The Ethics of Record Destruction

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This paper attempts to analyze an unnamed charity's journey for increased transparency and governance. Several potential misstep scenarios are discussed. The names of parties and organizations involved have been changed. The literature review overviews complexities associated with accounting/ organizational performance situations and introduce an ethical model for possible outcome determination and other discussion based considerations. This study articulates the evolution of ethics at both the unnamed charity and with its external and internal stakeholders and presents questions regarding the contextual approach of management, external auditors, and internal parties.

INTRODUCTION

In the introduction to an undisclosed charity's 2011 Stewardship Report, a statement is made that "We believe the public is entitled to know how we are performing against our stated business goals and evidence-based mission outcomes and how we hold ourselves accountable" (Undisclosed Charity, n.d.). At a time when donors and volunteers have more charitable choices than ever, the Charity's management and staff understand the obligation of the organization to demonstrate overall effectiveness to those key stakeholder groups.

While performing audit procedures over trust agreements associated with the 2011 annual external audit of the undisclosed charity's financial statements, it was noted that trust accounting statements that management did not specifically use in the annual financial statement presentation were shredded. This paper provides additional context and addresses the specific question "is it ethical to shred accounting statements not specifically used by management for annual financial statement presentation?"

"Some donors enter into trust or other arrangements under which nonprofit entities receive benefits that are shared with other beneficiaries" (American Institute of Certified Public Accountants, 2011). There are several stakeholders associated with these trust arrangements, including the nonprofit management, the nonprofit board, individual donors and their family members or other beneficiaries, and in some cases, based on individual state law, any interested individual in the state. "The assets that fund such arrangements are sometimes managed by the charity, sometimes by a third-party trustee" (Gross, M., McCarthy, J., Shelmon, N., 2005). Accounting statements are prepared by the third-party trustees' and include details to support any activity that has occurred for the trust assets, such as payments to beneficiaries, administrative fees, and investment activity. The activity detailed in these accounting statements can be used for both financial and fiduciary or operational purposes.

The question is an ethical dilemma primarily because uncertainty exists whether one can consider financial performance separate from how corporations communicate with different stakeholder groups and an imbalance may exist in the various stakeholder groups' expectations for proper stewardship of donations. An argument can be made that any accounting information not specifically used to determine financial performance as represented in the financial statements can be handled in any manner the organization management deems adequate. A counterargument exists that financial information obtained in the current year which could be used by a stakeholder group to assess financial or even operational performance should be maintained.

The question is also an ethical dilemma because "legitimacy theory and corporate social responsibility studies have found evidence to support the notion that firms use communication or accounting to defend or maintain legitimacy in the eyes of society and/or their stakeholders (Tilt, 2009). The ethical question considered in this paper arose because the Chief Financial Officer directed accounting staff to shred all account statements not specifically used by management in their calculation of the year-end trust receivable balance in order to avoid spending resources answering questions regarding activity that occurred prior to year-end but not used by management in the year-end financial statement balance (undisclosed VP, personal communication, July 14, 2011).

The area being audited was the year-end receivable estimate calculated by management for the Charity's beneficial interest in trust assets. The AICPA Audit and Accounting Guide for Non-Profit Organizations defines a beneficial interest in section 6:01 as "a benefit or advantage shared with other beneficiaries as a result of a trust or other arrangement" (American Institute of Certified Public Accountants, 2011). When the undisclosed Charity is named in a trust agreement, a receivable is recorded based on the fair market valuation. Determination of fair value is governed by Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements, (now codified in Topic 820 of the Financial Accounting Standards Board Accounting Standards Codification (ASC)). The context and terminology mentioned in this paper and key stakeholder interests should be considered when addressing the question "is it ethical to shred accounting statements not specifically used by management in the year-end audit?"

