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CORPORATE SOCIAL INITIATIVES IN THE PHILIPPINES: EXPERIENCES OF FOUR MAJOR CORPORATIONS

Raymund B. Habaradas, De La Salle University

ABSTRACT

While philanthropy is still largely regarded as "icing on the cake" (Caroll, 1991), some large Philippine companies have been engaged in philanthropic activities in light of the government's failure to adequately address social problems such as poverty, joblessness, and hunger. For some companies, corporate philanthropy has evolved from simply transferring resources (i.e., corporate giving) to being directly involved in community-based programs. When these corporate social initiatives (CSI) bring "social and economic goals into alignment" and improve a company's long-term business prospects, they enhance the competitive context of the corporation (Porter & Kramer, 2002), and provide strong justification for sustained philanthropic efforts. This paper presents the experience of four major Philippine corporations in implementing CSIs that provide both social and business value, thus adding to the empirical evidence supporting Porter and Kramer's proposition.

INTRODUCTION

Noted CSR scholar Archie Carroll (1991) says that businesses have four responsibilities: economic, legal, ethical, and discretionary (or philanthropic). While society might expect businesses to fulfill all of these responsibilities simultaneously, companies have historically placed an initial emphasis on their economic responsibilities, followed by their legal responsibilities, and only later, their ethical and discretionary responsibilities.

Recent studies show that companies facing concerns along economic, legal, or ethical dimensions are more likely to allocate their resources toward addressing these concerns before engaging in philanthropic activities. Nobel Prize winner Milton Friedman's (1970) contention that social spending by business comes at the expense of profitability seems to hold a decade into the 21st century. This validates Carroll's (1991) observation that most companies still saw philanthropy as "icing on the cake."

In a developing country like the Philippines, corporate philanthropy is often seen as a way to augment the government's efforts to address pressing social problems such as poverty, joblessness, homelessness, and hunger (Habaradas, 2011a).

Going by the internationally-accepted definitions of poverty, the Philippines still has a long way to go to match the records of its neighbors Malaysia and Thailand, which have practically eradicated extreme poverty (i.e. percentage of the population living on less than $1.25 per day). Even Indonesia and Vietnam have done better than the Philippines in this regard (see Table 1).

Table 1: Poverty Rates of Selected Asian Countries at International Poverty Lines

Country	Survey year	Population below $1.25 a day	Population below $2.00 a day
Bangladesh	2005	49.6	81.3
Cambodia	2004	40.2	68.2
China	2005	15.9	36.3
India	2004-05	41.6	75.6
Indonesia	2005	21.4	53.8
Lao PDR	2002-03	44.0	76.8
Malaysia	2004	< 2	7.8
Pakistan	2004-05	22.6	60.3
Philippines	2006	22.6	45.0
Sri Lanka	2002	14.0	39.7
Thailand	2004	< 2	11.5
Timor-Leste	2001	52.9	77.5
Vietnam	2006	21.5	48.4
Source: Poverty Data: A supplement to the World Development Indicators 2008. World Bank			

Not surprisingly, a substantial number of Filipinos have suffered from involuntary hunger. A survey conducted by the Social Weather Station (SWS) on March 19-22, 2010 revealed the proportion of families that experienced involuntary hunger at least once the past three months was 21.2%, or an estimated 4.0 million households. This was far above the 1998-2010 average of 13.4% (SWS, 2010, as cited in Habaradas, 2012). That the unemployment and underemployment rates have remained fairly constant over the past five years (see Table 2), even as the population continued to grow, has probably aggravated the situation.

Table 2: Employment Statistics, January 2006-2010

Period	Labor force participation rate	Employment rate (in %)	Unemployment rate (in %)	Under-employment rate (in %)
Jan 2010	64.5	92.7	7.3	19.7
Jan 2009	63.3	92.3	7.7	18.2
Jan 2008	63.4	92.6	7.4	18.9
Jan 2007	64.8	92.2	7.8	21.5
Jan 2006	63.8	91.9	8.1	21.3
Source: NWCB, www.nscb.gov.ph/sectstat/d_labor.asp				

Clearly, the sustained economic growth registered by the Philippines over the past decade, which accelerated to 7.9% in the first semester of 2010, has yet to trickle down to the masses (Habaradas, 2012). The situation in the Philippines brings to mind the rather colorful quotation attributed to multi-awarded American screen and stage actress Rosalind Russell: “Life is a banquet, and most poor suckers are starving to death.”

CORPORATE CITIZENS’ TO THE RESCUE

“So massive and pervasive is poverty in our country that our response to it cannot be small”. This is according to Tony Meloto (2009), who received the Magsaysay Award for Community Leadership in 2006 for his work as founder and primary mover of Gawad Kalinga, a Philippine-based NGO that has mobilized “a massive army of volunteers who are working together in *bayanihan* (cooperation) to bring about change and to restore the dignity of the poorest of the poor” (Gawad Kalinga, 2009).

To win the battle against poverty, various sectors, including business, government, academe, and NGOs must contribute their share. Big Business, in particular, is expected to take an active role by exercising corporate social responsibility, especially in the form of corporate philanthropy. “With poverty as a major social pressure point,” according to Roman (2007), “government capacity to deliver social equity is stretched, and business is called upon to ‘take up the slack.’”

This position is supported by Teehankee (2007), who presents a compelling case on the inherent responsibility of corporations to contribute to social development. He argued that since corporations are allowed to exist only by virtue of a ‘social license’ granted by society through the government, they are “not simply an instrument of private property that can be used for the private interests of shareholders at the expense of other stakeholders and society as a whole.” The Philippine corporation, according to him, must be socially responsible because it was created by State policy “to promote the good of society and to spread the benefits of capitalism for economic and social development.” He added that “in light of the grave social inequality in Philippine society, the responsibility of corporations has become more critical than ever.”

Fortunately, more and more businesses in the Philippines have become responsible corporate citizens, and have allocated substantial resources for philanthropic activities. For many companies, philanthropy takes the form of charitable contributions. For some, corporate philanthropy has shifted from charity (i.e., corporate giving) to building partnerships with the community (Alfonso, 2005, as cited by Roman, 2007).

Companies have become aware of the dangers of creating a situation in which beneficiaries are no longer better off because they have become dependent on dole-outs, rather than becoming self-sufficient. Thus, more companies are getting involved in ‘community relations’, which refer to the direct involvement of the company in community-based programs either by themselves or in collaboration with other organizations, whether these are businesses, non-government organizations, or government agencies (Alfonso and Amacanin, 2007). Collaborative arrangements are especially valuable because they allow for the pooling of resources and expertise. This results into greater benefits for the community. A related concept is community investment, or corporate social initiative, through which companies are directly involved in, and provide resources to, community projects (Hess and Warren, 2008).

Worth higlighting are CSIs that fall under what Michael Porter and Mark Kramer (2002) label as strategic philanthropy. According to them, strategic philanthropy "brings social and economic goals into alignment and improves a company's long-term business prospects" by enhancing its competitive context (i.e. the quality of the business environment in the location or locations where they operate). This justifies sustained philanthropic efforts.

Porter and Kramer (2002) presented empirical evidence of how companies utilized philanthropy to influence the four interrelated elements of the local business environment (i.e., factor conditions, demand conditions, context for strategy and rivalry, and related an supporting industries) in ways that enhanced these companies' long-term economic prospects. Cisco Networking Academy, for example, improved demand conditions by helping customers obtain well-trained network administrators. As a result, it increased the size of the market and the sophistication of users, leading to users' interest in more advanced solutions. Another example is Safeco, an insurance and financial services firm, which worked in partnership with nonprofits to expand affordable housing and enhance public safety. As home ownership and public safety increased in its four test markets, insurance sales did too, in some cases by up to 40%. Thus, say Porter and Kramer:

> *When corporations support the right causes in the right ways – when they get the* ***where*** *and the* ***how*** *right – they set in motion a virtuous cycle. By focusing on the contextual conditions most important to their industries and strategies, companies ensure that their corporate capabilities will be particularly suited to helping grantees create greater value. And by enhancing the value produced by philanthropic efforts in their fields, the companies gain a greater improvement in competitive context. Both the corporations and the causes they support reap important benefits.*

This paper highlights the experiences of four major Philippine corporations in the implementation of corporate social initiatives, and shows how these have created value, both for the company and the community. These cases, which are situated in a Third World setting, provide additional evidence supporting Porter and Kramer's proposition. These companies are Jollibee Foods Corporation, Pilipinas Shell Petroleum Corporation, Ayala Corporation, and the SM Group of Companies.

BRIEF PROFILES OF THE FOUR PHILIPPINE CORPORATIONS

Jollibee Foods Corporation and its subsidiaries, collectively known as "the Jollibee Group", are primarily involved in the development, operation, and franchising of quick service restaurants (QSR) under the trade names "Jollibee", "Chowking", "Greenwich", "Red Ribbon", "Delifrance", "Manong Pepe", "Mang Inasal", "Yonghe King", and "Hong Zhuang Yuan". Jollibee is the biggest fastfood (burger, fries, fried chicken, pizza, and pasta) chain in the Philippines, beating global giants such as McDonalds, KFC, and Pizza Hut (Jollibee, 2009).

Shell Philippines Exploration, B.V. (SPEX) is at the forefront of oil and gas exploration activities in the Philippines. It operates the Malampaya Deepwater Gas-to-Power Project on behalf of the Department of Energy and its partners (Chevron Malampaya LLC and the Philippine National Oil Company – Exploration Corporation). SPEX is one of the Shell companies in the Philippines (SciP), which include various businesses involved in oil and gas exploration, production, oil refining, distribution, sales, and customer service. SciP started its operations in 1914, and has grown to be one of the country's largest investors, directly employing over 4,000 people nationwide (http://www.shell.com.ph).

Ayala Corporation, which was founded in 1834, is one of the oldest and largest business groups in the Philippines. Employing more than 22,000 employees, it holds interest in businesses in industries such as real estate (Ayala Land), banking and financial services (Bank of the Philippine Islands), telecommunications (Globe Telecom), water distribution (Manila Water), electronics manufacturing services (Integrated Microelectronics), automotive dealership (Ayala Automotive), and business process outsourcing (LiveIt Investments) (Ayala, 2008; Ayala, 2009).

The SM Group of Companies is one of the country's biggest conglomerates, and has a total of almost 40,000 employees. Its holding company is SM Investments Corporation. It is the Philippines' leader in the retail industry. Its retail companies include SM Department Store, which is country's leading one-stop lifestyle and fashion chain; and SM Supermarket, which is the country's top supermarket chain that has an extensive nationwide presence. Another company, SM Prime Holdings owns and runs world-class malls all over the country, providing millions of square meters of floor area for a fully integrated shopping, dining, and entertainment experience. SM is also a leading player in banking and finance, property development, and real estate investment industries.

All four corporations have created foundations that take the lead in implementing their corporate social initiatives. These are the Jollibee Foundation, Inc. (JFI), Pilipinas Shell Foundation, Inc. (PSFI), Ayala Foundation, Inc. (AFI), and SM Foundation, Inc. (SMFI).

HELPING FARMERS BECOME RELIABLE SUPPLIERS

The Farmer Entrepreneurship Program (FEP) is one of the flagship programs of Jollibee Foundation (JF). Formerly known as "Bridging Farmers to the JFC Supply Chain", the FEP is implemented in partnership with Catholic Relief Services (CRS) Philippines, a non-government organization, and the National Livelihood Development Corporation (NLDC), a government agency mandated to provide credit to farmers through its affiliated microfinance institutions (MFIs).

The FEP is an offshoot of CRS' market linkage project funded by the United States Department of Agriculture (USDA), which assisted 3,000 farmers in Mindanao from 2005 to 2008. Drawing from its experience, CRS came up with an eight-step field agent guidebook "that spelled out market-driven strategies" to link small farmers to institutional markets such as food processors, supermarkets, fast food chains, hotels and restaurants, and institutional caterers (Mariano, et. al., 2011).

However, institutional markets transact in commercial quantities, and only buy produce that meet certain quality standards. Because individual farmers produce small amounts of low value crops with uneven quality, they could not tap lucrative markets, and would usually sell their produce to wet markets, traders, or traders' agents from whom they might receive cash advances for farm production or for their household needs.

JF, CRS, and NLDC believed that this situation can be addressed by organizing these farmers so that they could "provide a stable, diversified source of supply that would meet the required quality standards." Thus, the "Bridging Farmers" program was launched. The pilot projct aimed to: (a) organize farmers into farmer groups to consolidate product supply and pool logistics; (b) assist farmers in value-adding activities and quality compliance; (c) increase farmer knowledge and productivity, reduce costs, and increase competitiveness; and (d) increase incomes and build a more durable trading relationship for small farmers (Mariano, et. al., 2011).

To find out whether this business model would actually work, they tested it in several project sites that were chosen according to the following criteria: (a) the presence of a local institution (i.e., a municipal local government unit, a non-government organization, or people's organization) that JF, CRS, or NLDC had worked with previously; (b) the area has to be an agrarian reform community where credit is available from an affiliated MFI of NLDC; (c) a product that JFC would need in considerable volume must be grown in the area to enable farmers' production to be driven by market opportunities.

Under this program, small-farmers' cooperatives received assistance to develop the farmers' capability to provide the requirements of Jollibee Foods Corporation (JFC) for rice, onion, and vegetables. In 2009, about 300 farmers from the provinces of Nueva Ecija, Nueva Vizcaya, Bukidnon, and Zamboanga Sibugay participated in the program, which provided them with training and technical assistance (e.g., adopting effective farming technologies like rain shelters to protect crops) (JFI, 2009).

Farmers also participated in "site working groups" (SWGs) consisting of the local agricultural office, microfinance institutions, and research institutions, which helped the farmers organize themselves and develop the agro-enterprise project (JFI, 2009). The SWGs took the lead in gathering information about local farming conditions and market options, and mobilized support for the project, particularly from the local government.

In San Jose, Nueva Ecija, for example, four members of the SWG were constituted into a local research team, which conducted a Product Supply Assessment (PSA) and a Rapid Market Appraisal (RMA). For the PSA, the team organized focused group discussions and interviewed key informants to get data on current production technologies, yield ranges, productions costs and margins, marketing costs, and price behavior. It also looked into financing options for farmers. For the RMA, the team not only interviewed key informants but also did market learning visits to traders in nearby wholesale markets. This was followed by a learning visit to meet JFC's Purchasing, Commissary, Research and Development (R&D) teams, and various consolidators and traders in selected Metro Manila wet markets (Mariano, et. al., 2011).

The results of the PSA and RMA were put together into a report that the SWG analyzed and later presented to a core group of onion farmers in San Jose during a consultation session. The conclusion was clear: "market opportunities such as JFC would remain beyond the reach of small farmers unless they could organize and consolidate a significant product volume for the market" (Mariano, et. al., 2011). This led to the formation of two farmers' clusters, which soon became the KALASAG Farmers Producers Cooperative.

The cluster members were guided on how to prepare an enterprise plan, starting with the consolidation of the following details: (a) planting and harvest calendars, (b) production guide with costs and returns, (c) product quality management plan or the "must do" in harvest and post harvest, and (d) basic policies agreed upon by the members (e.g., monthly meetings, planting schedules, payment of service fees, savings). The CRS staff assisted the farmer clusters in coming up with each of the components of the enterprise plan, namely the market plan, the production supply plan, the business development services plan, and the management and financial plan.

In implementing the agro-enterprise plan, cluster representatives met with JFC several times to process KALASAG's accreditation as a supplier, and to submit product samples for JFC's R&D to assess. The clusters also agreed on the production practices that ought to be adopted to bring down the costs for labor and materials. This served as the basis for their price offer to JFC's Purchasing Department. The farmers then entered into a supply agreement with JFC after getting some training (through role playing) on price negotiations (Mariano, et. al., 2011).

Once the supply agreement was secured, KALASAG arranged for the bulk purchase of onion seeds, fertilizers and other farm requirements using the loan provided by *Alalay sa Kaunlaran, Inc.* (ASKI), an NLDC-affiliated MFI. This was to ensure that its members have available farm inputs that would enable them to comply with their agreed planting calendars. The farmers also attended the Farmer Field School established by PhilRice, a research institution based in the nearby city of Muñoz. The School gathered the farmers monthly to test and develop improved farming practices step by step (from seedling preparation to harvesting), which led to better crop yields and reduced production costs.

Within a year, the San Jose farmers, through KALASAG, successfully delivered 60 MT of onions to Jollibee, which paid them a "fair and just price" (or about 42.5% higher than their traditional markets) for their produce. This allowed the farmers to pay off their loan to ASKI. And because of the attention to detail of the members assigned to post-harvest activities (i.e., sorting, grading, and trucking), KALASAG incurred a rejection rate of only 0.17%. This enabled KALASAG to secure from JFC a second supply agreement of 197.2 MT covering weekly deliveries from February to July 2010 (Mariano, et. al., 2011).

The increase in the production and delivery volume was made possible because of the acceptance of 10 more farmers as cluster members. KALASAG also secured additional loans from ASKI, the Peace and Equity Foundation (PEF), and the Agricultural Credit Policy Council (ACPC) of the Department of Agriculture, which enabled it to pay for additional production inputs, cold storage facilities, and increased post-harvest activities. Prudent financial management resulted in 100% payment of these loans.

Clearly, the farmers of Nueva Ecija, as well as those in other sites in Bukidnon, Misamis Oriental, Nueva Vizcaya, Quezon, and Zamboanga Sibugay, have benefitted in terms of acquiring technical, entrepreneurial, and organizational skills that have resulted in higher incomes and a stable market for their produce. Jollibee also benefits from this arrangement because self-sufficient farmer groups become reliable suppliers for Jollibee's supply chain. And because this CSI is linked to JFC's business structure, it is likely that the program will be sustained, thus benefitting more farmer groups across the country. As JFC Corporate Purchasing Director Ajie Rebaldo said, in a testimonial published in Jollibee Foundation's 2009 Annual Report, the Bridging the Farmers program "has added value and meaning to Jollibee's role in the country's agricultural sector" (JFI, 2009).

HIRING COMMUNITY RESIDENTS FOR INDUSTRIAL PROJECTS

In 1990, Shell Philippines Exploration B.V. (SPEX) signed a service contract with Occidental Philippines, Inc., which the paved the way for investments in oil and gas exploration in Northwestern Palawan. Using advanced exploration technology, the joint venture discovered oil and gas reserves in the Malampaya / Camago field.

In 1998, Shell started its development of the Malampaya field, on behalf of its joint venture partners Chevron Malampaya LLC and the PNOC Exploration Corporation, to enable the production of natural gas in the country (Shell, 2009). The Malampaya Deep Water Gas-to-Water Project, considered the largest industrial investment in the Philippines, extracts natural gas from below the seabed off the coast of Palawan and transports it more than 500 kilometers by undersea pipeline to a natural gas refinery in Batangas City on Luzon Island (Herz, La Vina & Sohn, 2007).

Even before the Malampaya project gained steam and reaped commercial benefits, SPEX consciously integrated the value of sustainable development in its operations. This meant "integrating the economic, environmental and societal aspects of its business activities to ensure resource developments are carried out effectively without compromising the environment." SPEX did this in partnership with PSFI, which, by then, already had a solid track record of implementing social investment projects designed to help disadvantaged people become more productive and responsible members of society (Shell, 2009).

The partnership between SPEX and PSFI gave birth to sustainable development programs in several sites. These include programs in Palawan, the main site and source of deep water gas; in Tabangao, Batangas, where the on-shore gas plant is located; in Subic, where the Concrete Gravity Structure or the base platform was built; and in Oriental Mindoro, where the gas pipelines traverse from Palawan to Batangas (PSFI, 2002). PSFI introduced a comprehensive, though varied, set of interventions meant to enhance the quality of life of residents in the above-mentioned host communities. These programs were introduced after PSFI consulted community members and stakeholders to determine their specific needs (Habaradas, 2012).

In Batangas, PSFI implemented a sustainable development program geared towards helping the communities surrounding the Shell Tabangao Refinery and the Malampaya On-Shore Gas Plant (MOGP). These communities are collectively known as T.A.L.I.M. (Tabangao, Ambulong, Libjo, San Isidro, and Malitam), a Tagalog word that means 'sharp'. This is likely a reference to the 'balisong', a locally-crafted knife for which the province of Batangas is known (Habaradas, 2011a).

PSFI introduced programs that developed the leadership potentials of TALIM youth, strengthened the Barangay Development Councils, and trained women for community service. Using a participatory planning approach to harness the communities' potentials, PSFI supported the local organizations in the community by providing them with various capability building workshops, such as vision-mission-goal exercises and community action planning workshops.

A critical component of PSFI's sustainable development program in Batangas is Job Link, which was a response to expectations that job vacancies created by industrial projects be filled in by residents of the communities hosting the business. When Shell embarked on the construction of the MOGP in Tabangao, thousands of workers were required to put up the plant. Since the locals did not initially possess the skills required by the contractors, Shell considered bringing in workers from elsewhere.

However, local legislation required a minimum of 75% of the workforce of projects to be recruited from the local barangay (community). The consequence of this "was that the project at peak activity had more than 2,000 mainly unskilled local labourers at site, out of a total peak workforce of over 3,000" (Reymert, 2002). To ensure fair recruitment of workers and to promote health, safety and environment (HSE) training, PSFI convened a Job Link committee that included contractors, project managers, and local community leaders.

SPEX implemented an extensive site induction, skills training, and an HSE training program to ensure that the workers were qualified in terms of safe work practices. Workers were provided with basic personal protective equipment (PPE), including safety glasses, and harnesses for those working above 1.5 meters. A site clinic was also established to provide medical services free of charge (Reymert, 2002).

Once the construction phase was completed and the refinery was brought online, Shell needed only about eight people at a time for its operations. PSFI, thus, provided residents with skills training (e.g. animation and electronics) so that they could find jobs in other companies located in Batangas City. PSFI also set up a job placement program to help the trainees find work in other companies that needed their skills (Herz, La Vina & Sohn, 2007).

When the MOGP was completed in 2001, 3,500 residents had benefitted from Job Link, which has since been replicated in some PSFI sites. Through Joblink, PSFI did not only help Shell procure needed talent, but also enhanced the company's standing in the community as a responsible corporate citizen, especially since the foundation initiated other local capability building programs for the youth and the women of the community (Habaradas, 2011a).

CONNECTING PUBLIC HIGH SCHOOLS TO THE INTERNET

Gearing up Internet Literacy and Access for Students (GILAS) was a project organized and implemented by a multisectoral consortium of 25 companies, business associations, and not-for-profit organizations, in partnership with the Department of Education (DepEd) and the Department of Trade and Industry (DTI). The project's goal was to boost the quality of education in the Philippines by connecting all public high schools to the Internet, which is an important tool for communication and for gaining access to information and knowledge.

Launched in January 2005, GILAS built on the achievements of earlier independent efforts, including Ayala Foundation's Youth Tech, which had been providing high school students access to educational materials in the worldwide web the previous four years. In 2001, Ayala Foundation formed the connectEd.ph consortium, together with the Makati Business Club (MBC) and the Philippine Business for Social Progress (PBSP), which also had projects similar to Youth Tech. By 2004, these various efforts had succeeded in connecting 323 schools to the Internet, but this constituted only six percent of the country's 5,443 public high schools at that time (GILAS, 2011a).

Ayala Foundation, Inc. (AFI), under the leadership of Ayala Corporation Chairman and Chief Executive Officer Jaime Augusto Zobel de Ayala, convened the GILAS consortium and organized a steering committee composed of CEOs and top leaders of companies, business associations, and the concerned government agencies. The consortium's task was to scale up what was started by the connectED.ph consortium.

Patterned after the template that had been developed by Youth Tech, the GILAS package consisted of an Internet laboratory with 10 to 20 PCs, local area network, Internet connection with free Internet use for one year, training for teachers and school heads, and technical assistance for one year (GILAS, 2011a).

To determine the schools that will receive the GILAS package, AFI coordinates with the DepEd division office in target cities or municipalities. It then conducts a division-wide orientation of schools. This is followed by ocular visits to individual schools, during which the

AFI staff assesses the situation of the school in terms of information and communication technology (ICT). After the visit, AFI prepares a shortlist of schools that qualify as GILAS beneficiaries.

According to Joysen Accad, Senior Development Associate, and Mary Rose Erika Barja, Development Associate of the Education and Leadership Development unit of AFI, an important consideration is whether the school has electricity, and whether it has a place where the computers can be secured against theft. The school principal charge must also commit to the maintenance of the computer laboratory and the equipment.

Once the schools have been identified, AFI approaches the LGU to which the schools of a particular division belong. AFI would typically talk to the city mayor, who must be convinced to participate in the 50:50 funding scheme for the project. Thus, if several schools in the city's jurisdiction require P1 million to connect them to the Internet, AFI offers to invest P500,000 from donations of the private sector, if the city government agrees to put up an equivalent amount as its counterpart. In cases when the city government does not have enough funds, AFI would go to the provincial governor or the district's congressman to seek additional funding support. The participation of the local government unit (LGU) ensures ownership on the part of the community (Habaradas, 2012).

In the beginning, though, GILAS had to rely largely on private sector support, according to Julie Bergania, Manager of AFI's Center for Social Development. "During the first two years of GILAS," she said, "we mostly used funds raised from the private sector. Our partnership with the LGUs was not that strong. But we eventually realized that LGUs have the potential to be a partner because they have the funds" (personal communication, March 30, 2011).

Once the funding has been secured and the beneficiary schools have been identified, AFI contacts the school principal and orients him or her about the packages that will be received by the school. It is made clear to the school that it is its responsibility to secure and maintain the computer units, to maximize the utilization of the computers, and to provide the computer cabinets, computer tables, and the Internet subscription beyond the first year.

The GILAS team then coordinates with the school and the supplier of the computer units, and prepares the necessary paper work (e.g. requisition forms) so that the deployment, installation, and networking of the computers can proceed as scheduled. Once the hardware is in place, the GILAS staff contacts the DepEd division coordinator so that teacher training can be scheduled for teachers in a particular area. The three-day training includes modules on basic computer literacy, Internet use, and network maintenance and administration. The GILAS team also provides the schools with technical support for one year, and assists the teachers-in-charge whenever they need to do some troubleshooting (Habaradas, 2012).

In 2009, the DepEd backed up its support for GILAS by providing a monthly subsidy for schools to cover the Internet service fees, which was a major step towards ensuring GILAS' sustainability. This was a major boon for Globe Telecom, the Ayala's telecommunications subsidiary, which previously shouldered the fees. Interestingly, DepEd's move also benefitted

Globe's major competitor PLDT-SMART, which is also a member of the GILAS Consortium. The irony was not lost to AFI President Victoria Garchitorena, who observed that "the GILAS program is an excellent example of what can be achieved when parochial interests are put aside" for a noble goal (GILAS, 2011b).

By October 2011, GILAS had provided computer labs with Internet access for about 4.4 million students in 3,306 public high schools. GILAS had also trained 13,538 teachers to improve their competency in Internet-assisted instruction, as well as 542 school principals and their assistants on ICT leadership (GILAS, 2011a).

A large part of GILAS' success was due to an effective resource mobilization strategy that focused on four donor groups – private corporations, government, overseas Filipinos, and the general public. GILAS was able to generate P365 million-worth of funds and in-kind donations such as hardware, software, teacher training, Internet use, and educational content or materials. Resources generated from the non-government sectors were used as leverage to obtain counterpart funding from the local government units (LGUs) through a 50:50 cost-sharing scheme (GILAS, 2011a).

The DepEd, under the leadership of Education Secretary Br. Armin Luistro FSC, has since taken on the challenge of continuing the work of GILAS after a turnover ceremony in Dusit Thani Hotel on November 21, 2011. This is the first private initiative in education that will be scaled up by the government (GILAS, 2011b).

More than the revenues that Globe has generated from Internet service fees, the larger benefit Ayala Corporation has derived from the GILAS experience would be the building of social capital with its business partners and with local governments throughout the country. The goodwill generated from this collaborative undertaking, while not immediately quantifiable, will prove valuable for Ayala companies wherever they operate in the Philippines. Moreover, the successful turnover of GILAS to government cements the reputation of Ayala Corporation as a visionary and innovator both in the fields of business and social development.

OUTREACH PROGRAMS AT SM SUPERMALLS

SM Supermalls have become ubiquitous in major urban areas in the Philippines. They offer varied opportunities for millions of Filipino families to shop, dine, watch a movie, or just unwind. Given the volume of people who frequent these malls, thousands of entrepreneurs find these malls a lucrative place to do business and grow.

Recognizing the extensive reach of SM malls, SM Foundation, Inc (SMFI) saw this as an opportunity to help the less-privileged through its 'Mall-based Outreach' program, which includes quarterly campaigns. 'Share Your Extras', for example, encourages shoppers to donate apparel, household items, furniture, food, and other items by dropping them off in booths that were put up in different areas in SM malls. In 2009 alone, the campaign distributed donations to 10,000 families or approximately 50,000 individuals in 12 municipalities, eight cities, 93 barangays, and 16 welfare institutions. For this, SMFI partnered with the Department of Social Welfare and Development (DSWD), various local government units, and with local media entities (SMFI, 2009).

The outreach program includes a book donation drive, which generates donations from shoppers and publishing companies. Donated books are distributed to thousands of public schools, libraries, and day care centers nationwide. SMFI also conducts a medicine drive, which is supported by pharmaceutical companies, who donate medicines that are dispensed to patients during the foundation's medical missions in various parts of the country. In 2011, SMFI gave away 183,485 books to 1,238 beneficiaries through its Donate-a-Book project, and distributed P1.18 million worth of medicine through its *Gamot Para sa Kapwa* project (SMFI, 2011).

Every Christmas, the Foundation also invites mall-goers to 'Share-A-Toy' through drop-off points at SM Supermalls. In 2009, donated toys were distributed to almost 11,000 indigent children in depressed areas, government hospitals, and charitable institutions. This Christmas campaign also includes 'Make A Child Happy', which gathers underprivileged children in various SM malls for a day of fun-filled activities (e.g., songs and dances, party games, and kiddie rides) and gift giving (SMFI, 2009).

While the social value of SMFI's Mall-based Outreach program can be easily quanitified through the number of beneficiaries, the business value of this philanthropic activity is more difficult to gauge. It is conceivable, though, that individuals and groups that go to the mall to give their donations are likely to spend money while they are there. More importantly, these outreach activities enhance the image and reputation of SM Supermalls, which according to SMFI's Mall Outreach Program Manager Bob Navida, have become venues "not just for commerce leisure, but for selfless sharing, as well" (SMFI, 2009).

SUMMARY AND CONCLUSIONS

This paper provides additional empirical evidence, this time from a developing country, that supports the proposition of Porter and Kramer (2002). They advocated the adoption of a strategic approach to philanthropy to improve a company's competitive context, which consists of four interrelated elements of the local business environment that shape potential productivity. According to them, these elements are:

- factor conditions – availability of high quality, specialized inputs such as human resources, capital resources, physical infrastructure, administrative infrastructure, information infrastructure, scientific and technological infrastructure, and natural resources;
- demand conditions – presence of sophisticated and demanding local customers, presence of local demand in specialized segments that can be served nationally and globally, and presence of customer needs that anticipate those elsewhere;

- context for strategy and rivalry – presence of local policies and incentives (e.g., intellectual property protection) that encourage investment and sustained upgrading, and presence of open and vigorous local competition; and
- related and supporting industries – presence of capable, locally based suppliers and companies in related fields, and presence of clusters instead of isolated industries.

The case of Jollibee showed how a company helped poor farmers improve their lives by providing them with skills that enabled them to be integrated in the company's supply chain (i.e., related and supporting industries).

The case of Shell showed how dialogue between contractors, project managers and community representatives resulted into a viable training program that addressed both the company's need for skilled workers (i.e., factor condition) and the community's expectation for Shell to hire local talent.

The case of Ayala highlighted how collaboration between the public and the private sectors, and also between business partners (and even competitors), resulted into a large-scale program that cannot be done by a single organization. This eventually led to the decision of the national government to scale up the project, which opened up opportunities for additional business for the telecommunication companies that were part of the GILAS consortium. This is a clear case of an improvement in the context for strategy and rivalry.

Finally, the case of SM illustrated how a company involved both its customers and mall vendors (e.g., book publishers and pharmaceutical companies) in its philanthropic activities, which conceivably resulted into increased patronage and stronger loyalty for the company (i.e., demand conditions).

A closer examination of the experiences of these four companies also revealed important insights on what factors contribute to meaningful corporate social initiatives. Drawing inspiration from the works of noted CSR scholars such as Hess and Warren (2008), I propose that meaningful corporate social initiatives have the following characteristics: (a) they address pressing social needs; (b) they are driven by corporate values and leadership; (c) they adopt a relational approach, not only in dealing with community members or beneficiaries, but also in involving various stakeholders; (d) they are shaped by learning and innovation; and (e) they exhibit managerial accountability (Habaradas, 2012). I intend to test this proposition by studying the CSIs of other Philippine firms.

In conclusion, the experiences of Jollibee, Shell, Ayala, and SM are proof that social responsibility and business performance don't have to be mutually exclusive. The truly meaningful corporate social initiatives are the ones create value for both business and society.

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ENVIRONMENTAL ACCOUNTING OF SMALL AND MEDIUM-SIZED ENTITIES FOLLOWING THE 2011 TOHOKU–PACIFIC OCEAN EARTHQUAKE

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ABSTRACT

The disastrous earthquake and tsunami in Japan on March 11, 2011 caused enormous damage not only to large companies but also to small and medium-sized entities (SMEs). For example, the shortage of electric power obliged many SMEs to replace some of their least energy-efficient equipment, even though Japanese legislation does not require SMEs to account for asset retirement obligations. Some Tohoku local governments also sought investment funds to invest in struggling SMEs because the diminished value of their damaged real estate assets was insufficient to serve as collateral for bank loans. In the refrigerated warehouse industry, accounting for asset retirement obligations and accounting for provisions would assist SMEs in dealing with these environmental-disaster-related problems. However, differences between financial accounting standards and the associated tax rules could prevent SMEs from doing this because a provision in excess of that allowed for tax purposes would not be tax deductible. In a sustainable society concerned with protecting the environment, it would be far better if the accounting treatment of SMEs was identical to that of large companies.

