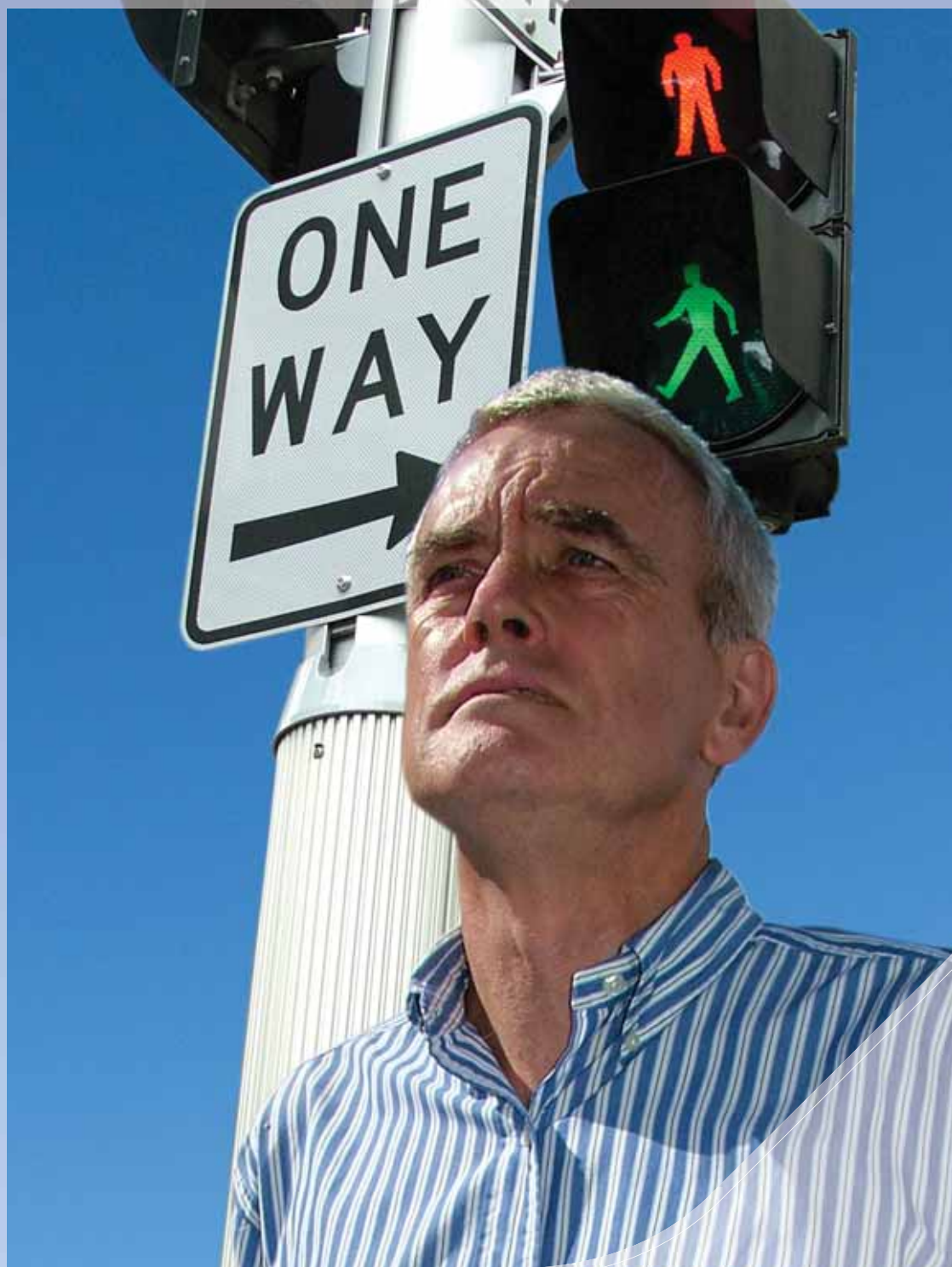


# The Institute of Chartered Accountants in Australia Values, codes of ethics and the law

Discussion paper

Prepared by Professor Jack Flanagan, University of Notre Dame Australia, Sydney



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The Institute of  
Chartered Accountants  
in Australia

## The Institute of Chartered Accountants in Australia

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## Foreword

Welcome to this debate on the accounting profession and ethics.

As the Institute leads the profession at a time of regulatory change and in an environment of highly publicised corporate wrong doing, it was decided to host a forum to look at how the accounting profession deals with values, ethics and the law.

As a foundation for the ethics forum, the Institute commissioned Professor Jack Flanagan of the University of Notre Dame, Australia to write this paper that looks at the foundations of ethics and then the position of an accountant, their ethical conduct and dealing with conflict of interest. How do we, as accountants maintain the objectivity, neutrality and independence required of our profession?

We look forward to the outcomes of the forum and the white paper that should greatly assist in a better understanding of this area.

This debate on ethics is one of the Institute's Thought Leadership initiatives that provide a forum to look ahead, question, and positively influence the growth of our profession.

I look forward to hearing what is said.



**Graham Meyer**

CEO

The Institute of Chartered Accountants in Australia



**The Institute of  
Chartered Accountants  
in Australia**

# The Institute of Chartered Accountants in Australia

## Ethics forum



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## Executive summary

The Institute of Chartered Accountants in Australia (the Institute) states that its core purpose is 'to enhance and promote the reputation and role of chartered accountants, which in turn will benefit the business community and the *public interest*' (emphasis added).<sup>1</sup>

A major precursor to enhanced professional recognition is the belief that practitioners have chosen to act in a manner beneficial to the community in which they operate. For accountants to maintain or enhance their professional identity, the broader community must perceive that the discipline has made choices that are aligned with the social obligations expected of it.<sup>2</sup> Allegations that accountants are systemically violating this public trust, plus increasing government regulation of accounting issues, may ultimately result in the demise of the accounting profession as we know it today.<sup>3</sup>

To maintain this trust, the accounting professional has: (a) issued codes of professional conduct as a form of guidance to their membership; (b) tried to ensure that those individuals wishing to become professional accountants undertake study that acquaints them with their respective codes; and (c) instituted disciplinary procedures to deal with complaints about the conduct of their membership. While such policies deal adequately with the perception of ethical behaviour, it is still an open question whether the policies deal with the reality of ethical behaviour.

Little focus is placed on educating new or existing accountants in how the code of ethics is to be used. We thus have a paradox. The ethical character and the notion of serving the public interest are fundamental to the survival and development of the accounting profession, yet almost no time is devoted to ethics education nor understanding the notion of the public interest that the professional bodies assert are an important guide.

It is asserted that ethics is not an add-on to accounting and auditing education but a fundamental principle that should inform all deliberations. In carrying out the financial reporting function it can be asserted that all accountants are earnings managers. The question is whether they manage earnings in the interest of all stakeholders, one group of stakeholders, or themselves.

Today, professional codes of ethics need to work hand-in-hand with relevant legislation. Professional codes are promulgated in the belief that they are clear in what they require and how they are applied in practice. However, it is rare in professional codes of ethics for allowance to be made for any conflict between the relevant laws and the code of ethics. There appears to be an assumption that ethical codes and ethical values are hierarchical, with personal ethical values influencing the law and ethical codes and vice versa, with no contradictions.

