

An ethics case study for introductory business/ accounting students

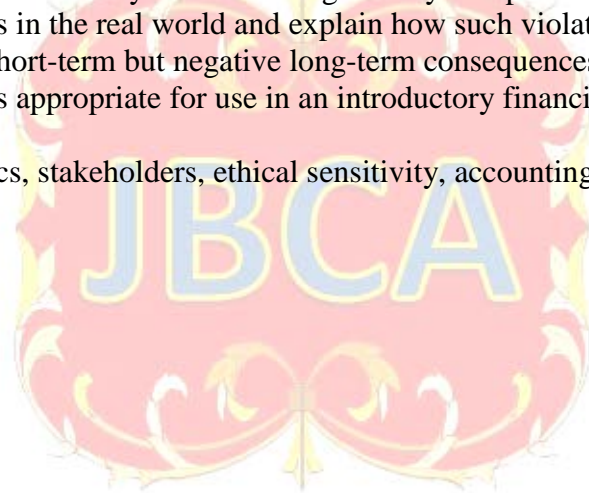
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ABSTRACT

This instructional case is designed to enhance the ethical sensitivity of introductory business/accounting students by analyzing ethical issues in a real-world setting. Case requirements ask students to identify violations of generally accepted accounting principles and other accounting concepts in the real world and explain how such violations may provide financial benefits in the short-term but negative long-term consequences for affected stakeholders. The case is appropriate for use in an introductory financial accounting course.

Keywords: business ethics, stakeholders, ethical sensitivity, accounting scandal



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INTRODUCTION

Accounting and business scandals continue to be headline news, even after legislative reform and calls from the profession to maintain high ethical standards. Some critics lay the blame at the door of business schools, charging that business schools focus on the creation of shareholder wealth as the ultimate goal with little, or no, discussion of appropriate ways to achieve that goal (AACSB 2004). The accounting profession believes that accounting programs desensitize students to ethical issues by placing too much emphasis on the quantitative aspects of accounting and minimizing the behavioral dimensions of the profession (IESBA 2014, PwC 2003). Both groups have called for educational institutions to incorporate ethics into accounting curriculums with the goal of increasing the ethical development of accounting and business students.

Ethical development is defined in terms of three key dimensions: ethical sensitivity/awareness, ethical reasoning/judgment, and ethical maturity/character (cf. AACSB 2004, IAESB 2007, IAESB 2014, Rest 1986). Ethical sensitivity or awareness relates to the ability to identify and relate to ethical concepts, conditions, issues, interests, responsibilities, and implications (cf. AACSB 2004, IAESB 2007, IAESB 2014, Rest 1986). This involves recognition of ethical issues, incentives for and consequences of behavior, and the impact of behavior on others. Ethical sensitivity/awareness is an initial component of ethical development and provides the foundation for ethical reasoning and behavior (AACSB 2004, IAESB 2007, Rest 1986).

The purpose of this case is to enhance students' ethical sensitivity as a precept for further moral development in subsequent business courses. The case requires students to research a real-world ethics scandal, in this case, WorldCom¹. The intent is for students to research enough about the scandal to understand the nature of the scandal and how it was perpetrated. In this way, they can understand what was done and what accounting principles and concepts were violated as a result. A second level of understanding is achieved by requiring students to determine the benefits that accrued to the company and the compensation of the top executives so that they understand the significant incentives that motivate professionals to violate laws and ethical norms. Finally, students are required to identify the consequences and penalties of such acts on a variety of stakeholders with the intent of increasing their empathy for others and understanding the long-term consequences of ethically expedient behavior.

The remainder of this paper is structured as follows. The next section presents the suggested courses and learning objectives for the case, the following section presents the case requirements and a brief discussion of classroom use, and the final section provides information on the efficacy of the case.