LITERATURE REVIEW

The process of keeping records involves consideration of legal requirements, ethical standards, and other external constraints, as well as the demands of the particular professional context. The professional context for the ethical question under review is a large nonprofit charitable organization. In June 2005, the Panel on the Nonprofit Sector issued a final report to Congress titled *Strengthening transparency, governance, and accountability of charitable organizations*. The Panel on the Nonprofit Sector is an independent effort by charities and foundations to ensure that the nonprofit community remains a vibrant and healthy part of American society. "Formed by Independent Sector in October 2004 at the encouragement of the U.S. Senate Finance Committee, the Panel prepared a series of recommendations for Congress to improve the oversight and governance of charitable organizations and for individual nonprofit organizations to ensure high standards of ethics and accountability" (nonprofitpanel.org, 2012).

The "heart of the report is its recommendations, which offer a comprehensive approach to improving transparency and governance" (Independent Sector, 2005). The report unfortunately does not address record keeping recommendations for accounting statements not directly pertinent to the year-end financial statements. Additionally, the only nonprofit governance and/or accounting legislation that has occurred since the 2005 report is the revised requirements for Form 990 which will be discussed later in this chapter.

In his book titled *Transparency* Warren Bennis states, "when we speak of transparency and creating a culture of candor, we are really talking about the free flow of information within an organization and between the organization and its many stakeholders, including the public" (Bennis, 2008). Bushman, Piotroski and Smith (2004) investigated corporate transparency and found reasons for how and why corporate transparency varies. They concluded that consideration of both governance transparency and financial transparency required distinction between mandatory and voluntary corporate reporting.

This paper is grounded using literature review of the ethical branch of stakeholder theory, which extends the argument of legitimacy and suggests that an organization is the vehicle for coordinating all stakeholder interests and management has a fiduciary relationship to all stakeholders (Tilt, 2009). O'Dwyer views accounting as "a mechanism aimed at enhancing corporate accountability and transparency to a wide range of external stakeholders, while addressing the social, environmental and ethical concerns and values of individuals upon whom a business has a non-economic impact" (2006, p. 220). Striking a balance in the delivery of stakeholder expectations associated with various legitimacy demands highlights the context for the particular ethical question raised in this paper.

The International Accounting Standards Board "IASB" established a framework for the *Preparation of Financial Statements*. The board stated "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions" (ISAC, 1989, para. 12). The framework acknowledged that "financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information" (ISAC, 1989, para. 13).

In addition to reviewing the accounting standards relating to this transaction, it is also important to review the document retention requirements. The Internal Revenue Service "IRS" recently revised the requirements for Form 990. This was the first revision since 1979. The IRS explained the reasons for the change in a background paper, stating "The Form 990 is a public document that is the key transparency tool relied on by the public, state regulators, the media, researchers, and policymakers to obtain information about the tax exempt sector and individual organizations" (Internal Revenue Service, n.d.). Among the new questions on the Form 990 is the inquiry "Does the organization have written policies on conflicts of interest, whistleblowers, and document retention?" (Green, J., Moskowitz, S., Bakale, A., 2009). The new questions are raised not only to address if the policies are in place but also "how the policies are enforced" (Green, J., Moskowitz, S., Bakale, A., 2009).

Section 404 of the Sarbanes-Oxley Act resulted in the creation of new document retention requirements. A publically traded company "must maintain evidential matter, including documentation, to provide reasonable support for the assessment of internal control" (Sneller, L., Langendijk, H., 2007). Compliance with section 404 of the Sarbanes-Oxley Act is not a current legal requirement of nonprofit entities. However, stakeholder expectations dictate voluntary compliance. Finally, the "Code of Professional Conduct of the American Institute of Certified Public Accountants consists of two sections: 1) the Principles and 2) the Rules (Duska, R., Duska, B., 2003). Compliance with the Code of Professional Conduct, as with all standards in an open society, depends primarily on members' understanding and voluntary actions.

This chapter reviewed the academic and professional literature related to the ethics associated with record destruction. The literature demonstrates there is guidance but often not a mandatory compliance requirement for retention of information not specifically used in the audited financial statements. The literature explores the concept of management of stakeholder interests in the nonprofit sector, which support the origins of the ethical dilemma raised in the first chapter. The next chapter will introduce an ethical model by which the question of shredding documents given the aforementioned criteria can be further analyzed.