If an accountant believes that there is a conflict between the public interest and an obligation to comply with the law and codes of ethics (especially in the area of confidentiality), then acting in the public interest may involve an acknowledgement that the authority of the legal requirements and ethical codes is not absolute. Under these circumstances how can accountants ensure that their actions are based on sound professional judgment and not self-interest, prejudice or coercion?

We need to accept that accountants have to make a private living. Conflicts will be ever present if accountants are expected to serve the public interest. The issue is to be aware of the conflict and learn how to deal with it in an ethical manner. If accountants are found to have been acting unethically the reaction will be swift and severe. The rapid demise of Arthur Andersen, one of the big accounting firms of the twentieth century, occurred because its clients no longer had faith in its ability to do the job for which it was being paid.

There are three fundamental and critical aspects of all professional preparation: thinking like a professional (training the head), performing like a professional (training the hand), and acting with professional integrity (training the heart). A potential problem arises when ethical reasoning is regarded as being outside the scope of professional training, when, in reality, it is central to that training.

There is some evidence, mainly from the US, which indicates that accountants rarely get beyond conventional moral reasoning, with auditor ethical judgment being most influenced by rule-based reasoning, with accountants focusing on compliance with standards<sup>4</sup>, and with moral reasoning declining as accountants progress to higher levels in a firm. Does this mean that accounting attracts people who cannot progress beyond a conventional level of ethical reasoning, or is there a deficiency in accounting education?

For accountants to satisfy professional obligations for integrity and objectivity of judgment, it would appear that some form of self-directed ethical reasoning based on values is necessary. If accountants do not have self-directed principled reasoning capabilities at post-convention level, the consequences are that they will be less resistant to client pressures or socialisation strategies and may tend to accept that rule following is sufficient to discharge their duties.

A part of that education and development may require a reassessment of the role of the public interest in guiding an accountant's deliberations, and a re-investigation of truth claims in accounting.

This would require some educational intervention at the university and/or professional year stages of an accountant's education, and preferably both.

Unless the professional bodies develop effective strategies to oblige their members to pay some attention to and translate these characteristics into the choices they make in their accounting practices, the professional accounting bodies are likely to continue to attract adverse criticism of their practices.

1. The Institute of Chartered Accountants in Australia, 'Core purpose of the Institute of Chartered Accountants in Australia', Professional Standards and Ethics Section, *Members' Handbook*, August, 2005.

2. J W Buckley, 'An exploration of the Professional Identity', in SE Loeb (ed), *Ethics in the Accounting Profession*, John Wiley, Santa Barbara [Calif.], 1978.

3. SYS Chan & P Leung, 'The Effects of Accounting Students' Ethical Reasoning and Personal Factors on Their Ethical Sensitivity', *AAANZ Conference Proceedings*, Perth, 2002.

4. LA Ponemon & DRL Gabhart, *Ethical Reasoning and Accounting in Auditing*, CGA Canada Research Foundation, Vancouver, 1993.

## Introduction

“I would like to tell you that our profession is standing steadfast to our principles and responsibilities. This I cannot do... I find that the most serious problems in our profession are caused by our indulgence... We just wait for the catastrophe, because we do not have a sufficiently strong or self-appraising accounting profession to right this public wrong before, and not after, serious injury results.”

Leonard Spacek, Managing Partner,  
Arthur Andersen, 1947–1963, speaking in 1956<sup>5</sup>

The Institute of Chartered Accountants in Australia (the Institute) in its Members’ Handbook states that its core purpose is ‘to enhance and promote the reputation and role of Chartered Accountants, which in turn will benefit the business community and the *public interest*’ (emphasis added).<sup>6</sup>

The application of the professional accountant’s knowledge and judgment is based on a general acceptance that there are both public and private interest aspects to their work.<sup>7</sup> The notion of there being a public interest component to the application of the accountant’s skill and expertise leads professional accounting bodies to enter into ‘social contracts’ to establish a fiduciary relationship with society to maintain minimum standards of competence in carrying out a function valued by society and to perform this function with integrity’.<sup>8</sup> These social contracts are spelled out in professional codes of conduct.

The social authority flowing from the knowledge held by accountants is threatened whenever their ‘*monopoly can be abused* [and their] *powers and privileges can be used to protect vested interests against the public*’.<sup>9</sup> Ongoing community support represents the social acknowledgment of the power and authority entrusted to accountants. The layperson’s comparative ‘ignorance’ reinforces society’s reliance on the professional accountant’s expertise, thus confirming the practitioner’s ‘*monopoly of judgment*’.<sup>10</sup> Such acknowledgment allows accountants great levels of autonomy within their professional jurisdiction. This autonomy of professional standing requires ongoing social sanction. Thus, management of the public interest aspect of professional accounting life is an important aspect in the ongoing development of the profession, but is it critical?

Emmet<sup>11</sup> suggested that a major precursor to enhanced professional recognition is the societal belief that practitioners have chosen to act in a manner beneficial to the community in which they operate. For accountants to maintain or enhance their professional identity, the broader community must perceive that the discipline has made choices that are aligned with the social obligations expected of it.<sup>12</sup> Allegations that accountants are systemically violating this public trust, plus increasing government regulation of accounting issues, may ultimately result in the demise of the accounting profession as we know it today.<sup>13</sup>

We live in a world where ethical violations have gained regular publicity and put increasing pressure on professional groups across the spectrum to demonstrate that observed violations of public trust are not systemic. One charge laid against professional business education in disciplines such as accounting is that many of the theories supporting accounting behaviour – such as capital market theory, transaction cost economics and positive accounting theory – appear to promote amoral, self-serving behaviour.<sup>14</sup>

Work carried out by Shulman for the Carnegie Foundation on teaching for the professions has identified three fundamental and critical aspects of all professional preparation: thinking like a professional (training the head), performing like a professional (training the hand), and acting with professional integrity (training the heart).<sup>15</sup> In the education of professional accountants most of the thinking skills are provided by university courses. Practical experience prior to or during professional training for completion of the Chartered Accountants Program is provided by employers, but professional integrity, although covered in the professional bodies’ courses, is largely left to the accountants themselves. So, developing skills in this area is a personal rather than a professional endeavour. The focus in accounting education is in developing habits of the mind, rather than habits of the heart.<sup>16</sup>

Shulman’s view is that a serious professional education must adequately cover all three aspects – mind, hand and heart – and that professional education located in one dimension can learn from those fundamentally located in another. Almost no time is spent on the values that inform accounting policy development or application, which might appear strange when the professional accounting bodies understand that serving the public interest is a cornerstone of their professional existence, but is understandable when professional accountants regard ethics and moral education as outside their domain of expertise.

5. From a speech given in 1956, quoted in BL Toffler & J Reingold, *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen*, Broadway, New York, 2003.

6. The Institute of Chartered Accountants in Australia, op cit.

7. TA Lee, ‘A Systematic View of the History of the World of Accounting’, *Accounting, Business and Financial History*, vol 1, no 1, March, 1990, pp 73–107.

8. D Emmet, *Rules, Roles and Relations*, Beacon Press, Boston, 1966, p 159.

9. E Greenwood, ‘Attributes of a Profession’, 1957, republished in HM Vollmer & DL Mills (eds), *Professionalisation*, Prentice Hall, Englewood Cliffs NJ, 1966.

10. Buckley, op cit, pp63-84.

11. Emmet, op cit.

12. Buckley, op cit.

13. SYS Chan & P Leung, ‘The Effects of Accounting Students’ Ethical Reasoning and Personal Factors on Their Ethical Sensitivity’, *AAANZ Conference Proceedings*, Perth, 2002.

