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## ACCOUNTING ETHICS: A RELUCTANT PROGRESSION FORWARD

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*Ethics is a discipline that encompasses the moral duties and obligations of individuals as they deal with what is good and bad, and as such, it is the backbone of a civilized society. This paper takes an in-depth look at the philosophical foundations of ethics, especially accounting ethics, and offers proposals to improve ethical oversight and behavior.*

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### INTRODUCTION

Ethics are the backbone of a civilized society. At the very least, a tenable society must have a universal agreement on the idea that people should work towards a common good. If everyone, or even the majority, only looked after their own interest at the expense of others, communication, travel, and commerce would cease. Economics, at its core, relies on the exchange of goods and services, which require the cooperation and honesty of those involved in trade. As trade becomes more complex, accounting is needed to organize the financial transactions into a coherent, understandable report. In order for the report to be reliable and relevant, the users of financial statements must have trust in the data contained therein. It is for this reason ethics are crucial for the accounting profession.

There are similar philosophical viewpoints regarding ethical behavior from the ancient Greek scholars to modern day behavioral theorists. The history of ethics in accounting got a much later start than other professions such as law and medicine, because businesses didn't begin the process of mass capitalization until the mid 19th century (Backof 1991). Once the public had a stake in a company, accountants were necessary to independently relay financial information to the stakeholders. As the accounting profession grew, the necessity for accounting-specific education was born (Brackner 1992). Part of that education was ethical studies. To this day, the effectiveness and instructional methods of ethics accounting courses are questioned and debated. This mirrors the reluctant history of accounting professional institutes of adapting to demands for ethical reform in the face of economic troubles. Many ideas abound to the question of how ethics can be improved in the corporate and professional environment. Many scientific studies of sociological behavior in an ethical context have been performed, seeking to glean explanations of human behavior. Some of the results of those studies are applied to public and private firms to increase the likelihood managers and workers alike will apply positive, conscientious, ethical judgment to situations as they arise

### PHILOSOPHICAL FOUNDATIONS OF ETHICS

Ethics is a discipline of deciding the moral duties and obligations dealing with what is good and bad (Merriam-Webster 2008). Philosophers, ancient and modern, generally agree that the foundation of ethical behavior is doing unto others as you would have done unto you. According to De George (2008), The Greek philosopher Plato, in his work Republic, says that good is the source of being. Socrates believed an ethical impulse to do good works was the cornerstone of all philosophic thought. Aristotle discussed many elements of an economic system, such as trade, exchange, wealth, property, and acquisitions, while universally condemning greed. Greed is the acquisition of goods and/or money for the sake of wealth itself, and not with the desire to better himself and society. Aristotle also opined that economic justice is the idea that both parties of a transaction benefit equally. Philosophers such as Thomas Aquinas, Martin Luther, and Adam Smith, despite their ideological differences, believed greed and dishonesty are the primary causes of the degradation of ethical values (De George 2008).

Adam Smith and John Stuart Mill were the leading endorsers of the democratic ethics of free choice. This philosophy was underpinned particularly in the United States, which was founded upon the ideas of religious and economic freedom from tyranny. The free enterprise system includes three groups, groups which have the freedom to move from one to another. They are property owners, laborers, and managers. As long as this freedom of movement exists, and a perception that all receive benefits from their contributions, then everyone benefits from the goods and services created. In fact, the economic term "good" stems from the ethical implication that society benefits from the production of the item (Brackner 1993).

There are three major characteristics that comprise a free enterprise system, each with an ethical challenge to meet. First, profit motive induces an enterprise to create the goods or services, so that a monetary incentive is created. However, greed can take over, and society is harmed if expenses are shaved in the production of a good, reducing the quality of the product. Second, competition gives society a choice while also creating conditions leading to the

improved quality and economy of production. Competition must be conducted on honest and fair terms, or society is again harmed through possible monopolistic growth, which causes complacency and wasteful use of resources. Finally, unwarranted restrictions to punish wrong-doers also burden the innocent with economic obstacles to hurdle, lowering the standard and efficiency of production. Here to, ethical behavior by all benefit society by eliminating the need for punitive restrictions (Brackner 1993).