INTRODUCTION

The Japanese people listened to the following message from His Majesty the Emperor on March 16, 2011:

> \I am deeply saddened by the devastating situation in the areas hit by the Tohoku–Pacific Ocean Earthquake, an unprecedented 9.0 magnitude earthquake, which struck Japan on March 11. The number of casualties claimed by the quake and the ensuing tsunami continues to rise by the day, and we do not yet know how many people have lost their lives. I am praying that the safety of as many people as possible will be confirmed. My other grave concern now is the serious and unpredictable condition of the affected nuclear power plant. I earnestly hope that through the all-out efforts of all those concerned, further deterioration of the situation will be averted.

According to the Nihon Keizai Shimbun (2011), in Miyagi prefecture, earth and sand containing arsenic shifted into residential areas from a disused mine. In addition, the newspaper reporters found when visiting Miyagi prefecture in April that more than a few transformers containing polychlorinated biphenyl (PCB), which had been in use at refrigerated warehouses, had been washed away. At the time, the newspaper's reporters were unable to take pictures because of the unrecovered corpses of victims.

Before Statement No. 18: Accounting Standard for Asset Retirement Obligations (ASBJ, 2008), Japan had not permitted accounting for an asset retirement obligation except as a reserve for the decommissioning costs of nuclear power units of an electric power company (e.g., Tokyo Electric Power Company, 1989, p. 35; ASBJ, 2008a, par. 22). Accordingly, small and medium-sized entities (SMEs) would currently not need to act in accordance with this statement. A sustainable society will ask an entity to protect the environment, so it has to account and report in such a way, regardless of whether it is a large company or an SME. Our previous study (Tsuji & Fujibayashi, 2011) finds that the voluntary recognition of the fair value of a liability for an asset retirement obligation is necessary for maintaining a sustainable society. When considering the users of the financial reporting of smaller entities, it is significant that the Corporation Tax Law (Act No. 34 of 1965) does not permit this accounting provision.

Under current laws, a transformer containing PCB that is not in use and is designated for exchange is usually stored in a designated area/room until disposal. We cannot define this as an asset retirement obligation. In practice then, an entity may account for provisions. However, in Japan, the Accounting Standards Board of Japan (ASBJ) developed the standards for asset retirement obligations, and the accounting standards for provisions have not yet converged (ASBJ, 2009). Moreover, at the international level, the International Accounting Standards Board (IASB) has not yet completed its project on improving IAS37: Provisions, Contingent Liabilities, and Contingent Assets, in spite of two recent exposure drafts (2005; 2010a).

At the national level, Japan has a set of domestic tax rules. SMEs have applied these to preparing their financial statements in practice. The experience of the recent earthquake suggests that SMEs in Japan should be treated in accordance with these financial accounting standards.

FINANCING IN THE SPECIFIC AREA AFFECTED

On April 22, 2011, in order to know how our customers were doing, we visited Miyagi prefecture, which was one of the prefectures in the Tohoku district that suffered direct damage from the earthquake. We were able to ask four presidents and representative directors of food industry SMEs about the influence of the earthquake at that time. Their common response was that although they wanted to give priority to the maintenance of employment, the impairments to the property of the companies were so serious that they believed they should obtain a loan from a financial institution in order to resume their business.

Soon after the earthquake, however, it seemed impossible for a financial institution to make a loan to such a damaged entity without a foundation for a new guarantee system. We anonymously contacted the loan officers for five regional banks in the Tohoku district, who explained some of the reasons they gave for refusing new loans in the area. These included a decline in an entity's collateral value because of the earthquake, the lack of continuity and the interruption of cash inflow, and its worsened economic substance if it had already taken out a loan under the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc. (Act No. 96 of 2009).

Subsequently, the Japanese government and its agencies began to implement countermeasures against the effects of the earthquake. At the national level, for example, the Small and Medium Enterprise Agency established the Urgent Guarantee against the East Japan Earthquake in May (SMEA, 2011). The guarantee provided assurance for 14,182 claims totaling 352,200 million yen, more than ninety percent of which were for indirect damages by the earthquake (Credit Guarantee Corporation of Tokyo, 2011).

The guarantee provided assurance for 14,182 claims totaling 352,000 million yen, more than ninety percent of which were for indirect damages caused by the earthquake. At the local government level, the Miyagi Prefecture Credit Guarantee Corporation began to guarantee against the earthquake. As at the end of July 2011, it had guaranteed 3,864 claims totaling 65,900 million yen. Nevertheless, considering that the amount of damage caused by the earthquake in Miyagi prefecture alone would amount to more than seven trillion yen (Nippon Television Network Corporation, 2011), some financial institutions could not maintain a loan without adequate security in spite of the guarantee system.

By contrast, after the earthquake, the number of funds that attempted to support business realignment of SMEs, such as Music Securities, Inc. and Public Interest Incorporated Association Civic Force, appears to have increased. To determine whether they would invest in an SME, these funds applied due diligence in analyzing the financial reports useful for investment decision making rather than the SME's tax accounts.

LEGAL OBLIGATION IN ELECTRIC POWER LIMITATION

Some nuclear power stations in the Tohoku area were badly damaged by the earthquake, and this resulted in an electrical power shortage. As a result, the Ministry of Economy, Trade, and Industry announced 'the Imposition of Electric Power Limitation on Article 27 of Electric Utilities Industry Law (Act No. 170 of 1964)' on June 1, 2011.

This 'imposition' obliged customers demanding more than five hundred kilowatts of electric power to conclude a supply-and-demand contract with a specific electric provider, such as the Tokyo Electric Power Company, Inc. or the Tohoku Electric Power Company, to decrease electricity usage by 15 percent from the previous year. Any company violating this limit was to pay a fine of no less than one million yen under Article 119 of Electric Utilities Industry Law.

This fine is not included in charges against revenues pursuant to the provisions of Article 55(4) of the Corporation Tax Law. One method to comply with this new obligation is to replace transformers now in use with the most modern available. Most of the obsolete transformers in use contain PCBs. As related laws prescribe, an entity will be obliged to wait to dispose of their idle transformers. In practice, no one knows when the entity does dispose of their obsolete transformers.

Statement No. 18 (ASBJ, 2008) provides that 'an asset retirement obligation' is a statutory or similar obligation with regard to the removal of tangible fixed assets and is incurred when tangible fixed assets are acquired, constructed, developed, or used in an ordinary way. In addition to the obligation for the removal of tangible fixed assets, this statutory or similar obligation requires the removal of hazardous substances, etc., contained in tangible fixed assets, using a method stipulated by law, etc., governing the removal of the tangible fixed assets. This was to apply even though there may not have been any obligation concerning the removal of the tangible fixed asset itself (par. 3(1)). 'Retirement' of a tangible fixed asset is the cessation of use of the tangible fixed asset (excluding temporary cessation).

However, as becoming idle does not apply to 'retirement' (par. 3(2)), an entity will be faced with an accounting treatment for the disposal cost of its idle transformers. Moreover, an SME is not required to act in accordance with the statement. This is because the Financial Instruments and Exchange Acts (Act No. 25 of 1948) does not apply to SMEs because of their small size. Instead, an SME is encouraged to apply the Guidance on Accounting Standards of Small and Medium-Sized Business Entities. According to the current version (SMBE, 2011), an asset retirement obligation remains an agenda item. This entails that after considering its establishment in the Japanese GAAP (par. 89), the accounting treatment of an asset retirement obligation is under continual examination in the future.

Outside the area specifically affected, the Kansai Electric Power Company, Inc., for example, distributed a brochure to refrigerated warehouses in the Kinki district titled 'Request to save on electricity and guidance of a special agreement charge'. It is understandable that there were managers who decided to use this information to exchange equipment to enjoy the special agreement charge.

ACCOUNTING FOR PROVISIONS IN JAPAN

The latest revision in 1982 of the Business Accounting Principles by the Business Accounting Deliberation Council (BADC) and that of the Notes on the Business Accounting Principles regulate accounting for provisions. In the notes (par. 18), there are four requirements for provisions: (a) they represent certain costs or losses expected to be incurred in future periods; (b) to precisely match expenses with revenues, they are provided when expenses are incurred for the current period or before; (c) it is probable that they will occur; and (d) a reasonable estimate is possible. It is not possible that there can be costs or losses relating to contingent liabilities if it is improbable that they will occur. The meaning of 'probable' in (c) is much the same as for US GAAP (Takahashi, 2001).

Therefore, in Japan, while some provisions have the character of an obligation, others are not commitments to third parties, but rather internal costs in essence (Sakurai, 2001; 2011). Table 1 provides some examples of provisions. Provisions expected to be due within a year from the balance sheet date are included in current liabilities.

<table>
<tr><th colspan="3">Table 1: Category of Provisions</th></tr>
<tr><td>Provision deducting from an asset</td><td>-</td><td>Allowance for bad debts</td></tr>
<tr><td rowspan="11">Provision as a liability</td><td rowspan="6">Obligation</td><td>Allowance for warranty</td></tr>
<tr><td>Allowance for sales rebates</td></tr>
<tr><td>Allowance for sales returns</td></tr>
<tr><td>Allowance for employees' bonus payments</td></tr>
<tr><td>Allowance for guarantee of construction</td></tr>
<tr><td>Allowance for severance payments</td></tr>
<tr><td rowspan="5">Not obligation</td><td>Allowance for repairs</td></tr>
<tr><td>Allowance for special repairs</td></tr>
<tr><td>Allowance for guarantee losses</td></tr>
<tr><td>Allowance for damages</td></tr>
<tr><td>Allowance for directors' bonus payments</td></tr>
<tr><td rowspan="2">Legal reserve pursuant to Act on Special Measures concerning Taxation, etc.</td><td rowspan="2">-</td><td>Reserve for overseas investment losses</td></tr>
<tr><td>Reserve for fluctuation in water levels</td></tr>
</table>

Nobes (2004, p. 295) points out two major differences between Japanese GAAP and the International Financial Reporting Standards (IFRS) relating to accounting for provisions. First, in Japan, provisions can be set in place based on the decisions of the company directors before an obligation arises. In practice, for instance, the Nippon Sheet Glass Co., Ltd, which first applied IFRS effective for periods ending on March 31, 2012, explains that allowance for repairs, whose amount was 10,560 million yen on March 31, 2010, is not qualified as provision in conformity with IAS 37 (par. 14).

The second difference is that Japanese provisions do not generally need discounting. The Nihon Dempa Kogyo Co., Ltd has already begun to prepare its financial statements in accordance with IFRS since the accounting period ending March 31, 2010. Its securities report describes that its discount rate for noncurrent liabilities is 1.5 percent (2010, p. 81). In September 2009, the ASBJ published a discussion memorandum about the Japanese provisions and pointed out the differences between it and those under IFRS. However, the memorandum considered the IASB's exposure draft of 2005, not the reexposure draft of 2010. According to its comments on the request for views published in the agenda consultation in 2011 (ASBJ, 2011, par. 39), the ASBJ did not have a positive attitude toward the amendment of IAS 37.

According to Ogawa (2009), the number of Japanese entities that account for environmental items in their financial statements pursuant to the Financial Instruments and Exchange Acts has been steadily increasing from 33 in business year (BY) 2001, to 76 in BY2005, and 219 in BY2008. The number of items recorded in liabilities was 13 in BY2001, 33 in BY2005, and 129 in BY2008. In particular, 62 of the 111 long-term liability items in BY2008 related to PCB, asbestos, or soil contamination.

However, after considering the number of entities sampled in the study, the proportion of entities reporting environmental items is not very large. The application of a significance principle concerning an amount of the Business Accounting Principles might decrease the number of individual items related to the environment in financial statements (Ogawa, 2009). It is guessed that these items are included in the Other Items. In the case of an SME, we suppose that the application of the significance principle could move this figure the other way.

The above four requirements for provisions defined by the Guidance on Accounting Standards of Small and Medium-Sized Business Entities (par. 48) are the same as those in the note (par. 18). The guidance groups provisions into two categories: a legal obligation and a nonobligation (par. 49). Under the guidance, an SME has to account for a legal obligation as a provision. However, it is not until the amount is of significance that an SME has to record the item, which is then not a legal obligation, but rather a provision against payments in the future, and therefore a liability on the balance sheet.

The tax regulations also allow certain provisions for tax purposes. If these satisfy the conditions required above, their treatment is as provisions in the liability section. Nevertheless, the Corporation Tax Law prescribes for these to be treated as both allowances for bad debts (Article 52) and as sales returns (Article 53). Otherwise, their disclosure is part of the free reserves in the equity section (Sakurai, 2001, p. 1737). This is shown in the third category in Table 1.

The Outline of a Tax Reform Plan in 1998 specified that the calculation system for the allowance for bad debts would be changed and that any allowances for bonuses and warranties, etc., would not be tax deductible (MOF, 1998). Nonetheless, a company is able to record a provision in excess of that allowed for tax purposes, but the excess is not tax deductible, and so few companies do this. According to Nobes (2004, p. 291), this is an illustration of how the tax laws influence financial reporting in Japan.

IMPACT OF ENVIRONMENTAL PROVISIONS ON SMES

Even though an entity might request the Japan Environmental Safety Corporation to dispose of its transformer containing PCB, it is not until it is actually disposed of that the disposal cost can be determined. According to the Japan Environmental Safety Corporation, the cost is around six million yen per 1.5-ton transformer containing a high concentration of PCB.

Another disposal center told us that the cost was about one million yen for a transformer of up to 2.0 tons containing little PCB.

Table 2 includes some figures from the financial statements of six refrigerated warehouse companies in Japan. All of these companies are large, listed companies and the accounts are prepared in accordance with the Financial Instruments and Exchange Acts. In relation to equipment, allowance for damages is reported by Maruha Nichiro Holdings, Inc., the Nichirei Corporation, Nippon Suisan Kaisha, Ltd, and Toyo Suisan Kaisha, Ltd. Maruha Nichiro Holdings, Inc. records allowances for the environment and allowances for special repairs, and Kyokuyo Co., Ltd provides allowances for special repairs.

In the case of the warehouse industry, the cost shares of the main items are moving sideways for these five years (MLITT, 2010). Both the large public refrigerated warehouse companies shown in Table 2 (Ave. 3.40%) and the smaller private refrigerated warehouse companies shown in Table 3 (Ave. 3.67%) obtain lower figures for operating profit on sales than other industries (Ave. 4.59% for all listed companies in Japan excluding financial institutions). If an entity records the disposal cost of a transformer as an allowance for environmental repairs, the allowance will potentially have a significant influence on its (small) net income, as illustrated in Table 4.

None of our sample SMEs recognized any provisions relating to facilities. Accounting for allowances for environmental repairs could have a greater impact on SMEs than on large companies. This is because SMEs usually operate a simple kind of business, in this case a refrigerated warehouse business, whereas large companies often diversify their businesses, and the proportion of segmented refrigerated warehouse businesses among all business is very small, only nine percent in Japan (see Table 2).

Table 2: Highlight of Financial Statements of Public Companies

Name of company	Kyokuyo	Maruha	Nichirei	Nippon	Toyo	Yokohama
Number of employees*	2,566	13,216	11,471	10,929	4,021	1,141
Shareholder's equity**	16,826	60,010	116,721	52,081	165,641	56,195
Net sales***	162,731	823,399	437,808	494,294	305,911	124,051
Operating income***	1,588	17,418	16,681	8,088	25,811	4,193
Ordinary income***	1,783	15,083	16,115	6,275	27,191	4,298
Net income***	58	3,606	4,044	(921)	12,415	1,668
operating profit on sales****	0.98	2.12	3.81	1.64	8.44	3.38
Ratio of warehouse/distribution segment	2	2	29	2	4	15

*At the end of September, 2011.
**Millions of Japanese yen. At the end of September, 2011.
***Millions of Japanese yen. At the end of September, 2011. FY3/11 except Yokohama FY9/11.
****Per cent. Their average figure is 3.40.
(Source) Toyo Keizai (2011).

In addition, the disposal cost of a transformer will not be tax deductible. In practice, the entities in Table 3 do not record provisions relating to facilities, while some of them provide allowances for bad debts, severance payments, and directors' retirement bonuses.

It is then reasonable to suppose that an entity will record the disposal cost as a provision because the definite liabilities principle of Article 22(3) of the Corporation Tax Law does not regard the cost as a charge against revenue. However, the entity may not account for the cost as such because the provision is not tax deductible. We thus question whether such financial statements are very useful in making economic decisions.

Table 3: Highlight of Financial Statements of Private Companies

Name of company*	Company A	Company B	Company C	Company D	Company E	Company F
Number of employees**	190	170	20	27	22	11
Shareholder's equity**	226	135	20	16	30	10
Net sales***	3,760	1,434	186	167	165	107
Cost of sales****	3,690	1,115	156	188	163	108
Net income***	22.940	6.547	16.250	(21.612)	3.440	6.850
operating profit on sales*****	0.51	0.46	8.74	-	2.08	6.40

* FY3/11 of Company A, FY9/10 of B and FY12/10 of the others.
**Homepage of each company and Teikoku Data Bank.
***Millions of Japanese yen. Teikoku Data Bank.
****Including distribution costs and administration expenses.
*****Per cent. Their average figure is 3.64.

Table4: Relationship between Capital and Provision

Capital Provision	Less than 10 million yen	10 million yen – less than 100 million yen	100 million yen – less than 1 billion yen	1 billion yen and more	Total
Allowance for bad debts	10.3%	25.5%	64.5%	84.5%	18.2%
Allowance for bonus	5.0%	16.4%	59.4%	81.3%	11.1%
Allowance for severance payments	0.4%	7.6%	49.6%	67.2%	4.5%

(Source) National Tax Agency (1998).

ACCOUNTING FOR PROVISIONS IN A SUSTAINABLE SOCIETY

There is a precedent as to the definite liabilities principle from November 17, 1982 at the Osaka District Court (Administrative Casebook 33(11), p. 2285). In this, it was deemed that the cost associated with recovery or afforestation of a quarry, to be paid by the constructor under contract to the possessor when quarrying finished, should be tax deductible insofar as it was a fixed debt. It is important that the debt be sufficiently fixed that it can be estimated. Considering this precedent, we conceive it natural that the disposal cost of a transformer should be tax deductible. The amount of the construct is agreed with the constructor, and the transformer containing the PCBs is kept idle until final disposal.

The close relationship between financial and tax accounting in Japan originally existed because of the administrative convenience of tax governments (Sakamoto, 2009, p. 93). As it is impossible for national tax rules to necessarily harmonize with accounting standards, which are globally harmonized, it is necessary that work on accounting harmonization should have only limited influence on tax rules (Nakata, 2000, pp. 184–185).

While some researchers insist that the relationship between accounting and tax should be dissolved, others suggest that it is only internal transactions such as depreciation and provisions that should be adjusted in returns (Takeda, 1999, pp. 105–106). In consideration of this practical role, the dissolution of the relationship may result in a window-dressing settlement (Shinagawa, 2002, pp. 45–46). Further, the 2.5 million or thereabouts SMEs in Japan are so firmly focused on tax rules in preparing their financial statements that they can cut down the filing return penalty/subtraction calculation work in the Fourth Table of the Other Tables (Shinagawa et al., 2009, p. 133).

In the case of an SME, as its directors are also shareholders, a general meeting of the stakeholders or a meeting of the board of directors usually approves the financial statements. An SME accounts for the disposal cost of a transformer as a provision in accounting. Under Article 145 of the Companies Calculation Rules (Ministerial Ordinance of Ministry of Justice No. 13 of 2006), significant items that are complementary to the accounts shall be noted.

For general purposes, including protection of the environment, an SME has to prepare and present its financial statements in accordance with the same accounting standards that apply to large companies. Among the sample SMEs in Table 3, only Company B states clearly that it prepares and presents its financial statements in accordance with the guidance. This is a rare case (see Yamashita, 2010).

In the public interest, any stakeholder of an SME has to study financial accounting as well as tax rules (see Yanaga et al., 2010). In addition, any entity shall apply ‘a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles’ (IASB, 2010c, par. 6(a)) throughout the world, as well as in Japan.

It is commonly expected that neither large companies nor SMEs should pollute the environment. Consequently, accounting for provisions and for asset retirement obligations should not differ between large companies and SMEs. As many SMEs rely on the tax rules in preparing their financial statements, we suggest that Japanese Corporation Tax Law should allow for provisions related to the environment to be tax deductible.

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THE ECONOMIC, LEGAL AND ETHICAL PHILOSOPHY OF FRÉDÉRIC BASTIAT

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ABSTRACT

Frederic Bastiat (1801-1850) was an economist and journalist. A member of the French Liberal School, he is best known for his free trade ideas and his philosophy of law. Mark Blaug ranks him as one of the 100 greatest economists before Keynes. Schumpeter called him a brilliant economic journalist. Haney devoted a chapter of his History of Economic Thought to Bastiat.

Although Bastiat is known for his work on free trade and the philosophy of law, he also wrote on other topics. To date, only one scholar has examined his views on ethics and that study discussed only two of Bastiat's essays and was less than five full pages. The purpose of this paper is to expand on that study.

INTRODUCTION

Frédéric Bastiat (1801-1850) was a French political economist and journalist. He was a member of the French Liberal School, also referred to as the Optimist School (Cossa, 1893, 376-382; Gide & Rist, 1948, 329-354). Skousen (2001, 59) compares him to Franklin and Voltaire for his integrity and purity and the elegance of his writing style. Hébert (1987, 205) considers him to be unrivaled in the way he exposes fallacies (Skousen, 2001, 59). Haney (1949) devoted a chapter to Bastiat in his *History of Economic Thought.* Blaug (1986) ranks him as one of the 100 greatest economists before Keynes. Schumpeter (1954, 500) considered him to be a brilliant economic journalist, although not a first-rate theoretician. He used the reductio ad absurdum technique to demolish his opponents.

Much of his work, in the original French, is now available on the internet (Bastiat, 1848, 1850, 1861, 1862a&b, 1864, 1870, 1873a, b & c). About one-third of his works have been translated into English (Audouin, 1991; Bastiat, 1964a, b & c; 1968; 2007; Garreau, 1926).

A few books (Bidet, 1906; DeFoville, 1889; Imbert, 1913; de Nouvion, 1905; Roche, 1971, 1993; Ronce, 1905; Russell, 1969; 1985) and dissertations have also been partially (Buccino, 1990) or fully (Hendrick, 1987; Russell, 1959) devoted to Bastiat, as well as several articles. Hazlitt (1946; 1979) and Russell (1985) have written books applying Bastiat's methodology to a range of twentieth century issues.

He was very much opposed to socialism, which he equated with a government that goes beyond its role of protecting life, liberty and property and ventures into the realm of redistribution. He debated the socialists of his time, most notably Proudhon, with whom he exchanged a series of letters (Bastiat, 1862a, Vol. V). Unfortunately, that debate has not been discussed in the English literature to any great extent, although Imbert (1913, 57-66) and de Nouvion (1905, 256-269) discussed it in French and Mülberger (1896) wrote about it extensively in German.

Historians of economic thought cite Bastiat as being a leading proponent of the view that there is a harmony of interests between social classes (Screpanti & Zamagni, 1993, 94-95), a view that was diametrically opposed to the Marxist view of class conflict. However, the view that there was a universal harmony of class interests did not originate with Bastiat. Quesnay discussed the concept before Bastiat and several other political economists, including Say, Carey and Cantillon (1755), also discussed it (Schumpeter, 1954, 234).

Although best known for his views on protectionism (1850, 1862b, 1864, 1870, 1873a, b & c, 1964a&b, 2007) and the philosophy of law (1862a, 1968), Bastiat wrote on a number of other topics as well. Bastiat's ethical views have been mentioned in the literature, but only one article has focused specifically on his ethics, and that article examined only two of Bastiat's essays and was less than five full pages in length, which could not do full justice to his ethical views (O'Donnell, 1993). The purpose of the present paper is to expand on O'Donnell's article and discuss Bastiat's ethical positions in more depth.

Bastiat was both a utilitarian and a rights theorist. His utilitarianism was more complete and fully developed than that of many other utilitarian scholars, even by today's standards. His rights theory was based in religion but could just as easily be applied as a tool of ethical analysis by an atheist.

BASTIAT'S RIGHTS THEORY

Bastiat was a strong believer in the night watchman state (Bastiat, 1862a, IV, 342-393; 1968). Like Locke (1689) and Nozick (1974), he believed that the legitimate functions of government are limited to the protection of life, liberty and property (Chappell, 1994; Feser, 2004; Lacey, 2001; Paul, 1991; Schmidtz, 2002; Thomas, 1995; Wolfe, 1991). All three believed that individuals are unconditionally entitled to keep the fruits of their labor, unlike Rawls (1971, 2001), who believed individuals had a moral right to keep the fruits of their labor only if doing so benefited those at the bottom of the economic ladder (Freeman, 2003, 2007; Kukathas and Pettit, 1990).

For Bastiat, the role of government is to protect people, not to help them. Going beyond the basic protection function requires redistribution, which Bastiat considers to always be unethical. Stated alternatively, the state should have minimum functions, minimum taxes and maximum liberty ("Minimum de fonctions et minimum d'impôts avec maximum de liberté." Imbert, 1913, 97).

His most complete and comprehensive analysis of rights theory is in *La Loi* [The Law, 1968], which first appeared as a pamphlet in 1850 and was later reprinted in *Oeuvres Complètes de Frédéric Bastiat* (1862a, Vol. IV, pp. 342-393).

His theory begins with the premise that everyone has a natural right from God to defend their person, property and liberty (Bastiat, 1968, 6). Since all individuals have these rights, it follows that groups of individuals can organize and support a common force to protect these rights. In other words, governments are formed to protect pre-existing rights. Rights do not come from government, as legal positivists would have us believe (Austin, 1869; Bentham, 1843, 1988; Fuller, 1969; Kramer, 2003; Marmor, 2001; Waldron, 1987). They are inherent.

The common force that protects these rights cannot have any rights that the individual members who formed the collective entity do not have and it cannot have any purpose other than that for which it was formed. It cannot be used to destroy the equal rights of others. Justice will reign to the extent that this common force protects these rights. Injustice will reign if the common force goes beyond these basic duties.

Greed

The law can be perverted by two influences, stupid greed and false philanthropy (Bastiat, 1968, 9). There are two ways to accumulate wealth. One may work for it or one may seize the property of others. Satisfying one's wants by labor is the origin of property. Satisfying one's wants by seizing and consuming the property of others is the origin of plunder (Bastiat, 1968, 10).

Seizing the property of others may be dangerous or even fatal if individuals attempt it. It is safer and easier to confiscate the wealth of others if the government does it instead. As W.M. Curtiss has said, echoing Bastiat:

> Through the years, some men have discovered how to satisfy their wants at the expense of others without being accused of theft: They ask their government to do the stealing for them. (Curtiss, 1953, 19)

When the law is used not to protect property, but as the means by which property is confiscated, it become perverted. Since people are naturally inclined to seek pleasure and avoid pain, there is a natural tendency to resort to plunder rather than work whenever plunder is easier than work. It is the function of the law to make plunder more painful than work. The proper function of the law is to protect property and punish plunder (Bastiat, 1968, 10). Instead, the law has become a tool to be used to violate property rights.

> Under the pretense of organization, regulation, protection, or encouragement, the law takes property from one person and gives it to another; the law takes the

> wealth of all and gives it to a few – whether farmers, manufacturers, shipowners, artists, or comedians. (Bastiat, 1968, 17)

The law becomes an instrument of plunder by which special interests can use the law to benefit themselves at the expense of the general public. All legislation becomes special interest legislation. Rather than being used to protect property, the law becomes the tool by which property is forcibly transferred from the general public to some special interest. It is the process that would later be labeled rent seeking (Rowley, Tollison and Tullock, 1988; Tullock, 1970, 1989, 1993).

At this point, everyone looks to the state rather to themselves for sustenance. Farmers demand subsidies, price supports and protection from foreign competition (Bovard, 1989), or even competition from the neighboring state. Only milk from Ohio cows may be sold in Ohio and only milk from Pennsylvania cows may be sold in Pennsylvania, ostensibly for health reasons, but in reality to prevent a price war from harming the profits of farmers in Ohio and Pennsylvania.

Steel producers in the United States must be protected from steel producers in other countries, who try to *dump* their product on the domestic market at what the U.S. producers (but not the U.S. consumers) consider to be unfairly low prices, so they go to the legislature and ask for protection in the form of tariffs, quotas and antidumping laws (Bovard, 1991; Hindley and Messerlin, 1996; Lindsey and Ikenson, 2003). U.S. ship builders must be protected from foreign ship builders, so they go to the legislature and persuade them to pass laws that prohibit non-U.S.-built ships from docking in domestic ports (Jones Act, 1920). Any number of industries now use this approach to legal plunder to benefit themselves at the expense of everybody else. Things have not changed much since Bastiat wrote about this phenomenon in the 1840s.

The costs to consumers can be quite high (Hufbauer and Elliott, 1994; Kim, 1996; Messerlin, 2001; Shuguang, Yansheng and Zhongxin, 1999). Rather than trying to persuade consumers to buy their products, they seek protection from competition so that consumers will be prevented from purchasing the products of foreign producers.

The sick and infirm want health care but they want someone else to pay for it. The elderly want pensions but they want the younger generation who still works to pay for them. Parents want their children to receive an education but want the general public to pay for it. Artists argue that they are being inadequately compensated for their contributions to national culture, so they petition their legislature for subsidies and grants, which taxpayers must pay for out of their earnings.

> The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else. (Bastiat, 1964, 144)

As Bastiat pointed out, there are two kinds of plunder: legal and illegal (Bastiat, 1968, 19-20). Illegal plunder results when a thief takes the property of others by force or fraud. Legal plunder results when the government uses force or the threat of force to cause property to be redistributed from those who own it to those who want to own it. When the law protects plunder rather than property it is perverted.

> But how is this legal plunder to be identified? Quite simply. See if the law takes from some persons what belongs to them, and gives it to other persons to whom it does not belong. See if the law benefits one citizen at the expense of another by doing what the citizen himself cannot do without committing a crime.
>
> Then abolish this law without delay, for it is not only an evil itself, but also it is a fertile source for further evils because it invites reprisals. If such a law – which may be an isolated case – is not abolished immediately, it will spread, multiply, and develop into a system…The present-day delusion is an attempt to enrich everyone at the expense of everyone else; to make plunder universal under the pretense of organizing it. (Bastiat, 1968, 21)
>
> When a portion of wealth is transferred from the person who owns it – without his consent and without compensation, and whether by force or by fraud – to anyone who does not own it, then I say that property is violated; that an act of plunder is committed. (Bastiat, 1968, 26)

Bastiat gave many examples to illustrate his point that going to the government to obtain benefits that you could not get yourself without committing a crime is nothing more than legalized plunder. The French iron industry (1850; 1862a; 1964a, 25-30; 2007, I) was one of his favorite targets.

In one of his more comprehensive examples (Bastiat, 1964a, 25-30), he discusses the case of a French protectionist, whom he calls Mr. Protectionist [Monsieur Prohibant in French], who devotes much of his time and capital to converting iron ore into iron. Unfortunately for him, nature has been more kind to the Belgians, who can do the same thing he does at a much lower cost, making it difficult for him to compete. He is losing business because Frenchmen, prompted by their own self-interest, are buying their iron from the Belgians instead of from him. Every day one could see a multitude of nail makers, metalworkers, cartwrights, mechanics, blacksmiths and plowmen either going to Belgium themselves or sending their representatives to obtain the iron they need. Needless to say, he was not happy by this chain of events.

He decided to do something about it. His first thought was to prevent this cross border traffic himself. He would arm himself with his carbine, four pistols, a sword and a supply of ammunition, go to the border and kill the first metalworker, nail maker, blacksmith, mechanic or locksmith he encountered who put his own self-interest above that of Mr. Protectionist.

However, as he was about to depart he started to have second thoughts. He recognized the possibility that one of those selfish merchants might kill him instead. Furthermore, even if he sent all of his servants to guard the border they would not be able to do it because the border area was too large and the number of his servants was too small. The cost of sending the servants to guard the border and prevent this trade would exceed the benefit for him.

Just as he was becoming resigned to the fact that he would not be able to prevent this trade, he got a brilliant idea. He remembered that in Paris there was a great law factory. This factory made laws that everyone must obey. A police force was organized to enforce these laws and the funds required to do it were raised from the French nation. If he could manage to get the legislature to pass a law prohibiting the importation of Belgian iron, he would not have to expend anything to send his servants to the border. Instead, the government of France would send 20,000 sons of those recalcitrant metalworkers, nail makers, blacksmiths, locksmiths and mechanics to do the job for him and their fathers would be forced to pay for their salaries and supplies.

There were other benefits of this solution as well. He would not have to expose himself to the brutality of brokers. He would be able to sell iron at the price of his choice, not theirs.

This example fits Bastiat's definition of legal plunder. If the French iron maker attempted to stop the trade at the point of his own gun he would be guilty of a crime, but by having the French government do his dirty work for him, no crime has been committed. The law has merely been enforced. Of course, the property and contract rights of those who would prefer to buy Belgian iron are violated, but that is not his problem.

It is a classic case of rent seeking, a process that has been much discussed in the literature (Rowley, Tollison and Tullock, 1988; Tullock, 1970, 1989, 1993). Perceptive ethicists would be quick to point out that just because this action has been legalized does not make the practice ethical. Whenever some corporate official or industry representative goes to the legislature to get the government to do what he himself could not do without committing a crime he is acting unethically. The fact that his act of going to the legislature is legal does not change the ethics of the situation.