14. S Ghoshal, ‘Bad management theories are destroying good management practices’, *Academy of Management Learning and Education*, vol 4, no 1, 2005, pp 75–91.

15. LS Shulman, ‘Signature pedagogies in the professions’, *Daedalus*, Summer, 2005.

16. Attempts are being made to address this problem. See, for example, S Dellaportas, K Gibson, M Hutchinson, P Leung & D Van Homrigh, *Ethics, Governance and Accountability*, Wiley, Brisbane, 2005. It is not known how far such attempts have penetrated academic courses.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (also known as CLERP 9) at section 225(2B)(f) requires the Financial Reporting Council to 'promot[e], and monitor the adequacy of, the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor independence'.

This change in corporate legislation providing for an increased regulation of professional behaviour indicates an increasing unease among stakeholders about the independence of auditors and the ability of auditors and other accountants to manage conflicts of interest effectively by themselves, and also a growing awareness among regulators of the importance of ethical issues to the professional status of accountants and auditors. The worrying aspect of this development is the desire by government to monitor self-regulation by the profession, indicating a doubt that the professional bodies can regulate their members' activities (and especially auditors) effectively.

Historically, across virtually all social settings, the reaction of accounting's representative bodies to questions raised about the ethics of their members has been essentially threefold. Firstly, they have issued codes of professional conduct as a form of guidance to their membership. Secondly, they have tried to ensure that those individuals wishing to become professional accountants undertake some course of study that acquaints them with their respective codes. Finally they have instituted disciplinary procedures to deal with complaints about the conduct of their membership. The approach taken by the accounting profession worldwide has logical and intuitive merit. However the current post-Enron environment has led many observers to question how effective such a course of action has been and will be in the future. While dealing adequately with the perception of ethical behaviour, it is still an open question whether the moves deal with the reality of ethical behaviour.

We thus have a paradox. The ethical character and the notion of serving the public interest are fundamental to the survival and development of the accounting profession, yet almost no time is devoted to ethics education nor understanding the notion of the public interest that the professional bodies assert are an important guide. This paper will try to address these issues.

## Section 1 Societal perspective on ethical conduct

### 1.1 Trust and fairness in the capitalist system

#### 1.1.1 Fairness

From the early days of the modern capitalist economy in the mercantile activities of nineteenth century Britain, trust was seen as a valuable asset. This can be seen in the flourishing of Quaker businesses in England because a hallmark of the Quakers was a commitment to honesty and transparency in all dealings. Quaker businessmen were sought out because they could be trusted, and many became extremely prosperous.<sup>17</sup> Honesty and fair dealing were seen early in the development of capitalism as profitable endeavours.

Having a population of people that trust each other (especially strangers) in their everyday interactions, with an expectation of fair dealing, is a fundamental economic asset for a prosperous market economy. Social relations that embed trust and fairness over time become invisible and are assumed to be immutable. This is partly because underlying such trust is a social and legal framework that acts as a safety net on the relatively few occasions when the system breaks down.

Such trust is not 'natural' but needs to be developed and sustained. Just as it can be developed, it can also be destroyed. The paradox is that the more people trust others, the easier they are to exploit. Just as trust is an economy's most valuable asset, corruption is its most damaging. Over the past 200 years mechanisms have been developed to limit the potential for corruption. The development of company audits, the role of state and federal auditors-general, the increasing activities and powers of regulators – such as the Australian Securities and Investments Commission (ASIC), and the existence of the Australian Prudential Regulation Authority (APRA) and the Australian Competition and Consumer Commission (ACCC) – all attest to the need to deal with corruption of trust in society.

In general, members of society have an innate sense of fairness. In an ongoing series of experiments across differing social and cultural settings, two people are asked to share \$100 and the only rules are that one party can make a one-only offer of a split which the other party can reject if they do not like the split offered (in which case neither party receives anything). The results of this experiment are that in the majority of cases only 50:50 splits are acceptable because people would rather have nothing than let someone else get away with what they think is an unfair share of the spoils.<sup>18</sup> Fairness in social relations thus seems to be a reasonable expectation of members of society, and society informally observes how people in positions of power, authority and influence behave to see whether such behaviour accords to societal standards of fairness.

A belief in the fairness of those people granted special monitoring rights, such as accountants and auditors, is necessary for trust in the auditing profession to be maintained. If trust in accounting practices and auditors fails, then increased government regulation will be the natural response from society. We saw a move in this direction in the US with the collapse of Enron, and the speedy enactment of the *Sarbanes-Oxley Act* to regulate further the activities of corporate executives and auditors. The CLERP 9 amendments granting the Financing Reporting Council (FRC) a monitoring role over professional accounting ethics is another move in this direction.

However, such regulation is unlikely to solve all future problems because it is not possible to regulate all individual or group behaviour. Such increases in regulation have the potential to undermine the authority of the accounting profession at a time when trust in the work of the accounting profession for fair judgments is most needed. What may be needed is to bring professional ethics back to the core of professional accounting activities and not push it to the edge, through codification, where it has been increasingly relegated for the past 35 years.

#### 1.1.2 Values in society today: a source of conflict?

Ethics are important to all business organisations, their managers and accountants. The study of ethics is concerned with those principles that justify the value judgments that people use to explain their behaviour. Such value judgments include whether a particular behaviour is good or bad, right or wrong.

When we think of morality and ethics we tend to think of the distinction between good and evil, right and wrong. However, 'good' itself has various meanings. Firstly, there are personal desires and wants. Secondly, there is the tempering of our personal desires when these clash with the desires of others which leads to the development of social structures and institutions that provide for communal living and comprise the existing social order. The social structures involve linkages between the internal wants, desires and expectations of people and the external events through which they are expressed.<sup>19</sup>

Melchin uses a simple purchase transaction to explain the ubiquity of social structures and the moral obligations that are implied by them. Thus, in establishing a business relationship, negotiating a deal, making a final contract and setting the condition for a repeat transaction, there is a reciprocal exchange of shared meaning that allows the transaction to move to its completion in an atmosphere of mutual trust. He suggests that such structures involve an internal logic and morality that must be followed if the structure is to remain viable for future transactions to occur. Social structures inherently place obligations on participants, of which obligations the most important are moral obligations. Compliance with these inherent moral obligations enables people to make use of existing social structures without damaging the integrity and future utility of those structures.

17. See J Surowiecki, *The Wisdom of Crowds*, Little Brown, London, 2004.

18. W Güth, R Schmittberger & B Schwarze, 'An Experimental Analysis of Ultimatum Bargaining', *Journal of Economic Behaviour and Organization*, 3:4 (December), 1982, pp 367-388.

19. KR Melchin, *Living with other people: an introduction to Christian ethics based on Bernard Lonergan*, Toronto: Novalis, 1998, pp 44-50.

The relationship between the corporate accountant, the corporate client, the auditor, third-party users of accounting information and society is an example of a social structure. As with other structures, it is based on a sequence of activities and mutual trust, and therefore has its own internal moral logic. For example, third parties and society trust the accountant to prepare financial statements that are highly correlated with actual events, and they trust the auditor's opinion as confirmation of this correlation. If the moral logic of the social structure that exists in accounting relationships remains hidden from the individual accountant's consciousness as he or she chooses between competing accounting policies, the desirable ethical principles specified in the code of conduct issued by professional accounting bodies will have little impact as practical guides to action.