TARGETED COURSES AND CASE LEARNING OBJECTIVES

This ethics case was designed for an undergraduate introductory financial accounting course that includes all types of business majors, not just accounting. To complete case requirements successfully, students will need foundational understanding of accounting concepts, such as relevance, faithful representation, confirmatory value, completeness, neutrality,

¹ This case specified WorldCom as the scandal but the same case requirements could be applied to any business/accounting scandal.

freedom from error, and verifiability, and rudimentary generally accepted accounting principles such as those covered in an introductory financial accounting course. Since students need some understanding of these concepts to complete the case, it is best administered towards the second half of the semester.

The specific learning objectives for the case are to develop students' ability to:

1. Identify violations of generally accepted accounting principles (GAAP) in a real world setting.
2. Identify violations of accounting concepts and/or qualitative characteristics underlying financial reporting (such as relevance, faithful representation, confirmatory value, completeness, neutrality, freedom from error, verifiability).
3. Explain how individuals and companies may benefit in the short run from ethical and accounting violations.
4. Explain how stakeholders are ultimately negatively affected by unethical behavior and violations of GAAP in the long-run.

CASE REQUIREMENTS

1. Research the Worldcom accounting scandal using the internet or other sources. Please provide as much relevant, detailed, and important information as possible in your answers while adhering to the length requirements of the assignment.
2. Worldcom misled investors, lenders, and other stakeholders by not following proper Generally Accepted Accounting Principles. Describe the two primary ways the company increased net income by violating GAAP.
3. In addition, Worldcom violated some of the accounting principles, assumptions and qualitative characteristics we discussed in class. Describe two of the other accounting principles, assumptions or qualitative characteristics that were violated.
4. Before the accounting violations were discovered, they resulted in higher net income for the company. How did this higher net income benefit the following stakeholders:
 - The company
 - The bonuses of top executives
5. After the accounting improprieties were discovered, they resulted in serious consequences for several groups of stakeholders. Describe the penalties, punishment and/or other negative repercussions to the following stakeholders:
 - The company
 - Employees of the company
 - The company's key executives: CEO Bernard Ebbers and CFO Scott Sullivan
 - Shareholders who owned Worldcom's stock at the time the scandal was reported.

CLASSROOM USE

The ethics case may be assigned as a class discussion exercise, written case assignment, and/or presentation assignment on an individual or team basis. The authors first assigned the case as an individual written research assignment, followed by a class discussion. After completion of the case, students provided suggestions for improvement as well as an assessment of how well case objectives were achieved. Based on student suggestions, a second iteration of the case involved the following changes:

- Additional instruction reinforcing the effect of an error on both the balance sheet and income statement with examples,
- More focus on accounting concepts,
- Discussion of real-world ethics cases in class to expose students to relevant accounting issues and how to isolate the accounting issues and their impact from a case

The basis of these suggestions was for enhanced student understanding prior to being given a written case assignment. In addition, class discussion of the suggested response to the case requirements was expanded to enhance student understanding of the case subsequent to their written case submissions. This was also in response to student suggestions from the first case.

Other things that helped students' learning experiences are the proper amount of guidance given for the assignment and incorporation of personal ethical experiences. With respect to guidance, providing the "Goldilocks" amount of information to the students (not too much but not too little) is key; too little guidance frustrates students and too much impedes self-discovery. Another aspect that students liked was discussion of numerous real-world examples of accounting irregularities, including many from local businesses that had been in the news. In addition, the authors asked the students for ethical violations that they had personally experienced or knew about from their home towns. It was surprising how many examples the students had! These were effective ways to make the assignment more personal and to improve the students' sensitivity to unethical behavior. Finally, while it is tempting to allow students to select their own cases for analysis, it's really impractical at this academic level as many students do not possess the necessary background to analyze more complex cases that they may select. It is helpful to choose cases where the accounting irregularity is easier for the students to understand.

Time needed to discuss/present the case in class largely depends on the sophistication and level of detail associated with the assigned case. The authors have found that approximately 30 minutes of class time is adequate to address background, central case concerns, and case requirements. The time necessary to prepare the case from a student perspective is a function of conceptual understanding of the material, complexity of the case, and student effort. Students reported that the case took approximately 2 - 6 hours to research and prepare. The authors have found that an additional 30 minutes of class time is appropriate to discuss the correct responses and corollary issues that may arise from the case.

