

CHAPTER 7

Ethical behaviour and implications for accountants

7.1 Introduction

The main purpose of this chapter is for you to have an awareness of the need for ethical behaviour by accountants to complement the various accounting and audit standards issued by the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB) and professional accounting bodies.

Objectives

By the end of this chapter, you should be able to:

- discuss the meaning of ethical behaviour;
- understand why accountants need to apply a high level of ethical behaviour to their daily activities;
- know the sources and intent of the professional guidance in relation to ethical matters;
- appreciate how approaches to standard setting, laws and cultures influence our ethical standards;
- describe the various techniques to facilitate whistle-blowing when there are genuine breaches of appropriate legal and moral standards.

7.2 The meaning of ethical behaviour

Individuals in an organisation have their own ethical guidelines which may vary from person to person. These may perhaps be seen as social norms which can vary over time. For example, the relative importance of individual and societal responsibility varies over time.

7.2.1 Individual ethical guidelines

Individual ethical guidelines or personal ethics are the result of a varied set of influences or pressures. As an individual each of us ‘enjoys’ a series of ethical pressures or influences including the following:

- parents – the first and, according to many authors, the most crucial influence on our ethical guidelines;
- family – the *extended* family which is common in Eastern societies (aunts, uncles, grandparents and so on) can have a significant impact on personal ethics; the *nuclear* family

which is more common in Western societies (just parent(s) and siblings) can be equally as important but more narrowly focused;

- social group – the ethics of our ‘class’ (either actual or aspirational) can be a major influence;
- peer group – the ethics of our ‘equals’ (again either actual or aspirational) can be another major influence;
- religion – ethics based in religion are more important in some cultures, e.g. Islamic societies have some detailed ethics demanded of believers as well as major guidelines for business ethics. However, even in supposedly secular cultures, individuals are influenced by religious ethics;
- culture – this is also a very effective formulator of an individual’s ethics;
- professional – when an individual becomes part of a professional body then they are subject to the ethics of the professional body.

Given the variety of inputs, it is natural that there will be a variety of views on what is acceptable ethical behaviour. For example, as an accounting student, how would you handle ethical issues? Would you personally condone cheating? Would you refrain from reporting cheating in exams and assignments by friends? Would you resent other students being selfish, such as hiding library books which are very helpful for an essay? Would you resent cheating in exams by others because you do not cheat and therefore are at a disadvantage? Would that resentment be strong enough to get you to report the fact that there is cheating to the authorities even if you did not name the individuals involved?

7.2.2 Professional ethical guidelines

A managing director of a well known bank described his job as deciding contentious matters for which, after extensive investigation by senior staff, there was no obvious solution. The decision was referred to him because all proposed solutions presented significant downside risks for the bank. Ethical behaviour can be similarly classified. There are matters where there are clearly morally correct answers and there are dilemmas where there are conflicting moral issues.

In this chapter we will endeavour to increase your awareness of the moral issues in the accounting profession. We will also help you identify those problems where there are clear cut solutions, and encourage more searching and sensitive analysis of the complex issues.

Professional codes of conduct tend to provide solutions to common issues which the profession has addressed many times and therefore has had ample opportunity to apply the most experienced and knowledgeable minds to find the best solutions. Thus the professional code of ethics is only the starting point in the sense that it can never cover all the ethical issues an accountant will face and does not absolve accountants from dealing with other ethical dilemmas.

How will decisions be viewed?

Another aspect of ethical behaviour is that others will often be judging the morality of action using hindsight or whilst coming from another perspective. This is the ‘how would it appear on the front page of the newspaper?’ aspect. So being aware of what could happen is often part of ethical sensitivity. In other words, being able to anticipate possible outcomes or how other parties will view what you have done is a necessary part of identifying that ethical issues have to be addressed.

What if there are competing solutions?

Thus *ethical behaviour involves making decisions which are as morally correct and fair as you can*, recognising that sometimes there will be have to be decisions in relation to two or more competing aspects of what is morally correct which are in unresolvable conflict. One has to be sure that any trade-offs are made for the good of society and that decisions are not blatantly or subtly influenced by self-interest. They must appear fair and reasonable when reviewed subsequently by an uninvolved outsider who is not an accountant. This is because the community places its trust in professionals because they have expertise that others do not, but at the same time it is necessary to retain that trust.

7.3 Financial reports – what is the link between law, corporate governance, corporate social responsibility and ethics?

7.3.1 Law in relation to ethics

The law is the codification into binding rules of those minimum standards of behaviour which parliament sees as essential in a civilised society. These laws reflect societal values and by implication reflect the history and religious beliefs of the community. In other words, they reflect the ethical norms in that society. As minimum standards they do not provide a complete list of ethical guidelines. Compliance with laws which require accountants to follow accounting standards may not give a comprehensive indication of the company's financial position. To give a fairer representation they may have to be supplemented by additional information.

Thus ethical behaviour requires that the annual report be fair to all parties. A famous economist by the name of Baumol¹ provides an interesting concept of superfairness which would help with this type of ethical decision. He says if you didn't know what side of the transaction you were going to be on, what would you consider to be fair? If you didn't know whether you were going to be a company executive, or an auditor, or a buyer of shares, or a seller of shares, what do you think would be a fair representation of the company's performance and financial position? To give a simple example consider a mother who is tired of her two children arguing over who gets the biggest slice of cake. So she gives the whole cake to one child and says cut it into halves and your brother will have first choice of a piece of cake. The child will cut the cake as carefully as possible into two equal halves as the brother will choose whatever appears to be the larger piece of cake, leaving the cutter with the other piece. This is a simple application of superfairness in which neither party is in a position to argue that they were treated unfairly.

The other concern with legal guides is that they can be slow to change and an accountant will be judged by contemporary ethical standards as well as the legal requirements.

7.3.2 Corporate governance in relation to ethics

Corporate governance refers to the systems in place to avoid or resolve potential conflicts of interest. The presence of conflicts of interest means it is possible for one or more parties to make decisions which favour themselves at the expense of others. The possibility of unfair behaviour does not necessarily mean that unethical behaviour will occur. However, the objective of a corporate governance system is to reduce or remove the opportunity for unethical or self-interested behaviour in much the same way as internal controls are there to make it more difficult to commit fraud. They don't guarantee that fraud or unethical behaviour will not occur but they protect the honest from temptation, and they make it much harder for the dishonest to commit unethical behaviour in the areas covered by the system.

Thus corporate governance provides mechanisms in principal–agent situations which reduce the opportunity for unethical behaviour. By principal–agent situations we mean that directors are appointed to look after the interests of shareholders, and have power to act on behalf of shareholders (and thus are agents of shareholders) in situations where shareholders are unable to observe their behaviour. There is therefore a trust relationship and directors have a moral and legal obligation to act in the interests of shareholders. However, there is an element of ambiguity in that different shareholders may have different objectives such as different time horizons. Therefore, since it is sometimes difficult to prove impropriety, the presence of safeguards such as corporate governance mechanism is reassuring. We will be discussing corporate governance in more detail in Chapter 30.

7.3.3 Corporate social responsibility in relation to ethics

Corporate social responsibility (CSR) refers to the process of taking into consideration the financial, social and environmental considerations when making decisions as opposed to an emphasis solely on the financial impacts. Those who take a very narrow view of the corporation believe that the corporation should focus on achieving maximum returns to shareholders. If in the process they pollute the environment or cause social disruption in the community they ignore the cost unless they are likely to be held financially responsible. Ethical behaviour stimulates greater attention to social responsibility and comprehensive accounting. We will be discussing CSR in more detail in Chapter 31.

7.4 What does the accounting profession mean by ethical behaviour?

It is interesting to first consider the legal profession and its view of ethical behaviour and any implication this has for the accounting profession.

7.4.1 The legal profession and ethical behaviour

Kronman² wrote a book called *The Lost Lawyer* in which he noted and lamented the change in orientation of the legal profession and of the large legal firms. He said that until recently the lawyers saw themselves as serving the community and that resulted in good incomes. As a consequence, they saw themselves as guardians of the legal system and tried to implement the spirit as well as words of the laws. They saw themselves as professionals with the associated responsibility of safeguarding the interests of the public rather than the narrow interests of their clients.

Kronman made the point that, as law firms grew, there was a shift of emphasis in those firms to seeing themselves as businesses. As businesses, their objective changed to maximising partner incomes, preferably equivalent to those earned by the executives in the large corporations for whom they work. It is not that they don't have ethics; it is just that their frame of reference has shifted. Accordingly they see ethical questions in a different light. Kronman saw the middle-tier law firms as the new upholders of professional values.