One could extrapolate this example to arrive at the conclusion that all rent seeking constitutes unethical conduct because it violates someone's property and contract rights. Farmers, ship builders, textile union representatives, auto makers, steel company executives, shrimp harvesters and representatives of any other industry who get the government to do what they could not do without committing a crime are acting unethically. This issue has not been adequately addressed in the ethical literature. Bastiat does not raise the point directly, although he makes it clear that engaging in such activity constitutes theft. The mere advocacy of theft as an unethical act is not addressed by Bastiat.

False Philanthropy

The other way the law can be perverted is by false philanthropy. Philanthropy may be defined as the voluntary giving away of one's own assets for some worthy cause. However, the act of giving ceases to be voluntary when the government does it.

> Nothing can enter the public treasury for the benefit of one citizen or one class unless other citizens and other classes have been *forced* to send it in… The law can be an instrument of equalization only as it takes from some persons and gives to other persons. When the law does this, it is an instrument of plunder. (Bastiat, 1968, 31)

Tibor Machan (1998) has spoken about philanthropy, charity and generosity at length. One may only be moral where there is choice. Where there is no choice there can be no morality. One who advocates government charity is thus advocating legalized plunder. Children need to be educated. The poor must be fed, clothed, housed and given free medical care. Perhaps that is true and perhaps it is not, but the real question is how these things should be provided. Government provision of these services is only one of several options. Private charity and the market are two other options. Private charity and the market are the result of voluntary exchange. Government provision necessarily involves the violation of someone's property rights, and thus cannot be moral even if done with a pure heart and good intentions.

One question that has been ignored in the ethical literature is whether it is moral to ask the government to provide services other than the protection of life, liberty and property, since these acts, if done, would be legal plunder. If a group of neighborhood thugs forced a landlord to accept $300 a month rent for a property that would rent for $1,000 a month in a free market, how different is that, in substance, from having those thugs petition the local rent control board to force the landlord to charge $300 a month for renting the property?

BASTIAT'S UTILITARIANISM

Bastiat was more than just a rights theorist. He was also a utilitarian. His utilitarianism was more comprehensive and complete than the utilitarianism of many other theorists and ethicists. His essay, *What Is Seen and What Is Not Seen* (1850; 1862a; 1964a; 2007, I) is perhaps his best and most comprehensive essay from a utilitarian perspective.

Bastiat begins the essay by stating the difference between a good economist and a bad economist.

> There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into

> account both the effect that can be seen and those effects that must be *foreseen*. (Bastiat, 1964a, 1)

Hazlitt (1946; 1979) states Bastiat's position somewhat differently. He says that a good economist considers the effect a policy has on all groups in both the short-run and the long-run whereas a bad economist ignores some groups or some timeframe.

> …the whole of economics can be reduced to a single lesson, and that lesson can be reduced to a single sentence. *The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups*. (Hazlitt, 1979, 17)

The Broken Window

If one wants to start with an example of his application of utilitarian ethics to a particular case, there is no better place to start than with his story of the broken window, which comprised the opening salvo of his classic essay, *What Is Seen and What Is Not Seen* (Bastiat, 1850; 1964a, 1-50; 2007, I, 1-48).

The story starts when an incorrigible son breaks a pane of glass, which the father must pay a glazier to replace. The crowd that has witnessed the spectacle discusses the event and concludes that the destruction has a bright side. Such accidents are good for the economy because they keep industry going. Without occasional broken windows, glaziers would disappear.

What is seen is an increase in business for glaziers. It appears that breaking windows is good for business. Some observers might even conclude that the incident was what economists might call a positive-sum game.

But such an analysis would be incomplete. What is seen is the extra business the glazier receives. What is not seen is that the father, who must pay the glazier six francs to replace the pane of glass, now has six francs less to spend on other things. Rather than having a window and six francs, the father now has just the window. Upon consideration of the father's loss, economists might conclude that breaking windows is a zero-sum game, since the glazier's gain is equal to the father's loss.

But this analysis is also incomplete because it does not consider the secondary effects of breaking the pane of glass. If the window had not been broken, the father could have bought a pair of shoes. He would have had both a window and a pair of shoes. The cobbler would also have gained, since his business would have increased by one pair of shoes. So there are really two losers because of the broken window, the father and the cobbler, whereas there is only one winner, the glazier, leading economists to conclude that breaking windows results in a negative-sum game because there are more losers than winners.

The main thrust of Bastiat's argument is that a law or policy produces both immediate effects, which can be seen, and other, secondary effects that take place later and that cannot so easily be seen or predicted. We are lucky if we can foresee these secondary effects. Sometimes policymakers cannot predict what these secondary effects will be. In modern economic terms, we might say that there are unintended consequences.

Examples of Faulty Utilitarian Analysis

Many economists and policy makers over the centuries have engaged in faulty utilitarian analysis because they failed to take into account the effect that a policy would have on all groups in both the long-run and short-run. Keynes is a prime example. He even boasted of the fact that he ignored the long-run in his statement, "In the long-run we are all dead," (Keynes 1924, 64-65), which many economists consider to be an affront to Bastiat (Skousen, 2001, 348).

The Keynesian multiplier theory is a classic case of the misapplication of utilitarian ethics. The Keynesian multiplier (Keynes, 1936) basically states that an injection of money into the economy will result in some multiple of increased economic activity. For example, if the multiplier is five and one billion dollars is injected into the economy, economic activity will increase by five billion dollars. Even Keynesian economists now point out that the theory does not work quite the way Keynes said it would because of "leakages." (Hansen 1953, 86-105). Some economists even give a detailed mathematical analysis to explain why the theory does not work the way it is theoretically supposed to work. However, it is not necessary to revert to complex mathematical analyses to explain why the Keynesian multiplier does not work the way Keynes said it would. All one need do is apply a little logic to the situation, which Bastiat did in the 1840s.

Bastiat might say, "What is seen is one billion dollars injected into the economy. What is not seen is where the billion dollars came from and where it might have gone if it had not been sucked out of one sector of the economy so that it could be injected into another part of the economy." In other words, in order for one billion dollars to be injected into one sector of the economy, it must first be taken out of another sector of the economy. In order for one sector to expand by five billion dollars, other sectors must shrink by five billion dollars.

Bastiat discussed a similar situation in his essay, *What Is Seen and What Is Not Seen* (Bastiat, 1850, 1964a, 27-28). For every hundred-sou (a measure of French currency at the time) that is dropped into the economy, it will be like a stone that is thrown into a lake, causing an infinite number of concentric circles to radiate great distances in every direction (Bastiat, 1964a, 27). What is seen is the stone being thrown into the lake and the multitude of concentric circles that it causes. What is not seen is where the stone came from and the concentric circles that cannot now be made because the stone was thrown into the lake at Point B instead of Point A.

"The stone is thrown in at one point in the lake only because it has been prohibited by law from being thrown in at another." (Bastiat, 1964a, 28).

In other words, total economic activity has not changed. It has merely been shifted. Rather than creating wealth, government intervention into the economy has merely caused wealth to be redistributed.

At this point one may stop and conclude that the result is what utilitarian economists would call a zero-sum game, since the gain of one sector of the economy has been exactly offset by the losses in other sectors of the economy. However, such a conclusion ignores opportunity cost and preference theory. If the law requires the stone to be thrown into the lake at point B instead of point A, it means that the former owners of those funds are precluded from using their funds to spend on the products and services that are at point A. The funds will necessarily be spent somewhere else that is lower on the economy's preference scale. Because of that, total utility has declined because the funds were not spent on the consumers' first choice.

Another example of the faulty use of utilitarian ethics – perhaps the most atrocious, actually – comes from the discipline of international relations. Scholar after scholar in this field make it a point of ignoring the effects a policy will have on all groups. They deliberately ignore some groups that can be easily identified and they make little or no attempt to consider the effect that a policy will have on groups that are not as easily identified.

Lopez (1999) and Gordon (1999a&b) are typical examples. These two scholars conducted a debate in the literature on the issue of whether economic sanctions are successful more often than not. However, their definition of success is more than a bit curious to an economist, because they define a successful sanction as one that persuades or forces the target of the sanction to change behavior in the direction advocated by those who impose the sanction. Hufbauer et al. (2007) have even gone so far as to attempt to measure the success of hundreds of sanctions on this basis.

International relations scholars do not look at sanctions from a positive-sum, negative-sum game perspective and they often totally ignore rights issues (Cortright and Lopez, 2000; Haass, 1998; Haass and O'Sullivan, 2000; O'Sullivan, 2003; Selden, 1999; Shambaugh, 1999), with some exceptions (Singleton and Griswold, 1999). It is quite common to ignore the fact that all sides lose from most sanctions, in the sense that both the sanctioning countries and the target countries lose trade opportunities. The secondary and tertiary effects of the sanctions and the effects the sanctions have on these groups are usually ignored as well.

Thus, Bastiat's approach to utilitarian ethics is superior to those of many economists and international relations theorists working today. Bastiat at least tried to identify all the groups and individuals who would be affected by a policy, in both the short-run and the long-run. His utilitarian ethics applied opportunity cost theory a generation before Carl Menger (1871) developed the theory.

THE PHYSIOLOGY OF PLUNDER

> Plunder consists in prohibiting by force or fraud, freedom of exchange, in order to receive a service without rendering one in return. (Bastiat, 1964b, 132)

The two Bastiat essays that O'Donnell (1993) commented on were *The Physiology of Plunder* (Bastiat, 1964b, 129-146) and *Two Systems of Ethics* (Bastiat, 1964b, 147-154). In the first of these essays, Bastiat starts by repeating what he has said elsewhere, that there are only two ways to obtain the means necessary to preserve and improve life: *production* and *plunder*. Plunder is practiced on such a large scale that social scientists cannot ignore it. Indeed, plunder places a major brake of the advancement of society because so many people endeavor to live and prosper at the expense of everyone else (Bastiat, 1964b, 129-130).

Forcible plunder results when the plunderer waits until a man has produced something, then takes it away from him by the use of force. Such acts are specifically forbidden by the Commandment, *Thou shalt not steal*. When done by one individual, it is called theft and is punishable by prison. When done by one nation against another it is called conquest and leads to glory. (Bastiat, 1964b, 132)

The difference between the two acts is the way public opinion views them. Public opinion is against the thief but it is not against the nation's army. It is the power of public opinion that separates the injustice from the plunder. In the case of the members of the army, the fact that public opinion supports their acts causes them to not even realize that their act immoral. If public opinion is against the acts of the army, it is the public opinion of the plundered, but their opinion does not count and will not effect a change in the minds of the plundering soldiers. Plunder will not cease until the public – and the plunderers – realize that what they are doing is wrong.

Bastiat, perhaps being overoptimistic, goes on to state that society would be perfect in the absence of plunder. While he may be overstating his point, it would be fair to say that the body politic would be healthier if there were no leaches sucking the blood out of the productive members of society. Society and the economy would advance faster if the people who were using their energy to obtain the wealth of others would instead use their energy to create wealth of their own.

When plunder becomes a way of life for some critical mass of humanity, the result is a legal system that supports plunder and a moral code emerges that glorifies it. Bastiat identified four kinds of plunder by name: war, slavery, theocracy and monopoly. Plunder may be accomplished either by force or fraud.

In antiquity, war was used as a means to acquire hunting rights. During Greek and Roman times it was used as a means of acquiring hegemony over other nations and as a means of obtaining the wealth needed to support the fatherland. The problem is that war costs more than the booty is worth, according to Bastiat.

Forcible plunder can take another form. Rather than waiting until a man has produced something, the plunderer can take possession of the man himself. The result is slavery. When men learned that labor could increase wealth, some of them took slaves in order to increase their own wealth. "Yours the toil; mine the harvest." (Bastiat, 1964b, 130). In theocracy, those in charge scare the populace by threatening them with hell if they do not transfer their wealth and promising them heaven if they do.

The distinguishing characteristic of monopoly is that, while permitting service for service to continue, it upsets the just balance between *service received* and *service rendered*. Through protectionist legislation, some producers go to the legislature to obtain protection from other producers, sometimes domestic and sometimes foreign. French iron producers go to the legislature to protect themselves from Belgian iron producers, as was mentioned earlier, but his view of monopoly is not limited to foreign producers. Any artificially government-imposed restriction of voluntary exchange is a form of monopoly. Plunder results whenever the government prevents producers and consumers from getting together and entering into contracts according to the terms they decide.

Modern examples of such plunder include wage and price controls, artificial price supports, subsidies, penalties, occupational licensure laws, zoning laws and rent controls, to name a few. Many of these restraints existed in France during Bastiat's time.

In Bastiat's view, plunder always carries with it the germ that ultimately kills it. It is rare that the many plunder the few because the few would soon be reduced in number to the point where they could no longer satisfy the greed of the many. Thus, plunder would come to an end from want of sustenance.

This view could be challenged as overoptimistic. History has shown that it is quite possible for the many to plunder the few. The graduated income tax is one example. The estate tax is another. The many can vote to plunder the income of the rich few, but stop before they are bled dry. That way they will be able to continue to plunder the rich for an extended period of time.

In the United States, this kind of plunder has been going on since the Sixteenth Amendment to the Constitution legalized the income tax in 1913. A graph on the Tax Foundation website (2010a) shows that the top 1 percent of taxpayers in the United States pay more taxes than the bottom 95 percent. In 2007, the top 1 percent earned 22.8 percent of total income but paid 40.4 percent of total income taxes (Tax Foundation, 2010b). It is a clear case of exploitation.

According to Bastiat (1964b, 130) it is almost always the few that oppress the many. Again, he takes the position that such plunder is doomed to come to an end. The key to ending the plunder is education. If fraud is the means used to engage in plunder, as it is in the case of theocracy and monopoly, the plunder will end when the majority becomes aware of it.

Plunder not only redistributes wealth; it also destroys part of it. Theocracy diverts energy toward injurious or childish ends. Monopoly transfers wealth from one pocket to another, but much of it is lost along the way (Bastiat, 1964b, 131). The destruction of wealth accelerates until it reaches the point where the plunderers realize that they are poorer than they would have been if they had remained honest, at which point the plunderers stop plundering. Again, Bastiat seems to be overly optimistic that the plunder will stop as a result of some natural process.

Over the course of time, customs develop and the plunder becomes such an integral part of society that no one notices its existence and the plunderers do not even realize that they are engaging in it. Plunder flourishes in the darkness of ignorance. The role of political economy is to expose the fraud to the light of day, which Bastiat believes will destroy it. Plunder will cease only when public opinion is against it. That is the job of education. "…there is no substitute for an informed and enlightened public opinion. It is the only remedy." (Bastiat, 1964b, 139).

Again, Bastiat's education solution seems overly optimistic. While he is correct that the plunder will cease once a sufficiently large proportion of the public comes to the realization that plunder is going on and that it is bad, getting the general public educated to this injustice seems like an insurmountable task. The most educated western democracies are also the countries that most strongly support the status quo.

Glenn Beck (2007, 2009a&b, 2010) is trying to educate the general public through his radio and television programs and his books, as are a few others (Barnett, 2004; Bovard, 1989, 1991, 1994, 1999; Higgs, 1987; Hindley and Messerlin, 1996; Levy and Mellor, 2008; Napolitano, 2004, 2006). The American Tea Party movement members are educating themselves (Armey and Kibbe, 2010; Bexley, 2009; Farah, 2003, 2010) and have risen up in protest against the status quo, and their protests had an effect on the 2010 elections in the United States.

But their protests were not so much a result of education as the increasingly observable fact that the current level of government spending is unsustainable. They want to keep the Social Security system. They just want to reform it. They want to keep government health care. They just want to make it less costly and more responsive to the needs of the people. They want tax cuts for everyone, not just the middle class, but they are not calling for an end to the exploitation of the rich because of the ingrained belief that the rich somehow have an obligation to pay more than the rest of us. The Marxist belief, "From each according to his ability, to each according to his needs," (Marx, 1875) is still alive and well in the United States and the other western democracies. While Bastiat's solution – education – seems like the only viable solution, the probability of its success is low, given the history of the nineteenth and twentieth centuries.

TWO SYSTEMS OF ETHICS

Bastiat identifies the central problem. There is an endless succession of unsatisfied wants in men's hearts. These wants cannot be satisfied without labor. Labor is as repugnant as its fruits are attractive. Although bread must be earned by the sweat of one's brow, everyone wants as much bread and as little sweat as possible. We cannot prevent people from engaging in a constant quest to increase their share of the fruits of labor while using force or fraud to shift the burden to others. (Bastiat, 1964b, 148-149).

Because of this natural tendency of mankind, there must be some benevolent force to minimize this natural human tendency. Plunder must be minimized, but how? Bastiat provides two possibilities. Either the plunderer must voluntarily abstain from plunder or the targets of the plunder must resist. This basic fact of human nature gives rise to two systems of ethics: religious or philosophical ethics and utilitarian ethics, which he refers to as *economic*. The two systems do not conflict; the can work in tandem.

Religious ethics, as one might expect, works on man's spiritual nature. One must reform and purify oneself. Do good, not evil. Subdue your passions. Sacrifice your own interests. Do not oppress your neighbors. Your duty is to love and comfort them. Be charitable.

Utilitarian ethics has the same goal in mind but uses a different approach. By showing individuals the effects of their actions, by showing them that plunder injures them, and by educating the masses, it increases their resistance to be victims of plunder.

Utilitarian ethics may also be used to change the attitude of the plunderer. By showing the negative effects that engaging in plunder can have on the plunderer, and by showing that the evil is always greater than the good, it is possible to change the plunderer's mind and convince him to cease and desist in his plundering.

Again, Bastiat's view of changing the attitude of the plunderers may be overly optimistic. For example, is it realistic to expect to convince steel workers that slapping on tariffs and quotas and imposing antidumping laws on foreign competitors is not in their best interest when their very jobs are at risk? The fact that society as a whole benefits by free trade is of no concern to them. Their primary interest is in keeping their jobs. Furthermore, because of their ignorance of economics, they often believe that protectionism also benefits the economy as a whole.

Bastiat believes that by a combination of moral philosophy, which stigmatizes the evil deed, and political economy, which discredits the act by showing its full effects, the plunder problem can be solved. Religious ethics can be used to soften the hearts of the plunderers. Political economy can be used to enlighten their dupes. People must be made aware that "heavy government expenditures and liberty are incompatible." (Bastiat, 1964b, 152). His argument of the 1840s is the same argument that is being waged today (Armey and Kibbe, 2010; Beck, 2009a&b; Bovard, 1994, 1999; Farah, 2003, 2010).

THE ETHICS OF RENT SEEKING

Although the Austrian School of Economics claims Bastiat as one of their own because of his methodology and his ideas, which were similar of those of Menger, Mises, von Wieser, Hayek and others in the areas of economic harmony, free trade, capital theory, subjective value, opportunity cost, human action, government plunder, false philanthropy, natural rights and freedom of exchange (DiLorenzo, 1999), the Public Choice School of Economics may also have a valid claim to him because of his early work on rent seeking.

Although rent seeking has existed since the time of the ancient Egyptians and Babylonians (Tullock, 2003), the modern literature had not analyzed the phenomenon in much detail before members of the Public Choice School of Economics, most notably Gordon Tullock but also James Buchanan and others, started looking into it in the third and fourth quarters of the twentieth century (Buchanan, Tollison and Tullock, 1980; Congleton, Hillman and Konrad, 2008a&b; Lockhard and Tullock, 2001; Rowley, Tollison and Tullock, 1988; Tullock, 1967, 1970, 1971, 1989, 1993, 2005). Tullock (2003, 5) credits Anne Krueger with coining the term "rent-seeking" in an article she wrote in 1974 (Krueger, 1974). The term has caught on and has been used ever since, although legalized plunder could also be used to describe the phenomenon.

This section discusses some modern examples of rent seeking. One may consider it to be an update and expansion of Bastiat's ethical philosophy. Much of what Bastiat had to say in his main works (Bastiat, 1964a&b, 1968, 2007) focused on rent seeking, although he did not use that term. He called it plunder, which may be defined more or less the same as rent seeking – using the government to obtain benefits that you could not obtain yourself without committing a crime. Tullock also refers to the phenomenon as a welfare loss from monopoly (Tullock, 2003, 2). It has been suggested that occupational licensure laws, rather than protecting the public, serve as opportunities to reap monopoly profits by restricting entry (Albon and Lindsay, 1984).

Occupational Licensure Laws

Rent seeking can take many forms, some of which are not at all obvious. The American Medical Association (AMA), for example, once sought to outlaw the practice of osteopathic medicine, dentistry and chiropractic by anyone who was not a licensed physician, ostensibly to protect the public interest but in actuality to protect medical doctors from competition. Milton Friedman (1962, 137-160) advocated the abolition of occupational licensing laws as a means of preventing rent seeking in labor markets.

The American Medical Association limits entry into the profession in many ways. It determines whether medical schools in the United States may exist and regulates the conditions of their existence. It determines the curriculum as well as who may teach in them. It puts its stamp of approval on hospitals. Hospitals that do not have its stamp of approval will likely go out of business.

By limiting the number of medical schools and enrollments it is in a position to put an artificial crimp into the supply of medical doctors who would otherwise be able to serve the public. Rather than protecting the public from unscrupulous or unqualified doctors, it is protecting them from lower prices and more choices.

The AMA restricts entry in other ways as well. In some states, one must be a U.S. citizen to practice medicine. One must pass a licensure exam in English, which restricts the entry of physicians who would otherwise practice in ethnic communities. This English language requirement prevented thousands of physicians who fled Europe in the path of the Nazis from practicing in the United States (Friedman, 1962) and it prevents otherwise qualified physicians who speak Spanish and other languages from practicing today.

> When these effects are taken into account, I am myself persuaded that licensure has reduced both the quantity and quality of medical practice; that it has reduced the opportunities available to people who would like to be physicians, forcing them to pursue occupations they regard as less attractive; that it has forced the public to pay more for less satisfactory medical service, and that it has retarded technological development both in medicine itself and in the organization of medical practice. I conclude that licensure should be eliminated as a requirement for the practice of medicine. (Friedman, 1962, 158)

Milton and Rose Friedman have advocated a constitutional amendment that would prohibit government from placing restrictions on professional labor markets (Friedman and Friedman, 1980, 305). Their proposed amendment reads as follows:

> No State shall make or impose any law which shall abridge the right of any citizen of the United States to follow any occupation or profession of his choice.

The American Medical Association is not the only culprit that uses government to protect the public from lower prices in their profession. The American Bar Association does the same thing for lawyers and other professions have their professional associations that use the same approach to limiting entry into their professions. There really is no need for a lawyer to have a four-year bachelor's degree before entering law school. Most of the subjects studied at the undergraduate level have little or nothing to do with the practice of law. Yet such a degree is required for admission to law school in most states.

England and some other countries do not have this requirement. Students who want to become lawyers can enter a law program upon graduation from secondary school, which means they only have to pay for three years of university education instead of seven.

The accounting profession serves as another example of rent seeking behavior. Although practically anyone can call themselves an accountant in most states, in order to become a certified public accountant you must be a college graduate, and in most states you must have 150 semester hours of college credits, which is about five years of full-time study, which is one year more than what is required for a bachelor's degree. Furthermore, in some states, none of the work taken in the fifth year of study need be in accounting.

The rationale for the fifth year is so that accountants can be more well-rounded, but in fact the fifth year requirement serves to further restrict entry into the profession. Ostensibly aimed at protecting the public from incompetent accountants, the education requirement serves to restrict entry into the accounting profession. A better approach would be to allow anyone to take the certified public accountant (CPA) exam, which would allow potential CPAs to cut their university education costs by as much as 80 percent, since they could learn what they need to know to pass the CPA exam by taking about 10 courses rather than the 50 courses they would need to take to earn a bachelor's degree plus the additional hours needed to fulfill the 150 semester hour requirement.

An even better solution would be to get government out of the picture entirely and allow private accreditation agencies to compete for the business of certifying accountants and other professionals. *Consumer Reports* and Underwriters Laboratories act as private screeners of unsafe products. The marketplace is quite capable of regulating the professions and competing agencies and organizations would break the monopoly now held by groups such as the American Medical Association, the American Bar Association and the American Institute of Certified Public Accountants and their state affiliates. Is it really necessary to take a medical exam if you have graduated from Harvard Medical School?

Occupational licensure laws now restrict entry to nearly 1,000 occupations in some or all states (Young, 1987, 4). Restrictions on entry increase the cost by causing the supply curve to shift to the left. They have a disparate impact on minorities and the poor (Freeman, 1980; Young, 1987, 75-80), who can least afford to pay for the arbitrary and irrelevant coursework that is often required to obtain the credentials needed to enter the various professions.

Licensure laws do not necessarily protect the public from incompetent or unscrupulous practitioners (Rottenberg, 1980; Young, 1987). Some studies have found that licensure actually has an adverse impact on safety (Rottenberg, 1980; Young, 1987). In states where electricians are strictly licensed, incidents of electrocution are actually higher than in states where restrictions on entry into the profession are less onerous. That is because tighter restrictions result in fewer licensed practitioners and higher costs. Rather than hire a licensed electrician, some people try to do the work themselves, leading to a higher rate of electrocution.

Occupational licensure laws have had an adverse effect on quality (Maurizi, 1980; Young, 1987) and efficiency (Evans, 1980; White, 1980; Young, 1987) and has reduced geographic mobility (Pashigian, 1980; White, 1980; Young, 1987) and geographic distribution of practitioners (Boulier, 1980). Licensure has retarded innovation (Rottenberg, 1980; Young, 1987). In many cases, licensure does not meet the utilitarian ethics test because it results in a negative-sum game. In all cases it violates property and contract rights because individuals cannot enter into contracts and exchange what they have for what they want.

Bastiat discussed the effect of governmentally imposed restrictions on the labor market in several of his works. One policy that particularly vexed him was the French requirement that individuals have a bachelor's degree from a government university in order to enter certain professions (Bastiat, 1964a, 242). A tangential problem was that the French government imposed what Bastiat considered to be an irrelevant and harmful educational curriculum that all future

French professionals must endure before being granted entry into the professions (Bastiat, 1964a, 280-283). Bastiat advocated the dissolution of the French educational monopoly and replacing government schools with private schools that would compete for students.

Trade Policy

One thing Bastiat is most famous for is his view on trade policy (Bastiat, 1850, 1862 a & b, 1873 a, b & c, 1964a & b). He was an advocate of unrestricted free trade. He believed that individuals should be free to trade what they have for what they want without government interference. His example above of the French iron producer was only one of many examples he gave to illustrate his opposition to trade restrictions. He based his view both on utilitarian ethics and rights theory. Free trade was the best policy because it was more efficient than any other alternative. It always resulted in a positive-sum game because there were more winners than losers. It was the only policy that did not violate property rights.

Restrictions on free trade are a form of plunder or rent seeking, since they use the force of government to transfer wealth from the rightful owners to special interests who have not rendered a service deserving of the wealth they are receiving. Tariffs increase the price of domestic goods and allow domestic producers to reap monopoly profits. Quotas and antidumping laws have the same effect. His essay, *The Candlemakers' Petition* (1873c; 1964b, 56-60), is one of the best defenses ever written for free trade and against antidumping laws. His essay on the balance of trade also shows the flaws in reasoning of those who advocate antidumping laws (Bastiat, 1964b, 51-55).

> Assume, if it amuses you, that foreigners flood our shores with all kinds of useful goods, without asking anything from us; even if our imports are *infinite* and our exports *nothing*, I defy you to prove to me that we should be the poorer for it. (Bastiat, 1964b, 55).

Protectionists would be quick to point out that free trade – allowing cheap foreign imports to cross our borders – destroys jobs, and they would be right. But that is not the whole story. As Bastiat, would say, what is seen is the destruction of jobs resulting from free trade. What is not seen is the multitude of jobs that are created by free trade (Bastiat, 1850, 1964a,1-50).

Schumpeter (1942) and others (Cowen, 2002) pointed out that capitalism involves the process of creative destruction. In order for new industries to be born, old industries must be allowed to do so that their resources can be shifted to higher uses. Other scholars (Hufbauer et al., 1986; McGee, 1994) have pointed out that free trade creates more jobs than it destroys because of increased economic efficiency. Thus, free trade meets the utilitarian ethics test because the result is a positive-sum game, a conclusion that agrees with what Bastiat said in the 1840s.

Yet trade restrictions continue to exist (Mastel, 1996; Nivola, 1993; Rivoli, 2005; Stiglitz, 2003). Domestic producers run to their legislatures and ask for protection against foreign imports. The protection can take many forms, the most common of which are tariffs, quotas and antidumping laws. Even international organizations that are purported to support free trade have adopted policies that restrict trade. Both the World Trade Organization (Jayaswal and Sujit, 2002; Schott, 1994, 2000) and the North American Free Trade Agreement (NAFTA) (Hufbauer and Schott, 1993) contain provisions permitting tariffs, quotas and antidumping laws (Friedman, 2005; Hindley and Messerlin, 1996; Lindsey and Ikenson, 2003; Mastel, 1996; Novola, 1993; Rivoli, 2005; Stiglitz, 2003) in spite of the fact that they restrict trade, decrease economic efficiency and result in higher prices to consumers, the group they are supposedly there to protect.

Eminent Domain Laws

Eminent domain laws allow the taking of private property for public uses and require compensation when property is taken. It used to be that only governments could take property by this method and it used to be that *public use* meant some government use, such as building a post office or constructing a road. But that is no longer the case (Barnett, 2004; 354-355; Levy and Mellor, 2008; Napolitano, 2004, 65-78).

The eminent domain laws are increasingly being used by private developers to take private property for private development such as shopping malls and housing developments. It has become another form of legal plunder (Epstein, 1985). Developers or other private parties, their lawyers and the politicians and judges who permit this kind of rent seeking are acting unethically.

In *Berman v. Parker* (1954), the U.S. Supreme Court defined *public use* broadly enough to include the concept of *public purpose*. As a result of this case, governments and private developers can now have property condemned because of urban blight, a nebulous term at best. Government can even seize well-maintained property in the name of economic development, which means no property is safe from confiscation (Levy and Mellor, 2008, 157). *Kelo v. City of New London* (2005) expanded the power of eminent domain to include the confiscation of private homes so that the property could be turned over to private developers, who would improve the property so that additional tax revenues could be generated by the new properties (Levy and Mellor, 2008, 155-156).

CONCLUDING COMMENTS

Much of Bastiat's ethical insights had to do with rent seeking, the act of using government to do what could not otherwise be done without committing a crime. It is a form of legalized plunder, the forcible taking of property. Individuals who engage in the practice are acting unethically both from a utilitarian perspective and a rights perspective.

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LAW AND ACCOUNTING: DID LEHMAN BROTHERS USE OF REPO 105 TRANSACTIONS VIOLATE ACCOUNTING AND LEGAL RULES?

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ABSTRACT

In September 2008, Lehman Brothers filed for bankruptcy. Lehman Brothers' bankruptcy was a critical event in the financial crisis. Prior to the bankruptcy filing, Lehman Brothers was able to use repurchase (Repo 105) transactions to disguise the true condition of the company. This paper addresses the use of Repo 105 at Lehman Brothers. At that time, the repurchase agreements were allowed to count as a sale rather than debt under Generally Accepted Accounting Principles; thus, Lehman understated their financial difficulties. Both the accounting principles, possible violations of U.S. securities law, and the conflict that results are examined. The authors conclude that as long as the conflict exists between what is expected of auditors (under accounting standards and GAAP) and the regulators and the law, Lehman-type events will continue to be likely.

INTRODUCTION

This article addresses both U.S. accounting standards and U.S. law by providing an analysis of repurchase agreements as used by the investment firm Lehman Brothers. The specific questions addressed are whether Lehman Brothers violated accounting and auditing standards and federal securities and financial regulation laws. This paper examines both the accounting practices and securities law and the conflict between them. At the time the repurchase agreements were used, the accounting treatment was considered acceptable under U.S. generally accepted accounting standards ("GAAP"). However, the authors conclude that the accounting treatment of the repurchase agreements, henceforth referred to as Repo 105 transactions, and the subsequent financial statement disclosures were done in violation of numerous U.S. laws. The contradiction between law and accounting/auditing standards is the focus of the article.

Prior to the collapse, Lehman Brothers was the 4th largest global financial services firm and the oldest of the five major global financial services firms (“Lehman Brothers”). In addition to Bear Stearns and AIG, Lehman Brothers was a major institution that failed during the financial crisis (McAfee & Johnson, 2010). The failure of Lehman Brothers is believed to have impacted financial markets for weeks (“Case Study: The Collapse of Lehman Brothers,” 2009).

While it was hardly the sole cause of the financial crisis, the failure of Lehman Brothers was a substantial event causing loss of confidence in the financial and banking systems. The Lehman Brothers event is considered so important in the minds of business and economic analysts that the terms "Lehman-type event" or "Lehman-type moment" is often used in the business press and business cable TV (such as CNBC). For example, analysts ask whether the possible fall of the Greek or Spanish economy would cause a worldwide catastrophe that would qualify as a "Lehman type event" (Kroft, 2012; CNBC, 2011; Pinetree Capital Ltd., 2012, Sandholm, 2011; Martinez, 2011). Lehman Brothers continues to make news with new lawsuits and news reports.

On September 15, 2008, Lehman Brothers filed for bankruptcy. The Lehman Brothers bankruptcy is the largest reported U.S. bankruptcy –twice as large as the second, Washington Mutual ("The Ten Largest Bankruptcies", 2009). Bank debt at Lehman Brothers was $613 billion. The bankruptcy was prompted by an acute cash shortage. Prior to the bankruptcy filing, investors were aware of Lehman's increasing financial difficulties. However, use of financial statement "window-dressing" through off-balance sheet transactions, such as Repo 105, disguised the extent of the financial difficulties.