ETHICAL DECISION METHODOLOGY

In order to address the ethical dilemma outlined in the introduction of this paper, review and consideration of business and accounting ethical decision methodologies was necessary. The context and terminology previously outlined in this paper and the balance of multiple nonprofit stakeholder interests requires application of an ethical decision making methodology to arrive at an acceptable answer when addressing the question for an accounting practitioner perspective of "is it ethical to shred accounting statements not specifically used by management in the year-end audit?"

The American Accounting Association "AAA" adopted an ethical decision model. The AAA model comes from a report written by Langenderfer and Rockness in 1990 (Langenderfer, H., Rockness, J., 1990). In the report, they suggest a logical, seven-step process for decision making, which takes ethical issues into account.

The AAA model includes the following steps: Step 1. *Determine the facts.* This step means that when the decision making process begins there must be no ambiguity about what is under consideration. Step 2. *Define the ethical issues.* This involves examining the facts of the case and asking what ethical issues are at stake. Step 3. *Identify major principles, rules and values*. This step involves placing the decision in social, ethical and professional behavioral context. In the last context, professional code of ethics is considered. Step 4. *Specify the alternatives*. Step 5. *Compare values and alternatives and see if the decision is clear*. When step 5 is complete, it should be possible to see which options align with the norms and which do not. Step 6. *Assess the consequences*, and Step 7. *Make the decision*. (Langenderfer, H., Rockness, J., 1990).

Cavanagh *et al.* (1981) identified three basic ethical philosophies, each of which represents a unique component of ethical situations faced by individuals in business organizations. The first is utilitarianism. The second philosophy is individual rights. This philosophy focuses on protecting individual rights such as the right to be informed or the right to due process, etc. The third ethical philosophy is justice. Such an ethical system stresses social justice and the opportunity for all individuals to pursue happiness.

Fritzsche and Becker (1984) concluded that most individuals allow one of these philosophies to dominate their ethical decisions with the utilitarian philosophy being dominant among business managers. Accountants frequently invoke cost/benefit methods into their discussions and evaluations of various topics. "Utilitarianism rests on the idea that the ends justify the means, but this is logically equivalent to the notion that one should engage in projects in which the benefits exceed the costs" (Armstrong, M., Ketz, E., Owsen, D., 2003). A limitation of utilitarianism is that while it seeks to bring about the greatest good for the greatest number, it has no way of protecting minority interests. As such, utilitarianism will be incorporated in the model as a potential reason for the management action that led to the ethical dilemma, but will not be the sole consideration for answering the ethical question.

Deontology focuses on moral obligation, rights and duties, and examines the act itself, not just the consequences of the act. "Deontological concepts are often applied in accounting courses, because emphasis in accounting is on principles (e.g. matching and revenue recognition) and ''the right way to do it,'' regardless of the consequences" (Armstrong, M., Ketz, E., Owsen, D., 2003). Deontology application is limited for the ethical dilemma associated with shredding accounting documents not used in the year-end financial statement presentation because the question requires consideration of uses for the shredded documents outside of the year-end presentation. However, deontological concepts will also be incorporated to discuss the results of selection of potential courses of action identified through application of the decision making model.

In an attempt to resolve the ethical dilemma in answer to the question "is it ethical to shred accounting statements not specifically used by management for annual year-end audit financial statement presentation?" a modified AAA ethical decision making model will be utilized as a cornerstone using all seven steps of the AAA model but expanding steps 1,4, and 6 to include application of basic normative philosophical theories coupled with consideration of pragmatic tools for assessing legal and corporate political system implications.

ETHICAL DECISION

The question "is it ethical to shred accounting statements not specifically used by management for annual financial statement presentation?" will be applied further through this chapter and a decision will be identified. The modified AAA ethical decision making model will be utilized and any decision reached.