7.4.2 The accounting profession and ethical behaviour

It could be argued that the development of the professional accounting firms has mirrored the development of legal practices. Duska and Duska³ say of accounting:

This tension between the demands of professionalism and the demands of business has created an identity crisis in the industry today.

Duska and Duska⁴ proceed to say that the greatest challenge to the accounting profession is to place the interests of clients and the public ahead of their profit-making interests.

This is illustrated by the demise of Arthur Andersen but this firm was not alone at the time. For example, the following extract⁵ reads:

The year [2002] that Arthur Andersen surrendered its licenses to practice Certified Public Accounts, it came under fire for questionable accounting practices in five other cases – overstating cash flow at WorldCom; inflating transaction volumes for clients CMS Energy and Dynergy; improper booking of cost overruns at Halliburton; and inflating revenue at Global Crossing. It should be noted Arthur Andersen was not alone – all ‘big five’ were involved in improper accounting of one form or other, from conflict of interest, misleading accounting practices to falsifying accounts.

In addition to the pressure to achieve improved profits, accounting firms were under pressure from clients to ignore problems or to structure transactions in a way that concealed the substance of the transaction and the resulting risks. Investors became extremely sceptical of the reliability of financial statements. Confidence that financial reports give a fair view is important for the successful operation of capital markets and led in the USA to the Sarbanes–Oxley Act (SOX) and also to pressure being exerted on the standard setters themselves.

7.4.3 The Sarbanes–Oxley Act (SOX)

It is interesting to note that following the collapse of both Enron and WorldCom in the USA public sentiment was so strong that the Sarbanes–Oxley Act (called SOX) was passed, which placed personal responsibility on the CEO and the CFO for the accounts, with serious penalties for misleading accounts. Also auditors had to confirm that companies had adequate systems and internal controls. Following the collapse of Arthur Andersen and/or the introduction of SOX, a large number of companies had to restate/revise their previous accounts. This raises questions as to the ethics of those who were responsible for the preparation and auditing of those restated accounts. However, there is resistance from business and, in spite of the progress in terms of better accounting, there has recently been a push by industry and commerce to wind-back the SOX provisions particularly in relation to smaller listed entities.

7.4.4 Negative pressures on standard setters

Standard setters have been under pressure which could result in lower quality or expedient accounting as reflected in FASB and SEC rulings. This pressure comes from industry and commerce both directly, and indirectly through threats from the legislators who are beholden to industry. For example, there were proposals to replace the SEC’s role in standard setting by transferring the role to a new regulator. The proposal was unsuccessful⁶ but illustrates the pressures that can be brought to bear on the standard setters in the US.

The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Historically, however, the SEC has supported FASB’s independence and relied on FASB and its predecessors in the private sector to set accounting standards.

The original amendment, which was introduced by Rep. Ed Perlmutter, D-Colo., would have transferred the SEC’s accounting standards oversight authority to a proposed new

regulator with a mandate to take an active role in accounting standards that it deemed could pose systemic risks.

The amendment that was passed acknowledged that the proposed systemic risk regulator that would be created under the bill would have the ability to comment, like other interested parties, on FASB standards-setting issues.

7.5 Implications of ethical values for the principles versus rules based approaches to accounting standards

It is common in the literature for authors to quote Milton Friedman as indicating that the role of business is to be focused on maximising profits, and also to cite Adam Smith as justification for not interfering in business affairs. In many cases those arguments are misinterpreting the authors.

Milton Friedman recognised that what businessmen should do was maximise profits **within the norms of society**. He knew that without laws to give greater certainty in regard to business activities, and the creation of trust, it was not possible to have a highly efficient economy. Thus he accepted laws which facilitated business transactions and norms in society which also helped to create a cooperative environment. Thus the norms in society set the minimum standards of ethical and social activity which businesses must engage in to be acceptable to those with whom they interact.

Adam Smith (in *The Wealth of Nations*) did not say do not interfere with business, rather, he assumed the existence of the **conditions necessary to facilitate fair and equitable exchanges**. He also suggested that government should interfere to prevent monopolies but should not interfere as a result of lobbying of business groups because their normal behaviour is designed to create monopolies. He also assumed those who did not meet ethical standards might make initial gains but would be found out and shunned. His other major book (*The Theory of Moral Sentiments*) was one on morality so there is no doubt that he thought that ethics were a normal and essential part of society and business.

7.5.1 How does this relate to accounting standards?

The production of accounting standards is only the starting point in the application of accounting standards. We have seen that accountants can apply the standards to the letter of the law and still not achieve reporting that conveys the essence or substance of the performance and financial state of the business. This is because businesses can structure transactions so as to avoid the application of a standard.

The simplest example of this is leasing. In the various jurisdictions, accounting for leases started from the proposition that leases can be divided into two categories, namely, those which involve longer-term commitments and those which are short term in nature or can be cancelled at anytime without substantial penalties. The long-term leases have traditionally been capitalised and appear in the statement of financial position (balance sheet). On the other hand, short-term lease payments are recognised as expenses as they are incurred and the commitments are shown as a note to the accounts. If a company does not want to capitalise a lease, it can approach the financier to change the terms of the lease so that it won't fall into the long-term category.

It is that type of gamesmanship which has worried accounting standard setters. The issue is whether such games are appropriate, and if they aren't, why haven't they been prevented by the ethical standards of the accountants?

7.5.2 How does the accounting profession attempt to ensure that financial reports reflect the substance of a transaction?

We have seen that standards have been set in many national jurisdictions and now internationally by the IASB, in order to make financial statements fair and comparable. The number of standards varies between countries and is described as rules based or principles based according to the number of standardised accounting treatments.

Rules based

Where there are many detailed standards as in the US, the system is described as rules based in that it attempts to specify the uniform treatment for many types of transactions. This is both a strength and also a weakness in that the very use of precise standards as the only criteria leads to the types of games to get around the criteria that were mentioned earlier for lease accounting. When companies have done that, such as in the Enron case, the regulators are influenced to adopt the wider override criteria to support (or replace) the rules.

Principles based

Where there are fewer standards as in the UK, the system is referred to as principles based. In the principles based system there is greater reliance on the application of the true and fair override to (a) report unusual situations and (b) address the issue of whether the accounts prepared in accordance with existing standards provide a fair picture for the decisions to be made by the various users and provide additional information where necessary.

These are positive applications of the override provision. However, the override criteria can also be misused. For example, many companies during the dot com boom around the year 2000 produced statements of **normalised** earnings. The argument was that they were in the set up phase and many of the costs they were incurring were one offs. To get a better understanding of the business readers were said to need to know what an ongoing result was likely to be. So they removed set up costs and produced **normalised** or **sustainable** earnings which suggested the company was inherently profitable. Unfortunately many of these companies failed because those one off costs were not one off and had to be maintained to keep a customer base.

However, the current discussions about IFRS being principles based whereas the USA GAAP is rules based is incorrect in that in neither case do the starting principles justify non-compliance with standards. It is true that the USA has more standards which have been developed for specific applications but that is not a difference in approach but rather a reflection that more effort has been addressed to more different circumstances. Having more choices as sometimes occurs in IFRS is not a principles based approach unless the choices made are not based on personal preferences but rather on reasoning which has to be justified on the basis of first principles. In addition, it could be argued that general purpose accounts (whether rules based or principles based) can never be appropriate for many purposes for which they are routinely used.

The decision has been agreed by the US and IASB that principles based approach should be adopted. This still leaves unanswered the question as to whether this approach can give a true and fair view to every stakeholder. Shareholders are recognised in all jurisdictions but the rights of other parties may vary according to the legal system. When, for example, do the rights of lenders become paramount? Should the accounts be tailored to suit employees when the legal system in some jurisdictions recognises companies are not just there to support owners but have major responsibilities to recognise the preservation of employment wherever possible?

The above discussion is designed to provide a feel for the type of issues which are relevant for the discussion of rules versus principles.

7.6 The principles based approach and ethics

The preceding discussion looked at the principle of true and fair or its equivalent from an accountant's perspective, but ultimately what it means will be determined by the courts. They might take a different perspective again, which is one of the problems of having a criterion which is subjective and liable to be defined more precisely after the event.