### **A BRIEF HISTORY OF ETHICS IN ACCOUNTING**

In the last quarter of the 19th century, as businesses grew in size due to the industrial revolution, the supply of capital and the management of capital became separate functions. Business enterprises, as a result of this division, became more complex, creating the need for public accounts to keep consistent and independent financial records of business activity. As the general public became financially involved in the ownership of capital through the stock markets, a need to know independent, reliable, and relevant financial information became important (Backof and Martin 1991).

The first organized accounting body was the American Association of Public Accountants (AAPA), formed in 1886. Accounting was not regarded as a respectable profession at this time, due in part to competitive bidding, contingent fees, and rampant advertising. In 1907, after a meeting in which professional prestige was the main focus, a code of ethics was written and amended into bylaws for the AAPA. Enforcement by the states was generally neglected, and it wasn't until 1917 that a revised set of eight rules of professional conduct was devised. One such rule stated, in reference to past behavior, that "no member shall directly or indirectly solicit the clients nor encroach upon the business of another member..." (Lowe 1987). An ethics committee was formed, heard cases, and disciplined members who violated minimum professional standards, such as an omission of a material item in a financial statement (Backof and Martin 1991).

Independence was defined as the primary ethical question of the early 20th century. In 1926, a work entitled "Report of the Committee on Professional Ethics" questioned if it was ethical to be an auditor and a director. The *Journal of Accountancy* approached this question in 1928 in an editorial on independence, but came to no decisive conclusion. In 1931, the American Institute of Accountants (AIA) held a meeting in which Frederick Hurdman presented "Relations of Client and Account," which pried into the independence issue with no formal action taken. It wasn't until the government intervened in 1933 that a mandatory definition of independence developed, put forth by the Federal Securities Act of 1933 and the Securities and Exchange Commission of 1934. Independence was the complete lack of interest or connection with the client. This was amended in 1937 to

read "substantial", rather than "complete", interest. In 1947, the AIA issued a report that became the affirmed position of General Accepted Auditing Standards in 1954, which stated that independence called for honest disinterest from the auditor, a judicial impartiality, and a fair presentation of facts (Backof and Martin 1991).

In 1962, ethics committee opinions were formally adopted into the code and organized around 5 areas of conduct: 1) Institute members' relationships with clients and the public, 2) technical standards, 3) promotional practices, 4) operating practices, and 5) inter-Institute relationships. The four most heavily scrutinized areas of conduct are independence, advertising and solicitation, commissions, and contingency fees. The American Institute of Certified Public Accountants (AICPA) finalized this code in 1973, and called it the "Code of Professional Ethics," a work that is still in use today (Lowe 1987).

Advertising, considered separate from soliciting in the 1917 rules of conduct, was generally prohibited. However, members agreed that consent of the AIA was needed to allow the circulation of mailers or "other instruments of publicity" (Lowe 1987). In 1920, the AIA allowed business cards to be circulated, with only the names, titles and the address of the firm admitted. In 1958, business cards could no longer be used in advertisements. Internal materials of the firm were restricted to the client and professional contacts, such as banks and legal firms. In certain cases, materials could be transferred to universities for educational purposes, but not if the means of attainment of services were displayed in the materials. In 1948, the Institute only allowed requested services to be furnished. A ban on all advertising, of any form, was created in 1964 and continued until the finalized restated code of 1973. Institute members considered advertising or solicitation demeaning to the profession and of no use to the public. However, in the 1970s, the U.S. Department of Justice began investigating the literature of ethics codes of professional organizations, including the AICPA's "Code of Professional Ethics," once outside organizations questioned the legality of the advertising related provisions. The U.S. Supreme Court ruled that professional organizations aren't exempt from federal antitrust laws (Lowe 1987). The current AICPA, rule 502 reads: "A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited" (Rule 502 1988).

Commissions, or the proceeds offered from the sale of goods and services from the laity (entity not engaged in public accounting as a central occupation), have been prohibited since 1905. In addition, referral fees are acceptable, as long as there is not an expectation of a commission. Rule 503 of the AICPA code continues to recognize that CPA firms cannot accept commissions when in the engagement of an audit, review, financial statement compilation, or examination of financial information.

Referrals and commissions may be acceptable otherwise, but only if disclosed as a note on the financial statement. Contingent fees are also prohibited, unless otherwise specified by an authoritative body, such as a court of law, as stated in Rule 302 (Lowe 1987).