Step 1's requirement is to *determine the facts.* The facts are the auditor has been informed current year monthly accounting statements not specifically used by management in the year-end financial statement presentation were shredded. The facts surrounding the question also include management's position that the decision was made to shred documents because management did not use those statements for the annual audit purposes and does not want to spend additional resources answering questions that may be raised by the auditor during an assessment of the year end valuation of trust receivable calculations. Operational usefulness is however also provided through the monthly review of the accounting statements not utilized in the year-end financial statement presentation. Investment activity can be analyzed, trustee performance and even abuse can be detected, and an analysis of monthly income and expenses and status of beneficiaries can occur. These operational considerations are deontological concepts included in consideration of the facts. Management's justification of the shredding based on a perceived cost savings associated with the external audit resources is a utilitarian concept that will also be considered.

Step 2's requirement is to *define the ethical issues***.** The ethical issue is whether or not management directed the shredding of accounting documents for a purpose other than reducing the potential for additional resources in time and money by addressing questions that may arise through review of the statements in the normal course of year-end financial statement audit efforts.

Identification of major principles, rules and values occurs in Step 3. This step will be expanded to include legal rules and corporate requirements. The norms, principles, and values are management has a fiduciary duty to stakeholders to have impeccable integrity and to ensure the company is providing a 'true and fair view' of its financial situation at the time of the audit. Auditors are entrusted with the task of opining on a company's financial accounts and anything that prevents or interferes with an auditor's due diligence could lead to a failure of the auditor's duty to stakeholders.

Since the undisclosed Charity operates as several independently chartered entities, state law in each chartered location has an impact on how fiduciary responsibilities are articulated and enforced. The undisclosed Charity complies with California state law as a minimum governance standard. In the context of California charities, the State of California considers charitable funds to belong to the public. Directors of nonprofit public benefit corporations have a statutory duty of care and according to California Corporate Code § 5231, "Directors must use such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances. This duty requires familiarity with the organization's finances and activities and regular participation in its governance" (CAL Corp Code § 5231). According to California Probate Code section 16047 a "duty of care is imposed on trustees in the State of California. A trustee in California has a standard of care for investment and management of the trust's assets" (CAL Probate Code § 16047).

The Charity's code of ethics states "consistent with the provisions of any applicable document retention policy, no associate shall falsify, destroy, mutilate, conceal, or fail to make required entries on any record within the associate's control, including the destruction of documents that are the subject of an investigation or a civil or criminal action to which the Charity is a party" (Undisclosed Charity, n.d.).The record retention policy at the undisclosed Charity does not address the requirements specific to trust agreements and their supporting documents which include monthly trust accounting statements. The record retention policy does indicate that any destruction of records requires thirty days advance notice to all interested parties so that all parties are involved in the destruction decision (Undisclosed Charity, n.d.). While it is not known if management was familiar with the record retention policy, thirty days advance notice was not provided to potential interested parties, including the internal and external auditors and legal staff responsible for management of probate trust assets.

Step 4 involves specification of *the alternatives*. Option one is to not order the destruction of records that may raise questions and require resources to address. Option two is to determine the records can be destroyed because the operational usefulness does not outweigh the potential cost of addressing questions that may result in a change in the year-end financial statement valuation and the activity is not deemed potentially illegal. Option two can be selected if it is determined that fiduciary responsibility is not violated by the activity and if stakeholders are willing to require external and internal auditors to spend additional resources obtaining the shredded accounting statements directly from the independent third party trustee if they have an interest in review of the content.

Step 5's requirement is to *compare values and alternatives and see if the decision is clear*. The course of action most consistent with the norms, principles, and values in Step 3 is to not shred documentation because it is a violation of both the Charity's record destruction principles for notification of interested parties and it is a potential violation of California state law because it weakness the ability of the undisclosed Charity to demonstrate duty of care in investment and management of trust assets.

Step 6's requirement is to a*ssess the consequences.* As a result of option one, management would not direct the destruction of records that may raise questions and require resources to address. Management may spend additional resources in time and money to address any questions that arise during the year-end audit procedures. Management may be forced to admit an error in accounting valuation.

From a transparency and corporate governance perspective, the fact that management directed documents to be shredded for the sole reason of reducing questions that may be asked by an auditor during the year-end financial statement audit should naturally lead any donor, investor, partner, employee, or other stakeholder to ask "what else would they shred when it really matters, or what else have they already shredded?" Option one would allow management to maintain and enhance the reputation and social standing of the organization, maintain public confidence in the audit results, and would serve the best interests of most stakeholders.