One can argue that had regulators and investors been informed of the true condition at Lehman Brothers, some of the problems in the financial crisis may have been averted. (The later bankruptcy filing by Lehman Brothers provided information on the repurchase transactions. Had Lehman Brothers not filed for bankruptcy, the accounting practices may have not been disclosed. Thus, we do not know the extent to which other investment firms used similar accounting treatments to window-dress financials.) Certainly, regulators would have had a clearer picture of the deteriorating financial condition at Lehman Brothers. Of particular concern to investors in Lehman Brothers were the leverage and the leverage ratio (Valukas, 2010, p. 800). The management at Lehman Brothers understood investors' concerns and in 2007 discussed the impact a deteriorating balance sheet and leverage condition would have on the company. The concern was that market declines and ratings downgrades would result if the financial condition were not improved (Valukas, 2010, p. 800).

With the implementation of a new accounting standard, Statement of Financial Accounting Standards (SFAS) 140, effective April, 2001, Lehman Brothers began using a tool to "manage" the balance sheet situation, repurchase agreements, Repo 105 and Repo 108 (Although Repo 105 and Repo 108 are technically different, this difference is in the amount of the cash inflow. The accounting treatment for each transaction is the same. For that reason, the article will refer both to Repo 105 and Repo 108 transactions as "Repo 105" in this. For Repo 105, fixed income bonds securities were used but for Repo 108, equities were used (Valukas, 2010, p. 732). As conditions at Lehman Brothers deteriorated, the firm increased its use of the Repo 105 agreements. Prior to the bankruptcy filing, in the 2nd quarter of 2008 SEC filing, Lehman Brothers had $50 billion in Repo 105 transactions not disclosed to investors. Clearly, the intention of management at Lehman Brothers in using Repo 105 transactions was initially to bolster the financial condition of the company in order to appease investors, and in later periods to avert bankruptcy. Despite the use of Repo 105, Lehman Brothers filed for bankruptcy with investors losing an estimated $46 billion in stock value.

The article is organized as follows:

1. First, there will be a discussion of the financial situation and events leading to Lehman Brothers bankruptcy and specifically how Repo 105 was used.
2. The article discusses the specific accounting, auditing, and factual requirements for the use of Repo 105 transactions; asset valuation under general accounting rules; and the usage of Repo 105 transactions at Lehman.
3. Finally, Repo 105 transactions are examined under specific laws: (1) the Securities Exchange Act of 1934, (2) Sarbanes-Oxley, and (3) the Private Securities Litigation Reform Act. Current cases and prior precedent are discussed.

Because of the complexity of Repo 105, we provide a short summary of the transactions and the accounting treatment at Lehman Brothers:

> A repo is a short term loan. Before quarterly and annual financial statements were filed, Lehman Brothers, which was in financial trouble, would make short term loans, using securities or equities as collateral. A "loophole" in GAAP (later changed) allowed Lehman Brothers to book this as a sale rather than a loan as long as Lehman put up at least 102% (of the value of the loan) in collateral. Lehman sometimes would put up 105% in securities or 108% in equities as collateral. Lehman would then use the "loan" money to buy down temporarily its debt, which reduced its leverage ratio (debt to equity), making the firm look less risky, and misleading analysts and investors. After the short term was up and the financial statements issued, Lehman would have to repay the loan with interest (the interest is thus a loss or "haircut"). Lehman did not acknowledge in SEC filings neither the amount of Repo 105 transactions nor the amount of debt that would shortly be repaid.

BACKGROUND: LEHMAN BROTHERS' FINANCIAL DIFFICULTIES: THE FINANCIAL CRISIS, AND FINANCIAL STATEMENT WINDOW-DRESSING—REPO 105

Lehman Brothers Financial Difficulties

Lehman Brothers was forced to file for bankruptcy in 2008. While Lehman filed for Chapter XI bankruptcy (usually meaning it might continue), the bankruptcy proceedings showed that the company needed to be liquidated and ended (as is usually the case under Chapter VII bankruptcy). Lehman Brothers, as a company, had the largest amount of assets for a firm filing for bankruptcy. At the time of the filing, it appeared that Lehman Brothers had $600 billion of assets with $30 billion in equity ("Lehman Brothers"). Months before the bankruptcy, Lehman Brothers' stock price had continued to fall.

By the weekend preceding the bankruptcy, Secretary of the Treasury Henry Paulson determined that Lehman Brothers had one of three options: (1) a purchase by another company, (2) a bailout (with no purchase) by other large investment and commercial banks, or (3) bankruptcy. One of the three had to occur before stock trading commenced the next week. The government determined that it did not have the legal authority to bail out an investment bank (although this could be done for a commercial bank). Yet, because of Lehman Brothers' enormous size and its connections throughout the U.S. and world economies, Paulson and Tim Geithner (head of the New York Federal Reserve bank) convened in secret with the heads of other large U.S. financial institutions. The fear was that Lehman Brothers' fall (coming after the fall of Bear Stearns) would trigger a cascading, free-falling economy (Paulson, 2010, p. 182-221).

During the weekend, the banks brought in their experts to examine Lehman Brothers' financials. They tried to value the assets and the tremendous amount of mortgage-related debt (While normally such financial dealings might seem dull, the BBC did both a movie and a documentary on that meeting ("The Last Days", 2009; "The Love of Money", 2009)). There was some concern among those present that assets might be over-valued.

One option was to bring in a buyer for Lehman Brothers. Paulson attempted to get Bank of America (BoA) to buy Lehman. But BoA was in no position to buy another troubled company, having recently purchased Countrywide, the largest of the non-bank mortgage companies. BoA appeared interested, but it eventually declined. The other potential purchaser was a large British bank, Barclay's. While Barclay's had a great interest in Lehman Brothers, the financial position of Lehman caused Britain's financial regulators to refuse to put one of its largest banks into harm's way (Paulson, 2010, p. 207-16).

The possible consortium of other U.S. banks reached the same conclusion. Investment of a considerable sum of money would be required to sustain Lehman Brothers. The consortium recognized both the riskiness of an investment in Lehman Brothers and the fall of Lehman Brothers would potentially result in other failures (Paulson, 2010, p. 187-221).

The world's largest stock trading company Merrill-Lynch was bought by BoA that weekend, but another tremendous blow was impending, and that was the fall of the largest insurer in the world—AIG. While AIG's regular insurance companies were doing reasonably well, AIG was not, selling around $80 billion dollars in credit default swaps, essentially insurance that one company would pay its loan back to another company. Most of these corporate borrowers were deeply in trouble with mortgage-related debt. This adversely affected AIG. Eventually the government would have to find a way to bail out both AIG and other banks through a program called TARP (Troubled Asset Relief Program) that would amount to hundreds of billions of dollars (Paulson, 2010, p. 322-401). Lehman Brothers filed for bankruptcy. The failures of Bear Stearns, Lehman Brothers, and AIG were signs that the economy and the stock market were headed toward the greatest recession since the Great Depression of the 1930s.

While Lehman Brothers' financial situation was desperate at the time of its bankruptcy filing, later investigations of its practices during the bankruptcy showed that through the use of Repo 105, the company was able to conceal a substantially worse financial condition. Through the use of Repo 105, Lehman Brothers had reduced the leverage ratio at the time when quarterly and yearly financial statements were reported by temporarily transferring investment assets with repurchase agreements, termed “Repo 105.” Financial difficulties had been hidden from investors and regulators.

When the second quarter of 2008 financials were filed, Lehman had over $50 billion in Repo 105 transactions (Valukas, 2010, p. 919). In 2006, Lehman Brothers executives had suggested an appropriate cap on Repo 105 (exclusive of Repo 108 transactions) at $17 billion (Valukas, 2010, p. 921). This cap of $17 billion was approximately 1 x leverage. Yet, in the fourth quarter of 2008, the amount on the leverage position was nearly 3 times what Lehman Brothers executives had set as a limit.

The self-imposed cap was less than Lehman Brothers' external auditor suggested as being material. Conversely, the audit firm reported within the walkthrough papers that any item alone, or in the aggregate with one tenth of a point change in leverage was considered material (Valukas, 2010, p. 964). (The definition of material is of significant amount to impact the investor and potential investor's decision-making.) Therefore, the amounts under Repo 105 were material to the financial presentation. Indeed, the usage of the Repo 105 transactions, as attested by internal Lehman Brothers discussions, served no economic purpose other than to improve financial statements.

Financial Statement Window-Dressing

The intention of Lehman Brothers’ management in using Repo 105 transactions was initially to bolster the financial condition of the company in order to appease investors and in later periods to avert bankruptcy. Corporations routinely engage in practices to improve financial condition through real activities manipulation, even though the practices are not expected to produce favorable economic benefits to the firm (Graham et al., 2004, p. 3). (An example of real activities manipulation is the payment of additional salesmen commissions at year end. In many cases, the salesman makes sales calls in December rather than in January, thereby not increasing overall sales.) The practices have been identified as a fourth quarter phenomenon with the implied intention of improving year-end financial condition. Lehman Brothers conducted Repo 105 transactions around quarterly and annual SEC filings.

Corporations also structure transactions to fit accounting treatments. This practice is called "earnings management" and has been observed in acquisitions, leases, and issuance of convertible debt (Xu et al., 2007, p. 195). Again, these practices are apparent in U.S. corporations. Lehman Brothers structured the Repo 105 transactions in a way to permit a specific accounting treatment.

Thus, the Repo 105 transactions, in a sense, are examples of both earnings management and real activities manipulation, both documented phenomena. Lehman Brothers' management engaged in transactions that did not make long-term economic sense, costing the firm amounts in what was in effect, interest, and also structuring the transactions to avoid both collateralization treatment and asset impairment. Also, consistent with corporate practices, this is an indication of a firm engaging simultaneously in both transaction structuring and business activities to manage earnings (Lin et al., 2006).

In contrast to what might be expected in U.S. corporations, the examination of Lehman Brothers provides a rather extreme example where a firm's financial condition is so dire as to lead to bankruptcy and the reliance on the accounting treatment is seen as a means to continue the firm's existence. Two points can are made concerning the Lehman Brothers case. First, the accounting literature is not well developed in this area of measurement of the financial impact or magnitude of manipulations. The bankruptcy proceedings provide us with a means to quantify this in an identified firm. Second, because of the extreme nature of the activities, the obvious materiality of the Repo 105 transactions and documentation provided by the bankruptcy proceedings and court cases offer a prime example to examine the role of law in both earnings management and real activities manipulation. Our examination of Lehman Brothers is relevant and applicable to other corporations within the U.S. Thus, the article addresses the issue of whether Lehman Brothers' management violated legal statutes. In order to address the issue, the article examines accounting and auditing standards, the Securities Act of 1933, Securities Exchange Act of 1934, Sarbanes Oxley reporting requirements, and other laws.

Repo 105 Transactions

General Discussion

Repurchase agreements are typically short-term arrangements where the financial assets of an entity are transferred temporarily to another party in exchange for a cash transfer (which would, thus, normally be viewed as a short-term collateralized loan). The purpose of such arrangements is to provide for temporary liquidity. In effect, the transfer is a short-term borrowing, with the knowledge that the assets purchased will be later sold back to the original seller (hence, the term "repurchase") after a specific time period. For Lehman Brothers, one advantage of repurchase arrangements was the ability to use the cash inflow to reduce liabilities. As financial statement dates neared, Lehman Brothers would transfer assets for cash and use the cash to reduce debt, thereby improving the debt position of the company. The difficulty with this procedure was that accounting standards would *usually* require Lehman Brothers to acknowledge a liability if there was also an agreement to repurchase the assets at a later date (after financial statement presentation). Thus, the debt position would not be improved. This recording of a liability is required under collateralization (For example, if investment assets of $100,000 were converted to cash, the liquidity of the firm would improve. If the cash was then used to pay down debts, the debt to asset ratio would improve. However, if an agreement to repurchase (buy back) the same assets post financial statement date existed, then one accounting treatment would be to acknowledge a liability prior to financial statement date. Because the buy-back would include interest, the total amount of liability would be greater than the $100,000 received. (Though, at Lehman, the practice was loaded and termed a "haircut".) Thus, repurchase transactions without a sale provision can have the potential to cause the debt to asset ratio to deteriorate. This accounting treatment would not have been beneficial to Lehman). Therefore, Lehman's financial position, specifically cash and liquidity, could be improved using repurchase arrangements, only if Lehman was able to use the cash inflow from the arrangements without recording a liability. Thus, the repurchase arrangement needed to be recorded as a sale and not as a collateralization to meet accounting standards. A apparent loophole in GAAP appeared to provide such an opportunity.

Repurchase agreements (arrangements) are fairly common in investment banking. At Lehman, not all transactions were given the same accounting treatment. For example, in a "typical" repurchase arrangement, the firm would receive cash and record a liability. However, in a Repo 105 agreement, the asset was removed from the books in exchange for cash and there was no recording of a liability. In this article, this transaction is discussed as a "sale" transaction. The legal implications of a sale transaction will be discussed in the next section and later in the paper.

Ultimately, what Lehman Brothers accomplished through Repo 105 was not just to convert a debt transaction into a sale, but to lower the leverage ratio, a prominent number to investors and analysts. Leverage is typically defined as liabilities divided by shareholder equity (The report actually uses a slightly more complex definition of leverage: (total assets minus collateralized agreements) divided by stockholder's equity. The collateralized agreements may have included some of the riskier mortgage-backed securities (Valukas, 2010, p. 752). The higher the leverage, the riskier a firm looks. Lehman would borrow money giving up collateral. When Lehman Brothers used the borrowed money temporarily to pay down its liabilities, the leverage ratio went down, making the firm look "less risky." For example, according to the Valukas Report, in quarter 2, over $50 billion in Repo 105 money was used to reduce leverage from 13.9 to 12.1 (Valukas, 2010, p. 748). This was a large reduction in leverage.

At Lehman Brothers, the cash amount received was less than the total value of the assets. In some cases, the amount was 5% less (thus "Repo 105") and in others, the amount received was 8% less (Repo 108). In accounting terms, then the cash received was less than the asset value removed; therefore, the difference needed to be recorded somehow or the transaction would be "out of balance". This difference is referred to as the "haircut". Normal accounting handling of a sale transaction when less is received than the value of the asset is to record a loss. However, with transactions this large, the financial impact on the profit and loss statement of only 5% or 8% would not have been favorable. To avoid recording the loss, Lehman Brothers reasoned that since this amount would later be repaid, it should be recorded as a derivative (an asset).

Lehman Brothers used the cash received from "sale" of securities to pay down liabilities. With reduced liabilities, the financial condition appeared to have improved, however, the amount borrowed plus interest would need to be repaid at a later date. Thus, the transaction was only a temporary solution, providing improvement of financial condition for financial statement presentation purposes, when recorded as a Repo 105 transaction. The longer term perspective would be a deterioration of financial condition as the amount of the cash plus interest would then need to be repaid. The larger Repo 105 transactions were done in 2007 and 2008 though the practice initiated as early as fiscal 2001. Repo 105 transactions typically were initiated right before quarterly and annual financial statements with repayment in seven to ten days. After the seven to ten days, Lehman Brothers would have to undo the transaction by repaying the money and interest to the counter-party (Valukas, 2010, p. 732-33). According to the financial officer, there was “no substance” to the transactions other than to change the balance sheet (Valukas, 2010, p. 735). By the second quarter of 2008, the amount was over $50 billion dollars (Valukas, 2010, p. 742).

Sale Requirements under Repo 105

The accounting standard in place at the time Lehman used Repo 105, SFAS 140, appeared to allow this switch from a debt transaction to a sale transaction and the rule contained three main requirements to determine the nature of the transaction. If the three requirements were met, the transaction could be recorded as a "sale"; otherwise, the transaction would need to be recorded as a collateralization. As discussed above, to improve financial condition, the transaction needed to be recorded as a sale. These requirements can be summarized as: (1) isolation of the transferred asset from the transferor; (2) the transferee has rights to pledge or exchange the assets with “no condition (that-sic) both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor”; and (3) “the transferor does not maintain effective control over the transferred assets through either an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47,49) or the ability to unilaterally cause the holder to return specific assets…” (SFAS 140)

In order for control over the assets to have been relinquished, the transferor (here, Lehman Brothers) “must have both the contractual right and the contractual obligation to reacquire securities that are identical to or substantially the same as those concurrently transferred. The transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all the cost of purchasing identical replacement securities during the term of the contract" (SFAS 140). This standard essentially assumes that the similarity in value of the transfers between the parties is a determinate of whether a sale has occurred. If the transfers are very similar, a sale has likely not occurred, but if the transfers differ, then a sale has likely occurred (SFAS 140);

> The Board also decided that the transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults. Judgment is needed to interpret the term *substantially all* and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline. The Board believes that other collateral arrangements typically fall well outside that guideline. (SFAS 140)

If the value of the assets surrendered were similar, according to accounting standards, the transfer is deemed to be of a temporary nature. The accounting treatment would be collaterialization and not a sale. Thus, by structuring the contract in a certain way, Lehman Brothers was able to meet one of the provisions of the accounting standard for recording the transaction as a sale.

Paragraph 218 of SFAS 140 set the requirement at as much as 98% collateralization for entities agreeing to repurchase and as little as 102% overcollateralization for securities lenders. The interpretation of the standard (which is a part of GAAP) was that if it was between 98% and 102%, then this was close enough to being a transfer of similar assets to qualify as a collaterialization. Lehman Brothers set the amount at 105% (fixed income) or 108% (equity) in order to fall outside the limits, so that the repurchase was then accounted for as a sale. The quantification of the amounts in the accounting standards provided a means for parties to record the transaction as a sale or a collateralization, by setting the terms of the arrangement. An increase or decrease in transferred amounts by as little as 1% would trigger a different accounting treatment, provided the other conditions set forth in SFAS 140 were met.

In order for it to be a sale, legally the transaction must be viewed as a sale. According to the Valukas bankruptcy report, legal counsel did not consider the transaction as a sale transaction (Valukas, 2010, p. 784). Indeed, Lehman Brothers was unable to find U.S. counsel that would support the transaction as a sale (Valukas, 2010, p. 784). Therefore, if the transaction were conducted within the U.S., U.S. commercial law would not be supportive of it being a sale transaction. Specifically, there existed an agreement to repurchase. However, Lehman Brothers contended that transactions between parties not within the U.S. could be accounted for using the law in existence for one of the parties. For example, if London law would identify the transaction as a sale, the transaction could be recorded as a sale on the books of the entity falling under London law. U.S. standards are silent on the issue of foreign law and this appears to be a very liberal interpretation of the standard.

As to whether the transaction was a "sale" or something else under the laws of the United States, securities law and even the Uniform Commercial Code as it relates to securities (Article 8 of the U.C.C.) are not particularly helpful because the term "sale" is so basic that it does not really need definition. By analogy, one can look to the U.C.C. Article 2 that deals with the sale of goods (recognizing, however, securities are not goods; goods here are moveable items in the form of personal property). U.C.C. section 2-106 says that a "'sale' consists in the passing of title from the seller to the buyer for a price." Title means the passage of ownership and would not normally be considered to be the transfer of collateral for money which for goods is governed by the law of secured transactions (Article 9 of the U.C.C.).

A secured transaction, which is governed by the U.C.C., is defined "as any transaction (*regardless of form*) which is intended to create a security interest" in collateral. Under Article 9, the collateral can be almost anything except real estate. The collateral under Article 9 explicitly includes securities (Uniform Commercial Code, § 9-105(i), 2001). The definition explicitly says that a secured transaction can exist "regardless of form."

(For example, so-called "leases" can be treated not as a true lease but a secured transaction if the "lessee" can acquire the leased items at the end of the lease for less than fair market value. Thus under Article 9, it is not the form but the substance (beyond the form) which designates it as a secured transaction and not a sale. In a secured transaction, the party giving up the right to repossess is known as the "debtor" and thus the transaction should then be regarded legally as debt (Uniform Commercial Code § 9-105(d), 2001). A debtor "owes payment or other performance of the obligation secured." (Uniform Commercial Code, § 9-105(d), 2001).

The term "secured" means that the debt is backed by collateral. Thus under United States law, it would be extremely difficult to call a Repo 105 transaction anything other than debt (or a secured debt); it is definitely not a "sale."

The major securities laws in the United States do not give a definition of the term "sale" but instead use it in creating other definitions. Thus, they seem to be relying on the same definition as found above.

Black's Law Dictionary defines a "sale" as a "contract between two parties, respectively, the "seller" (or "vendor") and the "buyer" (or purchaser) by which the former, in consideration or promise of a certain price in money, transfers to the latter the title and possession of property" (Black, 1968, p. 1200). But the definition distinguishes sales from other transfers such as mortgages where collateral is involved. *Black's Law Dictionary* also defines "security agreement" as an "agreement which creates or provides for a security interest" which involves an "agreement granting a creditor a security interest in personal property" which is under Article 9 in the U.S. as a secured transaction (Black's Law Dictionary, 1968, p. 1217). A debt is also defined "as a sum of money due by certain and express agreement…"; a "secured debt" is one "secured by collateral" (Black, 1968, pp. 363-64). From this discussion, one can concur with the Valukas bankruptcy report. Had the transaction occurred in the U.S., it most certainly could not have been considered a sale.

Lehman Brothers responded to this specific provision of SFAS 140 by using a party that fell under London law, where the transaction would be viewed apparently as a sale. The party was a related party, Lehman Brothers International (LBIE). Some securities under Repo 105 agreements originated within LBIE and others originated with the U.S. Lehman entities, transferred to LBIE. In order for the sale to occur, the final party to the transaction had to be outside Lehman Brothers. Thus, Lehman Brothers structured transactions with unrelated parties, outside of the U.S., in order to avoid recording the transaction as a collateralization. If the recording of the transaction had been as a collateralization, as noted previously, the debt would have to be recognized prior to the financial statement preparation and there would have not been a favorable financial statement impact from the Repo 105 transactions. Lehman Brothers also used the "bright lines" provided by the accounting standards to structure the haircut in an amount exceeding the limits of SFAS 140 so that the transaction could be recorded as a sale.

Asset Valuation

Another consideration in SFAS 140 was the liquidity of assets. If a market did not exist for the assets, it would be difficult to value securities and apply the 5% or 8% provisions in the Repo 105 agreements, i.e., the buyer of the securities could not easily purchase similar securities, as provided under SFAS 140. The phrase, within Lehman's internal accounting policy on Repo 105 was "'readily obtainable' meaning 'a market must exist where the assets are either traded on a formal exchange or are considered liquid and trade in a market where price quotations either are published or are obtainable through another verifiable source'." (Valukas, 2010, p. 793). Although most of the securities in the Repo 105 arrangements appear to be governmental, which suggests liquidity, from 9% to 16% of the assets under Repo 105 may not have been (Valukas, 2010, p. 797). Whether a market existed for these securities is debatable. Clearly, the intention of Lehman Brothers was that the securities should be liquid, so as to be in compliance with the provision of SFAS 140.

Although SFAS 140 provided a means to improve the cash situation of Lehman Brothers, if the sale were recorded according to the typical GAAP treatment of sales of assets, when the amount of cash received is less than the asset's book value, a loss should have been recorded. Lehman Brothers applied SFAS 133 (Statement of Financial Accounting Standard No. 133)R, recording the difference in value not as a loss, but as a financial asset, a derivative to reflect the amount of the "overcollateralization" in the Repo 105 arrangements. Thus, what would have been seen as a reduction to net income was shown as an increase in net assets. In the next accounting period, when the repurchase part of the transaction was concluded, the asset representing the "overcollateralization" would be removed. The striking fact of this aspect of the accounting treatment is that as noted above, Lehman argues the transaction is not a collateralization, but a sale and yet within the same transaction, argues the transaction is, indeed a collateralization, tied to the future transaction, when the securities will be repurchased. Yet, according to GAAP existing at the time, this was not a violation. That is to say, within one transaction, its handling could be a sale or a collateralization. This clearly contrasts with what the result would have been if U.S. law were applied, where the transaction would be identified as a collateralization (The co-author has not found any other transactions that can be divided into components with each component classified as a different type of transaction. The accounting standards generally give the circumstances by which a given transaction is classified—for example, in lease accounting. However, once the transaction is classified, each component part (account) is considered as falling under that classification. This "parceling out" within a journal entry is neither routine nor expected.).

Had Lehman Brothers not transferred assets through repurchase agreements, some assets would have certainly been seen as impaired. The accounting treatment for an impaired asset is to reduce the asset value and record a loss. If valued using fair value accounting, the value of the assets would have been reduced in line with market values. Depending on the nature of the investment, the accounting treatment would have resulted in either equity, other comprehensive income (OCI), or net income being negatively impacted. Lehman Brothers' use of Repo 105 transactions provided a means to "maintain" asset base (by transferring over-valued assets into cash) over what would have been had the assets remained on the balance sheet and not removed through repurchase agreements.

As the authors discuss later in the paper, neither Lehman Brothers' financial statements with related disclosures, nor the Management Discussion and Analysis section of the annual report (MD & A) discussed the accounting treatment of the Repo 105 transactions. Although the accounting for the transactions was complex, there was not disclosure within the SEC filings that would permit investors or regulators to evaluate the financial and economic impact.

Usage of Repo 105 at Lehman

Statement of Financial Accounting Standards No. 140 (SFAS 140) became effective in April, 2001 (Financial Accounting Standards Board, 2010). Lehman Brothers began to use the standard in 2001 (Valukas, 2010, p. 765). Within the firm, there were conflicts concerning the usage of the accounting treatment. The accounting treatment of the Repo 105 agreements clearly improved the balance sheet performance of the firm, providing end of financial period "window dressing". However, within the firm, executives were leery of the equality of investments. Those securities subject to repurchase arrangements were separated from other securities not under repurchase arrangements in internal documents (Valukas, 2010, p. 811) and the term "sticky assets" was used to describe less valuable assets (Valukas, 2010, p. 805; Attributed to Clement Bernard). Bart McBade, the "balance sheet czar" within Lehman Brothers, supported limits on the usage of Repo 105 arrangements. Upon becoming President and Chief Operating Officer (COO) of Lehman Brothers on June 12, 2008, McBade authorized a proposal to reduce the firm's reliance on Repo 105 arrangements from $50 billion to $25 billion in the third quarter of 2008 (Valukas, 2010, p. 819).

The implication from internal memos circulated within Lehman Brothers was that the use of the Repo 105 arrangements served as a means to increase financial presentation but did not support other goals of the organization, namely economic growth. The use of the Repo 105 arrangements resulted in an increased expense to the organization, as interest on the borrowed funds was higher than that of other financing means and did not provide incentive for profitability (Valukas, 2010, p. 878). The Repo 105 arrangements were seen as a way to make balance sheet targets instead of improving financials through asset management. Thus, while the accounting effect was to improve reported financial condition, the economic impact was to deteriorate financial condition. The failure to disclose the nature of Repo 105 transactions within SEC filings did not inform investors of the negative impact on financial performance.

The argument presented by McBade in proposing limitations on the use of Repo 105 arrangements was that traders "should have sold inventory to reduce balance sheet, rather than engage in Repo 105 transactions." (Valukas, 2010, p. 815). Others suggested that growth and not the balance sheet should be the emphasis of operations.

In August 2007, assets under Repo 105 arrangements totaled $36.4 billion. In May 2008, assets under Repo 105 arrangements totaled $50.4 billion. The firm clearly increased its reliance on the arrangements in 2008.

Although Lehman Brothers appears to have been cognizant of the difficulties in over-reliance on Repo 105 agreements, the firm increasingly relied upon the accounting treatment to improve the appearance of the balance sheet. This is evidenced by emails within the organization, where executives suggested the cost of the Repo 105 arrangements was "irrelevant, we need to just do it" (Valukas, 2010, p. 865; attributed to Kaushik Amin, Head of Liquid Markets, of Lehman Brothers). Although the Repo 105 arrangements may have satisfied specific accounting standards, they did not make long term economic sense. In the end, Lehman's liquidity issues forced the firm into bankruptcy.

ACCOUNTING STANDARDS

Accounting Standards and Generally Accepted Accounting Principles

Within the US, accounting standards are generally provided by the Financial Accounting Standard Board (FASB). Although the Securities and Exchange Commission (SEC) remains the ultimate authority on financial accounting standards for publicly traded companies, the Commission generally defers the actual application of standards to FASB. In 2009, the FASB Accounting Standards Codification became the official source of authoritative, nongovernmental U.S. generally accepted accounting principles (GAAP) (FASB, 2012). The Codification did not change GAAP, but rather solidified pronouncements by FASB, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), and others. The SEC guidance is also included within the Codification.

In the U.S., changes in accounting standards are established through a vetting process, where stakeholders are asked to comment on proposed changes. FASB has provided a conceptual framework (FASB, 2006). Specific accounting standards should be consistent with the conceptual framework. This framework suggests the over-riding objective, qualitative characteristic of financial information should be usefulness of decision-making. Additional primary characteristics are relevance (predictive value and confirmatory value) and faithful representation (completeness, neutrality, and free from material error). Additional enhancing characteristics are comparability, verifiability, timeliness, and understandability.

When the issue of Repo 105 agreements is considered within the FASB conceptual framework, there are a number of difficulties:

1. Relevance. Did the balance sheet presentation of cash when repurchase arrangements for less valuable assets existed provide predictive or confirmatory value?
2. Faithful representation. Was the information provided complete, neutral, and free from material error?
3. Did the balance sheet presentation provide for comparisons between Lehman at different points in time (given the increase in Repo 105 arrangements in later quarters)?
4. Did the balance sheet presentation provide for an understanding of the use of the Repo 105 arrangements and balance sheet impact?

Overall, although the accounting for Repo 105 agreements appears to fail to support the fundamentals of accounting, as presented in the conceptual framework provided by FASB, the individual standards (GAAP) are supported. This is because the individual standards provided within the codification cannot provide for all the objectives. The specific guidelines established (such as the “haircut” provision of Repo 105) can be based on "bright lines". The development of specific accounting standards is a political process, and the industry and transactional complexities of accounting make it difficult to provide for absolute consistencies within the codification. Indeed, the SEC acknowledges that “short-term financing arrangements can present complex accounting and disclosure issues, even when market conditions are stable” (SEC, 2010).

The fundamental issue brought to light in the use of Repo 105 agreements by Lehman is whether an accounting system based on industry standards, applied in response to specific accounting transactions and events, can fulfill the objectives of financial reporting. Unlike the legal system where changes in law or interpretations of law are challenged and resolved in the courts, the operations of FASB do not always provide an adequate way to address inconsistencies. One reason may be that, unlike law, where injured parties challenge findings, prompts for changes in accounting treatment are sluggish. Thus, it took disclosures of the Repo arrangement to prompt both SEC and FASB to respond to the GAAP inadequacies.

At Lehman Brothers, company employees and external auditors appear to be the only parties aware of the accounting treatment of the Repo 105 transactions. Neither party (except for the whistleblower) disclosed the treatment to investors or regulators. Had Lehman Brothers not filed for bankruptcy, the Repo 105 transactions might not have been disclosed.

SEC Response to Inconsistencies and Inadequacies in Reporting

The SEC response to the disclosure inadequacies of the repurchase arrangements can be seen in a proposed rule on Short Term Borrowing Disclosure. The expanded reporting requirements would require a separate subsection with comprehensive explanations, including both qualitative and quantitative information (SEC, 2010). Ironically, the proposal is similar to reporting requirements for financial statements that were repealed in 1994. However, unlike the previous reporting requirements, the presentation is within the Management Discussion and Analysis (MD&A), which is part of a company annual SEC 10-K report where a “qualitative” and quantitative discussion is required. The implication of this is that accounting (ex-information included in the face of financial statements and disclosure notes) does not provide all necessary information to inform investors.

The specific changes proposed in the release, dated September 17, 2010 were as follows:

-the amount in each specified category of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;

> -the average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings;
> -for registrants meeting the proposed definition of "financial company," the maximum daily amount of each specified category of short-term borrowings during the reporting period; and
> -for all other registrants, the maximum month-end amount of each specified category short-term borrowings during the reporting period (SEC, 2011).

The purpose of the proposal was to inform investors of the fluctuations in short term borrowings so that investors can make informed judgments as to the amount of "window-dressing" in financials presented. The proposal was unanimously accepted by the board on January 28, 2011. In addition, the SEC issued a letter, dated March 2010, to "certain" public companies requesting information on repo arrangements (or similar arrangements) with the clear intent to reinforce the need to disclose such transactions with MD & A:

> …if you accounted for repurchase agreements, securities transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets as sales and did not provide disclosure of those transactions in your Management Discussion and Analysis, please advise us of the basis for your conclusion that disclosure was not necessary and describe the process you undertook to reach that conclusion (SEC, March 2010).

FASB Response to Inconsistencies and Inadequacies in Reporting

FASB also responded to the repurchase arrangements by replacing Statement of Financial Accounting Standard (SFAS 140)_with SFAS 166, effective September 2009 or January 2010. Within the Accounting Codification, changes also would preclude similar repurchase agreements from being accounted for as a sale. From the Accounting Codification 860-10-40-42, Repurchase Financings:

> A transferor and transferee shall not separately account for a transfer of a financial asset and a related repurchase financing unless both of the following conditions are met:
> a. The two transactions have a valid and distinct business or economic purpose for being entered into separately.
> b. The repurchase financing does not result in the initial transferor regaining control over the financial asset. (FASB, 2012).

And the codification then specifically addresses the “window-dressing” issue:

> An example of transactions lacking a valid business or economic purpose for being entered into separately is if the transactions are structured to circumvent an accounting standard or solely to achieve a specific accounting result. Unless the initial transfer and the repurchase fTinancing meet all of the criteria in paragraph 860-10-40-44, the transaction shall be considered linked for purposes of applying this Topic” (FASB, 2010)

The difficulty with this new standard is that as indicated above, there are additional discussions in 860-10-40-44 that provide additional “holes” where standards could be circumvented. There is also some discussion among professionals as to whether the changes are enough to prevent a firm like Lehman Brothers from booking the same entries (Whitehouse, 2010).