If accounting is to be primarily or partially principles based, those principles need to be clearly spelt out in such a manner that those applying them, and those that are reviewing their application, clearly understand what they mean. Furthermore, those who will adjudicate in disputes over whether the criteria have been properly applied, which normally only occurs when substantial sums have been lost or unfairly gained, must at least have basically the same perspective. This is not to suggest law courts have to follow accountants. In application it is probable that the accountants will have to adopt the stance of the courts irrespective of whether they have correctly understood the subtleties of accounting. This means the principles must be expressed in everyday language. True and fair could perhaps be applied but it would have to have an everyday interpretation, such as Rawls⁷ expressed when he spoke of justice as fairness or what Baumol called superfairness.

It would, in order to avoid ambiguity, have to spell out 'fair to whom and for what purpose'. This is because at the present time society is in a process of reassessing the role of business relative to the demands by society to achieve high employment rates, to overcome environmental problems and to achieve fair treatment of all countries. Essentially this is suggesting that, given the changing orientation, consideration may have to be given to ethical criteria even if there is only a partial shift from a shareholder orientation to a balancing of competing claims in society. Daniel Friedman⁸ says: 'The greatest challenge is to realign morals and markets so that they work together, rather than at cross purposes.' This will need a balancing act specific to the problem faced. In other words, it would have to be principle driven.

7.6.1 Are principles linked to accounting standards?

The next issue is linking principles with accounting standards. The current conceptual framework assumes that we need to produce general purpose financial accounts using understandability, relevance, reliability, and comparability as guiding criteria. However, the individual standards do not demonstrate how those principles lead to the standards which have been produced. Only if that linkage is demonstrated can the standard setters demonstrate to accountants generally how to go from general principles to detailed applications. This is important if the intent is to go from basic principles which must be the underlying starting points. If principles are to dominate when there are no standards which are applicable, such as the case of a unique industry or to a new application, then practitioners could look to the derivation of existing standards to learn how to work out appropriate treatments for their previously unaddressed situation. Also in applying existing accounting standards, their intent should be evident from their derivation. Then accountants would have an obligation to apply the intent rather than being able to justify their avoidance through technical manoeuvring. However, if the intent is to be guided by principles, it should also be possible to justify non-compliance with standards if the assumptions made in formulating the standards do not hold in a specific case.

7.6.2 What are the implications of the above discussion?

Ethics has two major areas where it could impact on the principles based approach. These are that (a) ethics informs the principles and (b) cultural differences may lead to different principles being applied.

- (a) Ethics could supply all or part of the criteria used to derive and evaluate potential principles or could be part of the principles themselves. Also the way in which principles are used will not lead to good outcomes unless the accountants preparing and reviewing accounts have high moral standards. An accountant in preparing accounts will always have a potential clash between what his employer and superior wants and what is best from an ethical or community perspective.
- (b) If norms, laws and ethics are an integral part of the formulation of accounting principles then there may be grounds for different accounting being applicable to different countries. If the purpose of accounting is not the same in all countries with some countries placing, say, greater emphasis on the impact on employees or the community then the principles must differ. Further, it raises the question of how cultural norms and religion affect ethics both in coverage and how they interpret the individual guidelines. It brings into question the assumption that shareholders in every country have identical information needs and apply identical ethical criteria in assessing a company's operations.

An interesting piece of research compared the attitudes of students in the USA and the UK to cheating and found the US students more likely to cheat.⁹ The theoretical basis of the research was that different cultural characteristics, such as uncertainty avoidance or conversely the tolerance for ambiguity, lead to different attitudes to ethics. This means uniform ethical guidelines will not lead to uniform applications in multinational companies unless the corporate culture is much stronger than the country culture. This has implications for multinational businesses that want the accounts prepared in different countries to be uniform in quality. It is significant for audit firms that want their sister firms in other countries to apply the same standards to audit judgements. It is important to investment firms that are making investments throughout the world on the understanding that accounting and ethical standards mean the same things in all major security markets.

Where there are differences in legal and cultural settings then potentially the correct accounting will also differ if a principles based approach is adopted. Currently, Western concepts dominate accounting but if the world power base shifts to either being made up of several world centres of influence, or a new dominant world power, the principles of accounting may have to reflect that.

7.7 The accounting standard-setting process and ethics

Standard setters seem to view the process as similar to physics in the sense of trying to set standards with a view to achieving an objective measure of reality. However, some academics suggest that such an approach is inappropriate because the concepts of profit and value are not physical attributes but 'man made' dimensions. For instance, for profit we measure the progress of the business but the concept of progress is a very subjective attribute which has traditionally omitted public costs such as environmental and social costs. The criteria of fairness has been seen as satisfied by preparing profit statements on principles such as going concern and accrual when measuring profit and neutrality when presenting the profit statement.

What if fairness is defined differently? For example, the idea of basing accounting on the criteria of fairness to all stakeholders (financiers, workers, suppliers, customers and the community) was made by Leonard Spacek¹⁰ before the formation of the FASB. However, this view was not appreciated by the profession at that time. We now see current developments in terms of environmental and social accounting which are moves in that direction but, even so, CSR is not incorporated into the financial statements prepared under IFRSs and constitutes supplementary information that is not integrated into the accounting measures themselves.

The accounting profession sees ethical behaviour in standard setting as ensuring that accounting is neutral. Their opponents think that neutrality is impossible and that accounting has a wide impact on society and thus to be ethical the impact on all parties affected should be taken into consideration.

The accounting profession does not address ethics at the macro level other than pursuing neutrality, but rather focus their attention on actions after the standards and laws are in place. The profession seeks to provide ethical standards which will increase the probability of those standards being applied in an ethical fashion at the micro level where accountants apply their individual skills.

The accounting profession through its body the International Federation of Accountants (IFAC) has developed a *Code of Ethics for Professional Accountants*.¹¹ That code looks at fundamental principles as well as specific issues which are frequently encountered by accountants in public practice, followed by those commonly faced by accountants in business. The intention is that the professional bodies and accounting firms 'shall not apply less stringent standards than those stated in this code' (p. 4).

7.8 The IFAC Code of Ethics for Professional Accountants

The IFAC Fundamental Principles are:

- i) 'A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest . . .' (100.1)
- ii) 'A professional accountant shall comply with the following fundamental principles:
 - a) *Integrity* – to be straightforward and honest in all professional and business relationships.
 - b) *Objectivity* – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
 - c) *Professional Competence and Due Care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
 - d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
 - e) *Professional Behaviour* – to comply with relevant laws and regulations and avoid any action that discredits the profession' (100.5).

7.8.1 Acting in the public interest

The first underlying statement that accountants should act in the public interest is probably more difficult to achieve than is imagined. This requires accounting professionals to stand firm against accounting standards which are not in the public interest, even when the politicians and company executives may be pressing for their acceptance. Due to the fact that, in the conduct of an audit, the auditors have dealings mainly with the management, it is easy to lose sight of who the clients actually are. For example, the expression ‘audit clients’ is commonly used in professional papers and academic books when they are referring to the management of the companies being audited. It immediately suggests a relationship which is biased towards management when, legally, the client may be either the shareholders as a group or specific stakeholders. Whilst it is a small but subtle distinction, it could be the start of a misplaced orientation towards seeing the management as the client.

7.8.2 Fundamental principles

The five fundamental principles are probably uncontentious guides to professional conduct. It is the application of those guides in specific circumstances which provides the greatest challenges. The IFAC paper provides guidance in relation to public accountants covering appointments, conflicts of interest, second opinions, remuneration, marketing, acceptance of gratuities, custody of client assets, objectivity, and independence. In regard to accountants in business they provide guidance in the areas of potential conflicts, preparation and reporting of information, acting with sufficient expertise, financial interests, and inducements.

It is not intended to provide all the guidance which the IFAC code of ethics provides, and if students want that detail they should consult the original document. This chapter will provide a flavour of the coverage relating to accountants in public practice and accountants in business.

7.8.3 Problems arising for accountants in practice

Appointments

Before accepting appointments, public accountants should consider the desirability of accepting the client given the business activities involved, particularly if there are questions of their legality. They also need to consider (a) whether the current accountant of the potential client has advised of any professional reasons for not becoming involved and (b) whether they have the competency required considering the industry and their own expertise. Nor should they become involved if they already provide other services which are incompatible with being the auditor or if the size of the fees would threaten their independence. (Whilst it is not stated in the code, the implication is that it is better to avoid situations which are likely to lead to difficult ethical issues.)

Second opinions

When an accountant is asked to supply a second opinion on an accounting treatment, it is likely that the opinion will be used to undermine an accountant who is trying to do the right thing. It is therefore important to ascertain that all relevant information has been provided before issuing a second opinion, and if in doubt decline the work.