### THE UNDERPINNINGS OF ETHICS EDUCATION

Derek Bok, former president of Harvard University, stated, “virtually every business executive and lawyer, every public servant and physician, every politician and engineer will now pass through our colleges and probably through our professional schools as well” (Brackner 1992). This statement leads to the logical inference that those who perpetrate fraud, or other criminal acts, in the world are business graduates from colleges--perhaps prestigious ones. In the 19th century, universities considered moral development paramount in the progression of their students. Mandatory lectures were given to educate the student body on the subject of moral philosophy. The focus of ethics curriculum was personal behavior and the distinctions between right and wrong, based on Judeo-Christian principles. Noah Porter, the president of Yale in the late 1800s, pointed out the value he placed on right-minded professors, by stating, “A noble character becomes light and inspiration, when dignified by intelligent power and attainment.” (Brackner 1992).

Importance was gradually placed on academic achievement as more universities sprung up, and they were competing for the brightest students and faculty. It was thought that eccentric or controversial geniuses might get passed over if too much emphasis was placed on character. As the social sciences split from philosophy, the scientific method of inquiry became popularized, and judgmental questions were no longer asked. Rather, observations from patterns of behavior were collected from experiments. In essence, a person who was once considered “better” than another is now considered “different”, eliminating moral absolutes. Moral values became constraints because scientific experimentation requires unbiased, impartial observation of the subject. Ethics are taught primarily in a case by case style, where the student is often told what to do (or what not to do) in a specific situation. The values “right and wrong” are ignored (Brackner 1992).

Armstrong (2007) writes that according to Glen Feltham, the School of Business dean at the University of Manitoba, accounting is about trust and ethics. If a banking institution can't trust the financial statement, the bank won't know whether it's a safe investment to lend capital. If investors can't trust accountants of a corporation, the investor will be unsure whether to invest or not. He believes ethical dilemmas should be present in accounting case challenges for students to consider. Armstrong (2007) also notes that Sally Gunz, another accounting school head, believes several problems permeate colleges in regard to the instruction of ethics. The enormous technical content of

business programs overrides the time to impart ethical lessons. Also, there aren't many professors with expert scholarship in ethics. The professors who are proficient in ethics training are often reluctant to teach it, as it offers little in the way of advancement and promotion. However, difficulties aside, Gunz recognizes that many board rooms and executive offices across the community will include graduates from her business program, and the community will suffer if such people in powerful positions aren't motivated to behave in an ethical manner.

### EFFECTIVENESS OF ACCOUNTING ETHICS COURSES

Many have argued against including accounting ethics course(s) in the already crowded curriculum of most business programs. The belief is that the course does not objectively contribute to the ethical improvement of accounting students, and that it would take time from other technical courses needed for preparation for entrance into the workforce. Before delving into the merit of this argument, consideration should be given to the fact that many of the recent corporate failures were due in part to failures in audit procedures. In other words, some high profile audits failed not due to ethical violations, but because of poor fraud detection techniques. For example, the auditors of WorldCom would have detected unusual accounting activity had they viewed assets as having future value and expenses as having no future value (Bean and Bernardi 2007).

One theory of ethics that holds considerable sway in colleges is the Kohlberg model of moral development. The Kohlberg model (see Table 1) describes six stages of progressive attributes to ethical decision-making behavior. The lower stage represents the most base level of ethical thinking, namely a fear of reprisal. The higher stages represent advancement in ethical consciousness, or the will to do good deeds for the welfare of society rather than one's personal interest. This conforms to the ancient philosophers' viewpoints of ethical reasoning—the consideration to perform acts for the betterment of society on an impulse rather than a cost/benefit decision (Bean and Bernardi 2007).

