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**PREAMBLE**

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“In public accounting... a commitment to ethical behavior is regarded as the foundation for all other standards of performance.”

- Richard A Turpen, Philip R Witmer

Does the current institution of professional accounting promote an optimal level of auditor ethics?

It is my opinion that currently, it does not.

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**A BROADER DIAGONISIS**

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The grass has been trimmed to perfection. The players have practiced, dreamt, and lived for today. The fans are all in their seats cheering with excitement. It is the final game of the season. Professional football. A sport that has captivated the lives of many North American individuals, and oddly enough, something that Rushworth M. Kidder and Curtis C. Verschoor have been able to associate to the rules of professional auditing services performed by Chartered Accountants in Canada and Chartered Professional Accountants in the United States. In Kidder and Veschoor’s discussion of the association that can be drawn from football to auditing, the key player is the referee. They describe how, much like a referee, an auditor calls all the shots on how the “game” of a company will pan out. With the potential to make or break a team, a referee has to maintain his or her professional demeanor, neutrality, and confidence in his or her decisions. The opinions taken on goals, penalties, and the like, all reside in the discretion of one person, thus forcing the referee to maintain a set of standards that will allow ethical and unbiased decisions to be made. Referees follow rules that require the use of judgment. Failure to follow the rules and the display of poor judgment may result in gaining a poor reputation, suspension, and ultimately being fired. For an auditor, many of the same issues are at stake. An auditor must ensure they act professionally and within the guidelines set out by the Security and Exchange Commission, Institute of Chartered Accountants, generally accepted accounting principles, and other regulation boards depending on the area in which they audit. With many institutions governing the roles of auditors and the work they perform, the question rises of how it becomes possible for large scale accounting scandals such as those of Enron and WorldCom. One would think that auditors should be able to find the mistakes that have been made; which then governs the question of if they do find the mistakes should they report the errors? As investors rely on accurate information being reported in the financial statements, with proper ethical boundaries one would think the answer to this question is quite clear; yet the incorrect, and unethical, answer is often chosen. This provides the overall question to be answered:

**Does the current institution of professional accounting promote an optimal level of auditor ethics?**

The initial answer to this question would stem from an outline of what the optimal level of ethics is. Once this has been outlined two key derivatives of the optimal level of ethics can

be found with corresponding issues in the current market. As I do not believe that the current structure promotes an optimal level of ethics, it is through this paper that I hope to demonstrate methods of improvement with respect to the following two derivatives:

1. A specific level of ethics must be maintained and governed by institutions and industry standards with an issue of how to enforce and align these goals with those of auditors.
2. The level of education provided to students who will become future auditors must meet specific standards in ethical education, enforcing an optimal level of ethics from an early age with the issue of this not happening in all post-secondary institutions.

It is through this report that I hope to analyze these two key issues and develop a clear argument for my belief that we do not currently have the right institutional structure to promote an optimal level of auditor ethics.

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### AN OPTIMAL LEVEL OF ETHICS

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It is my view that the intent of ethical standards within accounting is to provide independence, public confidence, and confidentiality. While there may be additional aspects that others feel are important to recognize, through my undergraduate studies, and personal work in the audit practice I believe these three pillars are of utmost importance. Below I will define these three pillars in their relation to an optimal level of ethics. Once the optimal level of ethics has been defined I will demonstrate how these three pillars fit into the two derivatives of ethical behavior in accounting outlined above.

The roles of these three pillars to ethics are as follows:

#### **Independence:**

“Independence is a multilayered and multidimensional phenomenon that has a reciprocal relationship with trust and ethical behavior as expressed through the rhetoric of corporate governance and regulatory codes.”

-Michael Page and Laura Spira

To ensure audit decisions are non-biased, auditors must maintain a level of objectivity in their overall decision. An audit must not have any effect on the auditor as an individual nor as a professional. Decision must be made through the strict compliance with the rules and regulations set out in the audit methodology employed, and the Canadian Institute of Chartered Accountants handbook (the handbook). Threats of self interest, advocacy, self-review, familiarity, and intimidation must be avoided at all costs. This will prevent an auditor from performing work that, while complete in nature, may provide an influenced decision.

As a pillar of the optimal level of ethics, auditors must ensure they maintain a degree of independence that avoids all such threats.

## **Public Confidence:**

“Investor protection is paramount in everything we do. Investors rely on the integrity of the numbers to make their investment decisions, and the sanctity of these numbers forms the very foundation on which confidence in America's markets is built. Ensuring public confidence begins with the auditor.”