The case submissions were assessed using a grading rubric based on the case learning objectives. The grading rubric is attached in Appendix A.

EFFICACY OF THE CASE

The case was assigned in four sections of Principles of Financial Accounting classes across two semesters. The courses included all business majors. The authors assessed the effectiveness of the case from both the instructor perspective and the student perspective. Students provided feedback in the form of a survey taken after completion of the case and by providing suggestions for improvement. A copy of the student survey appears in Appendix B. There were a total of 116 students assessed and 98 students who completed the survey. The results of the student surveys from both semesters, where the second semester case included revisions based on student comments, appear below. The results of the second semester are shown first, and are designated by S2; the results of the first semester are shown second, and are designated by S1. A summary of student comments appears in Appendix C.

Learning Objective	Student Survey Statement	Mean Student Responses ²	Assessment Expectation	Mean Student Score ³
1	1. This case helped me identify violations of generally accepted accounting principles in a real world setting.	S2=4.32 S1=4.19 Increase=3.1%	1. Students should demonstrate understanding of the impact of the violation on income.	S2=3.92 S1=3.68 Increase=6.5%
2	2. This case helped me identify violations of accounting concepts and/or qualitative characteristics underlying financial reporting (such as relevance, faithful representation, confirmatory value, completeness, neutrality, freedom from error, verifiability).	S2=4.34 S1=4.06 Increase=6.6%	2. Students should demonstrate understanding of the accounting concepts violated by the unethical act(s) in sufficient detail.	S2=3.72 S1=3.60 Increase=3.3%
3	3. This case helped me understand how companies can benefit in the short run from ethical and accounting violations.	S2=4.59 S1=4.57 No change	3. Students should demonstrate understanding of how the violation impacted executive bonuses.	S2=3.65 S1=3.58 Increase=2.0%
4	4. This case helped me understand how stakeholders are negatively affected by unethical behavior and violations of generally accepted accounting principles in the long-run.	S2=4.68 S1=4.33 Increase=8.1%	4. Students should demonstrate understanding of the negative repercussions to the company, employees, key executives, and other stakeholders.	S2=4.18 S1=4.11 Increase=1.7%
Overall value	Overall, I found this case to be a useful learning experience.	S2=4.36 S1=4.17 Increase=4.6%	N/A	N/A

² Student Survey Scale: 1 = strongly disagree, 2 = disagree, 3 = neutral, 4 = agree, 5 = strongly agree. S2 refers to the second iteration; S1 refers to the first iteration.

³ Assessment Scale: 1 = did not meet expectations, 2 = met minimal expectations, 3 = met expectations, 4 = exceeded expectations, 5 = markedly exceeded expectations. Note that assessment raw scores were adjusted to a 5-point Likert scale for comparability.

Both student and instructor assessments improved from the first iteration to the second iteration.

Specifically, the student assessments improved by an average of 4.7%, with a range of 0 – 8.1%. The instructor assessments improved by an average of 3.2%, with a range of 1.7 – 6.5%. These results indicate that the changes made to the case were effective in increasing student sensitivity and understanding.

Students reported that they found the case a very useful learning experience and instructors' assessment concurs with this conclusion. At the very least, students' understanding of ethical issues and their impacts was improved as a result of this case.

TEACHING NOTES

In order to facilitate the implementation and grading of the case, the following suggested solutions are provided for each of the case requirements:

1) Describe the Two Primary Ways the Company Increased Net Income by Violating GAAP

The two primary ways that Worldcom increased net income by violating GAAP were: 1) reduction of reported line costs, and 2) exaggeration of reported revenue.

Reduction of reported line costs: Line costs are those costs paid (often to other telecommunication companies) to carry a voice call or data transmission from its start point to end point. These costs typically represented Worldcom's largest single expense, and they were understated by a total of \$3.8 billion. In 1999 and 2000 alone, for example, line costs were improperly manipulated by a total of \$3.3B by coding line costs to balance sheet accounts rather than the proper expense account. These manipulations were directed by senior management, including Chief Financial Officer Scott Sullivan, Controller David Myers, and Director of Accounting Buddy Yates (Ber 2003).