Bean and Bernardi (2007) cited James Rest as the one who devised, what he called, a Defining Issues Test (DIT), the results of which places the subjects on the Kohlberg Model. This test, performed many times in universities on the entire student body, shows that accounting students rate lower than their peers in other fields of study. Stage 5 and 6 encompass the “what should be done” mentality. Stage 4, where accounting students place on average, display the “follow the rules” attitude. This makes sense, as much of the accounting curriculum does not involve critical thinking of complex scenarios, but instead rigid rules and regulations to memorize and apply. Bean and Bernardi (2007) also cited two studies which were conducted using Rest's Defining

**Table 1: Kohlberg's Model of Moral Development**

Level	Stage	Description	Explanation
Pre-conventional	1	Obedience and Punishment	How can I avoid punishment?
Pre-conventional	2	Self-Interest	What's in it for me?
Conventional	3	Interpersonal Conformity	Conform to social norms
Conventional	4	Authority/Social Order	Law and order mentality
Post-conventional	5	Social Contract	Democratic mindset
Post-conventional	6	Universal Ethical Principles	Conscience

Source: Crain, W.C.. *Theories of Development*. (New Jersey: Prentice-Hall, 1985), 118-120.

Issues Test, one by Richard Bernardi in 2006 and another by Mary Beth Armstrong in 1993). Both indicated that those with experience in accounting ethics courses scored better on Rest's DIT.

Bernardi also performed a controlled test that employed over 400 test subjects of big accounting firms. This test measured the ability to detect imbedded fraud. It also looked at the amount of exposure auditors were willing to divulge as it related to the embedded fraud. The auditors who fared better on Rest's DIT were vastly superior at detecting and reporting examples of fraud (75% to 49%). In addition, those who scored higher on Rest's DIT used more conservative estimates as their benchmarks for materiality (Bean and Bernardi 2007).

### ETHICAL STUDIES OF THE CORPORATE ENVIRONMENT

Carpenter and Reimer's (2005) studied the theory of planned behavior as it relates to financial managers in a high corporate setting. The study seeks to discover what behavioral trait is dominant in unethical decision making. A strong causal relationship exists between planned behavior and behavioral intentions, allowing researchers to predict, with near certainty, the probability the action will occur. There are three basic determinants to behavioral intentions: attitude, subjective norm, and perceived behavioral control. Attitude is the individual's feelings favorable about performing the intended behavior, subjective norm is the individual's perception of the opinion of others about the intended behavior, and perceived behavioral control is the perceived ease or difficulty in performing the intended behavior.

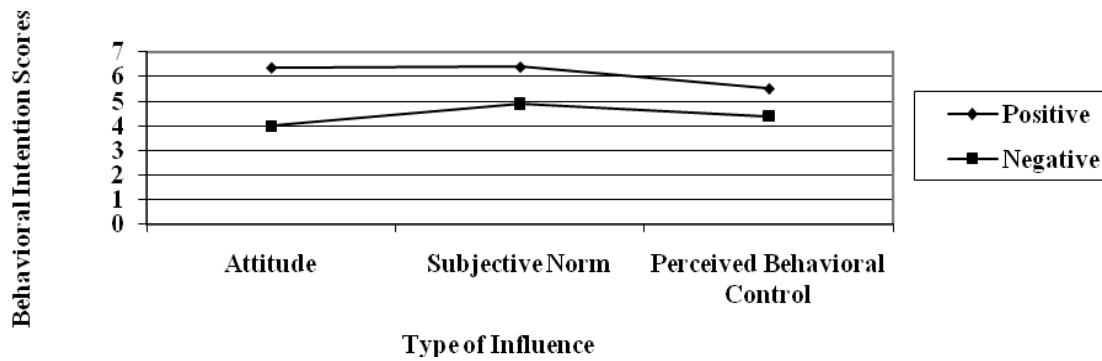
The study involved a task for 70 MBA students with multiple years experience in the workforce. The task was to answer questions regarding a decision to defer expenses and massage earnings with the goal of receiving an end-of-year bonus. The questions are designed to highlight the subject's behavioral intentions based on the three determinants. The data was then run through statistical analysis to draw conclusions on what most shapes planned behavior. In addition, a second test was performed on a different set of students in the same program, to test the three behavioral

determinants in a positive and negative light, resulting in six scenarios. Rather than scaled questions, these questions probed behavioral tendencies where factors exist that either encouraged or discouraged actions. For example, the first test would have you rate, on a Likert scale, the following: "I intend to delay the expense until the following year." The second test may ask: "Upper management also tends to defer expenses until next year, so should I?" (Carpenter and Reimers 2005).