Remuneration

Remuneration must be adequate to allow the work to be done in a professional manner.

Commissions received from other parties must not be such as to make it difficult to be objective when advising your client and in any event must at least be disclosed to clients. Whilst not discussed in the document, the involvement of accountants in personal financial planning has raised ethical issues where the investment vehicle rewards the accountants with commissions. Some accountants have addressed that by passing the commissions on to their client and charging a flat fee for the consulting.

Marketing

Marketing should be professional and should not exaggerate or make negative comments about the work of other professionals.

Independence

Accountants and their close relatives should not accept gifts, other than insubstantial ones, from clients. IFAC para. 280.2 provides that:

A professional accountant in public practice who provides an assurance service shall be independent of the assurance client. Independence of mind and in appearance is necessary to enable the professional accountant in public practice to express a conclusion.

Professional firms have their own criterion level as to the value of gifts that can be accepted. For example, the following is an extract from the KPMG Code of Conduct:

Qn: I manage a reproduction center at a large KPMG office. We subcontract a significant amount of work to a local business. The owner is very friendly and recently offered to give me two free movie passes. Can I accept the passes?

Ans: Probably. Here, the movie passes are considered a gift because the vendor is not attending the movie with you. In circumstances where it would not create the appearance of impropriety, you may accept reasonable gifts from third parties such as our vendors, provided that the value of the gift is not more than \$100 and that you do not accept gifts from the same vendor more than twice in the same year.

7.8.4 Problems arising for accountants in business

In relation to accountants in business, the major problem identified by the code seems to be the financial pressures which arise from substantial financial interests in the form of shares, options, pension plans and dependence on employment income to support themselves and their dependants. When these depend on reporting favourable performance, it is difficult to withstand the pressure.

Every company naturally wants to present its results in the most favourable way possible and investors expect this and it is part of an accountant's expertise to do this. However, the ethical standards require compliance with the law and accounting standards subject to the overriding requirement for financial statements to present a fair view. Misreporting and the omission of additional significant material which would change the assessment of the financial position of the company are unacceptable.

Accountants need to avail themselves of any internal steps to report pressure to act unethically, and if that fails to produce results, they need to be willing to resign.

7.8.5 Threats to compliance with the fundamental principles

The IFAC document has identified five types of threats to compliance with their fundamental principles and they will be outlined below. The objective of outlining these potential

threats is to make you sensitive to the types of situations where your ethical judgements may be clouded and where you need to take extra steps to ensure you act ethically. The statements are deliberately broad to help you handle situations not covered specifically by the guidelines. IFAC para. 100.12 provides that:

Threats fall into one or more of the following categories:

- (a) Self-interest threat – the threat that a financial or other interest will inappropriately influence the accountant’s judgment or behaviour;
- (b) Self-review threat – the threat that a professional will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant’s firm or employing organization, or on which the accountant will rely when forming a judgment as part of providing a current service;
- (c) Advocacy threat – the threat that a professional will promote a client’s or employer’s position to the point that the professional accountant’s objectivity is compromised;
- (d) Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
- (e) Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

7.9 Ethics in the accountants’ work environment – a research report

The Institute of Chartered Accountants in Scotland issued a discussion paper report¹² entitled ‘Taking Ethics to Heart’, based on research into the application of ethics in practice. This section will discuss some of the findings of that report.

From a student’s perspective, one of the interesting findings was that many accountants could not remember the work on ethics which they did as students and therefore had little to draw upon to guide them when problems arose. There was agreement that students need to get more experience in dealing with case studies so as to enhance their ethical decision making skills. This should be reinforced throughout their careers by continuing professional development. The training should sensitise accountants so that they can easily recognise ethical situations and develop skills in resolving the dilemmas.

Exposure to ethical issues is usually low for junior positions, although even then there can be clear and grey issues. For example, padding an expense claim or overstating overtime are clear issues, whereas how to deal with information that has been heard in a private conversation between client staff is less clear. What if a conversation is overheard where one of the factory staff says that products have been despatched at the year end which are known to be defective? Would your response be different if you had been party to the conversation? Would your response be different if it had been suggested that there was a risk of injury due to the defect? Is it ethical to inform your manager or is it unethical not to inform?

Normally exposure to ethical issues increases substantially at the manager level and continues at senior management positions. However the significance of ethical decision making has increased with the expansion of the size of both companies and accounting practices. The impact of decisions can be more widespread and profound. Further, there has been an increase in litigation potentially exposing the accountant to more external review. Greater

numbers of accounting and auditing standards can lead to a narrower focus making it harder for individual accountants to envisage the wider ethical dimensions and to get people to consider more than the detailed rules.

Given the likelihood of internal or external review, the emphasis that many participants in the study placed on asking ‘how would this decision look to others?’ seems a sensible criterion. In light of that emphasis by participants in the research it is interesting to consider the ‘Resolving Conflicts’ section of BT PLC’s document called *The Way We Work*¹³ which among other things says:

How would you explain your decision to your colleagues in different countries?

How would you explain your decision to your family or in public?

Does it conflict with your own or BT’s commitment to integrity?

This emphasis on asking how well ethical decisions would stand public scrutiny, including scrutiny in different countries, would be particularly relevant to accountants in businesses operating across national borders.

The role of the organisational setting in improving or worsening ethical decision making was given considerable attention in the ICAS report. A key starting point is having a set of ethical policies which are practical and are reinforced by the behaviour of senior management. Another support is the presence of clearly defined process for referring difficult ethical decisions upward in the organisation.

For those in small organisations, there needs to be an opportunity for those in difficult situations to seek advice about the ethical choice or the way to handle the outcomes of making an ethical stand. Most professional bodies either have senior mentors available or have organised referrals to bodies specialising in ethical issues.

The reality is that some who have taken ethical stands have lost their jobs, but some of those who haven’t stood their ground have lost their reputations or their liberty.

7.10 Implications of unethical behaviour for financial reports

One of the essential aspects of providing complete and reliable information which are taken seriously by the financial community is to have a set of rigorous internal controls. However, ultimately those controls are normally dependent on checks and balances within the system and the integrity of those with the greatest power within the system. In other words, the checks and balances, such as requiring two authorisations to issue a cheque or transfer money, presume that at least one of those with authority will act diligently and will be alert to the possibility of dishonest or misguided behaviour by the other. Further, if necessary or desirable, they will take firm action to prevent any behaviour that appears suspicious. The internal control system depends on the integrity and diligence, in other words the ethical behaviour of the majority of the staff in the organisation.

7.10.1 Increased cost of capital

The presence of unethical behaviour in an organisation will raise questions about the reliability of the accounts. If unethical behaviour is suspected by investors, they will probably raise the cost of capital for the individual business. If there are sufficient cases of unethical behaviour across all companies, the integrity of the whole market will be brought into question and the liquidity of the whole market is reduced. That would affect the cost of funds across the board and increase the volatility of share prices.

7.10.2 Hidden liabilities

The other dimension related to the presence of unethical behaviour is associated with hidden liabilities. To illustrate, if a firm cuts corners in terms of quality control, there will be future costs in terms of satisfying warranties and perhaps the undermining of the value of goodwill.

If suppliers are treated unethically and unfairly, they may in the longer term refuse to supply or make the supply more expensive. Alternatively they may consolidate activities by mergers so as to increase their bargaining power. Once again the value of intangibles of the purchaser may be undermined.

A liability, particularly an environmental one, might not crystallise for a number of years as with the James Hardie Group in Australia. The James Hardie Group was a producer of asbestos sheeting whose fibres can in the long-term damage the lungs and lead to death. A number of senior executives of the company themselves died from this. The company was slow in taking the product off the market after the potentially dangerous nature of the product was demonstrated although it has for a number of years now only produced and sold the safe alternative fibre board. The challenge the company faced was the long gestation period between the exposure to the dust from the asbestos and the appearance of the symptoms of the disease. It can be up to 40 years before victims find out that they have a death sentence. The company reorganised so that there was a separate entity which was responsible for the liabilities and that entity was supposed to have sufficient funds to cover future liabilities as they came to light. When it was apparent that the funds set aside were grossly inadequate and that the assessment of adequacy had been based on old data rather than using the more recent data which showed an increasing rate of claims, there was widespread community outrage. As a result, the James Hardie Group felt that irrespective of its legal position, it had to negotiate with the state government and the unions to set aside a share of its cash flows from operations each year to help the victims. Thus the unfair arrangements set in place came back to create the equivalent of liabilities and did considerable damage to the public image of the company. This also made some people reluctant to be associated with the company as customers or employees. The current assessment of liability (as at 2009) is set out in a KPMG Actuarial Report.¹⁴

7.10.3 Auditor reaction to risk of unethical behaviour

In addition to the above type items, unethical behaviour should make auditors and investors scrutinise accounts more closely. Following the experiences with companies such as Enron, the auditing standards have placed greater emphasis on auditors being sceptical. This means that if they identify instances of unethical behaviour, they should ask more searching questions. Depending on the responses they get, they may need to undertake more testing to satisfy themselves of the reliability of the accounts.