Auditing Standards

General Discussion

Auditing standards within the U.S. for publicly traded companies, such as Lehman Brothers, are established by the Public Company Oversight Board (PCAOB) (Sarbanes-Oxley Act, 2006a). Prior to passage of the Sarbanes Oxley Act, auditing standards for publicly traded companies were set by the American Institute of Certified Public Accountants (AICPA). The PCAOB has accepted the AICPA auditing standards in the interim until auditing standards can be promulgated.

There are ten generally accepted auditing standards (GAAS) recognized in the U.S. The intent of the ten GAAS is to set a benchmark below which auditors should not perform. Courts have generally recognized the standard as a basis for performance (see below in Section IX). Auditors are required to follow the ten standards under the AICPA Code of Professional Conduct.

The first three standards, termed "General Standards", require the auditor to have adequate technical training and proficiency, independent mental attitude, and exercise professional care. The four "Standards of Fieldwork" require the auditor to plan work and supervise assistants, understand the entity and the environment, and obtain sufficient appropriate evidence. The four "Standards of Reporting" require the auditor to state in the audit report when financials are in accordance with GAAP, identify inconsistent application of GAAP between accounting periods, state when disclosures are inadequate, and express an opinion on the financial statements taken as a whole.

The Securities Exchange Act of 1934 requires financial statements and an auditor's opinion on annual filings (Securities Exchange Act, 2006a, 2006b). The end result of the audit is a publicly available document, termed the "audit report" that expresses the audit firm's opinion as to the financial statements. A standard clean or unqualified opinion is reserved for instances when: (1) all financial statements are included; (2) the three general standards have been followed; (3) sufficient appropriate evidence has been accumulated and the audit was conducted so that the fieldwork standards are met; (4) the financial statements are presented in accordance with GAAP, including footnotes and disclosures; and (5) no circumstances require the addition of an explanatory paragraph or modification to the report (Arens et al., 2012, p. 48).

The standard clean auditor's report contains the wording, "in our opinion, the financial statements referred to above present fairly, in all material aspects, the consolidated financial position of <u>company</u> at <u>dates</u> and the consolidated financial position of <u>company</u> at <u>dates</u> and the consolidated results of its operations and its cash flows for each of the <u>n</u> years in the period ended <u>date,</u> in conformity with U.S. generally accepted accounting principles". It is important to note here that the wording, "in conformity with U.S. generally accepted accounting principles" is a modifier to the phrase "present fairly". As noted in *Auditing and Assurance Services,* page 48, the term "present fairly" is one of most controversial parts of the auditor's report (Arens et al., 2012, p. 47).

Auditors are required to review the M D & A section of the annual report (the SEC's required (10-K) to see "whether it is materially consistent" with the information in their financial statements. (Statement on Auditing Standards (SAS 8.03)). (Technically, the Public Company Accounting Oversight Board (PCAOB) is responsible for establishing auditing standards for publicly traded companies; however, as an interim procedure, the PCAOB has accepted AICPA audit standards issued through April 16, 2003. The SEC has oversight over PCAOB and standards must be approved by the SEC.). A review of the M D & A is less stringent than an audit. However, according to PCAOB AT Section 701.107,

> if the practitioner concludes that the MD&A presentation contains material inconsistencies with other information included in the document containing the MD&A presentation or with the historical financial statements, material omissions, or material misstatements of fact, and management refuses to take corrective action, the practitioner should inform the audit committee or others with equivalent authority and responsibility. If the MD&A is not revised, the practitioner should evaluate (*a*) whether to resign from the engagement related to the MD&A, and (*b*) whether to remain as the entity's auditor or stand for re-election to audit the entity's financial statements. The practitioner may wish to consult with his or her attorney when making these evaluations. (PCAOB, 2003)

Therefore, if the M D & A contains material inconsistencies, at a minimum, the audit firm should inform the audit committee if the client refuses to take corrective action.

Lehman Brothers Audit

Ernst & Young (E&Y) conducted the audit of Lehman Brothers for each of the three years ending on November 30, 2007, prior to the bankruptcy filing. Concerning the three general standards, E&Y appears in general to have met these standards. However, the Valukas report questions whether E&Y exercised "professional care" by failing to disclose Repo 105 practices to Lehman Brothers' audit committee. Complaints were made by Lehman top employees both to management and E&Y about the practice (Valukas, 2010, p. 956-57). One day after a complaint was made to E&Y, the auditor met with the Lehman Brothers' Audit Committee and did not raise the subject (Valukas, 2010, p. 959). The Valukas report discusses an accountant's duty to reveal fraud, material misrepresentations, and illegalities (Valukas, 2010, p. 1056). Therefore, whether E&Y was not correct in failing to inform the audit committee hinges on whether the client is believed to have committed fraud, material misrepresentations, and illegalities. The Valukas bankruptcy report suggests that the board of directors and outside disclosure counsel were unaware of the Repo 105 accounting usage and financial implications (Valukas, 2010, p. 855, 945).

Concerning the four standards of field work, E&Y was aware of the Repo 105 transactions and the accounting for the transactions. The auditor understood the accounting for Repo 105. According to the Valukas Report, the head of E&Y's audit group knew of Lehman's use of Repo 105 for years and stated while E&Y had not proposed the practice, they were "comfortable" with it (Valukas, 2010, p. 748-50). E&Y reviewed the documents showing Repo 105 but they were satisfied that they met with accounting standards (presumably the GAAP rule SFAS 140) (Valukas, 2010, p. 951, 953).

The four standards of reporting would require E&Y to identify consistent application of GAAP between periods. There is no indication that the Repo 105 transactions were handled differently in the accounting periods the auditors examined. However, given the previous discussion on accounting standards, the accounting for Repo 105 transactions is not consistent with other promulgated generally accepted accounting principles, such as not recording a loss on transfer and not recording liabilities when amounts are estimable and expected to be paid. According to GAAP, the disclosures related to the financials were adequate.

E&Y issued unqualified or clean audit reports prior to the bankruptcy filing. Had the standard wording of the audit report not included the phrase, "in conformity with U.S. generally accepted accounting principles", one might argue that the financials did not present fairly in all material aspects the financial position of the company. However, from the wording, it appears Lehman Brothers followed GAAP by structuring the transactions carefully within the existing provisions of accounting standards. Also, E&Y is required by auditing standards to not disclose proprietary information. (The exceptions to this general rule are not applicable to the Lehman

Brothers analysis.) Generally accepted auditing standards did not require disclosures beyond that of GAAP and GAAP at the time did not require additional disclosures.

According to the SEC document, *A Beginner's Guide to Financial Statements,* provided to investors, significant accounting policies and practices that are "most important to the portrayal of the company's financial condition and results" should be disclosed in footnotes (SEC). The footnotes to Lehman Brothers' financial statement did not discuss specifically the accounting treatment for Repo 105. However, GAAP at the time did not provide guidance as to what information, if any, should be provided concerning Repo 105 transactions.

External auditors reviewing the transactions under the repurchase agreements might question the legality of the sale, however, external auditors are not legal authorities. In applying SFAS 140, external auditors are bound by AU Section 336, "Using the Work of a Specialist":

> The auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter (SFAS 140).

Included within AU Section 336 is a reference to legal questions. For example, auditors should consider using a specialist for "interpretation of technical requirements, regulations, or agreements (for example, the potential significance of contracts or other legal documents or legal title to property).

AICPA Rule 203

Audit firms fall under the guidance of the AICPA. As such, they are bound by the rules of professional conduct of the AICPA. Rule 203, in particular, is applicable to the E&Y audit of Lehman Brothers (AICPA, 1988). Rule 203 is consistent with the working of the standard auditor's report, that is, conformity with GAAP is lack of departure from accounting principles promulgated by authoritative bodies. However, the last sentence of Rule 203 is as follows:

> If, however, the statements or data contain such a departure and *the member can demonstrate* that due to unusual circumstances the financial statements or data would otherwise have been misleading the member *can comply* with the rule by describing the departure, its approximate effects, if practicable,

> and the reasons why compliance with the principle would result in a misleading statement.(Rule 203, AICPA, 1988)

We have added the italics to emphasize that the auditor is not required to disclose or to depart from promulgated GAAP if the financials are misleading but that the auditor can do so and would do so under unusual circumstances. The auditor is not required under Rule 203 to require changes to the financials even if they may be misleading. The AICPA further clarified Rule 203 in an interpretation:

> There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.
>
> However, in the establishment of accounting principles it is difficult to anticipate all of the circumstances to which such principles might be applied. This rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading.
>
> The question of what constitutes unusual circumstances, as referred to in Rule 203 [sec. 203 par. 01] is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle within GAAP would be regarded generally by reasonable persons as producing misleading financial statements. (Rule 203 par. 02).

Thus, while the interpretation seemed to put more responsibility on the auditor, in the end, it is a matter of professional judgment. To summarize, then, E&Y would have to have had a compelling belief that the financials were materially misleading and then would have had to choose to require Lehman Brothers' to correct the financials (or issue something other than the standard unqualified audit opinion). The rule assumes that in nearly all instances, GAAP should be adequate. The rule seems to put the burden on E&Y to show that following GAAP would have created misleading financials by stating that in almost all circumstances the presumption is that the promulgated GAAP would not be misleading. E&Y is permitted professional judgment in this decision.

Rule 203 is more frequently used when the auditor’s clients depart from promulgated GAAP. Then, auditors can issue an unqualified audit report but add a paragraph to describe the client's departure from GAAP.

Presumably, E&Y did not find "the literal application of pronouncements in accounting principles" to "have the effect of rendering the financial statements misleading". To prove that

E&Y did not abide by Rule 203 would require questioning the professional judgment of the auditor. Given there are no indications that the minimum standards (except for the reference to "professional care" alluded to above) were not met, this would be difficult to establish. But if there were legal red flags, auditors would normally seek legal counsel.

FEDERAL SECURITIES AND ACCOUNTING LAWS

The Securities Exchange Act of 1934

A clear distinction can be made between the GAAP standards (as they then existed) and the federal securities law and this is where the conflict arises; the accountants have their standards but they may occasionally run into difficulties with the law. The Securities Exchange Act of 1934 deals primarily with ongoing problems in securities markets while the Securities Act of 1933 deals primarily with the registration of securities. The former law is the one that would apply to the present facts. Under the Securities Exchange Act of 1934 there are two provisions that appear to be relevant: (1) Section 78j which relates “Manipulative and Deceptive Devices” or more commonly known as fraud (The Securities Exchange Act of 1934, 2006a) and (2) Section 78m which deals with periodic reporting (The Securities Exchange Act of 1934 (2006b). Since the reporting by Lehman Brothers dealt with their quarterly and yearly financial statements under (2), that section would be relevant. But also since these quarterly and yearly financial statements are used by investor and investment advisor, they may also be “deceptive” or perhaps fraudulent.

Periodic Reporting

The 1934 law requires companies that have $10 million in assets and 500 shareholders, companies that are traded on national stock exchanges, or those that have made registered offerings under the 1933 Act to file annual report (10-K), quarterly reports (10-Q), and form 8-K when material events occur (Securities Exchange Act of 1934, 2006b).

These reports required by the 1934 law are different than the glossy reports that shareholders typically get from corporations. But false or misleading reports under the 1934 law are illegal and impose liability for any party involved in the filing (Securities Exchange Act of 1934 (2006c)). An implied provision for civil damages has been allowed by the courts for private parties (Herman & MacLean v. Huddleston, 459 U.S. 375, 383 (1983)). If, as it appears, Lehman Brothers was knowingly (through false statements or omissions) manipulating its quarterly and yearly statements by Repo 105 to show lower leverage just before they were issued, the 1934 law would appear to have been violated. Given the circumstances of the actions, specifically the unusual actions of trying to convert liabilities to assets for just a few days when the statements would be issued and the need to get a legal opinion on what a “sale” is outside of the United States, it could readily be inferred that the statements were known to be misleading. In fact, such transactions were the kind that the two possible buyers of Lehman, Bank of America and Barclay's, were fearful of: that Lehman Brothers' financial situation was much worse than it appeared on the surface. That Lehman Brothers went to such elaborate lengths to make its statements look better for such a brief period of time when it was required to issue the statements under the 1934 law, would seem to indicate that a defense of lack of knowledge would be likely to fail. The reporting requirements not only include financial statements, but also they have several parts where risk factors are to be discussed (Title 17: Commodity and Securities Exchanges, 2011a). It would seem that the use of Repo 105, which appeared to hide risky assets, would need to be disclosed.

The penalties for violation of the law are substantial. Depending on the type of violation, criminal and civil penalties can be quite substantial if knowingly done. For example, for knowingly and willingly issuing false periodic financial statements can result in fines up to $5 million and up to 20 years in prison (Sarbanes-Oxley, 2006b).

The 1934's Antifraud Provision (sec. 10b)

Almost all fraud cases brought by the government or by private parties are brought under the Securities Exchange Act's provision Section 10b (Securities Exchange Act (2006c). This section is interpreted by the SEC through its Regulation 10(b)-5. This provision prohibits in regard to nationally traded securities "(a) to employ any device, scheme, or artifice to defraud, (b) "to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase of sale of securities." (Title 17: Commodity and Securities Exchanges, 2011b).

One of the factors that cause section 10(b) to differ from common law fraud is that omissions can count as fraud just as much as deceitful statements can. The misstatements or omissions do have to be material—that is, likely to have an impact on the price of the securities. Like common law fraud, the prosecutor does have to prove "scienter"—that is, the statement or omission was made knowingly or with reckless disregard for the truth. Mere negligence (without scienter) is not enough show fraud under 10b-5 (Holdsworth v. Strong, 1976).

Private parties have an implied right to sue for fraud under Section 10(b) (Herman & McClean v. Huddleston, 1985; Wachovia bank & Trust Co. v. Nat'l Student Marketing Corp., 1980). As plaintiffs, they must be purchasers or sellers of the securities and must have relied on the statements or omissions (Blue Chip Stamps v. Manor Drug Stores, 1975); if the government is the prosecutor or plaintiff, it is not subject to showing these preceding elements. Privity (or a contractual relationship with the defendant) is not required (Superintendant of Insurance v. Bankers Life & Casualty Co., 1971).

Also, some courts have ruled that private plaintiffs have shown reliance merely by the availability of the securities in the marketplace, because the misstatements or omissions may have affected the price. This is known as the "fraud-on-the market" theory. The idea is that the market is acting as an agent of the investor and thus is giving information to the investor. Thus, under this theory, direct reliance is not necessary. This theory is supported by the U.S. Supreme Court *(*Basic, Inc. v. Levinson,1988; Blackie v. Barrack, 1975).

Those who aid and abet the violation of section 10(b) are also liable if the party knew of the violation and gave substantial assistance to the violator (Sarbanes-Oxley Act (2006c)). The statute of limitations for private right cases (which was lengthened by Sarbanes-Oxley) is two years after the discovery of the facts or five years from when the violation occurred (Sarbanes-Oxley Act (2006d)). Violation of the law involves both civil liability to private parties and the SEC and also potential criminal penalties of up to $5 million per violation and up to 20 years in prison. Corporations can be liable under criminal law for up to $25 million (Sarbanes-Oxley Act (2006e)).

State securities laws have similar provisions and, since the major exchanges are in New York City, it is not unusual for the State of New York (sometimes in connection with other states) to bring action against securities violators (New York v. Ernst & Young, 2010).

We considered whether the Repo 105 accounting treatment violated section 10-b. Clearly the accounting treatment made Lehman falsely look better, altering liabilities, temporarily increasing cash, and resulting in lower leverage ratios. This undoubtedly kept the Lehman Brothers' stock price from falling faster than it eventually did, postponing the bankruptcy filing. Lehman Brothers' executives thought that it might buy them time to stay out of bankruptcy, to get a government bailout, or to be bought by another company (such as BoA or Barclay's). Keeping the stock price higher also undoubtedly helped Lehman Brothers' executives who owned stock in the company and who possibly had stock options. Lehman Brothers' executives referred to the increasing use of Repo 105 as a "drug," "window dressing," and an "accounting gimmick." (Valukas, 2010, p. 869).

Was there "scienter" on the part of Lehman Brothers, the Lehman Brothers' executives, E&Y and the lawyers? "Scienter" refers to whether the misrepresentations were knowingly done (or sometimes done with reckless disregard for the truth). There are several factors here, any of which indicates that what they did was misleading and that they knew it. First, the timing suggests it. The Repo 105 was scheduled to occur right before their quarterly and yearly financial statements (Valukas, 2010, p. 733). The repurchase had to be undone quickly, right after the statements came out. Second, according to the bankruptcy examiner, they couldn't find accountants and lawyers to sign off on the deal in the United States. So Lehman had to go to London to find accountants and lawyers (Valukas, 2010, p. 740). This suggests that the Lehman executives were shopping for someone to sign off on the financials, thus ignoring the misleading nature of their practices. Various statements, emails, and other documents suggest that the company knew exactly what they were doing. According to Global Financial Controller Martin

Kelly, “the only purpose or motive for the transaction was reduction in balance sheet” and “there was no substance to the transactions.” (Valukas, 2010, p. 735). He also said that “if there was more transparency to people around the transactions, it would present a dim picture” of Lehman (Valukas, 2010, p. 886).

Also, the Valukas Report (realizing it is not the last word since a trial has not occurred and counter-evidence has not been produced) seems to be damning. First, the facts themselves are more than suspicious. Using an unusual accounting treatment before quarterly and yearly financial statements were issued and going to London when no U.S. lawyer could be convinced to call it a “sale” rather than a secured loan are indications that the firm was less than forthright. According to the Valukas report, the only reason for the usage of Repo 105 agreements was to make the balance sheet more appealing even though the transactions would be undone in a few days. Lehman Brothers’ executives believed that Standard and Poors put a high value on the leverage ratio in regard to rating the firm. Dick Fuld ordered system wide deleveraging; given the assets that Lehman had, Repo 105 appeared to be the only means possible (Valukas, 2010, p. 735-36). Lehman Brothers did it to win back investors by restoring confidence (Valukas, 2010, p. 737). The CFO tells analysts that the balance sheet was made to look transparent while hiding the use of Repo 105 (Valukas, 2010, p. 739).

Lehman Brothers attempted to reign in the use of Repo 105 by setting quarterly limits, and yet every quarter they went over the limit (Valukas, 2010, p. 741). The COO referred to the practice in an email “as the drug we r on (sic).” (Valukas, 2010, p.742). The employees referred to it as an “accounting gimmick” and “window dressing.” As time went on and as the situation worsened, Lehman Brothers increased its use quarter by quarter to up to $50 billion, and still the executives felt more and more desperate and thus they needed to expand its use (Valukas, 2010, p. 745-46). E&Y regarded moving the leverage ratio one tenth of 1 point as material. The use of Repo 105 moved the leverage ratio down by several points (Valukas, 2010, p. 747). Thus, the Valukas Report concluded that the financial statements were certainly “materially misleading.” (Valukas, 2010, p. 747). All of this is backed by not only the facts, but by statements made to Valukas investigators and in numerous Lehman e-mails, documents, and plans.

If E&Y were involved, it would seem that they would be involved in more than “aiding and abetting” the scheme, since they would have been involved with certifying the financial statements (particularly the 10-K’s) and appeared to know of the practice (The Supreme Court has ruled that merely “aiding and abetting” in not sufficient for private parties to sue under Securities Law under sec. 10(b) (Stoneridge Investment Partners, LLC v. Scientific-Atlanta (2008)). But additional parties could be apparently liable if all of the elements of a basic 10-b case are present. These include a material misrepresentation or omission, scienter, purchase or sale, reliance, loss, and causation. *Id.* But it would appear Ernst & Young, by issuing 10-Q’s and 10-K’s, could indeed have misrepresented or omitted material facts and that investors could have relied on these documents. That, of course, would depend on the specific facts (Wilkes, 2010). Even if the practice technically was appropriate under GAAP, the resulting financials would be misleading. Liability would exist for all of the parties. Again "scienter" would have to be proven in order for E&Y to be liable. E&Y denied that they instigated the practice, but it is clear from the facts of the bankruptcy examiner that E&Y did know that the practice was being used (particularly after they were told by Lehman executive Matthew Lee) and yet they issued clean audit reports (Valukas, 2010, p. 956-58).

Part of the yearly 10-K is a required statement of "Management Discussion of Analysis"(MD&A). In the SEC's rule S-K, section 303, the purpose of the MD&A is "to provide investors and other users information relevant to an assessment of the financial condition and results of operations of the registrant, as determined by evaluating the amounts and certainty of cash flows from operations and from outside sources." (Title 17: Commodity and Securities Exchanges, 2011c). Thus, a narrative is required because the numerical nature of the financials may not be adequate for "an investor to judge the quality of earnings" and to judge the "short- and long-term analysis of the business of the company." The intent of the MD&A discussion is to provide "a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present." (SEC, 2012a)

Certainly, the amount of transactions under Repo 105 and the positive effect on financial ratios would have affected investors' opinions about the long term situation, and indeed, the solvency of Lehman Brothers. Clearly, given the internal management discussion of the Repo 105 agreements (as documented in the bankruptcy filing), their importance in operations, and impact on financials should have been discussed in order to provide investors with an understanding of management's view of operations. In addition to those objectives previously discussed, the MD&A is intended to "provide the context within which financial information should be analyzed" (SEC, 2012a). Without the inclusion of a discussion of Repo 105 transactions, investors would not have known the impact the transactions were having on financials. Likewise, within this interpretation, the SEC defines addition information to include in the Management Discussion and Analysis: "companies must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance…" (SEC, 2012b). Given the usage of the Repo 105 agreements within Lehman, the importance of the agreements in meeting certain financial performance goals, and the material significance of the agreements, clearly the Management Discussion and Analysis should have addressed the usage of Repo agreements and the financial impact of the agreements.

The standard instructions for Filing Forms, Regulation S-K, say:

> Liquidity. Indentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the

registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets (SEC, 2012c).

The Repo 105 agreements did result in material changes in liquidity and were an internal/external source of liquidity by temporarily transferring assets to cash. Therefore, failure to discuss the Repo 105 agreements was a clear violation of the filing requirements. In addition, paragraph 4, also of item 4, discusses the reporting requirements under M D & A for off-balance sheet arrangements and lists specific items that Lehman should have disclosed. At a minimum, then, Lehman Brothers should have disclosed the business purposes of the arrangement: to improve the financial presentation of the entity given the importance in terms of liquidity and the amounts of cash flows and expenses associated with the arrangements.

Section 303(a)(4) requires the MD&A to discuss "off-balance-sheet" arrangements that are likely to affect the financial condition of the company. Included are interests "in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support to such entity for such assets" (SEC, 2012c). Indeed, Repo 105 was in effect a loan backed by questionable assets (usually U.S. securities for Repo 105 or equities for Repo 108) (Valukas, 2010, p. 732). Thus, it was both a loan or credit involving third parties (thus unconsolidated) and also one that apparently indicated higher liquidity and/or market risk support since it caused its leverage ratio to be improved.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act (SOX) has largely been embedded into the Securities Exchange Act of 1934 (which, of course, has been amended many times).The law requires increased disclosure of "off-balance" transactions, such as Repo 105 transactions that were not disclosed by Lehman Brothers (Sarbanes-Oxley Act (2006f). The law also requires that "critical" accounting policies be reported from auditors to the audit committees. The authors are unable to find evidence suggesting that the practice was reported to the audit committee. The Valukas report suggests that the board of directors was not informed of the Repo 105 financial impact (Valukas, 2010, p. 1019).

Furthermore, CEOs and CFOs are required to sign off that the information "fairly represents in all material respects the financial conditions and results of operations" (Sarbanes-Oxley Act, 2006g). They are to review the report and to make sure that it does not contain any untrue statements or omissions of material facts and that internal controls are in place. Management can be liable if they certify knowing it is false or if they have not instituted internal controls to catch the problem. In this case there may be parties who could liable because they may have been knowingly at fault. This carries a criminal penalty of a fine of up to $1 million and up to 10 years in jail. If the false certifications were done knowingly and willfully, the penalty increases to $5 million and up to 20 years in jail (Sarbanes-Oxley Act 2006b). These, of course, are for each violation.

The Private Securities Litigation and Reform Act

The main purpose of the Private Securities Litigation and Reform Act (PSLRA) is to protect management, and in general, limit class action lawsuits against auditors and management particularly for forward looking financial statements. The law makes it difficult to make a prima facie case against management and auditors and limits liability based on percentage fault rather than allowing, perhaps, one party to take the entire loss (to stop joint and several liability). Another aspect of the law is to keep auditing firms from taking the entire loss if a company fails.

However, the law does have a large exception: the auditors, for example, can have joint and several liability if the defendants knowingly caused harm (Private Securities Litigation and Reform Act (2006a)). The bankruptcy examiner's evidence, if it is accurate, seems to indicate that scienter existed all around from top management to the auditors. It is interesting that the Valukas is reluctant to use the term "fraud," since the evidence that they gathered contains more than enough "smoking guns" in terms of evidence in the form of e-mails, documents, and testimony to show that "scienter" did exist.

The Private Securities Litigation and Reform Act was intended to give some protection to management and auditors. It also imposed some specific requirements on auditors. Auditors are required specifically to implement procedures to (1) detect material illegal activity, (2) identify material related-party transactions, and (3) evaluate a company's ability to continue as a going concern (Private Securities Litigation and Reform Act (2006b)).

Certainly it might appear that illegal activity was occurring by hiding liabilities in the form of sales through the use of Repo 105. In addition, the use of Repo 105 did affect investors' and analysts' view of Lehman Brothers. By changing the leverage ratio, it appeared that Lehman was doing much better than some believed—at a time when stock price was declining. In reality, Lehman's ability to continue as a "going concern" was questionable.

Furthermore, the law requires that the auditors must report such activity to the audit committee or the board of directors. The Board has one day to fix the problem and if the Board does not, the auditors are required to report the activity to the SEC or to resign (Private Securities (2006b)). Apparently, according to the Valukas Report, neither happened, though undoubtedly top management and eventually the auditors did know and use the apparently illegal practices.

One of the results of this law and recent cases is that it is more difficult for class action plaintiffs to succeed in regard to securities and other class action lawsuits. More and more of these cases are thrown out unless the pleadings are much more specific and show a plausible case against the defendant(s) (Ashcroft v. Iqbal (2009) and Bell Atlantic Corp. v. Twombly (2007); Craiger (2011), Cook (2006)). Lawsuits can be dismissed without the discovery necessary to add the detail required to survive a motion to dismissal. However, lawsuits against Lehman Brothers' executives and E&Y may be able to overcome these difficulties because of the specific facts uncovered in the Valukas report.

Current Lawsuits against Lehman Executives and Ernst & Young

As was mentioned earlier, there are still no SEC actions relating to Lehman Brothers executives or accountants. It is possible that the SEC is waiting for the bankruptcy judge to hold a hearing to determine the validity of the Valukas Report. The SEC may be continuing to study the massive amounts of evidence ("SEC says," 2012). Perhaps, they will do nothing, although the evidence so far seems overwhelming.

New York State has brought legal actions against E&Y for the Repo 105 transactions claiming that the practice was a manipulation of the firm's balance sheet (New York v. Ernst & Young, 2010). According to one news report, there could be both civil and criminal charges filed against E&Y (Lattman & Craig, 2010; Blackden, 2010). A civil complaint was filed in December of 2010 (New York v. Ernst & Young, 2010). The case started with a New York court, then was moved to federal court, and then back to New York. The case was moved from state to federal court since some apparently possible federal law was involved besides the state law. But later the federal court said the case brought by New York state could be tried exclusively under New York state law. It also concluded that the federal courts had no jurisdiction over this New York state law claim and thus sent it back to the state court (In re Lehman Bros. Securities and ERISA Litigation, 2012a).

However, a separate case involving private parties was brought in federal court (consolidated before the same federal judge) which involved not only the auditors, but also Lehman executives, underwriters, and UBS. In a motion to dismiss (before trial), the federal judge was not inclined to let the parties off the hook on all counts. The federal judge wrote a lengthy opinion on the motion to dismiss, much of which dealt with Repo 105:

> The suggestions that defendants believed that the Repo 105 transactions were permissible in and of themselves and that the financial reporting for them, in and of itself, complied with GAAP does not address the core of plaintiffs' claims — that they were used to reduce temporarily and artificially Lehman's net leverage and paint a misleading picture of the company's financial position at the end of each quarter. The allegations that these transactions were used at the end of each reporting period, in amounts that increased as the economic crisis intensified, to affect a financial metric that allegedly was material to investors, credit rating agencies, and analysts support a strong inference that the Insider Defendants knew, or were reckless in not knowing, that use of the Repo 105 transactions and the manner in which they were accounted for painted a misleading picture of the company's finances (In re: Lehman Bros. Securities and ERISA Litigation, 2011).

As to E&Y, the judge dismissed some counts but not those for the statements issued by E&Y after the meeting with Lehman whistleblower Matthew Lee.

However, in May 2012, a U.S. District Court approved a class action settlement against the Lehman executives. The amount was $90 million, which was paid from insurance policy. District Judge Kaplan expressed concern about not going after the personal assets of the Lehman executives but eventually approved the settlement, given the inherent risks of going to trial (In re: Lehman Brothers Securities and ERISA Litigation, 2012b). There is also a $426 million settlement, not yet approved, with the underwriters. The case against UBS and E&Y is still pending.

Accounting regulators in Britain are also looking at E&Y's practices over Repo 105 (Kennedy, 2010). The SEC has not taken action against E&Y.

Legal Cases Involving Conflicts Between GAAP and Law

While there are many cases involving fraud and misleading statements under securities law, the United State Supreme Court has not directly addressed a conflict between GAAP and potentially false and misleading statements. However, a number of Circuit Court cases deal with the issue. One of the seminal cases was decided in 1969, United States v. Simon (United States v. Simon, 1969; S.E.C. v. Arthur Young & Co., 1979). The case involved a misleading audit from an accounting firm in violation of the Securities Exchange Act of 1934 (United States v. Simon, 1969, p. 798). According to the court:

> Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then, as the Lybrand firm stated in its letter accepting the Continental engagement, he must 'extend his procedures to determine whether or not such suspicions are justified.' If as a result of such an extension or, as here, without it, he finds his suspicions to be confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established. At least this must be true when the dishonesty he has discovered is not some minor peccadillo but a diversion so large as to imperil if not destroy the very solvency of the enterprise (United States v. Simon, 1969, p. 806-07).

The defendant called eight expert accountants who testified that the financial statements were in accordance with GAAP and thus constituted "fair presentation." (United States v. Simon, 1969, p. 805). The defendants asked for jury instructions at trial that said the defendants should win the case if the accountants followed GAAP (United States v. Simon, 1969, p. 805). The trial judge refused to do so, and the Circuit Court said this was proper and the jury could find that accountants knowingly misled (United States v. Simon, 1969, p. 806).

More recent cases confirm the resolution of this conflict. . In a 2006, Court of Appeals case United States v. Rigas, the court found: "…GAAP neither establishes nor shields guilt in a securities fraud case." (United States v. Rigas, p. 220).

A recent finding in United States v. Ebbers (the CEO of WorldComm), a case cited *In re* Lehman Bros. Equity/Debt Securities Litigation, the opinion states:

"The rules [GAAP] are no shield, however, in a case such as the present one, where the evidence showed that accounting methods known to be misleading—although perhaps at times fortuitously in compliance with particular GAAP rules—were used for the express purpose of intentionally misstating WorldCom's financial position…"(United States v. Ebbers, 2006). Furthermore, the court said,

> However, even where improper accounting is alleged, the statute requires proof only of intentionally misleading statements that are material, i.e., designed to affect the price of a security. 15 U.S.C. §78ff. If the government proves that a defendant was responsible for financial reports that intentionally and materially misled investors, the statute is satisfied. The government is not required in addition to prevail in a battle of expert witnesses over the application of individual GAAP rules (United States v. Ebbers, 2006).

CONCLUSION

The Lehman Repo 105 situation is still playing out in court. The Valukas Report appears to have been meticulously done, but Lehman and Ernst & Young will be able to have their day not only in bankruptcy court, but also in civil court and quite possibly in criminal court, should the SEC send charges to the Department of Justice.

There is a lot of discussion as to why the S.E.C. has yet to move against Lehman Brothers executives and auditors. Certainly the firm itself is bankrupt, but its officers and its auditor, E & Y, could still be candidates for charges, civil or criminal. The facts are daunting in their complexity and proving liability before a jury would be difficult. The accounting standards that Lehman Brothers used, while open to misuse, are difficult at best to explain. Still, it would seem to be surprising if Lehman Brothers' executives and Ernst & Young would be left untouched by SEC. But given the length of time that has gone by, it is possible that the SEC is embarrassed that the scheme got so far.

The bankruptcy examiner's report is full of documents and emails that show that Lehman Brothers' executives knew precisely what they were doing and the purpose of the transactions. That these transactions occurred right before quarterly and annual statements would be enough evidence. That the transactions had to be moved from the United States to the U.K. to get a law firm to sign off on them as a sale rather than debt is another significant fact. Lehman Brothers also had actual documents on how they were to do these transactions with some limits (some of which were violated). These limits seemed to say, "we want to mislead but maybe there is a limit on how far we are willing to go." But eventually, even these limits were ignored.

Does all of this seem somewhat reminiscent of Enron? Certainly, the multitude of different types of Enron schemes seem to dwarf the Lehman Brothers' situation. Enron was not only "cooking" their books but also involved in massive schemes to monopolize parts of the energy sector, thus driving, for example, the price of California electricity through the roof (McLean & Elkind, 2004). On the other hand, the fall of Lehman Brothers, the largest U.S. bankruptcy ever, had a much greater impact on the economy.