- Hollis Ashbaugh

Professionals as a whole are held to a higher degree of ethical standards than the average individual. The decisions made by professionals are often of judgment, and have effects on many external parties. In terms of ethical standards, if the decisions made by professionals are not congruent with the rules and regulations set by the professional associations, and do not keep the well being of society in mind, there is a threat that the public as a whole will not view an auditor's decisions as valid.

As a pillar of the optimal level of ethics, auditors must ensure they are working towards the well being of society as a whole, securing confidence in their decisions.

## **Confidentiality:**

“A member is bound to professional secrecy and he may not disclose confidential information revealed to him by reason of his position or profession, unless he is authorized to do so by the person who confided such information to him or by an express provision of law.”

- Paragraph 3.02.25 of the Code of Ethics of Chartered Accountants

Auditor's have to work within their boundaries to finesse any issue they find and develop ways to ensure any external stakeholder that would be negatively affected by the issue is notified, without breaching any confidentiality laws. A key threat auditors' face is having information that others need, with no way of disclosing it.

As a pillar of the optimal level of ethics, auditors must ensure they act in a confidential manner to promote trust, while ensuring the exposure of issues that need to be relayed to external parties within a confidential, and law abiding manner.

As a whole, the employment of these three pillars will provide the institution of accounting with a strong level of ethical boundaries. Ensuring these three pillars are followed, and kept in mind during an audit is the tricky part.

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## **INSTITUTIONAL REGULATION AND ENFORCEMENT OF ETHICAL STANDARDS**

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“Lately it has been recognized that the way the practice of accounting is conducted calls for a means of disciplining firms as well as individuals.”

- Wallace E Olson

When teaching children manners, and social skills, simply telling them what they should do is far less effective than enforcing what they do. Parents teach their children through consistent communication and discipline for inappropriate behavior. In accounting, while the communication and discipline must take place at a much higher level, the same idea must be communicated: Unethical behavior will not be tolerated.

The issue of how to enforce and align these goals with those of auditors is the hard part. Currently, various techniques have been implemented such as codes of ethical conduct, legal forces, auditing of the auditors, and industry standards, however the effectiveness of these standards is questionable. It is my view that the following improvements can be made to the level of enforcement of ethics within accounting in order to provide an optimal level of ethics to the auditing practice. As you will see I suggest a number of social, as well as legal actions to be taken. It is my view that the use of social rules can be just as, if not more effective than the use of legal enforcement. This can be seen by comparing Canada and the United States. Canada has a majority of social standards in place for the rules that govern auditor decisions, while the United States has much more legal enforcement. Despite this legal enforcement, the United States also has a lot more fraud. As I believe this is due to the way rules are enforced in the United States, I have developed a much larger amount of social action recommendations. The use of these suggestions will further aid in aligning the goals of the industry with those of the auditors.

### **Independence**

1. “The profession needs to impose on itself or its clients a number of cures for past failures in corporate accountability.” (Wallace E Olson,1978) Olson specifically outlines in his paper the following issue I have further elaborated on.
  - a. There needs to be restriction on the scope of consulting services provided to audit clients. Accountants cannot audit their own work. It is that simple. By creating a situation where an auditor is placed in the position of auditing previous work they have provided a client with, independence is lost. It would be my suggestion that before taking on a new client, the implementation of a regulatory board that governs which firms can and cannot take on a client is implemented. Through the use of this board, all prior work performed for the client must be disclosed, and as a third party the board can decide if sufficient independence exists to govern taking on the audit. This will thus provide the first step of ethical behavior in that no auditor will feel as though they have a stake in the success of the audit, rather they are external to the company as a whole While firms currently use an automated process to confirm with an external party if they are able to take on a new audit client, it is my view that a regulatory board would provide more jurisdiction. With the implementation of a regulatory board random reviews of a firm’s clients can be done, ensuring firms are not sneaking around and taking on clients they have no right to be auditing. Another alternative would be to have the regulation board assign a firm’s clients, rather than firms asking permission to take on a client. By implementing this suggestion into the auditing practice, independence threats will be eliminated at a much higher level. (The legal and structural ramifications of this suggestion are beyond the scope of this report as this would be valued in an ethical perspective.)