It has been observed that financial reports have gone beyond mere technical communication and now play a crucial role in the 'construction' of the business entity for all stakeholders.<sup>20</sup> This means that accounting can never be a 'neutral' or 'independent' activity. The relevance and reliability of disclosed financial information increasingly focuses on the behaviour of those who prepare it and attest to it. Employer and client expectations and training may lead to behaviour where otherwise ethical people are socialised into unethical behaviour.<sup>21</sup>

Accountants and auditors are required to make professional judgments constantly. The judgments involve choices: the accountants must judge which choice to adopt and the auditor must attest to the choices made. Which choice is made depends on the values that inform those choices, and all values involve ethical considerations. Thus, all judgments involve ethics. Ethics is thus not an add-on to accounting and auditing education but a fundamental principle that should inform all deliberations. In carrying out the financial reporting function it can be asserted that all accountants are earnings managers. The question is whether they manage earnings in the interest of all stakeholders, one group of stakeholders, or themselves.

### 1.1.3 Truth and the capitalist system

Being honest and keeping investors and other stakeholders fully informed about their business activities are important ethical norms for managers. Managers who conceal their activities or who misrepresent those activities make it difficult for stakeholders to assess how well a business is performing. Overstating profits, for example, may result in investors allocating more resources to a company than actual results would justify. This misallocation results in a loss of value to society and often leads to financial harm for those who use this information.

Ethical behaviour is particularly important for accountants because the reliability of accounting information depends on the integrity of those who prepare, report and audit this information. Managers may make decisions that benefit themselves at a cost to investors or other stakeholders. If they then attempt to conceal these decisions by pressuring their accountants to report incorrect information, that information is not an accurate description of the economic activities of a business. If employees steal money or other resources from a business and the thefts are overlooked or not detected, the company's accounting information also will not properly reflect the company's economic situation. If those who audit a company fail to ensure that reported information is a fair representation of the company's business activities, those who rely on the information are likely to be disadvantaged.

Those who contract with businesses today increasingly are being forced to consider the ethics of those who manage them. Managers, including accountants, who are willing to bend rules or act dishonestly are likely to be untrustworthy and act purely out of self-interest. An important role for accountants is to evaluate whether appropriate rules are being followed honestly and fairly in accounting for reporting business activities, and act accordingly.

## 1.2 The law, codes of ethics and ethical behaviour: a source of conflict?

A survey of psychologists in the US in 1988 asked them whether they had broken any law or formal ethical principle because of some deeper ethical value.<sup>22</sup> Fifty-seven per cent of respondents stated that they had, and 77 per cent said that they would violate legal and formal ethical codes on the basis of deeper values or to protect their clients. Sixty-eight per cent said they had consulted another person before taking any action, and 91 per cent said the results were beneficial. Only 18 per cent said that their formal training adequately dealt with conflicts between deeply held values and formal legal and ethical codes.

Such a survey highlights that the relationship between the law, formal ethical rules and personal ethical values is not the straightforward relationship that the professional bodies and the community would like it to be. The relevant laws of a country are generally regarded as the bedrock on which social action is based. Ethical codes developed by professional groups like accountants build their codes on the assumption that there is no conflict between the public interest and the obligation of the accountant to comply with the law and codes of ethics. Rarely in professional codes of ethics is allowance made for a contradiction between the law and the code of ethics. There appears to be an assumption that ethical codes and ethical values are hierarchical, with personal ethical values influencing the law and ethical codes and vice versa, with no contradictions (see Figure 1).

20. RD Hines, 'Financial Accounting Knowledge, Conceptual Framework Projects and the Social Construction of the Accounting Profession', *Accounting, Auditing & Accountability Journal*, vol 2, no 2, 1989, pp 72–92.

21. See part 1.6.11 on rationalisation and socialisation of corruption in organisations.

22. KS Pope & TR Bajy, *American Psychologist*, vol 43, no 10, 1988, p 828.

This may be the reality in many situations but what about situations where the law and personal ethical values are in conflict? The most noted example of where this is tolerated is in the area of civil disobedience that was first analysed by Thoreau.<sup>23</sup> The British suffragettes and Ghandi used such methods to great effect to get laws changed. A lack of any attempt by the parties concerned to avoid detection is a hallmark of this form of action. However, for accountants, publicly disclosing financial information about the activities of clients or employers is difficult without betraying the confidentiality of the relationship with the employer or client (required by the code of conduct<sup>24</sup>) which an accountant will do only with strong commitment to the choice being taken.

If an accountant believes that there is a conflict between the public interest and an obligation to comply with the law and codes of ethics (especially in the area of confidentiality), then acting in the public interest may involve an acknowledgement that the authority of the legal requirements and ethical codes is not absolute. Under these circumstances how can the accountant ensure that his or her actions are based on sound professional judgment and not self-interest, prejudice or coercion?

Figure 1: The law, codes of ethics, and ethical values

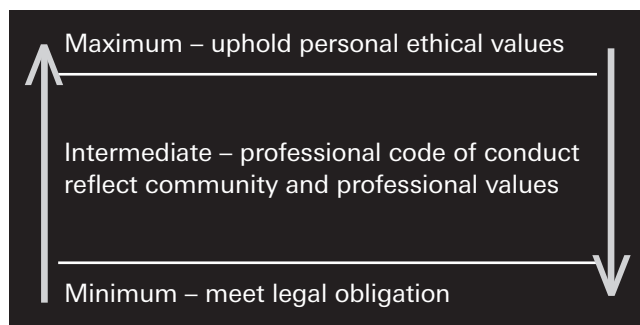


Figure 2: Ethical principles

Type	Principle	Decision rule	Issues
Virtue (Plato, McIntyre)	Adopt morally beneficial character.	Choose a characteristic and live by it – benevolence, courage, justice.	Which characteristic is preferred? What if they are in conflict?
Consequentialist (Bentham)	Maximise wellbeing of group.	Cost-benefit analysis where benefits outweigh costs.	How can you measure non-quantifiable consequences – pleasure, sadness, etc.? What is good for one may be harmful to another.
Duty (Pufendorf, Kant, Finnis)	Respect rights of others. People are ends not means.	Treat people with dignity. Live by rules that focus on doing no wrong to others. Focus on good.	What happens when rights are in conflict – right to privacy versus right to truth? What happens if you do nothing?
Justice (Rawls)	Society ‘as a fair system of cooperation over time’, that provides for a fair distribution.	Principles of equal liberty and equal opportunity distribute benefits and burdens fairly. Sense of reasonableness.	What happens if the inequality of benefits and burdens becomes extreme? Is this still fair and reasonable?

23. HD Thoreau, ‘Civil disobedience’, in Peabody, *Resistance to Civil Government*, Aesthetic Papers, 1849

24. The Institute of Chartered Accountants in Australia/CPA Australia, *Joint Code of Professional Conduct*, Section B Fundamental Principles of Professional Conduct Applicable to All Members, 1997.

25. The Institute of Chartered Accountants in Australia and CPA Australia, *GN1 Members in Business Guidance Statement*, 2002.

### 1.3 Ethical guidelines: where do they come from?

Most ethical views come from suggested behaviour proffered by the great philosophers and religious figures. The ethical views that are presented most often are normative, that is they give prescriptions as to how one should behave. Each offers only one ultimate criterion of moral conduct. They do not describe actual behaviour. Figure 2 provides a brief summary of some of the major ethical perspectives that are offered to us as prescriptions. Note, however, that whereas the choice of an ethical principle appears clear cut, there are usually unresolved issues when adopting one particular view, so they provide no unambiguous prescriptions for dealing with real ethical dilemmas faced by people when they need to make decisions where they are faced by choices.