The passage of Sarbanes-Oxley was designed to stop these types of practices. But in spite of the law, Lehman happened anyway. One could respond by saying that increasing the requirements and penalties will never stop the "bad guys" from violating the law. While this is true, it raises the question (which is hardly new) whether there are fundamental problems in relying upon detailed accounting standards.

Generally Accepted Accounting Principles (GAAP) is rule-based. However, if companies find a way to "game" the rules, they may well be tempted to do so. The only reference we find to an overriding accounting rule over GAAP is the AICPA Rule 203 (discussed above) that allows possible departure from GAAP if following GAAP would be misleading. While auditing standards rely on GAAP, federal laws—the Securities Exchange Act of 1934, Sarbanes-Oxley, and the Private Securities Litigation Reform Act—provide some support that GAAP in unusual circumstances may not be the final word.

One approach to resolving the differences between GAAP and the law, then, might be to have an overarching rule in GAAP that says that all other rules are subordinate to showing in the statements the true financial condition of the company**.** External auditors benefit from accounting rules with "bright lines", it makes their jobs easier to find misstatements without additional steps in interpreting standards. It is unlikely that the accounting profession would be supportive of this change.

Toba suggests that presenting fairly the financial condition of a company should be approached using a conditional approach. First, it is necessary to know what the proposition, "presenting fairly" means. Second, the determination of a way to verify should be established. Lastly, there must be a collection of evidence (Toba, 1980). This approach suggests then that the auditor would first accept the legal definitions of "present fairly" and then proceed with the audit.

It is beyond the scope of this article and the ability of the authors to suggest a workable alternative to the present system. This issue has long been a concern to the profession. In 1972, J.C. Burton observed, "by writing precise rules the Board (sic—APB Board) made it possible for people to observe the letter and avoid the spirit of the blessing—and often with the assistance of their auditors". (Stewart, 1986).

The setting of accounting standards is dynamic and the Lehman Brothers case, Repo 105, is an example of this. As put quite succinctly by Steward, "repeated attempts to logically derive accounting standards from a set of objectives and definitions overlook that standards depend not only on premises, but also on moves made in response to them, counter to them, and so on" (Stewart, 1986, p. 406).

In the Lehman Repo 105 case we present, the accounting practice was initiated in 2001. SFAS 166, that removed loopholes in GAAP exploited by Lehman Brothers, became effective in 2010. Additional SEC reporting requirements to address window-dressing were proposed in 2010 and unanimously accepted by the board in 2011. Thus, Lehman Brothers was able to use Repo 105 transactions to adjust financial results for many years before either FASB or the SEC made adjustments.

The amounts placed in Repo 105 transactions in early 2001 may not have been considered material in the examination of what constitutes fair presentation of financials; however, at the time of Lehman Brother's bankruptcy filing in 2008, the accounting effect from the Repo 105 transactions did materially improve the financial presentation. Lehman Brothers would not have entered the agreements, except for the expected positive impact on their financial condition and investor reactions, as the transactions did not have economic substance.

Still, even if GAAP inconsistencies are somehow fixed, there remains an even more fundamental question. The problem is the inconsistency between the auditing standards and the securities law. One could argue that the auditors should have been alerted to the potential that the financials were not presented fairly; in other words, the sale opinion and netting grid should have been "red flags" under auditing standards. On the other side, under current auditing standards, the auditors were not found to be in violation of standards of fieldwork. The question really is one of determining what the auditor's responsibility for an examination of financial statements is. Is the auditor responsible for interpretation of the financial statements and understanding what "the reasonable man" would conclude or should the auditor rely on the pronouncements of authoritative bodies and the standard setting bodies to determine compliance? Auditing standards suggest reliance on the promulgations from authoritative bodies while securities laws may in rare circumstances suggest otherwise. One could also argue that since GAAP is backed by not only the AICPA, but also the government entities, the PCAOB and the SEC, a conflict of law exists. Since the SEC is not only in charge of enforcing securities law and also in regulating the PCAOB, the possibility exists to fix these kinds of problems. While current precedent might suggest that Securities Law might trump GAAP in courts, a better solution is to resolve the conflict and bring the two into harmony. The ultimate goal is to have companies provide informative financial statements that are not misleading. The most troubling conclusion from this analysis is that as long as there are contradictions between what is expected of the auditors (by investors and regulators) and what the auditor does (as supported by auditing standards and GAAP), Lehman-type events will continue to be likely.

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ACCOUNTING EDUCATORS AND PRACTITIONERS' PERSPECTIVES ON FRAUD AND FORENSIC TOPICS IN THE ACCOUNTING CURRICULUM

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ABSTRACT

This study surveyed 500 accounting educators and 500 practitioners on their perceptions regarding the relative importance of fraud and forensic topics to include in the accounting curriculum. Twenty-one topics were selected to assist students in preventing, investigating and detecting financial statement fraud. Responses were received from 303 respondents (30.3% response rate). The responses are ranked based on the mean scores using a five-point Likert scale ranging from "1" unimportant to "5" very important. Overall, the results show that a majority of business schools do not offer a separate course or program in fraud or forensic accounting which validates the purpose of this study. In addition, there is a general agreement between both groups on the relative importance of the topics with internal control selected as the number one topic. However, the results of the partitioned sample (educators versus practitioners) identified nine significant differences between the two groups, which could be attributable to job-related experience. The results of this study can assist educators and administrators in the selection process of fraud related topics to include in the accounting curriculum.

Keywords: Accounting curriculum; fraud education; forensic accounting; fraud examination

INTRODUCTION

Preventing and detecting fraud in organizations continue to be problematic for the accounting profession based on the number of reported fraud cases and statistics. It is estimated that a typical organization loses five percent of its annual revenue to fraud; therefore, organizations in the United States loose approximately $994 billion to fraud each year (ACEF, 2010) and based on the 2011 Gross World Product (GWP) this translates to a potential fraud loss of more than $3.5 trillion (ACEF, 2012). Given the magnitude of fraud problems and the frequency to which auditors are associated with fraud; one might expect that most accounting curricula would include fraud training. However, this is not the case (Peterson, 2003, 263). As a result, investors, regulators and other stakeholders are concerned with the failure of accountants to detect fraud in organizations. Consequently, business schools have received much of the blame for the lack of education and training of accountants to detect fraud. Albrecht et al. (2009) noted three failures by educators that contributed to the large number of financial statement frauds during the years 2000-2002. First, educators had not provided sufficient ethics training to students, therefore many students were not equipped to deal with ethical dilemmas. Second, educators were not teaching students about fraud; therefore, the majority of students do not understand the elements of fraud, perceived pressures and opportunities[1]. A third educator failure is the way accounting and business students are taught. Effective accounting education must focus less on teaching content as an end unto itself and instead use content as a context for helping students develop analytical skills.

Many business schools have responded by redesigning the accounting curriculum to include fraud courses and programs to help prevent and detect fraud (Fletcher, Higgins, Mooney, and Buckhoff 2008). However, the results of a study by Meier, Ravindra, and Yihong (2010) show that AASCB accredited schools have been slow in adopting programs and courses in forensic accounting and fraud examination. Due to financial constraints, many business schools may not be able to add new courses or programs to the accounting curriculum. Thus, implementing fraud and forensic topics into existing courses maybe the only solution for many business schools. The purpose of this paper is to assist educators and administrators in selecting the most relevant fraud and forensic topics to include in the accounting curriculum. We surveyed 500 accounting educators and 500 accounting practitioners on their perceptions regarding fraud and forensic topics to include in the accounting curriculum. After reviewing the relevant accounting literature along with forensic and fraud textbooks, we selected 21 topics to include in the curriculum to help students prevent and detect financial statement fraud. The responses were scored on a five-point Likert scale ranging from a score of "1" indicating unimportant to a score of "5" indicating very important. The results from the both the full and partitioned samples show that both groups selected internal control as the number topic. The partitioned sample between educators and practitioners identified nine significant differences in the mean scores. Overall, the results show that both groups perceived the coverage of fraud and forensic topics in the accounting curriculum to be very important. The results of this study can assist educators and administrators in the selection process of fraud and forensic topics to include in the accounting curriculum.

The remainder of the paper is organized as follows. The next section provides a discussion of relevant literature. The third section discusses the methodology used to gather and analyze the data. The fourth section provides a discussion of the results. The final section includes the summary and conclusion along with limitations and opportunities for future research.

BACKGROUND

The numerous high profile financial statement frauds (e.g., Enron, WorldCom, Global Crossing) during the years from 2000-2002 has changed society's perception of the accounting profession. Teaching fraud and forensic accounting to business students to mitigate fraud is a great concern to many in our society. As a result, the accounting profession, government, and academics and other stakeholders are aggressively addressing the issues related to fraud.

Standards and Regulations on Fraud Education

Fraud has been addressed by several organizations prior to the numerous high profile fraud cases mentioned above. For example, in an effort to address fraudulent financial reporting, the National Commission on Fraudulent Financial Reporting (NCFFR) discussed the parties responsible for detecting fraudulent financial reporting. Internal auditors and independent auditors along with management were identified as key players in detecting fraud (Treadway, 1986). Similarly, in its final report, the NCFFR (1987) recommended that throughout the business and accounting curricula, educators should foster an understanding of the factors that may cause fraudulent financial reporting. In addition, it noted that rigorous and thorough academic preparation will assist students in gaining leadership employment and help them face the challenge of preventing, detecting, and deterring fraudulent financial reporting more successfully. Furthermore, the Accounting Education Change Commission (AECC, 1990) noted that accounting programs have not kept pace with the changes in the accounting profession. Therefore, teaching fraud and forensic accounting will enable students to acquire the necessary knowledge, skills and abilities to combat fraud in today's accounting profession.

In addition to the above, several standards and regulations have addressed fraud. One of the first standards to address fraud was Statement on Auditing Standard (SAS) No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities (AICPA, 1988). Subsequently, the Auditing Standards Board (ASB) issued Statement on Auditing Standard (SAS) No. 82, Consideration of Fraud in a Financial Statement Audit (AICPA, 1997), which was updated with the issuance of SAS No. 99, Consideration of Fraud in Financial Statement Audit: A Revision of Statement on Auditing Standard No. 82 (AICPA, 2002). The main purpose of SAS. No. 99 was to provide further guidelines for auditors to identify and reduce fraud in financial statement audits. Congress also responded to the fraud with the passage of the Sarbanes Oxley Act 2002 (SOX), which created the Public Company Accounting Oversight Board (PCAOB) to bring more accountability to public companies and to deter the increase in fraudulent financial statements. Soon after the Bernie Madoff's Ponzi scheme in 2010, the Securities and Exchange Commission (SEC) made many reforms, which include improving fraud detection procedures for examiners and improving internal controls procedures (SEC 2010).

One of the first major steps in fighting fraud within an organization is the establishment of a strong internal control system. The strengthen the procedures for testing of the internal control systems by auditors, the ASB issued Statement on Auditing Standard (SAS) No. 78, Consideration of Internal Control in a Financial Statement Audit (AICPA, 1995). Later, internal control was also addressed by Section 404 of SOX and the Public Company Accounting Oversight Board (PCAOB) in its Report on Implementing Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (PCAOB 2005). The report specifically addresses internal control as a major part of the audit that should be evaluated and reported on by auditors with the ultimate purpose of the preventing and detecting fraud in financial statements.

Empirical Studies on Fraud Education

In response to the large number of financial statement fraud cases and criticism, some business schools have responded by adopting courses and programs in fraud and forensic accounting. Many educational models have been developed which include fraud and forensics in the accounting curriculum. Fletcher et al. (2008) discuss how Georgia Southern University achieved national distinction by creating a comprehensive ten-course forensic accounting curriculum that can prepare students to become fraud examiners and forensic accountants[2]. Kranacher, Morris, Pearson, and Riley (2008) explain how the National Institute of Justice developed a model curriculum for fraud and forensic accounting education. Also, Fleming et al. (2008) discusses the challenges West Virginia University faced with their multi-course fraud and forensic accounting program. The school received $614,000 from the National Institute of Justice to support the research and development efforts to build the program. This is an indication of how expensive it can be to develop a model curriculum in fraud and forensic accounting.

Some studies examine the necessary skills students will need to effectively mitigate fraud. For instance, DiGabriele (2008) investigates the relevant skills of forensic accountants from the perspectives of forensic accounting practitioners, accounting academics, and users of forensic accounting services. The author's results indicate that new graduates need to move away from a narrow approach and apply a more holistic technique with nine competency skills that include critical thinking, investigative flexibility, analytical proficiency and specific legal knowledge. Pearson and Singleton (2008) model entailed fraud and forensic accounting in digital environment to provide students with knowledge and skills on how the IT system is used to commit fraud. In addition to the necessary skills listed above, the authors assert that accounting education has traditionally included little forensic or fraud-related content, although the tangible impact of fraud arises in the accounting, finance, and IT side of business enterprise. In addition, they feel that accounting educators have fallen out of step with the practicing business community in some respects by not adapting the curriculum to match businesses increasing reliance on IT.

Other studies have assessed the benefits of adding courses or topics in forensic in conjunction with the ones offered in fraud. For example, Curtis (2008) asserts that the objective of forensic accounting is to develop and present evidence establishing the commission of the act and the identity of the perpetrator and students must be aware of the essential elements of each crime, i.e., the prohibited conduct (actus reus) and state of mind of the perpetrator (the mens rea). Also, the issue for accounting educators is not whether criminology should be included in the curriculum, but how and how much. In addition to the above study, Carpenter et al. (2011) empirically examines the incremental benefits of a forensic accounting course on skepticism and fraud-related judgments using 37 students enrolled in a Masters of Accounting program. The students were given a case and asked to provide a risk assessment on bad debt expense at three different time frames (the first day of class, the last day of class and seven months after completing the course). The results show that students at the end of the semester had a higher risk assessment than students on the first day of class. Furthermore, to examine the persistence of the training effect, post-training (end of semester) results were compared to follow-up (seven months after completing the course) results and no significant difference was found in the level of risk assessment. This implies that students are retaining the knowledge.

Some authors argue that the way students learn is very important. For instance, Lenard and Alam (2009) assert that the method by which students study is important and that students should study fraud the way they study history. Crumbley (2010) provides guidance on how to implement mock trials in class to provide students with practical experience. The students participate by playing the role of different parties (jury, prosecutor, etc,) involved in a trial and argue facts concerning a real fraud case. Teaching fraud and forensic accounting to all accounting majors will enhance the skills of future accounting graduates to investigate and detect fraud in organizations. The objective this paper is to assist colleges and universities in choosing the relevant fraud and forensic accounting topics to include in the accounting curriculum.

RESEARCH METHOD

The present study used a survey questionnaire to obtain the perspectives of accounting educators and practitioners on the relative importance of fraud topics to include in the accounting curriculum.

Survey Questionnaire

We developed and pre-tested the survey questionnaire by sending it for review and comments to a sample of 15 accounting professors and 15 accounting practitioners. Minor revisions were incorporated and we generated a final version of the questionnaire based upon the comments received from both groups. We excluded pre-tested data from the reported results. Based on a review of relevant research (ACFE, 2010; Pearson and Singleton 2008) and fraud and forensic textbooks (Albrecht, Albrecht, Albrecht, and Zimbelman, 2009; Crumbley, Heitger, and Smith 2009) we selected 21 fraud and forensic topics for the survey questionnaire. Also, a second part of the questionnaire gather data from educators on whether fraud examination was a taught as a separate course and at what level (undergraduate or graduate). The last part of the instrument requested demographic information to assist in analyzing the results.

Data Gathering Techniques

We mailed the survey instrument to a random sample of 500 CPAs and 500 accounting educators obtained from two major sources. The mailing list of CPAs was obtained from the American Institute of Certified Accountants (AICPA) and the mailing list of educators was obtained from the 2008 -2009 Hasselback Accounting Faculty Directory. The respondents were asked to rate the importance of the 21 fraud and forensic topics on a five-point Likert scale, ranging from a score of 1 indicating "unimportant" to a score of 5 indicating "very important". The 21 topics selected were not an exhaustive list of all topics relating to fraud and forensic accounting. In an effort to increase the response rate, a follow-up letter was sent two weeks after the first mailing to non-respondents. Table 1 shows a total of 303 usable surveys, representing a 30.3 percent response rate. A test of non-response bias was conducted between early (first mailing) and late respondents (second mailing). The results indicate that non-response bias is not a concern for this sample.

Table 1: Summary of the Response Rate

	Educators	Practitioners	Total
Total mail outs	500	500	1000
Usable Responses	173	130	303
Response Rates	34.6%	26.0%	30.3%

RESULTS

Demographics of the Respondents

Table 2 presents a full demographic profile of the respondents. The data for the educators consist of responses from 125 AACSB-accredited schools and 48 non-AACSB-accredited schools. Seventy-four schools (42.77%) indicate that the accounting program is separately accredited. Also, the results show that 118 (68.2%) educators have obtained the rank of associate professor or higher and 135 (78%) have over ten years of teaching experience and 94 percent has a CPA along with other certifications (CPA, CMA, CFE, CIA, etc.). Similar to the educators, 111 (84.5%) of the practitioners have over 10 years of work experience and 121 (93.1%) work in public accounting. In addition, 100 percent hold a CPA certification along with other credentials. This is not surprising since they are all members of the AICPA.

Table 2: Demographics of Surveyed Respondents		
Panel A: Educators		
Faculty rank:	**Frequency**	**Percent**
Professor	67	38.7
Associate professor	51	29.5
Assistant professor	44	25.4
Instructor/Lecturer	11	7.3
Total	173	100.0
Years in higher education		
Less than 5	5	2.9
5-10	33	19.1
11-15	29	16.7
Over 15	106	61.3
Total	173	100.0
Professional certifications		
CPA	163	94.2
CMA	27	15.6
CFE	21	12.1
CIA	20	11.6
Other	18	10.4
Total is n/a *		
AACSB Accreditation: Business school		
Yes	131	75.7
No	42	24.3
Total	173	100.0
Separate accounting program		
Yes	74	42.7
No	99	57.3
Total	173	100.0
Panel B: Practitioners		
Employment area:	Frequency	Percent
Public accounting	121	93.1
Private industry	4	3.1
Government	1	0.7
Other	4	3.1
Total	130	100.0
Years in profession:		
Less than 5	6	4.6
5-10	13	10.0
11-15	10	7.7
Over 15	101	77.7
Total	130	100.0
Professional certifications:		
CPA	130	100.0
CMA	2	1.5

Table 2: Demographics of Surveyed Respondents		
CFE	4	3.1
CIA	1	0.8
Other	19	14.6
Total is n/a *		
Note: * A total is not applicable since many respondents hold multiple certifications		

Results of the Full Sample

In this study, accounting educators and practitioners are asked to rate the relative importance of 21 selected fraud and forensic topics to include in the accounting curriculum. Table 3 summarizes the mean scores and ranks of the topics which are scored on a five-point Likert scale ranging from "1" unimportant to "5" very important. The results show that 12 of 21 topics have a mean score above four on a five point Likert scale, which is an indication of educators and practitioners' perceived importance of the topics in the accounting curriculum. It is not surprising that internal control is the selected as the number one topic (mean score of 4.60) since standard setters, regulators and others place much emphasis on the importance of a strong internal control system to prevent and mitigate fraud within organizations. Furthermore, internal control is considered one of the first steps in deterring fraud within an organization. Theoretically, fraud is less likely to occur in organizations with a strong internal control system in place versus one with a weak internal control system. Likewise, perpetrators of fraud may look for weaknesses in the internal control system as an opportunity to commit fraud. Therefore, it is imperative for accounting students to have a thorough understanding of how to evaluate an internal control system to prevent and detect fraud in the workplace.

The remaining topics have also received a considerable amount of attention, especially a much discussed topic like ethical issues, which ranks five on the list with a mean of 4.37. In a complete moral environment, unethical behavior such as fraud would not be a problem; however, this is not the case. In the 2012 ACFE Report to the Nation, accountants are listed as people society entrust to investigate, prevent and detect fraud and are most likely to be perpetrators of fraud. Therefore, studying ethics is important because it helps students become aware of ethical dilemmas they might encounter in the workplace. The majority of the top ranked topics include topics to help detect and recognize fraud. The two lowest ranked topics on the list are forensic litigation and civil litigation, which are very important topics that involve actual or anticipated disputes.

Table 3: Full Sample (n =303)		
Mean Scores and Ranks of Topics		
Topics	Rank	Mean
Internal control	1	4.60
Elements of fraud	2	4.49
Fraudulent financial statements	3	4.44
Fraud risk factors	4	4.43
Ethical issues	5	4.37
Prevention/deterrence	6	4.32
Fraud symptoms	7	4.29
Fraud detection	8	4.25
Fraud schemes	9	4.18
Case Studies	10	4.15
Asset misappropriation	11	4.13
Computer/Internet schemes	12	4.08
Investigative methods	13	3.92
Legal environment	14	3.85
Interviewing skills	15	3.64
Corruption	16	3.50
Criminology	17	3.44
Fraud remediation	18	3.34
Report writing	19	3.31
Forensic litigation services	20	3.00
Civil litigation services	21	2.67

Results of the Partitioned Sample

A t-test was conducted to determine whether there exist significant differences in the mean scores between educators and practitioners. Similar to the full sample, Table 4 shows that both groups selected internal control as the number one topic. Although the mean scores and ranks are similar for the majority of topics, the results did identify nine significant differences between the two groups. Faculty scored higher on the elements of fraud (4.57), fraud risk factors (4.54), ethical issues (4.49), prevention/deterrence (4.39), legal environment (3.94) and practitioners scored higher on computer/internet schemes (4.19), corruption (3.62), report writing (3.51) and forensic litigation (3.15). A plausible explanation for the differences found may be attributable to different job experience by both groups.

As Table 5 shows, we further examine the data by partitioning the sample into AACSB versus non-AACSB accredited institutions. Business schools with an AASCB accreditation status is often perceived to be of higher quality in terms of faculty, curricula, and programs versus schools without AACSB accreditation. As indicated in panel A of Table 5, no significant differences were found between educators at AACSB versus non-AACSB institutions regarding how and at what level fraud is taught. Overall, the results show that AASCB and non AASCB schools have little differences in terms of fraud education. The results show that fraud examination is not being taught at a slight majority of the institutions, AASCB (56.5%) and non-AASCB (62.5%). Considering the above results, our study should be of great value to accounting educators and administrators in selecting the most relevant fraud and forensic topics to integrate into other accounting courses in the accounting curriculum.

TABLE 4: Partitioned Sample
Mean Score and Rank of Topics

Topics	Faculty (n=173) Rank (mean)	CPAs (n=130) Rank (mean)	p-value
Internal control	1 (4.62)	1 (4.57)	.479
Elements of fraud	2 (4.57)	3 (4.38)	.015**
Fraudulent financial statements	5 (4.46)	2 (4.42)	.633
Fraud risk factors	3 (4.54)	4 (4.27)	.001***
Ethical issues	4 (4.49)	7 (4.21)	.007***
Prevention/deterrence	6 (4.39)	5 (4.22)	.046**
Fraud symptoms	7 (4.34)	6 (4.22)	.187
Fraud detection	8 (4.26)	8 (4.24)	.825
Fraud schemes	9 (4.19)	9 (4.18)	.893
Case Studies	10 (4.13)	10 (4.17)	.713
Asset misappropriation	11 (4.13)	12 (4.12)	.857
Computer/Internet schemes	12 (3.99)	11 (4.19)	.042**
Investigative methods	14 (3.91)	13 (3.93)	.845
Legal environment	13 (3.94)	14 (3.74)	.061*
Interviewing skills	15 (3.61)	15 (3.68)	.602
Corruption	16 (3.40)	16 (3.62)	.066*
Criminology	17 (3.42)	18 (3.46)	.756
Fraud remediation	18 (3.27)	19 (3.43)	.186
Report writing	19 (3.16)	17 (3.51)	.007***
Forensic litigation services	20 (2.88)	20 (3.15)	.022**
Civil litigation services	21 (2.60)	21 (2.77)	.152

Notes: For ratings, 1 = not important to 5 = very important.
*,**,*** significant at p <.10, <.05, <.01, respectively

Panel B of Table 5, concerns the level at which a basic course in fraud examination is being taught. The results indicate that it is being taught at both AACSB and non-AASCB schools at the undergraduate and graduate levels. For AASCB institutions, 34 percent of the respondents indicate that fraud is being taught more at the graduate level, while 19 percent indicate that it is being taught at the undergraduate level. However, we find opposite results for non-AACSB institutions, whereby 18 percent indicate that fraud is being taught at the graduate level and 33 percent indicate that fraud is being taught at the undergraduate level. Consistent with findings by Meier et al (2010), our results show that many colleges and universities have yet to integrate a basic course, such as fraud examination into the accounting curriculum. Therefore, integrating fraud and forensic topics in the accounting curriculum will help increase the knowledge and skills of 21st Century accounting graduates to prevent, investigate and detect fraud in organizations. Overall, the results from this study can assist educators, administrators and others in selecting some of the most relevant fraud topics to integrate into the accounting curriculum via separate course or in existing courses.

Table 5: AACSB versus Non-AACSB Institutions		
	AACSB	**Non-AACSB**
	(n=131)	(n=42)
Panel A: Question		
Is your school currently teaching a separate course in fraud examination?		
Responses		
1. Yes	43.5%	37.5%
2. No	56.5%	62.5%
Total	100.0%	100.0%
Panel B: Question		
At what level is fraud examination being taught?		
Responses		
1. Undergraduate	19.0%	33.0%
2. Graduate	34.0%	18.0%
Total		
Note: * A total is not applicable since many schools may or may not teach fraud education		

SUMMARY AND CONCLUSION

This study presents the surveyed results of educators and practitioners concerning the relative importance of fraud and forensic topics to be covered in the accounting curriculum. The overall results of the full sample show a general consensus between educators and practitioners concerning the topics with internal control selected as the number one topic with a mean score of 4.60. Thus, selecting internal control as the number topic is not surprising considering the fact that one of the first steps in combating fraud is the establishment of a strong internal control system. Half of the remaining topics had a mean score equal to four points are higher on a five-point Likert scale. This indicates that educators and practitioners perceived them the topics to be very important to the accounting curriculum. The results from the partitioned sample (educators versus practitioners) identified nine significant differences between the two groups which may be attributable to job-related tasks and experience. The results show that the mean scores for educators are higher on the following topics: elements of fraud (4.57), fraud risk factors (4.54), ethical issues (4.49), prevention/deterrence (4.39) and legal environment (3.94), while the mean scores for practitioners are higher on the following topics: computer/internet schemes (4.19), corruption (3.62), report writing (3.51) and forensic litigation (3.15). Although, educators and practitioners are in the accounting profession, the type of work can affect the perception of the relative importance of fraud and forensic topics.

We also partitioned the sample of educators into AACSB accredited versus non-AACSB accredited institutions and found that less than half of the AACSB and non-AACSB schools do not offer a separate course in fraud examination. Furthermore, respondents from AACSB accredited institutions indicate that they teach a course in fraud examination more at the graduate level versus undergraduate, which is almost a mirror image of the results found for the respondents at nonAACSB institutions. Since all students are not likely to attend graduate school, it is important that fraud and forensic be introduced at the undergraduate level regardless of the school's accreditation status. Furthermore, all business schools should at the least integrate fraud and forensic topics the accounting curriculum. The results of this study may provide valuable guidance to educators and administrators in the selection process of fraud and forensic topics to include in the accounting curriculum.

We would like to note two limitations to our study. First, the results of the study are based on a responses obtained from a survey questionnaire, which may be limited by the subjectivity of the professors who teach accounting and the practitioners who practice in the accounting profession. Second, this study includes only 21 selected topics to assist students in developing the necessary skills and knowledge to prevent, investigate and detect financial statement fraud. Therefore, the 21 topics are not exhaustive of all topics related to fraud and forensic accounting. The inclusion of additional topics to the list may generate a different selection order of the topics.

Future research relating to fraud and forensic accounting can explore the effectiveness of introducing students to fraud and forensic accounting topics in the curriculum via seminars/ webinars versus a traditional classroom setting. Also, since fraud is a world problem, future research could examine fraud education across different countries. Conducting a study on the knowledge, skills and experience of accounts across borders might shed some light on new ways to teach and integrate fraud into the accounting curriculum.

ENDNOTES

1 The "Fraud Triangle" developed by Dr. Donald Cressey, states that three key factors must be present for a person to commit fraud: (1) perceived pressure, (2) perceived opportunity, and (3) rationalization

2 Joseph T. Wells, CPA, CFE, is founder and chairman of the Association of Certified Fraud Examiners explains the difference between a fraud examiner and a forensic accountant. In reality, a fraud examiner and a forensic accountant perform different but related jobs. A forensic accountant actively seeks to investigate and detect fraud in organizations and can include fraud, bankruptcy, valuation and other professional services. Fraud examiners are thought of as financial detectives and are called upon once a forensic accountant has suspected fraud. Fraud examiners conduct fraud examinations to gain further

evidence based on the forensic accountant's findings to either prove or disprove that fraud has occurred by an individual or company (Wells 2003).

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THE FEDERAL GOVERNMENT'S WAR ON MARRIAGE AKA THE MARRIAGE PENALTY TAX: UNFAIR TO INDIVIDUALS AND HARMFUL TO SOCIETY

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ABSTRACT

Empirical research has shown that public policy such as tax and transfer programs have had a deleterious effect on marital stability. This study analyzes the cost to individuals of various aspects of the marriage penalty tax (MPT) and thereby how it discourages marriage and how it harms both individuals and society at large. Decline of the family, especially married couples, is regarded as one of the critical problems facing American society. Past research indicates that the MPT, due to its negative impact on marital stability and two-parent families, results in major social and economic costs, such as higher rates of children living in poverty, lower education, higher unemployment, more crime, and poorer health. Given its harm, we conclude that the MPT should be eliminated from the tax code. Opponents to repealing the marriage penalty have complained that 'higher-income' taxpayers receive disproportionate benefit. However, this research shows that the MPT has an equally negative effect on couples in the lowest income categories, particularly with its impact on the earned income tax credit. Further, regardless of a couple's income level, the marriage penalty is detrimental to marriage, and thus, to society overall. Tax laws, as part of public policy, should foster, not hamper, two-parent families and their corresponding economic benefits such as improved employment, better public health, and lower crime.

Key words: Marriage penalty tax, public policy, family

INTRODUCTION

Research studies on public policy such as tax and transfer programs have revealed their negative impact on marital stability. One of the most negative aspects of tax law is the marriage penalty tax (MPT). The current study analyzes the cost to individuals of various aspects of the MPT, and consequently, how it discourages marriage and how it harms both individuals and society at large. The decline of the family, especially regarding married couples, is considered one of the critical problems facing American society. Past research indicates that the MPT, due to its negative impact on marital stability and two-parent families, results in significant costs to individuals, and leads to major social and economic costs, such as higher rates of children living in poverty, lower education, higher unemployment, more crime, and poorer public health.

Considering its harmful impact on individuals and to society, the conclusion is that the MPT should be eliminated from the tax code. Those opposing repeal of the marriage penalty have argued that 'higher-income' taxpayers receive a disproportionate amount of the tax reduction. However, findings of this study indicate that the MPT has an equally negative effect on couples in the lowest income categories, especially regarding the earned income tax credit. Further, elimination of the MPT only reduces taxes for married couples, not single taxpayers; thus, married taxpayers receive a 'disproportionate' benefit relative to single taxpayers.

President Lincoln is famous for saying that foreign invaders could never destroy America but that America could be destroyed only if Americans themselves were the author and finisher of their own destruction (Lincoln, 1838). Marriage and families are regarded as building blocks of civilization. Winston Churchill observed: "There is no doubt that it is around the family and the home that all the greatest virtues, the most dominating virtues of human society, are created, strengthened and maintained" (ThinkExist, 2012). Yet, in America, numerous parts of the federal tax code, directly penalize marriage and thereby have a detrimental effect on American families.

Regardless of a couple's income level, logically, the couple should not have to pay more taxes, simply for the reason that they are married, as opposed to simply living together unmarried. Many studies on family structure that control for variables such as race, education and income level, have found that children raised in married two-parent families have better outcomes on average than children raised in other settings (Coverdale, 2007; Deleire & Kalil, 2002; Demuth & Brown, 2004; McLanahan, 1996; Morse, 2003; Parker & Johns, 2002). By its financial disincentives, the MPT is anti-marriage and anti- family; consequently, the MPT is harmful to children and to all of society. The family unit is the bedrock of civilization; if families decline, civilization will break down (Feucht et al., 2009; Feucht et al., 2008; Hagelin, 2007; Heritage Foundation, 2012b). Tax laws, as part of public policy, should foster, not hamper, two-parent families and their corresponding economic benefits such as improved employment, better public health, and lower crime.

The marriage penalty tax is typically defined as the excess of (1) the amount of income tax that a married couple would pay using the filing status of married filing jointly minus (2) the combined amount of income tax that two single (unmarried individuals) would pay filing as single individuals. MPTs are generally largest when the spouses have equal or nearly equal amounts of income. On the other hand, a marriage bonus tax (MBT) is said to exist when the (1) combined amount of tax that two single individuals have to pay is larger than (2) the amount of tax paid by a married couple filing a joint return. MBTs are generally largest when one spouse in a married couple generates all or nearly all of the couple's total income.

The MPT dates back to the first few years following the ratification of the 16th amendment and the enactment of the Revenue Act of 1913 that provided one progressive tax rate schedule for individuals. Under that schedule, rates ranging from one percent applied to incomes up to $20,000 to seven percent on income over $500,000. Thus, there was no MPT at that time due to the tax rate schedule. However, there was a MPT related to the personal exemption that was $3,000 for an individual and $4,000 for a married couple living together. Thus, two single individuals living together could exempt up to $6,000 from tax, $2,000 more than a married couple. After 1916, the personal exemption amounts were changed such that they resulted in no MPT through 1943. In fact, through 1969, overall, MPTs were either nonexistent or small, and in some cases MBTs existed (Brozovsky & Cataldo, 1994).

