case 3
When they graduate from university, Mary and Barbara get their first job with an American firm based in Germany. The people in their department are extremely diverse. Over lunch breaks, they spend most of their time explaining the American way of doing things and what a wonderful place America is.

Comment

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This type of behavior accentuates foreigners’ perception of arrogance. Mary and Barbara should view this as a wonderful opportunity to go deeper into German cultural attitudes and ways. Help colleagues with their English speaking skills, but rather than talk about their home country, listen more to learn more. Listening actually increases goodwill because it is another form of showing respect to foreign cultures.
SOX and Business Ethics

Case 4
Mary and Barbara get transferred to an overseas office in Asia. They notice that, for them, it is easier to get important orders if they “grease” hands (even though giving bribes is against the law in the U.S.A; refer Section 402 SOX Act). They feel that this is acceptable and ethical in foreign climes and will also enable them to perform more effectively and get promotions more quickly.

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While accepting and giving bribes in certain countries can occur, we should not labor under the misapprehension that this form of behavior produces the best results. Mary and Barbara should take a different approach; never give or take bribes, but try to build up a long term relationship of trust and reliability with their Asian partners. “Foreigners” request bribes simply because they do not respect people from the West. It is surprising the positive results that can be obtained by working hard to build a relationship of trust.