7.10.4 Risk of fraud

There is an increasing need to be wary of unethical behaviour by management leading to fraud.

Jennings¹⁵ points out that while most of the major frauds that make the headlines tend to be attributed to a small number of individuals, there has to be many other participants who allowed it to happen. For every CEO who bleeds the company through companies paying for major personal expenses, or through gross manipulation of accounts, or back dating of options, there has to be a considerable number of people who know what is happening but

who choose not to bring it to the attention of the appropriate authorities. The appropriate authority could be the board of directors, or the auditors or regulatory authorities. She attributes this to the culture of the organisation and suggests there are seven signs of ethical collapse in an organisation. They include pressure to maintain the numbers, dissent and bad news are not welcome, iconic CEOs surrounding themselves by young executives whose careers are dependent on them, a weak board of directors, numerous conflicts of interest, innovation abounds, and where goodness in some areas is thought to atone for evil in others.

Others have suggested that companies with high levels of takeover activity and high leverage often are prime candidates for fraud because of the pressures to achieve the numbers. Also if the attitude is that the sole purpose of the firm is to make money subject to compliance with the letter of the law, that is also a warning sign.

The ICSA Report¹⁶ *Taking Ethics to Heart* noted that it appeared that the current business and commercial environment placed an enormous pressure on accountants, wherever they work, which may result in decisions and judgements that compromise ethical standards. It noted also that increased commercial pressures on accountants may be viewed by many within the profession as heralding a disquieting new era.

The accountant working within business has a different set of problems due to the dual position as an employee and a professional accountant. There is a potential clash of issues where the interests of the business could be at odds with professional standards.

7.10.5 Action by professional accounting bodies to assist members

The various professional bodies approach things in different ways. For example, the ICAEW established the Industrial Members Advisory Committee on Ethics (IMACE) in the late 1970s to give specific advice to members with ethical problems in business. This is supported by a strong local support network as well as a national helpline for the guidance of accountants. At the moment IMACE is dealing with 200 to 300 problems per year but this is more a reflection of the numbers of chartered accountants in business than a reflection on the lack of ethical problems.

The type of problem raised is a good indication of the ethical issues raised for accountants in business. They include:

- requests by employers to manipulate tax returns;
- requests to produce figures to mislead shareholders;
- requests to conceal information;
- requests to manipulate overhead absorption rates to extort more income from customers (an occurrence in the defence industries);
- requests to authorise and conceal bribes to buyers and agents, a common request in some exporting businesses;
- requests to produce misleading projected figures to obtain additional finance;
- requests to conceal improper expense claims put in by senior managers;
- requests to over- or undervalue assets;
- requests to misreport figures in respect of government grants;
- requests for information which could lead to charges of ‘insider dealing’;
- requests to redefine bad debts as ‘good’ or vice versa.

For accountants in industry, the message is that if your employer has a culture which is not conducive to high ethical values then a good career move would be to look for employment

elsewhere. For auditors, the message is that the presence of symptoms suggested above is grounds for employing greater levels of scepticism in the audit.

7.11 Company codes of ethics

Most companies now adopt codes of ethics. They may have alternative titles such as our values, codes of conduct, and codes of ethics. For example, BP has a code of conduct whose coverage, which is listed below, is what one would expect of a company involved in its industry and its activities covering a large number of countries. Its Code of Conduct includes the following major categories:

- Our commitment to integrity.
- Health, safety, security and the environment.
- Employees.
- Business partners.
- Governments and communities.
- Company assets and financial integrity.

Note that at the time of writing (June 2010), BP's code of conduct is under close scrutiny due to the oil drilling disaster in the Gulf of Mexico.

However, the challenge is to make the code an integral part of the day-to-day behaviour of the company and to be perceived as doing such by outsiders. Obviously top management has to act in ways so as to reinforce the values of the code and to eliminate existing activities which are incompatible with the new values.

BP has been criticised for behaviour inconsistent with its values but such behaviour may relate to actions taken before the adoption of the code.¹⁷

Thus it is important to ensure that the corporate behaviour is consistent with the code of conduct, that staff are rewarded for ethical behaviour and suffer penalties for non-compliance. Breaches, irrespective of whether they are in the past, are difficult to erase from the memories of society.

Stohl *et al.*¹⁸ suggest that the content of codes of conduct can be divided into three levels.

- Level 1 – there is an attempt to ensure that the company is in compliance with all the laws which impact on it in the various countries in which it operates.
- Level 2 – focuses on ensuring fair and equitable relations with all parties with which the company has direct relations. In this category would be the well publicised adverse publicity which Nike received when it was alleged that their subcontractors were exploiting child labour in countries where such treatment is legal. The adverse publicity and boycotts meant that many companies reviewed their operations and expanded their codes to cover such situations and thus moved into the second level of ethical awareness.
- Level 3 – is where the companies take a global perspective and recognise their responsibility to contribute to the likelihood of peace and favourable global environmental conditions. In most companies the level one concerns are more dominant than level two than the level three. European firms are more likely than US to have a level-three orientation.

7.11.1 Conflict between codes and targets

On the one hand, we see companies developing Codes of Ethical Conduct whilst on the other hand we see some of these same companies developing Management by Objectives

which set staff unachievable targets and create pressures that lead to unethical behaviour. Where this occurs there is the risk that an unhealthy corporate climate may develop resulting in the manipulation of accounting figures and unethical behaviour.

There is a view¹⁹ that there is a need to create an ethical climate that transcends a compliance approach to ethics and focuses instead on fostering socially harmonious relationships. An interesting article²⁰ proceeds to make the argument that the recent accounting scandals may be as much a reflection of a deficient corporate climate, with its concentration on setting unrealistic targets and promoting competition between the staff, as of individual moral failures of managers.

7.11.2 Multinationals face special problems

The modern multinational companies experience special problems in relation to ethics. Firstly, the transactions are often extremely large, so that there are greater pressures to bend the rules so as to get the business. Secondly, the ethical values as reflected in some of the countries may be quite different from those in the head office of the group. One company did business in a developing country where the wages paid to public officials were so low as to be insufficient to support a family even at the very modest living standards of that country. Many public officials had a second job so as to cope. Others saw it as appropriate to demand kick backs in order for them to process any government approvals as for them there was a strong ethical obligation to ensure their family was properly looked after which in their opinion outweighs their obligation to the community.

Is it ethical for other nations to condemn such behaviour in the extreme cases? Should a different standard apply? What is the business to do if that is the norm in a country? Some may decline to do business in those countries, others may employ intermediaries. In the latter case, a company sells the goods to an intermediary company which then resells the goods in the problem country. The intermediary obviously has to pay fees and bribes to make the sale but that is not the concern of the multinational company! They deliberately do not ask the intermediary what they do. However, it could become a concern if a protest group identifies the questionable behaviour of the agent and decides to hold the multinational responsible. A third option is to just pay the fees and bribes. The problem with the second and third positions is that they may be held responsible by one of the countries in which they operate which has laws making it illegal to corrupt public officials in their country or any other country. Also there is the problem that if companies pay bribes that behaviour reinforces the corrupt forces in the target country which, in turn, makes it difficult for the government of that country to eliminate corruption.

The Serious Fraud office in the UK²¹ and the Department of Justice in the US are actively investigating corrupt practices. For example, in 2010 BAE Systems had to pay substantial fines for being involved in bribery. In the USA it had to pay \$USD400 million to settle allegations of bribery in relation to arms deals with Saudi Arabia. The Serious Fraud Office in the UK made it pay £30 million in relation to over-priced military radar sold to Tanzania whilst taking into account the implementation by BAE Systems of substantial ethical and compliance reforms. Part of the fines is being passed on to the people of Tanzania to compensate for the damage done.