Carpenter and Reimer's (2005) results in both tests strongly suggest that attitude is the main determinant to unethical behavior. Table 2 illustrates that when conditions to behave unethically are painted as unfavorable (negative), in all cases respondents scored highly. However, when conditions to act unethically appear favorable, attitude has the largest disparity between positive and negative behavioral intentions. When asked without condition, 29% of respondents would have violated GAAP. When conditions were positive for unethical behavior, 52% would have violated GAAP and deferred the expenses. The implications for this study indicate greater efforts need to be made by top management to set a tone for ethical behavior. Conversely, if attention is focused on creating an atmosphere where violating ethical guidelines is considered unfavorable, as opposed to merely neutral (no mention at all), the vast majority of test subjects would not have violated GAAP (Carpenter and Reimers 2005).

O'Leary and Pangemanan's (2007) study analyzed the effect of groupwork when accounting students make ethical decisions. Many companies utilize teams to make decisions, organize data, or brainstorm new ideas. Previous studies have shown that groups are superior to individuals because there's an opportunity for interaction. Error checking is prevalent which leads to better quality control. A greater collection of insights and opinions leads to new thoughts. On the other hand, if a problem is extremely complex or deep, the most capable member will grasp the solution, and compromises result as the other members defer upwards. In this experiment, 5 scenarios were presented to undergraduate students, and three choices were presented for each. One choice represents an ethical response, while the other choices are neutral and unethical.

**Table 2: Testing Results - Carpenter Reimers**



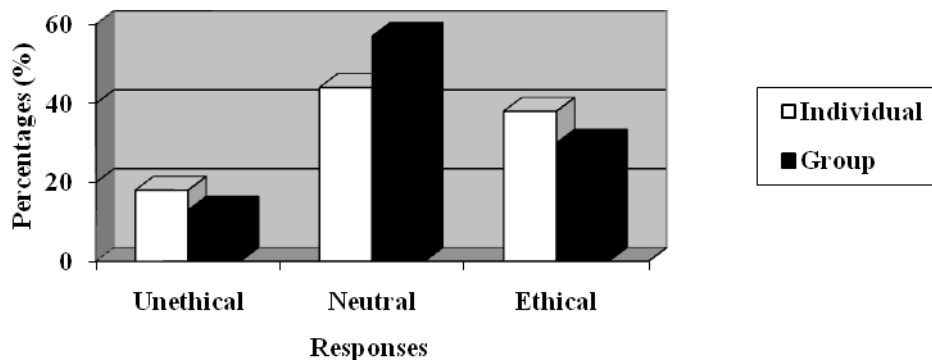
Source: Carpenter, Tina D. and Jane L. Reimers. "Unethical and Fraudulent Reporting: Applying the Theory of Planned Behavior." *Journal of Business Ethics*, 2005.

**Study**

O’Leary and Pangemanan’s (2007) results demonstrated that groupthink tends to lead to safer or more neutral answers. Also, charismatic or dominant group members may sway opinions to a consensus not actually shared by the majority. Individuals are more likely to exhibit more ethical and unethical decisions. These results support the prevailing

wisdom that groups tend to feel pressure to conform to the other members. Persons with extreme ideas, whether correct or not, fear they may appear foolish or inept. Therefore, when peer pressure doesn’t exist, individuals are free to express their true feelings on an ethical issue, hence the greater extremes. See Table 3 for a graphical representation of the data (O’Leary and Pangemanan 2007).

**Table 3: Individual v. Groups (O’Leary and Pangemanan Study)**



Source: O’Leary, Conor and Gladies Pangemanan. "The Effect of Groupwork on Ethical Decision-Making of Accountancy Students." *Journal of Business Ethics*. 2007.

## RECENT CORPORATE FRAUDS

Fraudulent financial reporting is not new, but the ramifications for failure are larger currently due to the size and influence of giant global corporations. The 1960s had real estate scandals, and the 1970s had international frauds and bribery. The Foreign Corrupt Practices Act of 1977 attempted to regulate corporations dealing in foreign countries by placing standards intended to prevent illegal transfers of money. The 1980s saw Wall Street corruption, insider trading, and junk bond schemes (Vickers 2002). The Treadway Commission in 1987 called for increased ethical behavior in corporations and strengthened internal control systems. However, detection and employee fraud were the focuses of the Treadway Commission, not management fraud and prevention, so many larger schemes went unnoticed. Strategies were not in place to detect unethical behavior by management (Rockness 2005).