The basis for all good decision making lies in understanding what is happening and what options are available for dealing with any situation. Good understanding comes from good enquiry and observation. Therefore, the starting point for any basic model of *ethical* decision making is to ask relevant questions.

The ethical decision-making models suggested by the professional accounting bodies are based on a ‘questioning’ structure, following a ‘check-list’ approach.<sup>25</sup> The focus of such an approach is on the decision itself rather than the processes used by the decision-maker. We may ask whether such a ‘checklist’ approach, by itself, equips accountants with the requisite skills both to ask questions and to interpret their responses. Like doctors or lawyers, it is accountants’ judgment and ability to make ‘good’ decisions that are the features of their vocation that distinguishes them as a professional group.

We should ask whether the suggested approach to ethical decision making is useful and used. When analysing several scenarios used as examples for ethical decision making by accountants, two things stand out. The scenarios do not appear to be good examples of genuine ethical conflict, and the solutions always appear to follow a consequentialist approach, applying a cost–benefit strategy. Such strategies tend to look at trade-offs between stakeholders with the least cost to the person having to make the decision. This is not to say that a consequentialist approach is wrong, but may not be justified in all circumstances. The accountant may need to assess what the relevant values are in the situation before it can be effectively and satisfactorily resolved.

Take the following example for instance:

Alex Down is the new chief accountant, on a very good salary and bonus scheme, of New Line Industries Limited (NLI) a major supplier of building materials. To support sluggish sales, the company is negotiating to acquire a major building material retail division including significant retail property assets from another company. This is a potentially risky move as there are some forecasts suggesting that the building industry could go into decline within a year or two. The acquisition will be funded mainly by borrowed funds. The amounts involved are large, and if the borrowing is brought onto the balance sheet now it is likely that the company will be sailing close to its existing loan default targets for the ratio of debt to equity.

The chief executive officer (CEO), an aggressive but charming person, seeks advice from the company's legal advisors who suggest the establishment of a shelf company to buy the property assets and manage the loans, with the major lenders for the acquisition being the shareholders of the shelf company and thus owners of the retail property assets which NLI will rent. A side contract with the lenders will transfer the assets to New Line Industries when the loans have been repaid.

The CEO tells Alex that he has full confidence in Alex's ability to manage the acquisition through the shelf company. Alex does as instructed.

How does the accountant disentangle the legal and professional ethical aspects of this problem? There are self-interest issues and the pressure from the CEO. There is the legal advice that if followed will alleviate the loan default issue. Going against the legal advice may compromise the accountant's position. Will the accountant even see a conflict between the profession's overriding requirement to serve the public interest and compliance with the law? By going along with the suggestion, the accountant may believe he or she is complying with relevant elements of the code of ethics (especially in the area of confidentiality).

Acting in the public interest may involve going beyond all the legal advice and acknowledging an authority beyond compliance with the law. How then can the accountant then ensure that his or her actions are based on sound professional judgment applying ethical principles and not self-interest, prejudice or coercion?

## 1.4 What is the 'public interest' and is it a useful concept?

The term 'public interest' is a much-used term, but for accountants it plays a special role. If the 'public interest' is so important then it is also important to understand its dimensions. It is a difficult term to pin down. However, the legal profession has had to come to grips with it in deciding such things as whether legal aid should be provided to litigants. One ground for so doing is that it is in the public interest to do so. Let us look at the two elements separately:

**Interest.** First, let us focus on 'interest'. Is it possible to infer interest from conduct? Probably not if people present themselves, deliberately or innocently, in an inaccurate manner. A person's true interests may be unknown even to themselves, so we tend to focus on their *expressed interest*. Then again, should we focus on short-term or long-term interest? We could also focus on vital interests (prerequisites for survival) and their chosen interests (lifestyle preferences). We could further dichotomise material and ideological interests. So, interest itself raises some interesting questions.<sup>26</sup>

**Public.** Turning our attention to 'public', we should ask 'Who is the public?'. Is it the group of individuals who comprise the public today or some notional public in the future? Should one focus on aggregated individual interests or focus on shared interests when we think of the public? There are many groups formed in society to pursue shared or common interests. Can we talk about one public interest or could there be many public interests. Is the public interest a separate thing in itself? That is, is there a public interest that is independent of the interests of the individuals, some notional 'social' public interest that is separate from the sectional interests of different groups that comprise society? Is this what we mean when we think of governments legislating in the public interest, which is usually for the general wellbeing of the community?<sup>27</sup>

Taking this approach, the public interests are 'those interests of sufficient magnitude when aggregated to warrant being termed public'<sup>28</sup>. However, this raises the question who is to aggregate and choose the interests of sufficient importance to be labelled public interests? We can thus distinguish sectional public interest (aggregate individual interests) from societal public interest (based on the political and social forces at play).

When assessing whether an action has public interest bearing, lawyers tend to perform some sort of cost–benefit analysis. This is done by assessing the cost of mounting a case against the benefits that will accrue to the community applying a range of social value criteria. Such criteria are always discriminatory in favour of a segment of society. This means that those with a voice can manipulate the perceived 'public interest'. So, the role of sectional interest lobby groups must be identified. Lobby groups can seek to advance their members interests (Australian Medical Association), seek to advance the community generally

26. P Pleasance & S Maclean, *The Public Interest*, Legal Aid Board Research Unit, London, 1998, pp 2–4.

27. P Pleasance & S Maclean, 1998, *op cit*, pp 5–7.

28. P Pleasance & S Maclean, 1998, *op cit*, p 7.

(Sydney Breast Cancer Foundation), or be passive (local football club). Weisbrod developed what he called a public interest ratio calculated by dividing the external benefit by the sum of the internal plus the external benefit. The maximum score is one, and the smaller the ratio the greater the influence of private interest.<sup>29</sup> The question is then of determining in some subjective way the alignment of sectoral interest with the public interest. The problem is that such a ratio takes no account of the size of the group. It may be better to focus on the absolute benefit in terms of the people affected. For example, is the public interest better served when 2,000,000 people benefit rather than when 2,000 benefit? Initially we might say yes, but what if the 2,000,000 are at the higher end of the social spectrum (first-home owners) whereas the 2,000 are homeless children? Thus, we need to specify who the beneficiaries will be. We also need to distinguish the 'public interest' from what the public are interested in. The two can be vastly different.

Despite the difficulties in developing a framework for the public interest, lawyers often need to do just this. In the main they have opted to identify the sectional and social interests involved and assess the impact of a particular activity on these. As to whether an activity furthers the public interest, the balance of societal versus sector interests must be assessed, no matter how subjectively, with the proviso that extreme caution should be exercised when making public interest determinations.<sup>30</sup>

We can summarise the public interest argument by saying that when the accounting profession says it wants to serve the public interest, it might be useful to have some evidence to determine in what way the public interest is or is not served:

- a Is it an expressed or inferred interest, is it long-term or short-term interest, and are we talking about material interests?
- b Which 'publics' do we need to identify? Accountants have a dual role of serving clients and the public interest. There are key sectoral interests served by accountants, such as shareholders and lenders. Does the term stretch to employees and significant others? What are the social interests that accountants serve? Do we need to identify these stakeholders and their interests?