### **Public Confidence:**

2. Codes of ethics need to become more visible within the industry and within firms specifically. There must be a “tone at the top” structure within each accounting firm. In this area a high level of communication will be necessary. Often codes of conduct are placed on company websites, given to employees in the form of a manual, and discussed at large group meetings. Research performed by Betsy Stevens indicates that these methods are less effective in conveying standard levels of ethics to employees. By providing a more effective way to ensure codes of ethics are followed, investors can be confident that companies are practicing ethical behavior assuring public confidence in their ethical decisions. It would be far more useful if the following tactics were used to communicate codes of ethics to employees:
  - a. Managers and partners should lead their employees and set clear examples. “Managers who lead by setting clear standards and expecting the best from everyone including themselves are able to create ethical cultures. Ones who consider the ethical codes superfluous fail to establish an ethically meaningful culture. Most employees are motivated to commit to higher principles and unite in a common cause.” (Betsy Stevens, 2003) In particular, new accountants entering the world of audit will need guidance from their managers and partners. By providing such guidance, and use of the code of ethical behavior in job meetings, auditors will be forced to acknowledge its existence, and will have no excuse for performing unethical behavior under the context of never having been told differently.
  - b. There is a need to involve auditors in the creation of the ethical codes of conduct. By doing so, they will feel morally and personally entwined with the success and use of the code. As Betsy Stevens outlines, a five step process including the use of a collaborative process, frequent discussion of the code, use of the code to solve ethical issues, communication of the code to all members, and reward for excellent use of the code will all aid in the alignment of the code’s goals with those of auditors. There will be less apathy with regards to paying attention to, and using the code if auditors are engaged in its development.

### **Confidentiality**

3. Self regulation is key to ensuring ethical standards are used in the world of auditing. Auditors need to feel comfortable with stating their opinion on unethical behavior and its effects on those that use the information provided by the audit. It is my opinion that there is a need for a whistle blowing function to be implemented in the accounting practice. Auditors need to have a safe, confidential, and legal way of disclosing information that may show a client, or associate having committed fraud. By developing an independent association to support the actions of a whistle blower, the likelihood of fraud surfacing before it is too late will increase, along with a decrease in the amount of fraud due to a higher risk of being caught. This will also provide confidentiality to the practice, in that if fraudulent behavior is found, it can be rectified and discussed with the correct and confidential authorities. (The legal and structural ramifications of this suggestion are beyond the scope of this report as this would be valued in an ethical perspective.)

The use of these tactics and the enforcement of them by regulation boards, and accounting firms is key to their success. They must be implemented and maintained, with constant updating and reworking to ensure the optimal level of ethics is maintained at all times.

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### THE ETHICAL EDUCATION OF FUTURE AUDITORS

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“Over the last century the priorities of American higher education have shifted from a focus on the training of ministers and civic leaders for an agrarian society to a focus on training of specialists and managers for an industrial and service-oriented society”

- Robert H Schwartzm, Sami Kassem, and Dean Ludwig

The education of future accountants has always been a very time restricted field. Professors are often faced with the need to pack a course full of technical information, and hope to complete it. Exams consist of technical answers, and discussion within the classroom is rare, as the ultimate goal of the course is to deliver to students the various accounting methods, rather than spending time discussing them. An ethical discussion of the various accounting methods and possible alternatives is rarely, if ever, reviewed in the classroom. Many professors believe, “ethics cannot be taught in the classroom... some claim that an individual's virtue derives from his or her upbringing, and therefore college courses have very little impact on a students responses to ethical issues. Others believe that ethical dilemmas must be dealt with on the job as they are encountered, rather than in a classroom setting”. (Earley and Kelly, 2004) Yet, “a study of accounting firms' attitudes toward ethical training found that the vast majority of firms ‘rely primarily on colleges to cover the ethics and ethical behavior expected in the profession’, rather than provide ethics training on the job.” (Earley and Kell, 2004) It is obvious through research that a gap between what professional accounting firms believe is taking place in regards to ethical training and what professors feel they can do has been developed.

A specific level of ethical educational standards must be implemented into the classroom to ensure that educators and professional firms can rely on the specific standards being taught to students at an early age. While there may end up with one bad egg in the batch, it is still important to realize that education, and an undergraduate education in specific, provides the opportunity to inscribe knowledge into students. The issue of how, and to what degree is the where the dilemma resides.

Many of the post-graduate programs students enroll in for training for the Chartered Accounting (CA) designation do not require an ethics course as a prerequisite. In order to promote an optimal level of ethics within accounting, and to future auditors, students should be required to take a course on ethics, with specific reference to ethics in accounting in order to register in any CA programs. With regards to the 3 pillars of the optimal level of ethics, the course should cover or include the following items:

#### **Independence**

- 1) Students must be provided with a basic understanding of why independence is important and what independence specifically means to an auditor.

- a. A review of the basic threats that face auditors including self interest, advocacy, self-review, familiarity, and intimidation must take place in the form of discussion. Students should be engaged in discussion on ways to avoid such threats, allowing the professor to facilitate discussion and provide guidance to students. Students must also be encouraged to ask questions they have concerns about with regards to independence as a function of ethics, including the topics of consulting work provided to audit clients, insider trading, and personal interests.