7.11.3 The support given by professional bodies in the designing of ethical codes

There are excellent support facilities available. For example, the Chartered Association of Certified Accountants website (www.accaglobal.com) makes a toolkit available for accountants

who might be involved with designing a code of ethics. The site also provides an overview which considers matters such as why ethics are important, links to other related sites, e.g. the Center for Ethics and Business from Loyola Marymount University in Los Angeles²² with a quiz to establish one's ethical style as an ethic of justice or an ethic of care and a toolkit²³ to assist in the design of a code of ethics.

7.12 The increasing role of whistle-blowing

It is recognised that normally when the law or an ethical code is being broken by a company, a range of people inside and outside the company are aware of the illegal activities or have sufficient information to raise suspicions. To reduce the likelihood of illegal activity or to help identify its occurrence, a number of regulatory organisations have set up mechanisms for whistle-blowing to occur. Also a number of companies have set up their own units, often through a consulting firm, whereby employees can report illegal activities and breaches of a firm's code of ethics or any other activities which are likely to bring a company into disrepute.

Immunity to the first party to report

For example, in many countries the regulatory authority responsible for pursuing price fixing has authority to give immunity or favourable treatment to the first party to report the occurrence of price fixing. It may be possible for the person's lawyer to ascertain whether the item has already been reported without disclosing the identity of the client. This arrangement is in place because of the difficulty of collecting information on such activities of sufficient quality and detail to successfully prosecute. For example, British Airways was fined about £270 million after it admitted collusion in fixing the prices of fuel surcharges. The US Department of Justice fined it \$300 million (£148 million) for colluding on how much extra to charge on passenger and cargo flights, to cover fuel costs and UK's Office of Fair Trading fined it £121.5 million, after it held illegal talks with rival Virgin Atlantic. Virgin was given immunity after it reported the collusion and was not fined.

Anonymous whistle-blowing

In the case of large companies, it is difficult for top management to be fully informed as to whether subordinates throughout the organisation are acting responsibly. One solution has been to arrange for an accounting firm to have a contact number where people can anonymously report details of breaches of the law or breaches of ethics or other activities impacting on the good name of the company. It has to be anonymous for several reasons. Firstly people will often be reporting on activities which they have been 'forced' to do or on activities of their superior or colleagues. Given that those colleagues will not take kindly to being reported on, and are capable of making life very difficult for the informant, it is important that reports can be made anonymously. Also even those who are not directly affected will often view whistle-blowing as letting the side down. The whistle-blower, if identified, could well be ostracised. Whilst firms having anonymous hot lines may well support individuals if they ask for it, whistle-blowers need to realise from the beginning that ultimately they may have to seek alternative employment. This is not to suggest they shouldn't blow the whistle. Rather it is to reflect the history of whistle-blowers. However, this should be contrasted with the alternative. If the behaviour you are being required to undertake exposes you to criminal actions, it is better to do the hard work now than suffer the consequences of lost reputation, possibly lost liberty, severe financial penalties, and the

stress of drawn out law cases. If you are not involved but are just trying to prevent the company from getting further into negative territory, you may be doing many people a favour. You may prevent the company from getting into a position from which there may be no recovery. You will avoid other people from suffering the same stress which you are under.

Take Enron as an example. The collapse of the company meant many people lost their job and a substantial portion of their superannuation. Others served time in prison. This included executives, and external parties who benefited from or supported the illegal or unethical behaviour. Also the events surrounding the failure contributed to the series of events which destroyed their auditors Arthur Andersen. If someone had blown the whistle much earlier then perhaps a number of those serious consequences would never have occurred. As it was, the staff member who raised the issue of dubious accounting with the CEO, Kenneth Lay, shortly before the collapse, made it harder for him to deny responsibility when he was tried for fraud.

Proportionate response

In spite of the above comments, it is important to keep in mind that the steps taken should reflect the seriousness of the event and that the whistle-blowing should be the final strategy rather than the first. In other words, the normal actions should be to use the internal forums such as debating issues in staff meetings or raising the issue with an immediate superior or their boss when the superior is not approachable for some reason. Nor are disagreements over business issues a reason for reporting. The motivation should be to report breaches which represent legal, moral or public interest concerns and not matters purely relating to differences of opinion on operational issues, personality differences or jealousy.

Government support

There are legal protections against victimisation but it would be more useful if the government provided positive support such as assistance with finding other employment or, perhaps, some form of financial reward to compensate for public spirited actions that actually lead to professional or financial hardship for the whistle-blower.

7.12.1 The role of financial reporting authorities

The financial markets are very dependent on the presence of trust in the integrity of the system and all major players in its operation. It is noticeable that in periods when there have been lower levels of trust participation rates have fallen, prices are lower and prices are more volatile. To maintain trust in the system, financial regulatory authorities monitor inappropriate behaviour and take action against offenders. We comment briefly on the FINRA in the US and the Accounting and Actuarial Disciplinary Board in the UK.

FINRA (Financial Industry Regulatory Authority)

In announcing its creation of the ‘Office of the Whistleblower’ on 5 March 2009 the FINRA said:²⁴

Some of FINRA’s most significant enforcement actions have resulted from investor complaints or anonymous insider tips. They include FINRA’s 2007 action against Citigroup Global Markets, ordering the firm to pay a \$3 million fine and \$12.2 million in restitution to customers to settle charges of misleading Bell South employees in North and South Carolina at early retirement seminars; FINRA’s 2006 fine of \$5 million against Merrill Lynch to resolve charges related to supervisory violations at its customer Call Center; FINRA’s 2005 landmark action against the Kansas firm

Waddell & Reed, Inc., in which the firm was fined \$5 million and ordered to pay \$11 million in restitution to customers to resolve charges related to variable annuity switching; and, FINRA's 2002 action against Credit Suisse First Boston to resolve charges of siphoning tens of millions of dollars of customers' profits in exchange for 'hot' IPO shares, which resulted in a \$50 million fine imposed by FINRA and an additional \$50 million fine imposed by the Securities and Exchange Commission.

The Accounting and Actuarial Disciplinary Board

In the UK there is the Accounting and Actuarial Disciplinary Board which investigates and hears complaints. It has on its web pages²⁵ details of pending cases and reports on completed cases. People with complaints are referred to the relevant accounting professional bodies (ICAEW, ACCA, CIMA, CIPFA) which will try to resolve the issues and if appropriate will refer them to the tribunal.

Whistle-blowing – protection in the UK

In the UK the Public Interest Disclosure Act came into force in 1999 protecting whistle-blowers who raised genuine concerns about malpractice from dismissal and victimisation in order to promote the public interest. The scope of malpractice is wide-ranging, including, e.g. the covering up of a suspected crime, a civil offence such as negligence, a miscarriage of justice, and health and safety or environmental risks.

Whistle-blowing – policies

Companies should have in place a policy which gives clear guidance to employees on the appropriate internal procedures to follow if there is a suspected malpractice. Employees, including accountants and internal auditors, are expected to follow these procedures as well as acting professionally and in accordance with their own professional code.

The following is an extract from the Vodafone 2009 Annual Report:

Ethics

Vodafone's success is underpinned by our commitment to ethical conduct in the way we do business and interact with key stakeholders.

Business principles

Our *Business Principles* define how we intend to conduct our business and our relationships with key stakeholders. They require employees to act with honesty, integrity and fairness.

The principles cover ethical issues including:

- Bribery and corruption
- Conflicts of interest
- Human rights.

The Business Principles set a policy of zero tolerance on bribery and corruption. Our *Anti-corruption Compliance Guidelines* help ensure employees comply with all applicable anti-corruption laws and regulations. We have also introduced an anti-bribery online training course.

Reporting violations

Employees can report any potential violations of the Business Principles to their line manager or local human resources manager in the first instance. Alternatively, they can raise concerns anonymously to our Group Audit Director or our Group Human Resources Director via an online whistle-blowing system.

Our Duty to Report policy applies to *suppliers* and contractors as well as employees. Concerns can be reported either by contacting Vodafone's Group Fraud Risk and Security Department directly, or via a third party confidential telephone hotline service. The line is available 24 hours a day. All calls are taken by an independent organisation with staff trained to handle calls of this nature.

However, although the whistle-blowing policies might have been followed and the accountants protected by the provisions of the Public Interest Disclosure Act, it could result in a breakdown of trust making their position untenable; this means that a whistle-blower might be well advised to have an alternative position in mind.

Breach of confidentiality

Auditors are protected from the risk of liability for breach of confidence provided that:

- disclosure is made in the public interest;
- disclosure is made to a proper authority;
- there is no malice motivating the disclosure.