The Accountancy Foundation Review Board (AFRB) in the UK, in a recent publication, asked the UK professional accounting bodies to define the public interest. The general response was that it was very difficult to define as there were many publics (different groups who did not share a uniform view) and their interests differed, and it may be necessary to engage in trade-offs with some groups being satisfied at the expense of others.<sup>31</sup>

The AFRB received comments to the effect that the professional accounting bodies as well as serving employers and clients should serve 'the collective well-being of the community' to secure general benefits for the community expressed as the 'greater good' of society.<sup>31</sup> From its review of the literature, the AFRB noted that the public interest boiled down to a 'realisation of the social and political goals and values of the community at large'.

Societies are complex and pluralistic with many groups competing for attention whose interests may not align with the collective public interest. If it is assumed that people are at heart motivated by self-interest, then the public interest could be construed as the structures that allow people to pursue such self-interest without undue restrictions. It could be argued that accountants serve the public interest by providing reliable information or attesting to information that allows markets to work effectively.<sup>33</sup> This definition, as far as accountants are concerned, construes the public interest very narrowly as being those who rely on financial information.

On the other hand, many groups are affected by financial information. The International Federation of Accountants (IFAC), in an early version of its Code of Ethics, identified a number of stakeholders: clients, credit grantors, governments, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of professional accountants to maintain the orderly functioning of commerce.<sup>34</sup>

The Auditing Practice Board in the UK identified several classes of stakeholder served by auditors: primary stakeholders (owners of organisations), secondary stakeholders (those with a direct economic interest in organisations – managers, employees, lenders, suppliers, debtors and creditors), and, lastly tertiary stakeholders (those without a direct economic interest – potential investors and the community).<sup>35</sup>

Providing information in the public interest may give rise to conflicts for the accountant. Disclosing information publicly may have a negative effect on profitability of an organisation, depress share prices and cause loss of employment for the accountant.

A significant point raised by the AFRB, in its paper, is that from a public interest standpoint, the accountant needs to be aware of the different interests of all stakeholders before making a decision.<sup>36</sup>

29. P Pleasance & S Maclean, 1998, op cit, p 14.

30. P Pleasance & S Maclean, op cit, p 24.

31. Accountancy Foundation Review Board, *Protecting the Public Interest*, London, 2002, February, paragraphs 1.9, 2.5 and 2.7.

32. op cit, paragraph 2.8.

33. E Stamp, *Corporate Reporting: Its Future Evolution*, CICA, Toronto, 1980, cited in *Protecting the Public Interest*, op cit, p 50.

34. IFAC, *Code of Ethics for Professional Accountants*, New York, 1998, January.

35. Auditing Practices Board, *The Audit Agenda*, London, 1994.

36. AFRB, *ibid*, p 53.

After reviewing the literature and receiving comments, the AFRB did not directly try to define the public interest but stated that accountants were operating in the public interest if:

- a They pay regard to their responsibilities to the community as a whole as well as the organisation employing them
- b Their decisions are reached and implemented in an efficient and effective manner.

An interesting development that may have some bearing on perception of the 'public interest' can be observed in the agreement by all Australian states to uniform defamation laws in Australia in 2006. Originally there were two tests regarding any public statement about individuals. Firstly, was the statement true? Secondly, was it in the public interest to disclose the statement? In the revised defamation law, there is only one test. Is the statement true?

With regard to defamation, retired judge David Levine stated: 'Truth is the greatest driving force for integrity in the media...'<sup>37</sup>. Such a move could indicate that the 'public interest' criterion may be too difficult as a reference point even for lawyers to apply.

## 1.5 What is a conflict of interest and how is it identified?

If an accountant has to make a private living and serve the public interest does self-interest conflict with the public interest? We need to look at this issue from two perspectives: that of the individual and that of the professional accounting body.

It is accepted that accountants need to make a living and may be motivated by self-interest over the public interest. However, excessive self-interest by individuals needs to be avoided. Membership of the accounting profession enables an individual to gain access to the privilege of being a professional accountant and thereby charge significant fees and earn a high income. Accounting knowledge also confers a degree of power on an accountant who is in an advantageous bargaining position with unknowing clients.

This puts an onus on the professional accounting body that has a social contract with society and needs the respect and trust of the community at large, not just the client base of individual accountants and firms. As the community is not well placed to assess the quality of services provided by accountants, society provides the professional body with a monopoly in accounting activities in exchange for a reasonable expectation that members act in the public interest. So, in the long run there is a close alignment between self-interest and public interest. Professional accounting bodies have established mechanisms for protecting their public interest mantle; namely their codes of ethics, continuing professional development and disciplinary procedures.

A worry for the professional accounting bodies is that it may only be in hindsight that the activities of individuals or accountancy firms are seen to have been in contravention of the public interest requirement.

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37. ABC, *The Media Report*, 'Uniform Defamation; and the cost of celebrity journalism', 13 April 2006, [www.abc.net.au/cgi-bin/common/printfriendly.pl?>www.abc.net.au/rn/talks/8.30/mediarpt/stories/s1614411.htm](http://www.abc.net.au/cgi-bin/common/printfriendly.pl?>www.abc.net.au/rn/talks/8.30/mediarpt/stories/s1614411.htm)

## 1.6 What examples of conflicts of interest can be observed in society in recent times?

Conflicts between the duties of accountants to their clients and self-interest are not the sole domain of accountants. In this section some examples of conflicts of interest between individuals and groups in society and the public interest are discussed. The examples are many, but we want to focus on identifying the conflict of interest issues that caused concern. To emphasise the issues, I have stated the facts (as I understand them) of the examples in a relatively confronting manner.