Monetarily speaking, the largest frauds to impact the world occurred in the late 1990s and the 2000s. In nearly all cases, the tone at the top, whether positive or negative, is noted as being the driver in ethical conduct. The culture fostered by upper management permeates down through the organization (Rockness 2005).

Enron is the most notable example because of the sheer size of the loss, over \$1 billion. Estimated earnings targets were overly aggressive, and the attitude at the top did not tolerate failure. As a result, the accounting department began making adjustments to earnings and over time, small adjustments became outright fraud. Special purpose entities, around 3000, were created to hide the accumulating debt. Complex transactions made uncovering the fraud extremely difficult. Eventually, documents were destroyed to hide the deception. Only after the bankruptcy did investigations uncover the extent of the public whitewash. Thousands lost their life savings as a result of the greed of top executives (Rockness 2005).

Worldcom CEO, Bernie Ebbers, was said to have scoffed at ethics and controls, and stated, "real men only worry about revenue growth" (Rockness 2005). Promotions were given to those who claimed to do things, not for what was actually done. In 2004, when failing to meet revenue expectations, the CEO instructed the CFO to fix the problem, and soon, records were systematically altered to meet expectations even after the books were closed. Expenses were reduced by improperly capitalizing operating leases. Many Worldcom employees were complicit in the underhanded accounting practices, and, after collecting documented evidence of the fraud, Cynthia Cooper blew the whistle on the operation thus making public the fraudulent financial reporting (Rockness 2005).

Another large corporate scandal was that of HealthSouth. A contractual adjustment account was inflated to increase net revenue. Fixed assets were falsified on the other side of the transaction to offset the entries to contractual adjustments. Many accounting staff members

were former Ernst and young employees, so they knew how to make adjustments that wouldn't be detected during audit procedures. False documents were even created to complete the deception. Three Board members had significant financial ties to the company, impairing their ability to be objective and skeptical of management activity. In the end, fifteen financial employees pled guilty to falsifying financial records (Rockness 2005).

Presented below are other examples of massive corporate fraud, all of which involve fraudulent financial reporting (Rockness 2005):

- Sunbeam – Understating inventory value, recognizing revenue from undelivered items, underreporting cost of goods sold.
- Waste Management – Misrepresentation of fixed asset lives, reporting expenses as assets, overvaluing landfill sites.
- Global Crossing – Overstatement of revenue.
- Xerox – Booking revenue before earned, failure to classify lease assets as the lessee.
- Tyco – Unauthorized loans and payments to senior staff.

Regarding these examples, Sunbeam had the smallest loss, \$60 million. In nearly all cases, the auditing firm was complicit, or negligent, in their duties. Each of the Big Five accounting firms have been charged with a variety of crimes, including but not limited to:

- False and misleading audit reports.
- Concealing material, adverse information from the public.
- Improper audit procedures.
- Conflict of interest.
- Lack of independence.
- Obstruction of justice.
- Destruction of documents.

Hundreds of millions of dollars have been spent by CPA firms litigating charges of fraudulent activities stemming from unethical behavior (Rockness 2005).

## ETHICS IN THE WORKPLACE

Trevino (1992) referred to the often cited work of Kohlberg's (1969) cognitive moral development (CMD) theory when studying manager's moral reasoning in business decisions. Kohlberg's CMD framework involves three broad levels of development with each level containing two stages. Briefly summarized, at Level one a person views rules as externally imposed and makes decisions at this level for rewards or to avoid punishments. The focus at Stage one is punishment avoidance, while at Stage two, fairness is interpreted in terms of a "you scratch my back, I'll scratch yours" reciprocity (Trevino, p. 2).

When the person advances to Level two, they have internalized the norms of society or a group with which they identify. Stage three is thought to be the behavior that is accepted and approved of by said group, while Stage four expands moral judgments to consider the rules and laws of legal, social or religious systems that are designed to promote the common good.

The third Level is only reached when the person sees beyond the law for law and order's sake. Stage five individuals think of changing the law for socially useful purposes, and at Stage six, the individual is guided by self-chosen ethical principles of justice and the rights of human beings. According to Kohlberg (1969), fewer than 20 percent of American adults reach this level.