7.12.2 Legal requirement to report – national and international regulation

It is likely that there will be an increase in formal regulation as the search for greater transparency and ethical business behaviour continues. We comment briefly on national and international regulation relating to money laundering and bribery.

Money laundering – overview

There are various estimates of the scale of money laundering ranging up to over 2% of global gross domestic product. Certain businesses are identified as being more prone to money laundering, e.g. import/export companies and cash businesses such as antiques and art dealers, auction houses, casinos and garages. However, the avenues are becoming more and more sophisticated with methods varying between countries, e.g. in the UK there is the increasing use of smaller non-bank institutions, whereas in Spain it includes cross-border carrying of cash, money-changing at bureaux de change and investment in real estate.

Money laundering – implications for accountants

In 2006 the Auditing Practices Board (APB) in the UK issued a revised Practice Note 12 *Money Laundering* which required auditors to take the possibility of money laundering into account when carrying out their audit and to report to the appropriate authority if they become aware of suspected laundering.

In 1999 there was also guidance from the professional accounting bodies, e.g. *Money Laundering: Guidance Notes for Chartered Accountants* issued by the Institute of Chartered Accountants which deal with the statute law, regulations and professional requirements in relation to the avoidance, recognition and reporting of money laundering.

Money laundering – the Financial Action Task Force (FATF)

The Financial Action Task Force (FATF) is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing. Recommendations issued by the FATF define criminal justice and regulatory measures that should be implemented to counter this problem. These Recommendations also include international co-operation and preventive measures to be

taken by financial institutions and others such as casinos, real estate dealers, lawyers and accountants. The Recommendations are recognised as the global anti-money laundering (AML) and counter-terrorist financing (CFT) standard.

The FATF issued a report²⁶ in 2009 titled *Money Laundering Through the Football Sector*. This report identified the vulnerabilities of the sector arising from transactions relating to the ownership of football clubs, the transfer market and ownership of players, betting activities and image rights, sponsorship and advertising arrangements. The report is an excellent introduction to the complex web that attracts money launderers.

7.13 Why should students learn ethics?

Survival of the profession

There is debate over whether the attempts to teach ethics are worthwhile. However this chapter is designed to raise awareness of how important ethics are to the survival of the accounting profession. Accounting is part of the system to create trust in the financial information provided. The financial markets will not operate efficiently and effectively if there is not a substantial level of trust in the system. Such trust is a delicate matter and if the accounting profession is no longer trusted then there is no role for them to play in the system. In that event, the accounting profession will vanish. It may be thought that the loss of trust is so unlikely that it need not be contemplated. But who imagined that Arthur Andersen as we knew it would vanish from the scene so quickly? As soon as the public correctly or incorrectly decided that it could no longer trust Arthur Andersen, the business crashed.

A future role for accountants in ethical assurance

The accountant within business could also be seeing a growth in the ethical policing role as internal auditors take on the role of assessing the performance of managers as to their adherence to the ethical code of the organisation. This is already partially happening as conflicts of interest are often highlighted by internal audits and comments raised on managerial practices. This is after all a traditional role for accountants, ensuring that the various codes of practice of the organisation are followed. The level of adherence to an ethical code is but another assessment for the accountant to undertake.

Implications for training

If, as is likely, the accountant has a role in the future as ‘ethical guardian’, additional training will be necessary. This should be done at a very early stage, as in the USA, where accountants wishing to be Certified Public Accountants (CPAs) are required to pass formal exams on ethical practices and procedures before they are allowed the privilege of working in practice. Failure in these exams prevents the prospective accountant from practising in the business environment.

In the UK, for example, ethics is central to the ACCA Qualification in recognition that values, ethics and governance are themes which organisations are now embedding into company business plans and expertise in these areas is highly sought after in today’s employment market. ACCA has adopted a holistic approach to a student’s ethical development through the use of ‘real-life’ case studies and embedding ethical issues within the exam syllabi. For example, the ACCA’s Paper P1, *Professional Accountant*, covers personal and professional ethics, ethical frameworks and professional values, as applied in the context of the accountant’s duties and as a guide to appropriate professional behaviour and conduct in

a variety of situations. In addition, as part of their ethical development, students will be required to complete a two-hour online training module, developed by ACCA. This will give students exposure to a range of real-life ethical case studies and will require them to reflect on their own ethical behaviour and values. Students will be expected to complete the ethics module before commencing their professional-level studies. Similar initiatives are being taken by the other professional accounting bodies.

Summary

At the macro level, the existence of the profession and the careers of all of us are dependent on the community perception of the profession as being ethical. Students need to be very conscious of that as they are the profession of the future.

At a more micro level, all accountants will face ethical issues during their careers whether they recognise them or not. This chapter attempts to make you more aware of the existence of ethical questions. The simplest way to increase awareness is to ask the question:

- Who is directly or indirectly affected by this accounting decision?

Then the follow up question is:

- If I were in their position, how would I feel about the accounting decision in terms of its fairness? (This is Rawls' (1971, revised 1999) and Baumol's (1982) superfairness proposal).

By increasing awareness of the impact of decisions, including accounting decisions, on other parties hopefully the dangers of decisions which are unfair will be recognised. By facing the implications head on, the accountant is less likely to make the wrong decisions. Also keep in mind those accountants who never set out to be unethical but by a series of small incremental decisions found themselves at the point of no return. The personal consequences of being found to be unethical can cover financial disasters, a long period of stress as civil or criminal cases wind their way through the courts, and at the extreme suicide or prison.

Another aspect of this chapter has been the attempt to highlight the vulnerability of companies to accusations of both direct and indirect unethical impacts and hence the need to be aware of trends to increasing levels of accountability.

Finally, you need to be aware of the avenues for getting assistance if you find yourself under pressure to ignore ethics or to turn a blind eye to the inappropriate behaviour of others. You should be aware of built-in avenues for addressing such concerns within your own organisation. Further, you should make yourself familiar with the assistance your professional body can give, such as providing experienced practitioners to discuss your options and the likely advantage and disadvantages of those alternatives.

REVIEW QUESTIONS

- 1 Explain in your own words the meaning of ethics.
- 2 Explain the link between corporate governance and ethical decision making.

3 Identify two ethical issues which university students experience and where do they look for guidance. How useful is that guidance? (Whilst the examples do not have to be personal accounts, they do have to be real student issues.)

4 The following is an extract from a *European Accounting Review*²⁷ article:

On the teaching front, there is a pressing need to challenge more robustly the tenets of modern day business, and specifically accounting, education which have elevated the principles of property rights and narrow self-interest above broader values of community and ethics.

Discuss how such a challenge might impact on accounting education.

5 The International Association for Accounting Education and Research states that: 'Professional ethics should pervade the teaching of accounting' (www.iaaer.org). Discuss how this can be achieved on an undergraduate accounting degree.

6 As a trainee auditor what ethical issues are you most likely to encounter?

7 Do some research on the failure of Enron and identify and explain at least one instance of unethical behaviour of an accounting or financial executive flowing from a self-interest threat.

8 Explain what you think are four common types of ethical issues associated with (a) auditing, (b) public practice, (c) accounting in a corporate environment.

9 In the ICAS report one accountant suggested that where a company is required to recast its accounts then all the accountants associated with those incorrect accounts, whether they be the preparer or the auditor or a director, should be investigated by the professional bodies for a potential breach of ethics. Discuss why this should or should not occur.

10 An interesting ethical case arose when an employee of a Swiss bank stole records of the accounts of international investors. The records were then offered for sale to the German government on the basis that many of them would represent unreported income and thus provide evidence of tax evasion? Should the government buy the records? Provide arguments for and against.

11 Look up the web page of a major company (other than one mentioned in this chapter) and report on the following aspects of the whistle-blowing arrangements:

(a) Is the whistle-blowing arrangement in-house or with a third party?

(b) If a third party handles the reporting, is that party seen as relatively independent of the company or might a whistle-blower perceive the relationship as too close?

(c) What is the range of activities which the reporting agency suggests are the type of activities that would lead to the use of the reporting arrangements?

12 In relation to the following scenarios explain why it is a breach of ethics and what steps could have been taken to avoid the issue:

(a) The son of the accountant of a company is employed during the university holiday period to undertake work associated with preparation for a visit of the auditors.

(b) A senior executive is given a first class seat to travel to Chicago to attend an industry fair where the company is launching a new product. The executive decides to cash in the ticket and to get two economy class tickets so her boyfriend can go with her. The company picks up the hotel bill and she reimburses the difference between what it would have cost if she went alone and the final bill. The frequent flier points were credited to her personal frequent flier account. Would it make any difference if the company were not launching a new product at the fair?