Example	Public interest element
<p><b>Assertions of price-fixing</b></p> <p>Under trade practices legislation, price-fixing by groups of businesses is illegal. In November 2004 Amcor Limited won a Federal Court order to retrieve documents taken by senior executives who had left the firm and were contemplating starting a competitive business. Legal groundwork had unearthed a breach of competition laws in its corrugated boxes division which it notified to the Australian Competition and Consumer Commission (ACCC). Consequently the CEO and two other senior executives resigned. The ACCC then instituted proceedings in the Federal Court, Melbourne against Visy Industries Holdings Pty Ltd and the Chairman and CEO of the Visy Group for allegedly engaging in conduct in the corrugated fibreboard container industry that was anti-competitive, including engaging in price-fixing and market sharing, in contravention of section 45 of the Trade Practices Act 1974. Amcor was not a defendant in the action. Amcor and its former senior executives have to date received immunity from legal proceedings under the ACCC leniency policy.</p> <p>The disclosure of price-fixing was deemed in the public interest, and thus the Amcor executives were given immunity from prosecution.</p> <p>Public interest – fair prices based on competitive conditions.</p>	<p>Conflict of interest (profit versus fair dealings) – self-interest dominates.</p> <p>Issue – level of management responsibility and legal requirements.</p>
<p><b>Illegal payments – AWB Limited</b></p> <p>As a result of the Volker enquiry report, the Federal government established the Cole Enquiry to investigate claims of \$300m being paid in kickbacks to the Saddam Hussein regime in Iraq. It transpired that the board of AWB had instigated an enquiry of its own into the trucking fees paid to Jordanian company Alia in 2003, but was claiming legal professional privilege to prevent disclosure of what they knew. It seems that far too many people in or around AWB appear to have extremely defective memories when it comes to AWB contracts with Iraq. For example in examination before the enquiry, chairman Trevor Flugge stated that he could not recall issues more than 100 times and his CEO, Andrew Lindberg, could not recall more than 250 times. Such a defence might seem more plausible if it was not for the size of the payments – hardly matters to be dealt with by a junior accountant.</p>	<p>Telling the truth.</p> <p>Conflict of interest (profit versus social responsibility) – self-interest dominates.</p> <p>Issue – lack of ability to ask pertinent questions and international treaty obligations.</p>
<p><b>Moral obligations – James Hardie Industries Limited (JHI)</b></p> <p>In 2001, JHI relocated its corporate headquarters to the Netherlands. Prior to moving offshore, the company settled the net assets of its two major asbestos-producing companies on a charitable trust, the Medical Research and Compensation Foundation, to service its known and contingent asbestos liabilities. In 2004, the fund trustees sounded the alarm by announcing that it was in danger of becoming insolvent: this strategy succeeded in bringing the matter of the adequacy of the provision for asbestos liabilities to a head. The state government set up a Commission of Inquiry as a result of the public outcry over perceived corporate irresponsibility. The findings of the inquiry were that:</p> <p>‘James Hardie deliberately avoided its responsibility to the victims of its asbestos products. David Jackson QC found that the company did not make adequate provision for the future victims of its products when it set up a compensation foundation before it relocated its corporate headquarters to the Netherlands in 2001. Jackson also found that the company’s CEO had made false and misleading statements to the stock exchange when he said that the compensation foundation was fully funded. While Jackson found that shifting the corporate headquarters to the Netherlands was legal he said the company still had a moral duty to compensate the victims of its products’ (Carrick, 2004).</p> <p>James Hardie provided an extra \$1bn for the victims of asbestos related-diseased in 2006.</p>	<p>Moral responsibility for legacy of company’s past activities.</p> <p>Conflict of interest (profit before responsibility to asbestos sufferers) – self-interest dominates.</p> <p>Public interest – be responsible for consequences of own actions.</p> <p>Issue – inability and lack of desire to be responsible for activities of the past.</p>

The three examples above provide evidence of failure of ethics in business situations. Also of interest is where lack of ethics flows into outright fraud. We can gauge the level of fraud in business over the last decade from the KPMG fraud surveys conducted to date. Figure 3 provides a summary of these survey findings.

Figure 3: KPMG fraud survey findings

Year	Sample surveyed	Response rate %	Organisations experiencing at least one fraud %	Instances of fraud reported	Average loss per organisation \$m	Fraud by management %
1997	1800	27	49	7,771	0.45	25
1999	1800	20	57	7,280	1.1	21
2002	2000	19	55	44,654	1.4	28
2004	2164	23	45	27,657	2.1	27

The cost of fraud appears to be growing, although the large non-response bias indicates that the results need to be interpreted carefully. Research by the Bureau of Crime Statistics also shows a significant upward trend in the incidence of fraud, so we can probably rely on the data revealed.<sup>38</sup> Management has a significant stake in fraud, with around 50 per cent of the value of fraud in organisations attributable to management. In 2002, the survey asked for the first time whether respondent organisations had suffered unethical behaviour in the reporting period. Forty-one per cent indicated that they had (compared to 33 per cent in 2004), and that unethical conduct was allowed to flourish because of lack of commitment by senior management.

In the 2002 survey, 55 per cent of respondents thought that fraud was a major problem for business in general, but only 17 per cent admitted that it was a significant factor in their own organisations. If fraud and unethical behaviour are significant and growing factors in the business sector, why is it that managers believe that it is not a significant factor in their own organisations. One possible reason is that managers are subject to the 'illusion of objectivity' in their own decision making.<sup>39</sup>

Unethical practices do not only occur in business. As the following examples illustrate, unethical practices are ubiquitous in the institutional arrangements established to keep society working effectively. Again, I have outlined the circumstances (as I understand them) of each example in a very direct way in order to highlight the public issue element.

Example	Public interest element
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**Politics**

Politicians are the one group whose overriding interest should be to work in the public interest. There is plenty of evidence to suggest that this might not always be their driving force.

**Travel rorts**

From 1997 onwards we have witnessed politicians being accused of, and frequently admitting to, rorting their travel allowances. Accusations about rorting levelled at Federal MPs Nick Sherry, Peter McGauran, Sharp and Jull in 1997, and then Mal Colson in 1999, it seems, led to a code of silence about allegations of rorting within federal parliament since both sides suffered.<sup>40</sup> When Trish Draper was accused of rorting the travel allowance in 2004, she said sorry and repaid the \$10,000, and nothing more was said.

Travel rorting is not confined to federal parliament or to any particular party. At the state level there have been several allegations. In 1997 there was an ICAC investigation into Brian Langton the NSW Transport Minister. In 2004 it was alleged that Victorian MP Andrew Olexander had breached guidelines by receiving an allowance while living within 28 kilometres of Melbourne, and in June 2005 the Speaker of Queensland Parliament Ray Hollis was accused but the allegations were dropped.

Claim only what is legitimately spent.  
 Conflict of interest (personal gain versus service to society) – self-interest dominates.  
 Issue – accountability.

38. M Chilvers, 'What lies behind the growth in fraud?', Bureau of Crime Statistics and Research, 2004, [www.lawlink.nsw.gov.au/lawlink/bocsar/ll\\_bocsar.nsf/pages/bocsar\\_index](http://www.lawlink.nsw.gov.au/lawlink/bocsar/ll_bocsar.nsf/pages/bocsar_index)  
 39. MR Banaji, MH Bazerman & D Chugh, How (Un)Ethical Are You?, *Harvard Business Review*, 81(12): pp56-64, 2003.  
 40. Crikey.com, 'Colton and Crane Travel Rorts', 2002, [www.crikey.com.au/politics/2002/11/14-travelrorts.print](http://www.crikey.com.au/politics/2002/11/14-travelrorts.print)

### Political leaders manipulating the 'truth'

The truth is always known in hindsight and is always subject to revision, but there are suspicions that not the whole truth is given by government ministers in response to a wide variety of questions. The federal government's 'children overboard' justification for the need for greater border protection, and America's 'weapons of mass destruction' justification for the invasion of Iraq, leave some unsettling questions about whether the electorate is told just what the government wants them to know. State governments are not immune from the same process with all public-private partnership (PPP) agreements being 'commercial in confidence' so the electorate cannot ascertain how good a deal has been done. With the cross-city tunnel in Sydney and many other projects, it appears to me that all the risks are borne by the taxpayer, and very little by the contractor.

Telling the truth.

Conflict of interest (justifying action on the basis of flimsy or no evidence) – self-interest of government dominates.

Issue – accountability and disclosure.

### Auditors-general reports

State and federal auditors-general departments have regularly reported that government departments do not play by the rule book. Governments seem so wedded to the concept of commercial confidentiality regarding contracts with private operators that parliament and the people are prevented from scrutinising how that money is spent. In 1998, the then Auditor-General of New South Wales, Tony Harris, voiced his concerns about the growing trend to secret government in Australia.<sup>41</sup> He stated that governments do not want to be accountable, and are using private sector participation to reduce the amount of information that is available. Also in 1998, the South Australian Auditor-General warned that the increasing use of commercial confidentiality by governments was undermining the foundations of parliamentary democracy, and the Victorian Auditor-General criticised the commercial in confidence contracts with the private operator of the state's prisons because of a lack of information to discharge accountability requirements.<sup>42</sup>

Telling the truth.

Conflict of interest – self-interest of government dominates.