### **Public Confidence**

- 1) Students must be aware of the role they are taking on as a public accountant. With all of the money put into recruitment, and the job opportunities available, students often view a career in accounting as one that will be full of riches and glamorous events. They do not however see the social responsibility that comes with the job. In order to rectify this, the specific class on ethics in accounting should include and utilize the use of:
  - a. An introduction into the needs for ethics in the business world, and the accounting profession in specific. By providing the basis for why ethics is important, future auditors will be able to keep a stated optimal level of ethics within their moral principals when making decisions.
  - b. Coverage of general moral reasoning in addition to context-specific training will aid in showing students examples of when their actions will affect total outcomes. (Earley and Kelly, 2004). This will provide students with the ability to relate what they are learning to practical situations. Working with situations that have taken place in past accounting scandals, and current events, to promote discussion will aid in the engagement of students. Furthermore, it will provide students with practical examples that can be employed when faced with ethical dilemmas in the future. The use of case studies and group work will force students to “think outside the box” and prove that with every issue they are handed, an ethical solution can be found.
  - c. Students must be aware of the consequences for not acting in an ethical manner, including both legal and reputation. Schools must ensure that students realize “that the hard work and competence are congruent with social responsibility” (Schwartz, Kassem, Ludwig, 1991) and being a professional places you in a higher level in terms of ethical behavior demanded by the public.
  - d. The formal teaching should be performed by the philosophy departments in universities rather than the business departments. Reasoning for this is the difference in values and goals. Philosophy professors are far less likely to be tainted by the means to an end, cut-throat, kill your competition attitude that many, if not all, business people have. By having a business person educate students on ethical behavior, the risk of their personal morals and “business” qualities will be passed on to students. (Shaw, 1996) This would ultimately provide negative reassurance within the public who may view many business people as crooks to begin with.

## Confidentiality

- 3) “People sometimes have to play tough to win, and if that’s the game, then doing so is fair. But when substantial percentages of students believe that they have to “sell their souls” or “step on others” in order to make it in business school, something other than playing tough is going on.” (Schwartz, Kassem, Ludwig, 1991)
- Specifically, students are being encouraged from an early age to act in unethical manners and breach levels of confidentiality in order to get ahead. While it may feel like a long stretch, these early actions of students will likely carry on into their careers as public auditors. To rectify this, business schools must include discussion of the use of client information, and the limitations an auditor has to it. Beyond that, how unethical use of confidential information will lead to the ultimate failure of ones career as a professional accountant as illustrated through past public cases. This will provide students with real life examples, and promote discussion on the topic of confidentiality in the classroom. “As a practical matter, it is not hard to expand the standard model in these ways in the classroom. Although obviously eclectic, such an approach can be pedagogically valuable because it exposes students to quite different but equally important areas of philosophical and moral concern.” (Schwartz, Kassem, Ludwig, 1991)

As a whole, students need to enter the work force with a basic understanding of the moral principles that govern the success of auditing. Unethical behavior will cause the industry as a whole to lose value, and thus the use of ethics is necessary from the very beginning of an auditor’s career.

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## FINAL NOTES

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“...as a field of inquiry business ethics is young, so we will have to wait and see. One should not be disappointed, however, if it turns out that business ethics never solidifies into a coherent discipline or academic specialty, remaining instead an umbrella sheltering a variety of competing academic interests, orientations, and methods. Many areas of human endeavor (religion is an example) are too rich for any one form of intellectual inquiry to capture, but that hardly diminishes their importance or the value of various studies of them. Whatever happens, business ethics labels an area of great practical relevance, pedagogical importance, and intellectual significance, and interest in it is unlikely to diminish.”

- William Shaw

It is clear that, while establishing a set of actions that can be implemented into the current structure, it will be very difficult to maintain and continue to improve the level of ethics that takes place in any profession. Ethics are a function of personal morals. While there may be specific rules, guidelines, and courses that an individual must abide by in order to join the world of accounting and practice auditing, there is no real way to ensure an individual will morally agree and thus abide by these rules.

I believe the specific actions I have recommended will provide value, and will increase the overall optimal level of ethics that currently exists within accounting. I further believe that a continued growth strategy must be maintained, and above all, ethics needs to be talked about. All the time. As a student, my interest in this topic was developed through discussion



of ethics in auditing with peers, professors, and colleagues. I have realized that the more you talk about ethics and ways to work in an ethical manner to solve issues, the higher chance you have at decreasing key ethical issues an auditor will have to face.

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