- (c) You pay a sizeable account for freight on the internal shipping of product deliveries in an underdeveloped country. At morning tea the gossip is that the company is paying bribes to a general in the underdeveloped country as protection money.
 - (d) The credit card statement for the managing director includes payments to a casino. The managing director says it is for the entertainment of important customers.
 - (e) You are processing a payment for materials which have been approved for repairs and maintenance when you realise the delivery is not to one of the business addresses of the company.
- 13** In each of the following scenarios outline the ethical problem and suggest ways in which the organisation may solve the problem and prevent its reoccurrence.
- (a) A director's wife uses his company car for shopping.
 - (b) Groceries bought for personal use are included on a director's company credit card.
 - (c) A director negotiates a contract for management consultancy services but it is later revealed that her husband is a director of the management consultancy company.
 - (d) The director of a company hires her son for some holiday work within the company but does not mention the fact to her fellow directors.
 - (e) You are the accountant to a small engineering company and you have been approached by the chairman to authorise the payment of a fee to an overseas government employee in the hope that a large contract will be awarded.
 - (f) Your company has had some production problems which have resulted in some electrical goods being faulty (possibly dangerous) but all production is being dispatched to customers regardless of condition.
- 14** In each of the following scenarios outline the ethical or potential ethical problem and suggest ways in which the ethical problem could be resolved or avoided:
- (a) Your company is about to sign a contract with a repressive regime in South America for equipment which **could** have a military use. Your own government has given you no advice on this matter.
 - (b) Your company is in financial difficulties and a large contract has just been gained in partnership with an overseas supplier which employs children as young as seven years old on its production line. The children are the only wage earners for their families and there is no welfare available in the country where they live.
 - (c) You are the accountant in a large manufacturing company and you have been approached by the manufacturing director to prepare a capital investment proposal for a new production line. After your calculations the project meets **none** of the criteria necessary to allow the project to proceed but the director instructs you to change the financial forecast figures to ensure the proposal is approved.
 - (d) Review the last week's newspapers and select **three** examples of failures of business ethics and justify your choice of examples.
 - (e) The company deducts from the monthly payroll employees' compulsory contribution to their superannuation accounts. The payment to the superannuation fund, which also includes the company's matching contribution, is only being made six monthly because the cash flow of the company is tight following rapid expansion.
- 15** It has sometimes been argued that there is no need to impose more regulations on auditors because the risk of being sued is so significant, and the amount of the potential awards against auditors so large that auditors, out of self-interest, will be conscientious in their tasks. Examine this argument in detail and whether the evidence supports the argument.

- 16** Should ethics be applicable at the standard-setting level? Express and justify your own views on this as distinct from repeating the material in the chapter.
- 17** Refer to the Ernst & Young Code of Conduct and discuss the Questions they suggest when putting their Global Code of Conduct into action.²⁸
- 18** Discuss the role of the accounting profession in the issue of ethics.
- 19** How might a company develop a code of ethics for its own use?
- 20** Outline the advantages and disadvantages of a written code of ethics.
- 21** (a) Obtain an ethical statement from:
(i) a commercial organisation;
(ii) a charitable organisation.
(b) Review each statement for content and style.
(c) Compare each of the two statements and highlight any areas of difference which, in your view, reflect the different nature of the two organisations.
- 22** Lord Borrie QC has said²⁹ of the Public Interest Disclosure Bill that came into force in July 1999 that the new law would encourage people to recognise and identify with the wider public interest, not just their own private position and it will reassure them that if they act reasonably to protect the legitimate interest of others, the law will not stand idly by should they be vilified or victimised. Confidentiality should only be breached, however, if there is a statutory obligation to do so. Discuss.
- 23** The management of a listed company has a fiduciary duty to act in the best interest of the shareholders and it would be unethical for the management to act in the interest of other shareholders if this did not maximise the existing earnings per share. Discuss.
- 24** The financial director of a listed company makes many decisions which are informed by statute, e.g. the Companies Act and the Public Interest Disclosure Act, and by mandatory pronouncements by, e.g. the ASB, the APB and his professional accounting body. What guidance is available when there is a need for an ethical decision which does not contravene statutory or mandatory demands – how can there be confidence that the decision is right?
- 25** Confidentiality means that an accountant in business has a loyalty to the business which employs him/her which is greater than any commitment to a professional code of ethics. Discuss.
- 26** It has been said that football clubs are seen by criminals as the perfect vehicles for money laundering. Discuss the reason for this view.

EXERCISES

Question 1

You have recently qualified and set up in public practice under the name Patris Zadan. You have been approached to provide accounting services for Joe Hardiman. Joe explains that he has had a lawyer set up six businesses and he asks you to do the books and to handle tax matters. The first thing you notice is that he is running a number of laundromats which are largely financed by relatives from overseas. As the year progresses, you realise those businesses are extremely profitable given industry averages.

Required:

Discuss – What do you do?

Question 2

Joe Withers is the chief financial officer for Withco plc responsible for negotiating bank loans. It has been the practice to obtain loans from a number of merchant banks. He has recently met Ben Billings who had been on the same undergraduate course some years earlier. They agree to meet for a game of squash and during the course of the evening Joe learns that Ben is the chief loans officer at the Swift Merchant Bank.

During the next five years Joe negotiates all of the company's loan requirements through Swift and Ben arranges for Joe to receive substantial allocations in initial public offerings. Over that period Joe has done quite well out of taking up allocations and selling them within a few days on the market.

Required:

Discuss the ethical issues.

Question 3

Kim Lee is a branch accountant in a multinational company Green Cocoa plc responsible for purchasing supplies from a developing country. Kim Lee is authorised to enter into contracts up to \$100,000 for any single transaction. Demand in the home market is growing and head office is pressing for an increase in supplies. A new government official in the developing country says that Kim needs an export permit from his department and that he needs a payment to be made to his brother in law for consulting services if the permit is to be granted. Kim quickly checks alternative sources and finds that the normal price combined with the extra 'facilitation fee' is still much cheaper than the alternative sources of supply. Kim faces two problems, namely, whether to pay the bribe and, if so, how to record it in the accounts so it is not obvious what it is.

Required:

Discuss the ethical issues.

Question 4

Jemma Burrett is a public practitioner. Four years earlier she had set up a family trust for a major client by the name of Simon Trent. The trust is for the benefit of Simon and his wife Marie. Marie is also a client of the practice and the practice prepares her tax returns. Subsequently Marie files for divorce. In her claim for a share of the assets she claims a third share of the business and half the other assets of the family which are listed. The assets of the family trust are not included in the list.

Required:

Discuss the ethical issues raised by the case and what action the accountant should take (if any).

Question 5

George Longfellow is a financial controller with a listed industrial firm which has a long period of sustained growth. This has necessitated substantial use of external borrowing.

During the great financial crisis it has become harder to roll over the loans as they mature. To make matters worse sales revenues have fallen 5% for the financial year, debtors have taken longer to pay, and margins have fallen. The managing director has said that he doesn't want to report a loss for the first time in the company's history as it might scare financiers.

The finance director (FD) has told George to make every effort to get the result to come out positively. He suggests that a number of expenses should be shifted to prepayments, provisions for doubtful debts should be lowered, and that new assets should not be depreciated in the year of purchase but rather should only commence depreciation in the next financial year on the argument that new assets take a while to become fully operational.

In the previous year the company had moved into a new line of business where a small number of customers paid in advance. Because these were exceptional the auditors were persuaded to allow you to avoid the need to make the systems more sophisticated to decrease revenue and to recognise a liability. After all, it was immaterial in the overall group. Fortunately that new line of business has grown substantially in the current financial year and it was suggested that the auditors be told that the revenue in advance should not be taken out of sales because a precedent had been set the year before.

George saw this as a little bit of creative accounting and was reluctant to do what he was instructed. When he tentatively made this comment to the FD, he was assured that this was only temporary to ensure the company could refinance and that next year, when the economy recovered, all the discretionary adjustments would be reversed and everyone would be happy. After all, the employment of the 20,000 people who work for the group depends upon the refinancing and it was not as if the company was not going to be prosperous in the future. The FD emphasised that the few adjustments were, after all, a win-win situation for everyone and George was threatening the livelihood of all of his colleagues – many with children and mortgage payments to meet.

Required:

Discuss who would or could benefit or lose from the finance director's proposals.

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