Following the enactment of the Tax Reform Act of 1969 and more recent tax acts, the MPT has become more prevalent except during the 2003 through 2012 period. McIntyre and McIntyre (1999) indicate that there are, in general, three main components of the MPT due to: (1) tax rate schedules, (2) differing standard deduction amounts, and (3) the earned income tax credit rules.

MARRIAGE PENALTY TAX DUE TO TAX RATE SCHEDULES

The Revenue Act of 1948 established the ability of married couple to do income splitting nationally to equalize the income tax treatment of married couples in common law states with those in community property states (Mattson, 1983). From 1948 through 1954, married persons divided their taxable income by two, calculated their tax on that one-half of the income, and then, multiplied that tax amount by two (Internal Revenue Service, 1948-1954). Since there was only one rate schedule used during this period, there was no MPT, because two single individuals with the same total amount of taxable income as a married couple would pay the same amount of income tax.

From 1955 through 1968, there was a separate married filing joint return rate schedule under which a married couple with the same taxable income as two single individuals would pay the same amount of tax (Internal Revenue Service, 1955-1968). But, this system created large MBTs where one spouse in a married couple earned all or almost all of the income. For example, for 1955, if one spouse generated taxable income of $12,000, the income tax was $2,720. If two single persons lived together and only one generated that same $12,000 of taxable income, the tax would have been $3,400 or $680 more than that of the married couple ($3,400 minus $2,720).

In 1952, a separate rate schedule for unmarried heads of household was developed, under which the rate brackets were lower than those for single individuals. This led to the possibility of MPTs, beginning in 1952 where an unmarried person with one or more dependents lived with another unmarried person with or without dependents. In that case, if each person had the same or near the same income, their combined income tax would be less than that of a married couple where the spouses had the same total amount of taxable income and each generated the same amount of income as the unmarried couple.

Concern over large MBT amounts led to the enactment of a new separate single person rate schedule in The Tax Reform Act of 1969, under which the tax for a single individual with a particular amount of taxable income could be no more than 20% larger than the amount applicable to a married couple filing a joint return with the same total amount of taxable income (Mattson, 1983). The 1969 Act also brought about a 50 percent maximum tax on earned income. The new single person tax rate schedule took effect in 1971 and resulted in MPTs due to rate schedule differences in the years 1971 through 2002, where two single individuals using the single rate schedule had the same taxable income as a married couple, and each of the individuals had equal or not substantially unequal incomes (Feucht, et al., 2009; Hulse, 2002; Tax Policy Center, 2008).

As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA), the tax rate MPT for single filers versus married filing jointly filers was eliminated starting in 2003, when the bracket jumps in the joint return rate schedule were set at just twice the value in the married filing joint return rate schedule as they do in the single person rate schedule for 10% and 15% marginal rates (see Tax Policy Center, 2008). Unless Congress acts to the contrary, the provisions of these acts will expire beginning in 2013, and the MPT due to tax rate schedules will be back (Jennings, 2011). Finally, it should be noted that the tax rate MPT that results when at least one single person living with another can file as a head of household described above continue to exist, as EGTRRA and JGTRRA did not remove that part of the MPT.

MPT due to the Standard Deduction and Additional Standard Deduction

From 1944 through 2002, there was a MPT due to the fact that two single persons could obtain a greater combined standard deduction amount than the amount that could be taken by married persons filing a joint return. Beginning in 1977, the standard deduction (called the zero bracket amount from 1977 through 1986) was one flat amount for single individuals and a higher amount for married persons filing joint returns. Through 2002, the married filing joint standard deduction amount was not twice as large as the single amount, thus causing a MPT when comparing the combined standard deduction amounts that two single persons would have versus the amount allowed to married persons filing jointly. In 2002, the single deduction amount was $4,700, so that two single individuals had a combined standard deduction of $9,400, compared to $7,850 for married persons filing joint returns (Tax Policy Center, 2012). JGTRRA modified the standard deduction amount rules such that from 2003 through 2012, the 'basic' standard deduction for married persons filing jointly was exactly twice the amount applying to single individuals eliminating the MPT due to the 'basic' standard deduction during those years.

However, the JGTRRA rules expire at the end of 2012, so that MPT will be back in 2013 unless Congress acts to change the law (Jennings, 2011).

Starting with the 1987 tax year, an additional standard deduction amount has been allowed for persons 65 and over and also for those who are blind under the definition of the law. From 1987 through 2012, a MPT has resulted from the additional standard deduction because single individuals meeting one of those tests are entitled to an additional standard deduction amount that is larger than that which is allowed to a married person filing a joint return in the same circumstance (IRS, 1987 through 2011; Lassila & Wiggins, 1996). For example, in 2011, assume two single individuals both over 65 live together. They collectively, would be entitled to an additional standard deduction of $2,900 ($1,450 times 2). If they were married filing a joint return, their collective additional standard deduction would be $2,300 ($1,150 times 2). JGTRRA did not end this cause of the MPT.

MPT Caused By the Earned Income Tax Credit (EITC)

The EITC has been in the law since 1975, and over time has become larger. The EITC can result in a MPT because (1) the credit amount is phased in over the same earned income range for both unmarried individuals (either single or head of household filers) and (2) the credit is phased out for unmarried persons at a level (measured by the greater of adjusted gross income or earned income) for married persons filing jointly that is far less than twice the same level at which the credit begins to be phased out for unmarried individuals (see Internal Revenue Service, 2000-2011; McIntyre & McIntyre, 1999). Prior to 2002, the phase out of the EITC began at the same dollar level for unmarried individuals and married persons filing joint returns.

The potential MPT has grown larger over the years along with the growth of the EITC. For example, suppose that in 2011, an unmarried individual had two qualifying children and lives with another unmarried individual without any children. Each has earned income of $20,000 and no other income. Collectively, their EITC would be $4,410. If the individuals were married, filing a joint return, their EITC would be $1,267. In this case, the MPT due to the EITC is $3,143 ($4,410 - $1,267). This is a large MPT relative to the income of the individuals and indicates that EITC can generate significant MPTs for lower and middle-income individuals.

Other Tax Return Items Resulting in MPT

There are a number of other provisions in the Internal Revenue Code that can generate MPT amounts for a number of reasons including (1) that a credit or deduction is phased out for married individuals filing joint returns at a dollar amount that is less than twice the amount applicable to a single individual, (2) that the amount of an allowed deduction is limited to an amount in excess of a certain percentage of adjusted gross income or some other figure or to a fixed dollar amount, regardless of filing status, and (3) certain items of income are recognized or a specified percentage is taxed beginning at an amount for married persons filing jointly that is less than twice that applicable to single individuals.

An example of the first reason is the Child Tax Credit. Under Internal Revenue Code (IRC) Section 24, a credit of $1,000 is allowed to a taxpayer for each qualified child. The credit is phased out a rate of $50 for each $1,000 (or part thereof) by which the taxpayer's modified adjusted gross income (MAGI) exceeds $75,000 for single individuals and $110,000 for married persons filing jointly. If two single individuals, each with MAGI of $70,000 lived together, a combined $2,000 child tax credit would be allowed. If the two were married filing a joint return, no credit would be allowed since the credit would be completely phased out at their $140,000 combined amount of MAGI. A second example is the exemption for the alternative minimum tax (AMT) under IRC Section 55. In 2011, that exemption amount was $74,450 for married persons filing jointly and $48,850 for unmarried individuals. Thus, two unmarried individuals could exempt up to $97,700 of income from exposure to the AMT, whereas a married couple could only exempt $74,450.

An example of the second reason is found in the phase-out of the exemption for the AMT where the exemption is phased out at a rate of 25 percent of the amount of alternative minimum taxable income (AMTI) in excess of $112,500 for single individuals and in excess of $150,000 for married persons filing joint returns. Thus, two single individuals who each have AMTI of $110,000 or $220,000 total would have no phase-out, whereas, if they were married with $220,000 of AMTI, $17,500 of their exemption amount would be phased out. As another example, under IRC Section 1211, individual taxpayers are only allowed a deduction on account of a net capital loss up to $3,000 per year. But, that limit applies both to single individuals and married persons filing joint returns. Thus, two single individuals living together each with net capital losses of $2,800 would be able to deduct the entire $5,600. If they were married filing a joint return, only $3,000 of that $5,600 would be deductible in the current year.

One example of the third reason is the IRC Section 86 rules for the taxation of social security benefits. That section establishes a two-tier system of taxation. Under the first tier, a taxpayer is subject to tax on the lesser of (1) one-half of the social security benefits or (2) one-half of the excess of the sum of (a) the taxpayer's modified adjusted gross income (MAGI) plus one-half of the social security benefits minus the base amount which is $25,000 for single individuals and $32,000 for married persons filing a joint return. There is a second tier of taxation applicable where the taxpayer's MAGI plus one-half of social security benefits exceeds a base amount of $34,000 for single individuals and $44,000 for married persons filing jointly under which up to 85 percent of social security benefits are taxable. See Lassila and Wiggins (1996) for details on this second tier.

The substantial MPT that can result from Section 86 can be illustrated as follows. Assume that the MAGI plus one-half of social security benefits each received by two individuals is each $21,000. If the individuals are unmarried and living together, none of the social security benefits will be taxable because the base amount of $25,000 is not exceeded. But, if the two were married filing jointly, up to $5,000 of their social security benefits would be taxed which would be one-half of $42,000 minus $32,000. Another example, can be found in the provision included in the Patient Protection and Affordable Care Act of 2010 (PPACA) under which an additional Medicare tax of 3.8 percent will apply to the lesser of (a) the taxpayer's net investment income or (b) the excess of MAGI over the base amount ($200,000 for single individuals and $250,000 for married persons filing a joint return) (Deloitte, 2012). Two single persons, each with MAGI of $195,000 would not be subject to this tax. However, if the two were married, filing a joint return, up to $140,000 could be subject to the 3.8 percent tax ($390,000 minus $250,000).

PRIOR RESEARCH

A number of papers and studies have been written concerning MPTs and MBTs. Some have been historical analyses, some have been explanatory with examples, and others have involved computer simulation and/or empirical analyses of the extent of MPTs and MBTs. Yet others have attempted to develop alternatives to the tax system at the time of their writing and/or analyze some of the societal consequences of the MPT.

Mattson (1983) presents an extensive analysis of federal tax laws and court cases over the period of 1913 to the time of the writing of the paper and how such laws and cases have dealt with, impacted, or resulted in MPTs. The paper includes an analysis of the reaction of politicians and Congress committee hearings concerning the subject. Mattson concludes by evaluating the laws of the states with income taxes at the time concerning how such laws result in MPTs.
Brozovsky and Catalodo (1994) provide a historical analysis of the MPT beginning with the Revenue Act of 1913 and going forward to 1993 based on the calculation of approximately 727 "short forms" (non-itemized deduction forms) from using weighted averages of IRS Statistics of Income data. Their study analyzed the MPT and MBT related to the personal exemption/standard deduction amounts and tax rate schedules during that period. Standard deduction penalties and bonuses over the period were determined by taking twice the amount of deduction allowed to single individuals and subtracting the amount allowed to married persons filing joint returns. They next examined the MPT due to the tax rate schedules and found it to be practically not existent before 1971, when the single person rate schedule enacted by the Tax Reform Act of 1969 took effect. Rate-based MPTs were found to exist throughout the 1971 through 1993 period.

A number of studies have evaluated various provisions of the law that have resulted in MPTs in addition to rate schedules and standard deduction amounts. Jagolinzer and Strefeler (1986) described MPTs that result from income recognition provisions such as those dealing with the sale or exchange of property, deduction provisions such as the limit on medical expense deductions and tax credits such as the EITC. A subsequent and more extensive listing of provisions that can result in MPTs and MBTs are presented by the GAO (1996), in Maule (1995), and in Hulse (2002). Furchgott-Roth (2010) discussed MPTs that arise under certain provisions in the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. For example, additional taxes under these rules on net unearned income and earned income apply to single individuals with $200,000 or more of income and married persons filing joint returns with $250,000 or more of income beginning in 2013.

Table 1: Common Provisions in the Internal Revenue Code that can Result in MPT

Code Section	Provision
1	Single vs. Married Filing Joint Return Rate Schedules
1	Head of Household vs. Married Filing Joint Return Rate Schedules
22	Credit for the Elderly and Permanently Disabled
24	Child Tax Credit
32	Earned Income Credit
36B	Health Care Premium Assistance Credit (takes effect in 2014)
55(d)	Alternative Minimum Tax Exemption and Phase-out of the Exemption
62(b)	Expenses of a Qualified Performing Artist
63(c)(2)	Basic Standard Deduction (except from 2003-2012)
63(f)	Additional Standard Deduction
67	Deduction Limit on Miscellaneous Itemized Deductions
68	Phase-out of Total Itemized Deductions (Partial from 2006-2009; None in 2010- 2012)
86(c)	Taxation of Social Security Benefits
151(d)(3)	Phase-out of Personal Exemption Deduction (Partial from 2006-2009; None in 2010-2012).
163(d)	Limit on Investment Interest Deduction
163(h)	Limit on Acquisition and Home Equity Indebtedness
165(h)(2)	Limit on the Deduction of Casualty and Theft Losses
170	Limitation on Charitable Contribution Deductions
179	Limit on One-Time Expensing Election
219(b)	Phase-out of Deduction for IRA Contributions
267	Losses Between Related Parties
302	Taxation of Stock Redemptions
304	Redemption Through The Use of Related Corporations
408A	Phase-out of the Amount of Allowable Roth IRA Contributions
469(i)	Passive Loss Limitation and Phase-out
1091	Wash Sales
1211(b)	Capital Loss Limitation
1239	Certain Sales of Depreciable Property
1411	Medicare Contribution Tax on Net Investment Income (effective in 2013)
3101	Additional Medicare Tax on Earned Income (effective in 2013)

One provision listed in some of these studies as resulting in possible MPTs is the IRC Section 163(h) $1 million acquisition indebtedness limitation and $100,000 home equity indebtedness limitation. The deduction for mortgage interest is limited to debt on a personal residence. not in excess of the sum of the $1 million and $100,000 amounts. GAO (1996) indicates that two unmarried individuals would be eligible for twice the amount of these limits, whereas married persons filing jointly would be subject to the $1.1 million limit. However, a recent Tax Court case held that the $1.1 million total limitation is applied on a per-residence rather than a per-taxpayer basis. Thus, two unmarried co-owners who jointly owned two residences were entitled to only one $1.1 million indebtedness limitation ($550,000 each) in determining their interest deductions. Table 1 presents a listing of a number of provisions that can result in MPTs.

There have been a number of papers containing computations illustrating the determination of MPTs and MBTs (e.g. McIntyre & McIntyre, 1999; Tax Policy Center 2008; and Cherry 2012). Some involve comprehensive computer simulation computations and/or empirical analysis. Wiggins et al. (1986) present one of the early simulation analyses of MPTs and MBTs concentrating on the early 1980s following the passage of the Economic Recovery Tax Act of 1981 (ERTA). Among other things, they determined the MPT and MBT amounts applicable in 1984 and 1981 (under pre-ERTA law) to married couples who did not itemize deductions, had income splits of 50/50 or 100/0, and had two children.

In the case of the 50/50 split, Wiggins et al. (1986) found that there were substantial MPTs that increased with the level of adjusted gross income (AGI). However, the 1984 MPTs were smaller, in part because of the two-earner deduction enacted by ERTA that applied in 1984. For the 100/0 split, substantial MBTs resulted, which were smaller in 1984 because of the reduction in tax rates by ERTA. They also partitioned the MPT for 1984 into its zero bracket amount (ZBA) (what the standard deduction was called then) and tax rate penalty components and found that for two individuals with equal income split that was a small penalty at all AGI levels from $0 to $100,000, but that the rate penalty rose significantly as AGI levels increased. Overall, they found that the MPT hit middle to higher income individuals hardest.

Lassila and Wiggins (1996) analyzed the MPT incurred by elderly individuals receiving social security benefits and took the standard deduction. They found that substantial MPT amounts could be incurred by elderly couples who are married and file joint returns and receive social security benefits, and that the Omnibus Budget Reconciliation Act of 1993 (OBRA ’93) substantially increased the amount of the MPT because it introduced a second tier of taxation under which social security benefits could be taxed at a rate as high as 85 percent beginning in 1994, beginning at a base amount of $34,000 for single individuals and $44,000 for married persons filing joint returns.

Some of the MPT was also due to the additional standard deduction amounts and the tax rate schedules (see the discussion above in the Background section). Using computer simulation analysis over a range of AGI amounts of from $10,000 to $200,000 (before social security benefits) with income divisions between the spouses ranging from 100 percent/0 percent to 50 percent each, they found that for the year 1993, substantial MPTs were incurred by married couples with AGI splits of 80 percent to 20 percent and less extreme and that the MPTs were higher when taking into account OBRA’93 law than under pre OBRA’93 law. For example, at a 50-50 split of AGI amounting to $50,000 of AGI before social security benefits of $13,500 (the maximum receivable in 1993) for the first spouse and $6,750 for the second, the MPT taking into account OBRA’93 law was $4,404. That was $1,984 higher than under pre OBRA’93 law. The authors concluded that IRC Section 86 should be changed to reflect base amounts for married persons that are twice the amount of those applicable to single individuals.

A number of empirical studies have been undertaken to determine the magnitude of MPTs and MBTs and the impact of various tax laws on those amounts. The results are summarized in Table 2. Rosen (1987) using an actual stratified random sample of U.S. individual tax returns and tax amounts generated from those returns by the Tax Simulation Model, (TAXSIM) maintained by the National Bureau of Economic Research (NBER) determined MPTs and MBTs that would have been found for the year 1988 reflecting the law as modified by the Tax Reform Act of 1986 (TRA'86) versus what would have resulted in that year if pre-TRA'86 law had been in effect. The average MPT per return for 1988 under TRA'86 law was about $119, whereas it would have been $529 under preTRA'86 law.

Feenberg and Rosen (1995) used the TAXSIM model to test a stratified random sample of tax returns filed in 1989 and aged to 1994 to determine the impact of OBRA'93 on MPT and MBT amounts for the year 1994. Calculations were made for 1994 reflecting OBRA'93 law and compared with results under pre-OBRA'93 law. They found that the average MPT for 1994 was $124 reflecting OBRA'93 law, whereas there was an average $143 MBT where the calculations were made using pre OBRA'93 law. On average, OBRA'93 resulted in the law going from being pro-marriage on average to anti-marriage. Part of the reason for this change was the change in the taxation of social security benefits analyzed by Lassila and Wiggins (1996).

Table 2: Net Marriage Penalty Tax Based on Prior Research

Study / year published [tax act]	Tax Year	Average Penalty % and $	Average Benefit % and $	Net Penalty ($B)
Feucht, et al. 2009 [JGTRRA]	2000			$(11)
Feucht, et al. 2009 [pre JGTRRA]	2000			$311
Bull, et al. 1999	1999	48 and $1,141	41 and $1,274	$31
CBO 1997	1996	42 and $1,380	51 and $1,300	-
CBO 1997 (all itemized)	1996	47 and $1,750	49 and $1,350	-
Alm and Whittington 1996	1994			$375*
Feeberg and Rosen 1995 [OBRA 93]	1994	51 and $1,244	38 and $1,399	$124*
Feeberg and Rosen 1995	1993	51 and $898	38 and $1,577	$(143)*
Rosen 1987 [TRA 86]	1988	40 and $1,091	53 and $609	$119**
Rosen 1987	1986			$529**
*1994 Dollars and **1988 Dollars				

Alm and Whittington (1996) used household data from the Panel Study of Income Dynamics to calculate what they refer to as the real value of the marriage tax or marriage subsidy over the period of 1967 through 1994. They used constant 1994 dollars and calculated amounts using two different approaches, (1) the High Earner Allocation Method (HEAM) where the higher earner becomes the custodial agent of the children in a divorce and the male is the high earner in over 80 percent of the cases and (2) the Female Allocation method (FAM) where the wife becomes the custodial agent of any children and receives all relevant tax preferences. While the two methods resulted in different amounts of MPTs and MBTs in most years in the period, by 1994, the average real MPT across all families under both methods was about $375.

Using 1996 tax data, the United States Congressional Budget Office (CBO) (1997) found that among married couples filing joint returns using a basic measure, about 42 percent incurred MPTs and that the average penalty was $1,380. MBTs were realized by about 51 percent of joint return filers with an average MBT of $1,300. Using a broader measure assuming that the higher earner takes itemized deductions, about 47 percent of joint returns incur a MPT averaging $1,750, whereas the percentage of returns with a MBT deceases to 49 percent with an average bonus of $1,350. The CBO attributed the results partly to the fact that among married couples, there was a substantial increase in two wage-earner households in the two decades preceding the 1996 year and that there was increasing equality in of the incomes of marriage partners, particularly in higher earner households.

Bull et al. (1999) of the Office of Tax Analysis (OTA) used the Individual Tax Model (ITM) to estimate marriage penalties and bonuses, which they updated to the 1999 tax year. They adopted what they referred to as a resource pooling approach that assumes that a married couple would live together and duplicate the same pooling of assets and expenses that occurs within their marriage without actually being married. They determined that about 48 percent of joint filers would have a MPT averaging $1,141 and that 41 percent would have a MBT averaging $1,274.

The tax law as in effect from 2003 through 2012 is the combined result of the 2001 and 2003 tax laws enacted during the early years of the George W. Bush Administration, EGTRRA and JGTRRA. One of the objectives underlying the laws was to reduce the MPT (Feucht et al., 2009). The applicability of those two laws was extended at the end of 2010 in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. Feucht et al. (2009) used data from the 2000 Supplementary Survey Profile of the U.S. Census to determine the impact of the enactment of JGTRRA on the MPT or MBT within each interval of combined income by marginal tax bracket. They compared the results of the tax liability amounts where spouses were married versus being single. MPTs and MBTs on average were calculated under the pre-JGTRRA law and then under the law as modified by JGTRRA. They found that JGTRRA, on average, resulted in substantial reduction in MPTs in all income classes. Overall, the MPT was calculated to be $311 under pre-JGTRRA law, compared to an average MBT of $11 under JGTRRA.

Other recent analyses of MPTs and MBTs following the enactment of JGTRRA have focused on another measure of those quantities, the effective tax rates that are incurred by a married couple, compared to what would be incurred if the spouses were unmarried and living together with the same divisions of income. Gravelle (2006) finds that joint return filers tend to have a higher effective tax rate at middle-income levels than do singles where one of the singles can file as a head of household and there is an even division of income. At high income levels with an even income division, joint return filers have a higher effective rate than single filers due to the alternative minimum tax.

Other prior research considers the societal effects of the incentives or disincentives for marriage that reside in the tax law. Feucht et al. (2009) provide an extensive review and analysis of that literature. For example, they indicate that Smith et al. (1999) provide an analysis of the impact of societal ethics, cultural trends, divorce law and public policies on marriage. They posit that public policy (i.e., tax and transfer programs) may affect marital stability and call for government policy to be more pro-child, pro-marriage (or at least neutral to marriage) and advance legislation that promotes marriage. Olshewsky et al. (2001) indicate that MPTs cost American married couples approximately $33 billion in the year 2000.

A notable consequence of the MPT is that it may discourage marriage (Alm & Whittington, 1995 & 1999) or at least have an impact on the rate and timing of marriage (Sjoquist and Walker 1995). If an unmarried taxpayer becomes a single parent, there may be greater challenges in child rearing. Studies have shown that children in single-parent homes have a higher probability for negative social outcomes such as under-education, delinquency, and incarceration (Demuth & Brown, 2004; Olshewsky et al., 2001; Smith et al., 1999). Thus, there are more possible consequences relating to MPTs than just the fact that certain provisions in the law cause married persons filing jointly to pay more in taxes than two unmarried individuals that have the same total income.

Illustrations of the MPT

Specific illustrations of the negative financial impact of the MPT, that is, higher tax liability as a result of being a married couple rather than two single individuals living together, are provided below. Five illustrations are given:

- Bias in the federal income tax rates
- Deductibility of real estate rental property losses
- Child tax credit
- Earned income tax credit
- Obama's proposal to increase tax rates on high-income earners

ILLUSTRATION: MPT BIAS IN FEDERAL INCOME TAX RATES

The marriage penalty has been incorporated into the federal income tax system for many years. Currently, there are six marginal tax rates for individuals (10%, 15%, 25%, 28%, 33% and 35%). These same rates apply to all individual taxpayers, but the income levels to which the higher rates apply depend upon one's filing status.

The 2011 Tax Rate Schedules for single taxpayers and for married couples filing jointly are shown in Table 3. The top third of the table shows the actual income levels to which the marginal tax rates apply for single individuals, while the middle third of the table shows the actual income levels for those same tax rates for married couples. The bottom third of the table reflects what the income levels should be for the same tax rates for married couples if there were no bias.

Currently, there is no bias toward married couples over single taxpayers at the 10% rate (10% of the first $8,500 of income for singles versus 10% of the first $17,000 for MFJ). There is also no bias relative to the 15% rate (15% of the next $26,000 of income for singles versus 15% of the next $52,000 for MFJ). However, for the last four marginal tax rates (25%, 28%, 33% and 35%), there is bias against married couples. For instance, the 25% rate ends at an income level of $83,600 for singles, but ends at an income level of only $139,350 and not $167,200 (double $83,600) for married couples filing jointly. In short, married couples begin paying tax at a 28% rate sooner than two single individuals would with the same amount of combined taxable income.

For example, assume a single man and a single woman have taxable income in 2011 of $80,000 individually. Each one would incur a gross tax liability of $16,125 or a combined amount of $32,250. Yet if they were married filing jointly with taxable income of $160,000, their gross tax liability would be $32,870. In this case, their penalty for being married results in paying $620 more ($32,870 - $32,250) in income tax.

If the same individuals each had $130,000 of taxable income in 2011, the single man and single woman would each incur a gross tax liability of $30,017 or $60,034 in total. If they were married filing jointly and there was no bias, their combined tax liability should be $60,034. However, using the actual rates for married couples from Table 3, their actual tax liability is $63,255 for 2011. As a result, they pay a penalty tax for being married of $3,221 ($63,255 - $60,034). The bias against married couples becomes even more pronounced at higher income levels when each earn about the same income. This MPT bias regarding tax rates on married versus unmarried couples is summarized in Table 4.

ILLUSTRATION: MPT BIAS IN DEDUCTIBILITY OF REAL ESTATE RENTAL PROPERTY LOSSES

An unmarried couple equally owns two rental duplexes that have usually been profitable each year. However, in 2011, due to extended vacancies in one of the duplexes, the rental properties generated a net loss of $30,000 for the year. Each of these two owners has an amount at risk on this real estate well in excess of the loss. They both actively manage the rentals and make all the major decisions concerning these properties.

Table 3: 2011 Tax Rate Schedule				
	If Taxable Income is Over	But Not Over	The Tax is:	Of the Amount Over
Single Schedule X Actual Rates	$0	$8,500	10%	$0
	$8,500	$34,500	$850 + 15%	$8,500
	$34,500	$83,600	$4,750 + 25%	$34,500
	$83,600	$174,400	$17,025 + 28%	$83,600
	$174,400	$379,150	$42,449 + 33%	$174,400
	$379,150	-	$110,016.50 + 35%	$379,150
	If Taxable Income is Over	But Not Over	The Tax is:	Of the Amount Over
Married Filing Jointly Schedule Y-1 Actual Rates	$0	$17,000	10%	$0
	$17,000	$69,000	$1,700 + 15%	$17,000
	$69,000	$139,350	$9,500 + 25%	$69,000
	$139,350	$212,300	$27,087.50 + 28%	$139,350
	$212,300	$379,150	$47,513.50 + 33%	$212,300
	$379,150	-	$102574 + 35%	$379,150
	If Taxable Income is Over	But Not Over	The Tax is:	Of the Amount Over
Married Filing Jointly Rates with No Marriage Penalty	$0	$17,000	0.1	$0
	$17,000	$69,000	$1,700 + 15%	$17,000
	$69,000	$167,200	$9,500 + 25%	$69,000
	$167,200	$348,800	$34,050 + 28%	$167,200
	$348,800	$758,300	$84,898 + 33%	$348,800
	$758,300	-	$220,033 + 35%	$758,300

Table 4: Impact of MPT on Tax Rates and Tax Liabilities, Unmarried Vs. Married Couple

	Single Male	Single Female	Total for Unmarried Couple	Total for Married Couple
Taxable Income	$80,000	$80,000	$160,000	$160,000
Related Income Tax	$16,125	$16,125	$32,250	$32,870
			MPT	**$620**
Taxable Income	$130,000	$130,000	$260,000	$260,000
Related Income Tax	$30,017	$30,017	$60,034	$63,255
			MPT	**$3,221**
Taxable Income	$200,000	$200,000	$400,000	$400,000
Related Income Tax	$50,897	$50,897	$101,794	$109,872
			MPT	**$8,078**

While net rental income from residential real estate is taxable to the owners, a net rental loss is considered a passive loss and is generally not deductible against salaries, commissions and bonuses, or against investment income. However a special code provision allows eligible taxpayers to deduct up to $25,000 of these losses annually against that income. Yet, if their adjusted gross income (AGI) exceeds $100,000, that deduction phases out at a rate of 50% for any excess AGI over $100,000. That benefit is totally eliminated when the AGI level reaches $150,000 [($150,000-$100,000) x 50% or $25,000]. The phase-out range is the same for both married couples filing jointly and single taxpayers.

This provision demonstrates bias in the code against married couples, particularly when the man and woman earn about the same income. To have no bias, the reduction in this benefit for married couples filing jointly should begin at an AGI level of $200,000 or double the beginning of the phase-out range for single taxpayers.

In the above example of the unmarried couple, assume that each has AGI of about $100,000 before the net rental loss of $30,000. As single taxpayers, both could claim a $15,000 deduction of the real estate rental loss on their respective tax returns to reduce their AGI and their taxable income. Since each of their AGIs before the loss does not exceed $100,000, none of the potential deduction is phased out. If both taxpayers have a marginal tax rate of 25%, then the tax benefit to each of them is $3750 or a total of $7500 combined ($30,000 x 25%).

However, if the couple is married filing a joint return, then none of the net rental loss of $30,000 is deductible. While the limit on this deduction is $25,000 per taxpayer, the potential deduction is totally phased out at an AGI level of $150,000. The married couple's AGI before the loss deduction is $200,000, so none of this benefit is available to them. As a result, for 2011, they lose $6250 in tax savings ($25,000 x 25%) compared to the unmarried couple in the above example who enjoyed a combined tax benefit of $7,500. The impact of the MPT regarding real estate rental property losses is summarized in Table 5.

Table 5: Impact of the MPT on Couples with Real Estate Rental Property Losses, Unmarried Vs. Married Couple (Given a $30,000 Net Rental Loss)

	Single Male	Single Female	Married Couple
AGI before the Loss	$100,000	$100,000	$200,000
Allocation of Rental Loss	15000	15000	30000
Loss Allowed after AGI Phaseout	15000	15000	0
Times Marginal Tax Rate	25%	25%	25%
Tax Benefit	$3,750	$3,750	$0
Lost Tax Benefit due to MPT ($25,000 x 25%)	-	-	$6,250

ILLUSTRATION: MPT BIAS IN CHILD TAX CREDIT

The child tax credit provides taxpayers who have a qualifying child with a credit against their tax liability. This credit is considered one of the family friendly provisions in the Internal Revenue Code. The child must be claimed as a dependent on the taxpayer's return and must be a U.S. citizen and under age 17 at the end of the tax year.

For the last several years, the maximum credit is $1,000 for each qualifying child of the taxpayer. However, the credit begins to phase out once the taxpayer's AGI (adjusted gross income) reaches a certain threshold. The reduction in the credit is $50 for every $1,000 increment or fraction thereof in which the taxpayer's AGI exceeds that threshold. For single taxpayers and heads of household, the AGI phase-out threshold is $75,000. For married couples filing jointly, the phase-out begins at an AGI level of $110,000 ($55,000 for married filing separately). If there were no bias in the Code against married couples, the phase-out would begin at an AGI level of $150,000 (double $75,000) for married taxpayers filing jointly.

Couples who earn about the same AGI and who have qualifying children could benefit more from this credit by not being married than those couples who are married. Let's take a scenario where Bob and Beth are a couple living together but not married and have two qualifying children for a potential credit of $2,000. Bob files as single and Beth files as head of household and she claims both children as dependents. Bob and Beth each have AGI of $75,000.

On the other hand, Ted and Tammy are married filing jointly and also have two qualifying children. Both Ted and Tammy each have AGI of $75,000 or $150,000 combined. With the first couple, Beth, as head of household, would receive a $2,000 child tax credit for her children. Since her AGI does not exceed $75,000, she is entitled to the full $2,000 credit. Ted and Tammy, however, would not receive a child tax credit for their two children. While their tentative credit is $2,000, since their AGI of $150,000 exceeds the $110,000 threshold by $40,000, their credit is totally phased out ($40,000/$1,000 x $50 = $2,000).

In this instance, Bob and Beth, who are unmarried with two children, receive a $2,000 credit; yet, Ted and Tammy, who are married with two children, receive no tax credit. Note that both couples have the same combined AGI of $150,000. The marriage penalty for Ted and Tammy in this example is $2,000. Ted and Tammy could file separately and receive a portion of the credit. If Tammy claimed the children as dependents on a separate return, she could receive $1,000 of the credit (The other $1,000 is phased out). However, there are several other factors married couples must consider in deciding whether to file jointly or separately. In either event, they are still subject to a marriage penalty with respect to this credit.