Trevino (1986) proposed that a manager's moral reasoning level would be lower in actual work-related decisions than those hypothetical, non-work-related dilemmas typical of Kohlberg's research. She found that when personal involvement in the decision-making process exists, individuals operate at the lower levels of CMD. In addition, she found that if a business organization focuses the individual's attention on quantitative analysis rather than on qualitative moral issues, or on obedience and conformity rather than broader issues of rights and justice, moral growth may not be supported.

### **PROPOSED METHODS TO IMPROVE ETHICAL OVERSIGHT AND BEHAVIOR**

The Sarbanes-Oxley Act of 2002 (SOX) was a major stepping stone in improving the ethical culture of companies, private and public. It provides incentive in the way of incarcerations and/or heavy fines to managers or public accountants who grossly violate ethical codes. However, if history is any guide, heavy enforcement of laws may wane over time, so a culture of ethics is necessary to create fundamental attitude changes in the corporate and professional landscape. According to Neil Lebovits (2006), the COO of Ajilon Finance, SOX is useful because it has given organizations a platform to discuss ethical improvements. Lebovits proposes three solutions to transform ethical practices in an organization: 1) Cultivate role models, 2) Demonstrate ethical decision making, and 3) Encourage pushback. Considering the study, which states attitudes are the strongest determinants to ethical behavior, a positive role model at the top of a company, and at key positions within the company, can inspire others to follow. These individuals should be properly rewarded and compensated for their latent effect beyond their basic job description. Ethical decision-making can motivate and inspire workers to push beyond their normal requirements, because job satisfaction is enhanced. Lastly, pushback should be encouraged. This is a way for employees to voice concerns for what may be dubious plans or actions by upper management. Executives should, in turn, foster this attitude of feedback (Lebovits 2006).

Stewart Hamilton (2006), Institute for Management Development Professor of Accounting at Lausanne, Switzerland, has a more cynical take on SOX. He believes SOX was rushed through Congress in an effort to prevent more scenarios similar to the Enron fiasco, and, as a result, does not address many factors that cause corporate failures, of which accounting plays a small role. The factors are:

- Poor strategic decisions – Management's misunderstanding of market conditions, technological advances, and complex financial instruments.
- Over-expansion – Greed-driven growth fueled by acquiring companies or subsidiaries. Organic growth is frowned upon because it's too slow, and executives pay is often tied to earnings. Cultural differences, lack of capacity, and costs outweighing benefits often doom this strategy.
- Dominant CEOs – Boards of Directors and shareholders are lulled asleep by past accomplishments, and the CEO's demands get rubber stamped, while their hubris becomes unchecked by increasingly irrelevant directors.
- Control Failures – Marked by geographically disbursed departments, poor communication, lack of an internal audit team, unqualified CFOs, improper financial structuring of assets and liabilities.
- Independent Directors – A lack of knowledge on complex financial matters (as well as financial ties to the company) can stifle a board into silence.

One solution could include adjusting executive compensation to long-term growth rather than short-term windfalls. Directors should have a clear understanding of a board meeting's agenda ahead of time to encourage adequate preparation. Only a strong board can rein in an over-ambitious executive head. Legislation won't do it (Hamilton 2006).

Pomeroy (2006) notes that ethics and compliance officers are becoming prevalent in many companies. This increase is due to directors' concern that merely obeying the law is not enough in a climate where everything can be made public. The executive director of the Ethics & Compliance Officer Association (ECO), Keith Darcy, says "enduring great companies have strong cultures" (Pomeroy 2006). Since enacting SOX in 2002, membership more than doubled in the following four years, and the average compensation for members increased substantially. This indicates that companies are becoming proactive in responding to increased skepticism the public holds regarding their ethical conduct.

### **Additional Ethical Oversight for Accountants**

There are policies and procedures already in place for CPAs to improve ethics understanding. The CPA Examination includes questions on ethics. Continuing



Professional Education is offered to CPAs as part of the 40 credits per year requirement. Practitioners who violate ethics may be barred from performing audits for companies listed with the SEC or IRS, which would have great consequences on their livelihoods. In addition, there are multiple ways CPA firms can monitor ethics awareness in their firm: 1) When potential employees are interviewed, ethical dilemmas to interpret and judge should be presented during the interview process, 2) Hire, or develop in-house, an ethics specialist to handle questions during the course of audits or reviewing work, as well as to resolve ethical questions within the firm, 3) Refrain from becoming too dependent on one client for revenue, and 4) Assess potential clients regarding ethical concerns, through the Better Business Bureau or court records, before engaging them. Firms should get in the habit of documenting everything to have as evidence for peer reviews and possible court hearings (Romal and Hibscheweiler 2004).