As a result of option two, management would risk being in both reputational integrity jeopardy and legal trouble if the destruction of the records was made public to key stakeholders. Documents and records can be: The smoking gun proving fraud, lack of oversight or mismanagement of assets, employment discrimination, sexual harassment, conflict of interest, etc. The evidence that disproves fraud, lack of oversight or improper management of assets, employment discrimination, sexual harassment, restraint of trade, conflict of interest, etc.

One other consequence to address is whether or not the management direction to shred was profitable. This question ties to the normative theory of utilitarian and is of interest to accounting professionals because it addresses the topic of profitability and cost versus benefit. The total hours spent researching questions and spending resources for external audit additional questions in the prior year for the area of trust accounting is best estimated at what was tracked by Internal Audit at 75 hours. Using a blended charge rate for external audit resources of $180 per hour, the benefit of shredding accounting can be estimated as $13,500. In an organization where the annual fees are approximately $1,500,000 annually, the benefit of shredding documents that may raise legal and transparency or governance questions does not outweigh the cost.

The final step of the AAA model is to *make the decision*. Therefore, the final decision reached through application of the model is the management action identified in the question of "is it ethical to shred accounting statements not specifically used by management in the year-end audit?" is deemed unethical. Management should be open to questions and should demonstrate accountability, transparency and proper governance practices.

IMPLICATIONS

Management's decision to direct the shredding of accounting statements they did not feel were pertinent to the year-end financial statements was unethical. This decision was only realized through careful analysis of accounting and ethics literature as well as objective application of accounting and business ethical decision models.

There are two primary reasons the position reached in chapter four is correct. First, a modified version of the robust and widely accepted model from the American Accounting Association was applied. The application of the modified AAA model highlights a concern that the activity was not only a violation of norm and practices in the Undisclosed Charity by violation of the records destruction policy but the risk of legal implications is also raised after consideration of California probate law. Secondly, why utilitarian concepts were considered in the modified model, utilitarian rationale cannot be the sole determinant for management decision in this case because the minority interests cannot be assured or even known at the time of the destruction.

This paper illustrates the need for continued exposure and elevation of the topic of ethics in importance in accounting curriculum. The external auditors for the case under review were made aware of the destruction of the records, yet they did not question the ethical impact of the management action. They took the position that if the uses for those shredded accounting statements were mainly operational effectiveness and efficiency functions outside of the financial statement from which they were opining, the issue would be more of a violation of company policy relating to record destruction rather than an ethical issue. No consideration was placed on what else could have been destroyed that may have a financial statement impact and no consideration was placed on modeling the dilemma in the format highlighted in chapter three. The question arises "were these external audit professionals trained adequately in their education and subsequent professional training to discuss potential ethical issues or were they trained solely to opine on the financial statements presented to them from management?"

The danger of teaching classical ethical theories in isolation (for example teaching only to look at utilitarian approaches such as a cost versus benefit analysis) or even as merely theory concepts is that students may be left with the impression that they are equally appropriate or always morally justifiable. If instructors nonetheless teach these theories to students, the instructors should explain the strengths and weaknesses of each.

While the role of individual cases to instruct students in accounting ethics appears essential, thought must be given to the selection of the cases that serve to best illustrate the ethical principles that the community of accountants has chosen as essential moral principles. Additionally, accounting educators who teach about the AICPA Code of Professional Conduct should be cautious about teaching the material as an end in itself, rather than as a means of understanding professional responsibilities. To focus on the rules of professional conduct deprives an individual from the practice of critical thinking and professional judgment and leaves room for ambiguity. An alternative approach to teaching detailed rules, such as independence rules would be that such an assignment that combines group work, research skills, critical thinking skills, writing, and ethics. It treats the rules as something that the students should be able to research, because compliance is important to the profession, but does not treat the rules as ''answers'' or ends in themselves. Even though accounting students may be exposed to ethical issues more often than other business students, this case demonstrates simple exposure to ethical issues may be necessary, but not sufficient, to change students' and ultimately professionals' ethical behavior.

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