Exaggeration of Reported Revenue: Worldcom's early success, as well as its ability to acquire numerous companies, was fueled by high year-over-year revenue growth. However, as the telecommunication industry's market conditions slowed in 2000 and 2001 due to over-supply, Worldcom's senior management made large accounting entries to increase revenue on a quarterly basis. Amazingly, handwritten notes have been found showing the calculations between actual revenue and target revenue. The calculated differences were then recorded as phantom revenue using the "Corporate Unallocated" revenue account so that reported revenues met or exceeded Wall Street's expectations. In total, reported revenues were exaggerated by \$2.8B (Ber 2003).

2) Describe Two of the Other Accounting Principles, Assumptions, or Qualitative Characteristics That Were Violated

There are several key principles, assumptions, and qualitative characteristics that Generally Accepted Accounting Principles are based on. For example, in order for accounting information to be useful, it must be relevant and faithfully represent the underlying activity. To be relevant, accounting information should have confirmatory value and/or predictive value. To be a faithful representation, accounting information should be complete, neutral, and free from error (Spice 2004). The underlying components of these fundamental characteristics that were violated by

Worldcom include:

Consistency: This characteristic refers to the use of similar accounting procedures over time for the same company. Worldcom violated this characteristic beginning in 1999. Examples of this include changing the way it accounted for line costs, manipulating accruals, and recording phantom revenue.

Verifiability: This characteristic implies that different accountants will arrive at the same account balances. However, it is intuitively obvious that other CPA's would not agree with the journal entries made at Worldcom. Thus, the Worldcom results are not verifiable.

Freedom from error: This characteristic indicates that the reported amounts reflect the best available information and are expected to reflect management's unbiased judgment. Since the intent of Worldcom's GAAP violations was to raise income to meet or exceed external income projections, they were not free from error or unbiased.

3) Describe How this Higher Net Income Benefitted the Company and the Bonuses of Top Executives

How higher net income benefitted the company: Worldcom made scores of increasingly large acquisitions over many years, and had trouble digesting these companies and managing them effectively. Also, a severe industry-wide downturn in the telecommunications industry occurred in the late 1990's due to supply-demand imbalances. Chief Executive Officer Bernard Ebbers was hyper-focused on continuing to achieve impressive growth through acquisitions (Stef 2005). Since Ebbers paid for the acquisition buying spree using Worldcom stock, the stock had to continue increasing in value to allow additional purchases. Before being discovered, the accounting improprieties artificially propped-up Worldcom's net income and stock price, this allowing the potential of additional acquisitions.

How higher net income benefitted the bonuses of key executives: The total compensation package (including stock options and bonuses) of key executives in most U.S. companies is closely correlated with their company's net income. At Worldcom, this was certainly the case. For example, CEO Bernard Ebbers received a bonus of \$7.1M in 1998 due to impressive net income. In 2000, CEO Ebbers and CFO Sullivan received bonuses of \$10M each, and Ebbers' total compensation package was \$34M. Also in 2000, Ebbers sold 3 million shares of stock for over \$70M in proceeds (Ber 2003). Thus, you can see how the net income manipulations increased the compensation of Ebbers and Sullivan, among others.