Eugene Flegm (2005), former auditor for GM, believes that SOX is on the right track to impose strict punishments on top executives, because their unethical behavior can bring down major companies, while a lower-level employee may only rattle a small department. The Public Company Accounting Oversight Board (PCAOB) is also a step in the right direction, as it replaces the AICPA as a self-regulator. However, Flegm believes the breakdown in cultural values makes it extremely difficult to create an atmosphere of positive ethical attitudes. Whistle-blower procedures should be written into SOX law to adequately protect the revealers of fraudulent activity.

### **Ethical Concerns Regarding Accounting Standards and Auditing Practice**

Fair value accounting also plays a role in the deteriorating confidence in financial statements, and pressure from the Financial Accounting Standards Board (FASB) does not help, as more assets are targeted for fair value treatment. Adjusting budgeting sights on the stock market is short-sighted, ignores strategic risks such as technology and innovation, and sets up a need for an additional set of books. The opportunities not only exist for fraudulent reporting, but are exacerbated by the conditions of short-term expectations based on speculative values of assets. Long-term stability should be management's, and the government's, focus to prevent ethical misconduct (Flegm 2005).

Auditors face extra scrutiny in today's enhanced climate of ethical concern. One consideration before SOX to enhance auditor independence is rotation of audit appointments to avoid cronyism with the client. Another line of thinking is that a permanent employment will give the auditing firm confidence that they won't be terminated, if such concerns are raised. This could lead to increased auditor objectivity. Peer reviewing has always been an appealing idea to ensure proper audit procedures are being

followed. Under SOX the PCAOB assumes responsibility for inspecting audit firms that audit public companies (Baker 2005). Some believe that being paid directly by the client, in and of itself, impairs auditor independence. Following this line of thinking a third party should become the client of a company, and then contract the work to an auditing firm, thus removing any perception of impropriety (Haber 2005). Others believe auditing firms should have the power to control the financial wing of companies at the behest of the SEC. This would remove CEO influence in financial micromanagement of the company. This would also ensure auditors are not dependent on compensation from the company (Moore 2003).

### **SUMMARY AND CONCLUSION**

The ethical environment surrounding financial decision making is in constant flux with the external conditions of the world. Complexity in technology, financial instruments, corporate acquisitions, and the speed of transactions, leads to difficulties preparing reliable, transparent financial statements. As a result, it is difficult to spot deliberate misstatements especially when members of the Board can't fully grasp the financial status of the company.

The two leading drivers of ethical misconduct and fraudulent financial reporting are greed and external pressure. Greed usually stems from the top, because executives have an incentive to massage earnings, often improperly, to meet the expectations of investors or lenders, and also to increase their personal compensation. External pressure exists for all competitive businesses, but the culture becomes unhealthy when management increases expectations to meet unrealistic demands. Couple this with the findings of Trevino (1986, 1992) which suggest that when a business organization focuses the individual's attention on quantitative analysis rather than on qualitative moral issues, or on obedience and conformity rather than broader issues of rights and justice, moral growth may not be supported, and unethical decisions are made.

Ethics courses should become mandatory for accounting students in college. Studies have shown that ethical awareness, from an educational point of view, later leads to more ethical decision-making in the business environment. In addition, ethical actions are undertaken through a conscious decision to benefit those who are affected by ones decisions, rather than a rule-based thought process which is self-centered. Legislation and regulation aids in the apprehending and punishing of ethical violators, but for society to refrain from becoming hurt in the process; a culture of civility needs to exist in the corporate and professional world from the outset. One positive change that is becoming more widespread is the implementation of Ethics & Compliance Officers in companies. Membership more than doubled from 2002 to 2006. This indicates that companies have realized that the cost of betraying the public's trust is greater than the cost of implementing a

culture of ethical adherence. Trust is, after all, the cornerstone of accounting.

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