At lower levels of AGI (but above $110,000), Ted and Tammy would qualify for a reduced child tax credit, but Beth would continue to receive the full $2,000 credit provided her AGI does not exceed $75,000. If the couples only had one qualifying child, Bob and Beth could each have AGI of $75,000 and Beth would receive the $1,000 credit for their child. Assume Ted and Tammy only had AGI of $65,000 each or $130,000 combined. They would still not receive a child tax credit on a joint return because of the phase out. As noted above, if Ted and Tammy filed separate returns, Tammy could receive a $500 reduced credit for their child (The other $500 is phased out.) based on her AGI of $65,000. Regardless of how they file, however, they are still subject to the marriage penalty when compared to the unmarried couple (Bob and Beth).

ILLUSTRATION: MPT BIAS IN EARNED INCOME TAX CREDIT

The Earned Income Credit (EIC) is a refundable credit that is designed to provide some tax benefits to low-income families. Since the credit is based on earned income, this provision encourages low to moderate-income taxpayers to be gainfully employed. Generally, the income base (up to a specified limit) can include salaries, wages, tips, other employee compensation and net earnings from self-employment. The credit rate to apply to the base depends upon whether the taxpayer has qualifying children. For taxpayers who are between 25 and 64 years of age without any qualifying children, the credit rate is 7.65%. For taxpayers regardless of age who have qualifying children as dependents, the credit rates are 34% for one child, 40% for two children, and 45% for three or more children.

Table 6 shows the 2011 the maximum earned income levels, the credit rates, and the maximum EIC for taxpayers with and without qualifying children. Also shown are income phase-out levels that result in a reduction in the EIC allowed for married couples filing jointly (MFJ) and for other taxpayers: single, head of household, or a qualified widow(er). Married couples must file jointly to claim the EIC.

Table 6: 2011 Earned Income Credit and Phase-Out Percentages

NUMBER OF QUALIFYING CHILDREN	MAXIMUM EARNED INCOME	CREDIT %	MAXIMUM EIC	PHASEOUT BEGINS	PHASEOUT %	PHASEOUT ENDS
MFJ						
NONE	$ 6,070	7.65%	$ 464	$12,670	7.65%	$18,740
ONE CHILD	9,100	34.00%	3094	21,770	15.98%	41,132
TWO CHILDREN	12,780	40.00%	5112	21,770	21.06%	46,044
THREE OF MORE	12,780	45.00%	5751	21,770	21.06%	49,078
OTHER TAXPAYERS						
NONE	$ 6,070	7.65%	$ 464	$ 7,590	7.65%	$13,660
ONE CHILD	9,100	34.00%	3094	16,690	15.98%	36,052
TWO CHILDREN	12,780	40.00%	5112	16,690	21.06%	40,964
THREE OF MORE	12,780	45.00%	5751	16,690	21.06%	43,998

As shown in Table 6, the AGI phase-out levels begin and end for married couples at $5,080 above the level for unmarried taxpayers. If there were no bias against married taxpayers, the reduction in the credit would begin for those couples at twice the level that applies to other taxpayers. In short, the income phase-out level for married couples should begin at $15,180 ($7,590 x 2) for those without children instead of beginning at $12,670. For those married couples with qualifying children, the income phase-out level should begin at $33,380 ($16,690 x 2) rather than at $21,170. This bias translates into lower EICs for parents who are married than for parents who are unmarried, but with about the same amount of total income.

Assume there are two couples (Bob & Beth and Ted & Tammy) with two qualifying children. Each parent has AGI of $20,000, consisting solely of earned income. Bob and Beth are unmarried and Beth claims the children as dependents. Ted and Tammy are married filing jointly and they claim their two children as dependents.

Beth, unmarried with AGI of $20,000 and two qualifying children, receives an EIC of $4,410. (The EIC amounts come from the EIC Tables provided by the IRS each year.) Ted and Tammy, also with two qualifying children, but with a combined AGI of $40,000, receive an EIC of only $1,267. So, while both couples have the same total income and the same number of qualifying children, Ted and Tammy pay a penalty for being married of $3,143. The MPT impact on EIC is illustrated in Table 7.

Table 7: Impact of MPT on EIC Benefits, Unmarried Vs. Married Couple (Two Qualifying Children)

	Single Male	Single Female	Total Unmarried Couple	Total Married Couple
AGI	$22,500	$22,500	$45,000	$45,000
EIC Allowed	N/A	$3,883	$3,883	$214
			MPT	**$3,669**
AGI	$20,000	$20,000	$40,000	$40,000
EIC Allowed	N/A	$4,410	$4,410	$1,267
			MPT	**$3,143**
AGI	$17,500	$17,500	$35,000	$35,000
EIC Allowed	N/A	$4,936	$4,936	$2,320
			MPT	**$2,616**
AGI	$15,000	$15,000	$30,000	$30,000
EIC Allowed	N/A	$5,112	$5,112	$3,373
			MPT	**$1,739**
AGI	$12,500	$12,500	$25,000	$25,000
EIC Allowed	N/A	$5,010	$5,010	$4,426
			MPT	**$584**

Even at lower income levels, there is still a marriage penalty. If each parent in the above example had AGI of $15,000 and two children, Beth would receive an EIC of $5,112. Ted and Tammy, with combined AGI of $30,000, would only receive an EIC of $3,373. Again, Ted and Tammy pay a marriage penalty of $1,739 relative to the EIC in this scenario.

ILLUSTRATION: MPT BIAS IN PRESIDENT OBAMA'S PROPOSAL TO INCREASE TAX RATES ON HIGH-INCOME EARNERS

A politically controversial tax proposal of President Obama was to eliminate the Bush tax cuts (allow them to expire) for taxpayers with incomes of more than $200,000 for individuals and $250,000 for couples. Democrats and Republicans were at odds, with the Bush tax cuts ultimately extended to all taxpayers. Democrats argued that eliminating the cuts to the high-income taxpayers would thereby protect the middle class. Republicans argued that extending the tax cuts to all taxpayers would benefit small businesses and jobs (McAuliff, 2012).

Regardless of whether the Bush tax cuts should be extended or not for high-income taxpayers, the marriage penalty in the proposal is blatant. Why should a high-income couple, who are living together but not married, get a lower tax rate than a high-income couple who are married? Since the proposal was to eliminate the Bush tax cuts (allow them to expire) for taxpayers with incomes of more than $200,000 for individuals, then to have no MPT, the income level for couples should be $400,000 (double $200,000), not $250,000 for couples.

Social and Economic Costs

Social and economic costs of the marriage penalty are many. One of the primary societal costs concern the impact on children. Social research has demonstrated that, on average, married couples provide a better-outcome environment for raising children. Children are less likely to be in poverty (Sheffield, 2012), more likely to avoid negative social outcomes such as under-education (McLanahan, 1996), violent crimes (Parker & Johns, 2002), substance abuse (Deleire & Kalil, 2002), incarceration (Jackson, 1997; Morse, 2003), and illegitimate births (Demuth & Brown, 2004). Whether a couple has children or not, marriage is also associated with better health and happiness (Raymond, 2011; Domonell, 2012).

According to Seton Hall University law professor John Coverdale (2007, p. 7), research on children and family structure shows: "[C]hildren raised in intact nuclear families have better outcomes on virtually every index than children raised in any other setting. This is demonstrated by numerous studies based on large national samples over extended time frames that control for other variables such as parents' race, education, and income level." Some might argue that a simple way to have a nuclear family and avoid the marriage penalty is to be unmarried parents, but this does not bode well for children. Statistics indicate that half of cohabiters split up in five years, compared to only 15 percent of married couples during this period (USA Today, 2005). A British study found that unwed parents were six times more likely to split up than married parents by the child's fifth birthday (Harris, 20011).

The negative social outcomes associated with the decline of marriage were well understood in 1965 when President Johnson warned that the breakdown of the family was the main threat to the well-being of African-Americans. The Moynihan Report (U.S. Department of

Labor, 1965) concluded that federal government programs would have the objective of "enhancing the stability and resources" of African-American families. In 1965, the percent of children born to unwed mothers was about 7 percent overall: 28 percent for African-American children compared to 4 percent for white children (Olshewsky & Smith, 2002). In 2009 the overall birth rate to unwed mothers was at 41 percent (72 percent for African-American children and 36 percent for white children), the great majority of whom were young and uneducated, those least able to support their children (Martin et al., 2011). The poverty rate for children in married, two-parent families is 6.8 percent versus a poverty rate for children in single-parent, female-headed families of 37.1 percent (Heritage Foundation, 2012a).

Repealing the MPT would benefit marriage, while reducing federal tax revenues. During times of record-setting federal deficits, anything that lowers tax revenues is carefully scrutinized. However, the economic benefits far outweigh the tax revenue loss according to research by Olshewsky et al. (2001). At the time of their study, elimination of the MPT would reduce tax revenues by $33 billion, but their analysis indicated that this would be offset by reductions in government expenditures on direct and indirect social program expenditures (e.g. drug rehabilitation and prison facilities).

CONCLUSIONS

This study builds on past research demonstrating how public policy such as tax and transfer programs, specifically the marriage penalty tax, negatively affects marital stability. While the MPT is found in many parts of the tax code, this study provided specific illustrations of the MPT in four parts of the tax code: Bias in the federal income tax rates, deductibility of real estate rental property losses, child tax credit, and earned income tax credit. In addition, this study shows the MPT bias in President Obama's proposal to increase tax rates on high-income earners. The MPT negatively affects married couples at all income levels, from the highest to the lowest. Why should any couple pay a higher tax, simply for the reason that they are married? The MPT defies logic and fairness, and harms individuals and society at large.

Decline of the family, especially married couples, is considered a fundamental problem of American society. Collapse of families is correlated to major social and economic costs, including poor education, reduced employment, crime, and health. Considering the harmful effects on society, the conclusion is that the MPT should be removed from the tax code. The MPT has a negative effect on couples at all income levels, but notably on the lowest income categories, especially the MPT bias regarding the earned income tax credit. Tax laws, as part of public policy, should foster, not hamper, two-parent families and their corresponding economic benefits such as improved employment, better public health, and lower crime.

A family unit is the key building block of civilization. Implementing a higher tax burden on married couples is not in the best interests of any nation. While taxes are a major political issue, eliminating the marriage penalty tax is something about which political parties should be able to find common ground. The strength of marriage and the family are essential to the future success of the American civilization.

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ANATOMY AND IMPACT OF BRIBERY ON SIEMENS AG

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ABSTRACT

The exposure of bribery by well regarded corporations to gain business contracts has seen a meteoric rise in recent years. The latest well known company to be accused of corruption in gaining business (in Mexico) is the world's biggest retailer—Wal-Mart. The rise in disclosure and prosecution of bribes and in general corruption can be traced to an aggressive enforcement of the Foreign Corrupt Practice Act (FCPA) by the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC). This paper examines the circumstances surrounding the largest penalty paid for bribes by Siemens AG (Siemens) for violating anti-bribery rules in United States and in its home country of Germany, and lessons learned which can be useful for other multinational companies. My findings show that management does not report activities that it considers detrimental unless legally required, and that even after a debilitating event, companies such as Siemens and others can recover by implementing strong and transparent anti-corruption internal controls that includes training.

INTRODUCTION

FCPA was enacted by the US congress in 1977 (amended in 1988 and 1998) in response to allegations that major U.S. corporations were bribing foreign government officials, politicians and political parties to attract business and to gain undue advantage. Interestingly, the bribery allegation came to surface during the Watergate investigations (O'Melveny Handbook, 2012). FCPA enactment was the first of its kind and led to growing number of anti bribery laws through the ratification of the Organization for Economic Cooperation and Development's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in 1998 (OECD Anti-Bribery Convention). The passage of the UK Bribery Bill in 2010 is the most recent act in connection with the OECD Anti-Bribery Convention (OECD, 2012). Essentially, being legally liable for bribery is a very recent phenomenon. More interestingly, before 1999 in Germany, corporations could deduct bribery payments as business expense (Schubert and Miller, 2012).

The U.S. Congress provided many justifications for passing the FCPA. Prominent among them are: (i) it is unethical and against the moral values and expectations of Americans; (ii) it erodes confidence in the much valued free market systems by directing resources to entities that are unable to compete on price, service and quality, and; (iii) it casts a shadow on all

American corporations whereby there is loss of reputation, loss of contracts, lawsuits, and possible seizure of corporation's assets in a foreign land (Unlawful Corporate Payments Act of 1977).

There are two parts to FCPA—(i) anti bribery and (ii) accounting provision—which are applicable to any person (issuer of U.S. securities, including non-public U.S. companies, U.S. residents, foreign non-residents) who directly or indirectly pays or promises to pay anything of value to a foreign official corruptly for influencing decision to obtain, redirect or retain business (O'Melveny Handbook, 2012). The accounting provisions require all issuer firms to keep their books and records in reasonable detail to accurately and fairly record all transactions and dispositions of their assets. Under the accounting provisions, issuers are also required to devise and maintain adequate accounting controls (O'Melveny Handbook, 2012).

Of the two enforcement bodies, DOJ is responsible for the criminal and civil enforcements as it relates to domestic concerns and foreign nationals, while the SEC is responsible for the civil enforcement as it pertains to issuers. There are two defenses to bribery allegation under the FCPA. The payment has to be (i) lawful under the country's laws, and or (ii) reasonable and bona fide expenditure such as travel and lodging expenditure for demonstration or explanation of the product or service to a foreign official. Also, payments made to expedite routine governmental actions such as permits, licenses, postal services, customs, and electrical connections are allowed. They are called grease or facilitating payments.

FCPA violation(s) may result in criminal and civil prosecutions by the DOJ and other actions by the SEC. First, in criminal prosecutions, business entities can be fined up to $2 million; officers, directors can be fined up to $100k and be jailed for up to five years. Violators can be also subject to alternative fines act which can result in fines up to double the amount of the benefit received. Civil violations can result in fines up to $100k for a natural person and up to $500k for any other person. The SEC can also bring action to enjoin the offending act against the business entity or the persons who act on its behalf. Moreover, the guilty party may be barred from doing any business with the federal government. Essentially, violation of the FCPA is not a slap on the wrist; it can substantially cripple the organization and or result in jail and ultimately loss of job and reputation for the officers/agents (Foreign Corrupt Practices Act, 2012). Until 1998 there were few prosecutions under the FCPA, however since then, prosecutions have increased many times over with peak number of cases filed in 2007. For example, there were 3 cases against companies (7 against individuals) in 2002, while there were 27 (16 against individuals) cases in 2007 (O'Melveny Handbook, 2012). While Wal-Mart is the latest big name company being investigated by DOJ/SEC, over the years many prominent firms (and individuals) such as: Halliburton Co., Smith and Nephew PLC, Diageo PLC, IBM, Johnson and Johnson, Daimler AG, Monsanto, BAE Systems, Avon, Alcatel-Lucent, Bridgestone Corporation, General Electric Company, Chevron Corporation, Lockheed Corporation, and Tyson Foods have come under the bribery scanner (FCPA and Related Enforcement Actions, 2012). Unfortunately, the list keeps growing; as of March 2012, the SEC is investigating 81 companies for possible FCPA violations (The FCPA Blog, News and Views about the United States Foreign Corrupt Practices Act, 2012). Generally, the offending companies tend to settle with DOJ/SEC by paying fines and implementing strong anti bribery controls. In addition to the Siemens anti bribery action, the United Nations Oil-for-Food Program in Iraq ensnared many prominent companies and their foreign subsidiaries. In Iraq, a humanitarian program was set up to provide food and relief to Iraqis from sanctions that followed against the Saddam Hussein led government following Iraq's invasion of Kuwait in 1990. Through this program, the Iraqi government could purchase food, medicine and critical infrastructure supplies by selling its oil. There was widespread corruption in this program, because the top Iraqi officials required anyone doing business with them to provide a 10% kickback. Entities that did business with Iraq under this program simply recouped the 10% kickback by adding "after sales service fee" in their bids or contracts with the Iraqi government. There were many prominent companies which participated in this scheme (SEC vs. ABB Ltd., 2010).

Generally, corporations investigated for FCPA violations experienced damaged reputations as well as a decline of 8.9% in their share prices (Karpoff et al., 2012). Moreover, Cheung et al. (2011), found that worldwide firms that win contracts by paying bribes underperform their peers from up to three before and three years after winning the contract for which the bribe was paid.

As stated previously, of all the companies charged for violating the FCPA, Siemens has paid the biggest price for its corrupting activities. It is estimated that Siemens paid about $1.6 billion dollars in penalties, fines, and disgorgement of profits to the SEC, DOJ and German authorities. So far this is the largest penalty/fine paid by a company for FCPA violations (Siemens AG and Three Subsidiaries, 2008). The goal of this paper is to examine the circumstances surrounding this case followed by an analysis of lessons from such violations of the FCPA.

BACKGROUND: SIEMENS AG BRIBERY CASE

Beginning in mid 1990s and through 2007, Siemens and its subsidiaries paid approximately $1.36 billion in bribes to win contracts in Venezuela, China, Israel, Bangladesh, Nigeria, Argentina, Vietnam, Mexico, Greece, Iraq and Russia. Of the $1.36 billion; $554.5 million was paid for unknown purposes and the remaining was paid to foreign officials through cash desks and slush funds. This was done through falsification of corporate books and records and knowingly failing to implement internal controls (Siemens AG and Three subsidiaries, 2008).

The most prominent of these payments was in connection with the National Identity Card Project in Argentina. Around 1994, the Government of Argentina issued tender for bids for a state of the art national identity card. In 1998, Argentina awarded the identity card project to Siemens (Argentina subsidiary) for approximately $1 billion. Thereafter, Siemens started making payments to an entity called Argentine Consulting Group, which provided no legitimate services on the project. These payments were to Argentine government officials for awarding the project to Siemens. In 1999, in the midst of a presidential campaign, Argentina put the project on hold. After the election, the new government informed Siemens that the project has to be renegotiated otherwise the project would be terminated. After the renegotiations, the top government officials said they would issue a decree that required all citizens of Argentina to get new identity cards. Thereafter, Siemens agreed to pay \$6 to \$10 million to those officials who would have issued the decree. However, the decree was never issued and the national identity card project was cancelled in 2001. From 1997 to 2007, Siemens paid at least \$15.73 million to entities that were controlled by Argentine officials, \$35.15 million to Argentine Consulting Group and \$55 million to other entities. It was well known to Siemens employees that these were improper payments. The cancellation of the project resulted in arbitration between Siemens and Government of Argentina. In 2007, Siemens was awarded \$217 million through the International Center for Settlement of Investment Disputes (ICSID) against Argentina. In connection with these corrupting activities; SEC and DOJ brought charges against Siemens and its Argentina affiliate, Siemens executives and other intermediaries/consultants who were part of the conspiracy to bribe Argentine officials.

In late 2011, DOJ and the SEC charged nine former Siemens executives and agents with conspiracy to violate the FCPA and the wire fraud statute; money laundering conspiracy and wire fraud (SEC Charges Seven Former Siemens Executives, 2012). The nine charged executives and agents were as follows:

(i) Uriel Sharef – managing board member from July 2000 to December 2007. He met in United States with payment intermediaries and agreed to pay \$27 million in connection with the Argentine national identity card program.

(ii) Ulrich Bock – head of major projects for Siemens Business Services from October 1995 to 2001. He authorized payments to Argentine government officials.

(iii) Stephan Signer – he replaced Bock and also authorized payments to Argentine officials.

(iv) Herbert Steffen – CEO of Siemens Argentina from 1983 to 1989 and again in 1991, and group president of Siemens Transportation Systems from 1993 to 2003. He directly met with Argentine officials and offered bribes.

(v) Andres Truppel – CEO of Siemens Argentina form 1990 to 2002, communicated with Argentine officials regarding bribe payments, also participated in meetings where bribes were negotiated and promised.

(vi) Carlos Sergi – board member of Siemens Argentina and also a consultant who served as intermediary for payments between Siemens and the Argentine officials.

(vii) Bernd Regendantz – Chief Finance Officer of Siemens Business Services group who authorized bribe payments on Siemens' behalf.
(viii) Miguel Czysch – served as an intermediary on Siemens' behalf.
(ix) Eberhard Reichert – technical head of Siemens Business Systems.

ANALYSIS

Siemens which is founded in 1847 is one of the largest companies in the world with market valuation of $72 billion dollars. It is considered to be very similar to General Electric with products and services in Energy, Healthcare, Industry, Infrastructure, Financial Services, Real Estate, Home Appliances, Telecommunications, and Communication networks (Siemens: Our Business, 2012).

Spokesperson for German investigators stated that "[b]ribery was Siemens' Business Model" and that "Siemens had institutionalized corruption" (Schubert and Miller, 2008). Bribing by Siemens may have started right after World War II. During the war the company's factories were bombed and its intellectual property confiscated. Thus, the company turned to bribery as a sales technique to gain access to less developed countries in order to stay in business. Before 1999, bribes were deductible business expense and not a crime in Germany. It all changed in February 1999 when Germany became signatory to the OECD Anti-Bribery Convention (Germany OECD, 2012).

The bribing culture was so embedded at Siemens that when one of Siemens's former mid level executive—Reinhard Siekaczek—was interviewed by a newspaper, he stated that he would never go to jail and thought if his and others actions became public, they all would go to the jail and play cards (Schubert and Miller, 2008). Mr. Siekaczek had an annual budget of $40-50 million for bribing. He states that these moneys were vital for maintaining Siemens' competitiveness overseas. He further elaborated that bribing helped to keep the business unit alive and not jeopardize thousands of jobs at Siemens.

The most prominent of the indicted Siemens executive was Uriel Sharef. Dr. Sharef completed his Economic and Social Sciences studies at Sydney University, Australia, and earned his doctorate at University of Fribourg in Switzerland. He joined Siemens in 1978, and finished his Siemens career as a member of the Siemens Managing Board in 2007 (Businessweek: Executive Profile & Biography, 2012). Under German law, the Managing Board is similar to the top management team of U.S. Corporations. The duties of the Managing Board are the "management of the Company and decide basic issues of business policy and corporate strategy as well as on the annual and multi year planning" (Siemens Annual Report, 2011). More importantly, the Managing Board is responsible for monitoring the company's adherence to statutory provisions, official regulations, and internal company policies. The Managing Board closely works with and provides information to the Supervisory Board (similar to Board of Directors of US corporations) of company's strategies, financial position, earnings, compliance and risks. Essentially, Dr. Sharef was part of the small group of powerful leaders at Siemens. While a member of the Managing Board, Dr Sharef was also responsible for managing the Power Generation, Power Transmission and Distribution groups and the Americas.

American authorities in their complaint alleged that Siemens won the bid for the Argentine national identity card in 1998 with litigation related to it finally ending in 2007 (SEC vs. Sharef et al., 2011).

In 1999, the President/CEO of Siemens emphasized that each business unit must earn a profit more than its cost of capital and in order to do that each business unit must hold top positions in their world markets. He concluded that the company is evolving into a highly flexible, *transparent* (emphasis added) growth oriented business. The Annual Report also stated that the company held its regular supervisory meetings whereby it interacted among Supervisory Board members and the members of the Managing Board. They also discussed the auditors report. There is nothing unusual noted in the Annual Report. In terms of risk assessment, the report noted that each business unit is responsible for its own risk management, but is helped by the staff departments to control risk through exercise of policy, coordination and management authority. The report added that *internal auditors* (emphasis added) regularly review the adequacy and efficiency of their risk management and control systems. Finally, the report showed that Dr. Sharef oversaw the Power Transmission and Distribution groups (Siemens Annual Report, 1999).

There seems to be nothing out of the ordinary except that, in 2000, the Power Generation and Transportation group had posted a loss. In 2000, Dr. Sharef was appointed to the Managing Board and to the Corporate Executive Committee. The Corporate Executive Committee is responsible for the worldwide internal control and risk management systems and its effectiveness. The goal of the risk management system is to ensure accurate and prompt accounting for all business transactions and to identify risk. (Siemens Annual Report, 2002). Again, the Annual Report noted no objections in its audit (Siemens Annual Report, 2000).

In 2001, the President/CEO reasoned that worldwide slowdown in business due to World Trade Center bombings and the upheaval in communication and information fields affected Siemens' performance. The report stated that company's six business areas are responsible for their own operations. Supposedly, the decentralized structure for each business unit at Siemens provided the units an opportunity to use its entrepreneurial skills to be close to their customers. I wonder if this lead to oversight problems that come to fore in few years. As previously stated, the company wants its units to be either number one or be second in their markets. I believe this put tremendous pressure on its business unit leaders to do well at any cost including bribing. Most importantly, the annual report mentioned the write-down (contract loss) of about 258 million euros in connection with production and outsourcing contract for a border control system in Argentina. It also stated that the contract was cancelled by an Argentina government decree (Siemens Annual Report, 2001).

The Siemens Annual Report (2002) stated that the company is committed to implementing the highest standards of corporate governance, and aims to be a good corporate citizen. The company also has code of ethics that is required to be followed by the members of the Managing Board and all Siemens employees worldwide. The letter to the shareholders also discusses that generally the confidence and trust in respected institutions has crumbled worldwide and restoring trust is now on the top of the company agenda. The Managing Board's goal is to provide transparency and welcomes the media and public policy arenas on strengthening corporate management and oversight systems. The letter emphasized Siemens' commitment to improve profitability beyond the target margins already defined. Ominously, it reported that the Latin market is extremely difficult.

In the 2003 Siemens Annual Report, the President of the company stated that we have established a highly transparent internal and external reporting system; and that integrity guides the company's conduct towards its employees, business partners and shareholders.

In 2004, Siemens adopted new by-laws for the Supervisory Board and its committees to reflect the requirements of the Sarbanes Oxley Act (SOX) and the revised German Corporate Governance Code. Again, according to the Annual Report, the Managing Board implemented a new risk assessment system which met all legal requirements. However, for the first time, company selected independent members on the Audit Committee, and the Supervisory and Managing Boards (Siemens Annual Report, 2004).

In 2005, the firm selected a new President/CEO and stated in its vision that it wants to uphold humanity, equal opportunity and strict ethical standards in all its businesses. While discussing its corporate responsibility, Siemens emphasized its goal of becoming the best-in-class in corporate governance, business practices, sustainability and corporate citizenship. The company again stated that it intends to grow twice the world economy. The firm reaffirms its commitment to corporate responsibility. The Siemens Business Services group faced problems and posted loss of 690 euros in 2005. Siemens again stated that its disclosure controls and procedures and its internal controls over financial reporting is effective The Siemens Business Services group was headed by Dr. Sharef at one time (Siemens Annual Report, 2005).

In 2006, except for the Siemens Business Services group, every group reported strong growth. More importantly, the bribery investigation is reported to the shareholders for the first time. Siemens management does a mea culpa, and states that "it has now become clear to us that our compliance measures are not yet sufficient, that several former and current Company employees are under investigation regarding allegations of embezzlement, bribery and tax evasion. The company hired a NY based law firm to start the investigation related to bribery and other violations. Also, a Managing Board member who was also the firm's Chief Financial Officer left the company. Due to the investigations, the company launched a new comprehensive, interactive online compliance course that will be completed by all senior executives in Germany, established a new communication channel via an ombudsman and set up a special task force to be headed by the Chief Compliance Officer to propose additional measures to end lapses on the part of individuals. Interestingly, Dr. Sharef is still photographed as one of the members of the Managing Board in the Siemens Annual Report (2006). Also, the Annual Report noted that the firm has been honored to be listed on the Dow Jones Sustainability Index (DJSI) for seventh year in a row. DJSI, launched in 1999, tracks stocks of firms in term of their economic, environmental and social criteria and assists investors who have interest in investing in firms with good sustainability practices (Dow Jones Sustainability Indexes, 2012).

In 2007, the company finally started anew and made meaningful and transparent leadership changes. The Chairman of the Supervisory Board and the President/CEO of the Company resigned. The new and the current President/CEO is Peter Loscher—a complete outsider to Siemens. Also, and probably more importantly the company created a managing board position for legal and compliance matters and hired Peter Y. Solmssen to head it. Other members of the Supervisory Board and Managing Board also departed and were replaced. Dr. Sharef continued to be member of the Managing Board. The firm also created a central helpdesk to which employees could direct compliance related questions regarding proper ethical behavior by them and their external business partners. Other changes that were made pertained to the Compliance Program with the goal of Prevent, Detect and Respond to bribery, and are listed below:

(i) Moratorium on Business Consulting Agreements, exceptions had to be approved in writing by a senior manager and Chief Compliance Officer.
(ii) Introduced new guideline regarding anti-public corruption compliance.
(iii) Created new polices regarding “retention of intermediaries who interact with the government on Siemens’ behalf, compliance in M&A transactions, joint ventures and minority investments, and gifts and hospitality.”
(iv) Implemented a centralization of its cash and management systems.
(v) Established a corporate Disciplinary Committee to dispense with disciplinary measures for violation of law or company policy or misconduct.
(vi) The company also adopted a global amnesty program for employees who voluntarily provided information regarding corruption. Senior Management was not eligible for amnesty.

Additionally, 1,400 senior executives were trained regarding fighting corruption and antitrust laws. The company expected another 100,000 employees to complete its web based training regarding compliance. Finally, the company requested arbitration against Government of Argentina in its ongoing litigation regarding the cancelled National Identification Program (Siemens Annual Report, 2007).

In 2008, Dr. Sharef was finally removed from the Managing Board along with five others (four had left on December 31, 2007 and one on April 30, 2008) and Siemens created history by appointing the company’s first female and first Corporate Legal and Compliance officer to its

Managing Board. These changes and efforts of the new management team paid off as the company received the highest ratings possible for risk management, compliance and protection of shareholders' interest. This recognition is remarkable because Siemens had the lowest ratings for the three categories described in 2007. The new President/CEO proclaimed that our goal is to be leader in compliance and to conduct itself ethically at all times in all places (Siemens Annual Report, 2008).

In March 2008, the company introduced a comprehensive compliance control systems in designated high risk units. The high risk units were companies with large business volumes, public-sector customers and regions/locations that are particularly susceptible to corruption as identified by Transparency International. The company also upgraded the IT based process for approving customer projects particularly for public sector customers. The company also started an intranet website with compliance section where employees can find current compliance information and contacts. It is called the Help Desk, with functions such as "Tell Us, Ask Us, and Find It." The company also conducted an anonymous online survey of approximately 90,000 employees to assess employee awareness of its compliance issues and received feedback. Also, the company revamped its management structure. The company's new organizational structure has three sectors and two Cross-Sector businesses. The three new sectors are Industry, Energy, and Healthcare. The Cross-Sector businesses groups support the three sectors in finance and information technology. The bribery investigation by the DOJ/SEC and German governments ended in 2009.

As stated earlier, Dr. Sharef and others were sued individually for violating FCPA by the DOJ and SEC in December 2011. There has been no resolution of this matter as of yet.

Today, Siemens is guided by its three values: (i) Responsible—committed to ethical and responsible actions, (ii) Excellent—achieving high performance and excellent results, and (ii) Innovative—being innovative to create sustainable value (Frequently Asked Questions, 2012).

LESSONS LEARNED

There are many lessons that can be learned from the Siemens bribing experience. First, the culture of an organization plays a big role in its actions. It seemed that all managers and executives were partaking in this behavior for the longest time. The only way the world learned of Siemens bribing was due to the passage of FCPA in USA, and Germany becoming signatory to the OECD convention on bribery in 1999. Outsiders still do not know how far back bribing became a business strategy for Siemens. As some have stated, it could have been as far back as World War II.

Second, when a practice is entrenched, the only way to get rid of it is to bring in outsiders. At Siemens, effective changes began only when it hired an outsider as its President/CEO, created a new position of Legal and Compliance Officer, and selected its first female managing board member. What was galling was that while all the investigations related to bribery were on-going, Dr. Sharef continued to be part of the company's managing board for a long period of time.

Third, management tends to lie or chooses not to be forthcoming unless legally required to in their corporate documents. Siemens' Annual Reports always stated that everything was fine, They practically certified in every Annual Report that the company's risk management is adequate, that it complies with German and SOX laws and its audit reports are certified by outside auditors. If it were not true, it sounds comical. Stakeholders have to examine beyond what is told to them by managers and look beyond the shiny brochures/website and stockholders' meetings. Stakeholders should seek independent verification of statements/reports provided by managers.

Fourth, in short term, while illegal and unethical acts may seem beneficial, but almost always they end up costing the firm and the shareholders more than the benefits gained. The fines and costs related to Siemens's grafts were approximately $1.6 billion. The company never received business close to that number.

Fifth, in countries where corruption is a way of life, it still very difficult for organizations to get a fair shot at winning bids. Siemens was only one of the many major organizations worldwide who resorted to bribing to enter markets or win bids for major projects. The only way to do business for international companies in countries prone to corruption (as provided by Transparency International) is to work together to prevent corruption in accordance with the international laws (such as OECD's anti bribery provision). Otherwise, companies that are ethical and follow laws will be unable to bid successfully. Not having a fair and transparent bidding process will ultimately hurt the consumers in those markets, whereby the product will be more costly, of lesser quality/variety and in some cases unavailable.

Sixth, and probably the most important lesson is that the quality of leaders an organization has matters. When hiring, companies should ask their potential hires questions that also pertain to ethics and decision making that requires difficult trade-offs. This is crucial because major organizations are now extremely globalized and its employees have different value systems. The results of the ethics tests should be analyzed and be part of the hiring and promotion process.

The seventh and final lesson is that companies need to be aware of changing laws and norms of the society. Thus companies should periodically update their policies and effectively disseminate them to employees at all levels. Of course, the top managers have to ensure that employees take the training and new information seriously.

CONCLUSION

The experience of Siemens shows that there are significant costs associated with bribing. Not only does the company lose its reputation but also its shareholders' incur litigation costs and wasted business opportunities. The overarching lessons for organizations are that they need to be aware of the changing social and legal norms of countries in which they conduct their business, and prepare their workforce including its senior management accordingly.

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