4) Describe the penalties, punishments, and/or other negative repercussions to the following stakeholders:

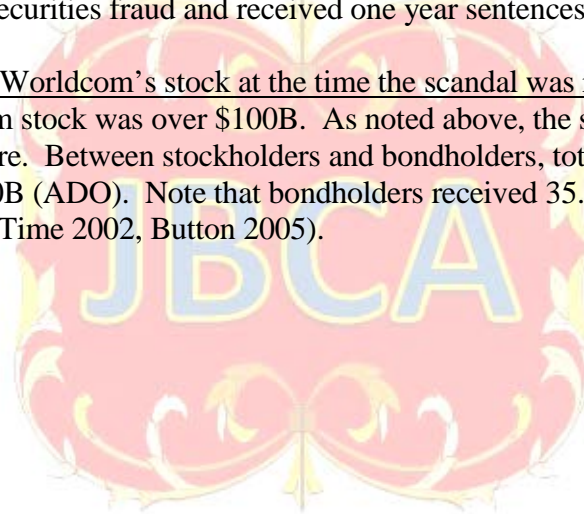
The company: The company paid dearly for the accounting improprieties. Worldcom filed for bankruptcy in July 2002. In addition, the company paid significant fines to settle two lawsuits arising from the debacle. First, the Securities and Exchange Commission imposed a \$1.5B fine, which was later settled with Worldcom for \$500M (Van 2003). Second, a \$750M payout was reached for the benefit of investors, of which \$500M was cash and \$250M was in MCI stock (Blau

2003). Note that Worldcom and MCI merged on November 7, 1997, and Worldcom emerged from bankruptcy as MCI.

Employees of the company: Employees also suffered greatly from the Worldcom accounting manipulations. The most obvious way was the loss of over 30,000 jobs (ADO). In addition, thousands of families lost most (if not all) of their retirement accounts, since these monies were often invested in Worldcom stock. Worldcom stock declined from a high of \$64/share to only 21 cents per share.

The company's key executives: CEO Bernard Ebbers and CFO Scott Sullivan: On July 13, 2005, CEO Bernard Ebbers received a 25-year prison sentence that he began serving in September 2006 (ADO). He was convicted of fraud, conspiracy, and filing false documents. In addition, the dramatic fall in the company's stock price made his fortune in company stock worthless. CFO Scott Sullivan was charged with fraud and the violation of securities law. After he pled guilty and testified against CEO Ebbers, Sullivan received a reduced sentence of 5 years (AP 2005). Note that Buford Yates (former Accounting Director) and David Myers (former Controller) also pleaded guilty to conspiracy and securities fraud and received one year sentences.

Shareholders who owned Worldcom's stock at the time the scandal was reported: The peak market value of Worldcom stock was over \$100B. As noted above, the stock price fell from \$64/share to under \$1/share. Between stockholders and bondholders, total investor losses in Worldcom exceeded \$180B (ADO). Note that bondholders received 35.7 cents on the dollar for their loans to Worldcom (Time 2002, Button 2005).



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APPENDIX A – GRADING RUBRIC

Topics	Did not correctly complete (0-50%)	Does not meet expectations (50-75%)	Meets Expectations (75-87%)	Exceeds Expectations (100%)
#1 – Summarize the Worldcom accounting scandal (4 points)	Did not correctly describe the accounting scandal (0-2 pts.)	Described only the basics of the scandal, but with insufficient details and/or facts (2-3 pts.)	Provided a reasonable discussion of the scandal, but not enough details missing some key details and/or key facts (3-3.5 pts.)	Provided an excellent discussion of the scandal, including all key details and facts (4 pts.)
#2 – Describe the 2 primary ways net income was increased by violating GAAP (4 points)	Did not correctly describe either of the ways net income was increased by violating GAAP (0-2 pts.)	Described only one of the ways (or only the basics of the 2 ways) how the scandal increased net income by violating GAAP (2-3 pts.)	Provided a reasonable discussion of both ways the scandal increased net income by violating GAAP, but not enough details (3-3.5 pts.)	Provided an excellent discussion of both ways the scandal increased net income by violating GAAP (4 pts.)
#3 – Describe 2 other accounting violations (4 points)	Did not correctly list any other accounting principles that were violated (0-2 pts.)	Correctly identified only one other accounting violation (2-3 pts.)	Provided a reasonable discussion of 2 other accounting violations, but not enough details (3-3.5 pts.)	Provided an excellent discussion of 2 other accounting violations, with great detail (4 pts.)
#4 – How did violations benefit company and executive bonuses (2 points)	Did not correctly describe how the violations benefitted the company or top executives (0-0.5 pts.)	Correctly identified the benefits to only 1 party or discussed both parties but many details missing (0.5-1 pts.)	Provided a reasonable discussion of how violations benefitted the company and key executive bonuses, but not enough details (1-1.5 pts.)	Provided an excellent discussion of how violations benefitted the company and key executive bonuses, with great detail (2 pts.)
#5 – Describe negative repercussions to company, employees, CEO, and stockholders (3 points)	Did not correctly describe any negative repercussions to the company, employees, CEO, or shareholders (0-1.5 pts.)	Correctly identified the repercussions to only 1 or 2 parties, and/or only identified some of the repercussions (1.5-2 pts.)	Correctly identified most of the negative repercussions to the company, employees, key executives, and stakeholders, but some details or key facts missing (2-2.5 pts.)	Correctly identified the negative repercussions to the company, employees, key executives, and other stakeholders in excellent detail. All key facts included (3 pts.)
Grammar, spelling, and footnotes (3 points)	More than 6 errors; significantly detracted from content (0-1.5 pts.)	4-6 errors that detracted from the content (1.5-2 pts.)	2-3 spelling or grammatical errors – did not significantly detract from the content (2-2.5 pts.)	0-1 grammatical, spelling, or punctuation errors (3 pts.)

APPENDIX B – STUDENT SURVEY

The purpose of this survey is to learn your reactions to the Worldcom case used in this class. Please do **not** indicate your name anywhere on this form. Your responses will remain completely anonymous and will only be used to evaluate and report the effectiveness of this case as an instructional resource.

1. Demographics: Age _____ Gender (M/F) _____

2. Student Major: _____

3. Student Classification Senior Junior Sophomore Freshman
(Circle one)

Please rate your response to each of the following statements on a scale of 1 to 5, with 1 indicating “strongly disagree” and 5 indicating “strongly agree”:

1. This case helped me identify violations of generally accepted accounting principles in a real world setting.

Strongly Disagree 1 2 3 4 5 Strongly Agree

2. This case helped me identify violations of accounting concepts and/or qualitative characteristics underlying financial reporting (such as relevance, faithful representation, confirmatory value, completeness, neutrality, freedom from error, verifiability).

Strongly Disagree 1 2 3 4 5 Strongly Agree

3. This case helped me understand how companies can benefit in the short run from ethical and accounting violations.

Strongly Disagree 1 2 3 4 5 Strongly Agree

4. This case helped me understand how stakeholders are negatively affected by unethical behavior and violations of generally accepted accounting principles in the long-run..

Strongly Disagree 1 2 3 4 5 Strongly Agree

5. Overall, I found the case to be a useful learning experience.

Strongly Disagree 1 2 3 4 5 Strongly Agree

APPENDIX C – SUMMARY OF STUDENT COMMENTS

The comments made by students were consistent with the improvement in student survey results from the first iteration to the second iteration. Although the 61 students participating in semester #1 generally had positive comments about the assignment, some also had a few concerns about the project, such as:

- Numerous students believed that insufficient background information on the Worldcom scandal was discussed by the authors prior to the assignment. This provided a challenge to the authors, since the intent is for the students to research the scandal on their own.
- Several students felt the instructions were somewhat confusing or vague.
- Some students suggested that students should be able to pick their own company or be given a list of companies to choose from. This is an interesting possible variation to the assignment given by the authors, but may be best suited for a more advanced accounting course.
- Some students wanted more discussion of the GAAP principles and accounting policies prior to the assignment.

As a result of this feedback, the authors made the revisions noted earlier for the second iteration. The student comments for iteration #2 were much more consistently positive. The comments from the 55 students who participated in iteration #2 included:

- Numerous comments that the assignment helped them learn about ethics.
- Several comments that the case showed them how accounting violations affect stakeholders.
- Far fewer comments expressing frustration about receiving insufficient direction and/or vague directions.

In conclusion, the authors were pleased to see that the changes made were beneficial to learning and student satisfaction.