Issue – accountability and disclosure.

### Media

It was never more obvious that the public interest is not the same as what the public is interested in. Media picks up on this and tends to follow personalities rather than the most pressing issues of the day. There is a tendency to focus on major personalities who may become easy targets, such as Steve Vizard, Rene Rivkin, Robert Gerrard, or media-friendly personalities (especially beautiful women, such as Michelle Lesley), and not the big issues of the day.

Also, journalists work to tight deadlines, and the size and complexity of business matters are not conducive to prolonged analysis. This might indicate why, when HIH collapsed, few journalists had analysed the company in any depth.<sup>43</sup> There is an expectation that journalists provide a forum for discussion of a limitless range of issues. However, where business problems are concerned this is rarely the case. Some topics are frequently off the agenda – for example, media giants do not investigate the conduct of each other – until overwhelming evidence emerges that can be used in print. Once a journalist adopts a critical stance towards a major company, all sources of communication with that company's executives are usually denied to them. Sources of authority, both within and without the company, are prepared to speak only off the record.

The most disturbing example of this tactic and its effect was the case of Robert Maxwell, former owner of Maxwell Communications. Maxwell owned the Mirror newspaper group and Pergamon Press in the UK. Rumours circulated that the Maxwell empire was not really profitable and that results were obtained by deception. He was a well-known litigant and with the use of legal writs the group's activities were not subject to effective media analysis. In 1991, with the game possibly almost up, Maxwell was found to have fallen off his boat and drowned. It transpired that he had looted millions of pounds of his employees' pension funds to prop up his group's cash flow, meet debt repayments and finance takeovers. This all occurred without effective media coverage of the issues, making the subsequent losses much heavier for all concerned.

Ability to do job by asking relevant questions, without suffering retribution.

Conflict of interest (manipulation of truth, seeking to suppress evidence) – self-interest dominates.

Issues – questioning and suppression of evidence.

41. ABC, *Background briefing*, 'Shrinking Democracy', 1 November 1998, transcript, [www.abc.net.au/rn/talks/bbing/stories/s19075.htm](http://www.abc.net.au/rn/talks/bbing/stories/s19075.htm)

42. ABC, *7.30 Report*, 1999, transcript, [www.abc.net.au/7.30/stories/s26883.htm](http://www.abc.net.au/7.30/stories/s26883.htm)

43. J Kitchener, 'Business reporting at the beginning of the 21st century: is it getting any easier?', *Working paper*, University of Canberra, 2004.

**Business advice**

The boom in real estate and share markets has attracted a number of less than scrupulous operators, to the detriment of consumers and honest property and investment advisers who lost potential business.

A Parliamentary Committee on Corporations and Financial Services reported significant problems associated with the provision of property and investment advice, including the variable quality of advice services and the unethical character of recommended investment strategies. There was a lack of disclosure of commissions and arrangements and relationships which promoters had with property developers and investment vehicle operators, and there were difficulties experienced where consumers tried to obtain redress. The Henry Kay property seminar circuit was a wonderful example of how the gullible and their money are soon parted, but the regulators did not have a solution to protecting such gullible people.

At the same time ASIC had been concerned about the conduct of National Exchange Pty Limited and its managing director David Tweed. National Exchange made unsolicited off-market offers to buy the shares of owners of small shareholdings in several listed companies. Tweed relied on information in share registries to identify his targets, and made offers substantially below market price. ASIC brought an action against National Exchange in the Federal Court and, while Justice Emmett found that the conduct of National Exchange was 'predatory and against good conscience' and in contravention of the Corporations Act 2001, on appeal to the full court the unconscionable conduct charge was not upheld.

Tweed subsequently changed his tactic, by offering a price close to current market price but with payment spread over several years. Thus, with his \$2 offer to small shareholders in OneSteel Limited, the payment was spread over 15 years, providing the equivalent present value to shareholders of 78 cents in comparison to the then current market price of \$2.10.

The regulators do not have problems only with, what on the surface appear to be, unprincipled operators. They have problems with some of the apparently reputable advisors who can be persuaded to put clients' money into obviously poor investments such as the mezzanine funds operated by Westpoint Corporation. Over \$300m was channelled into these funds which was promptly syphoned back to Westpoint and used to pay commissions to financial planners of 10 per cent, interest to investors and salaries to employees. Property was acquired with loans but these loans were secured so investors have lost their money.<sup>44</sup>

All the banks have been conscious that the original relationships they developed with mortgage brokers encouraged 'churning' of customers by brokers chasing commission. Most have tinkered with their commission structures to discourage the practice.<sup>45</sup>

The New York Attorney-General obtained a court order against Merrill Lynch's alleging that its research analysis was compromised to enable it to win corporate business. It is alleged that Merrill's research analysts tailored their research to win or retain corporate clients, recommending poor stocks to their clients in the process.

The allegations came on the heels of analysts' failure to unravel Enron's mythical financial performance – despite the role of investment banks in the off-balance-sheet partnerships that masked Enron's actual financial condition. Such allegations expose the conflict of interest surrounding those organisations that derive fees from companies and investors.<sup>46</sup>

A similar situation had developed in Australia during the 1990s with analysts failing to undertake serious scrutiny of corporate performance and activities. Few brokers make sell recommendations, especially where they work in firms with a corporate banking arm. In one analysis, 94 per cent of all recommendations were buy or hold.<sup>47</sup> In the case of HIH, analysts critical of the company were threatened with legal action and cut off from company information.<sup>48</sup>

The key issue is how to create an environment in which unethical conduct is exposed and a regulatory regime that can take reasonable steps to protect consumers.

Right to know, be kept fully-informed.

Conflict of interest (information that is not necessarily in the client's interest) – self-interest dominates.

Issues – disclosure and accountability.

44. A Kohler, 'A fundamental conflict exposed', *Sydney Morning Herald*, 3 February 2006.

45. S Bartholomeusz, 'ANZ broker squeeze set to become contagious', *Sydney Morning Herald*, 17 December 2004.

46. S Bartholomeusz, 'Conflict of interest needs ethics and disclosure, not more rules', *Sydney Morning Herald*, 16 April 2002.

47. B Clegg & J White, 'Australian stockbrokers exposed', *Australian Financial Review*, 25 May 2002.

48. W Pheasant, 'The conflicting interests of Australian brokers', *Australian Financial Review*, 16–17 June 2001.

### Plagiarism in the learned professions

Over the years we have witnessed a regular parade of academics and now lawyers who seem to think that plagiarism rules do not apply to them.

The most famous recent academic cases involved David Robinson and Rory Hume. David Robinson, then vice chancellor of Monash University, resigned after admitting in 2002 to plagiarising other people’s work in two of his published books.<sup>49</sup> Rory Hume, Vice Chancellor of the University of NSW, resigned after pressure over his handling of an enquiry into plagiarism by a noted UNSW academic, Bruce Hall.<sup>50</sup> There have been many other less illustrious examples, but the fact that such activities now reach the highest level of universities is cause for concern.

More recently, a federal magistrate stood aside after she included large parts of a colleague’s judgment in one of her own without attribution, and a federal court judge was accused of doing the same with an academic piece of work.<sup>51</sup> The issue here is apparently one of time pressure in getting judgments delivered, rather than a deliberate effort to pass someone else’s work off as their own.

Acknowledging the work of others.

Conflict of interest (pressure to publish versus acknowledging sources of ideas) – self-interest dominates.

Issues – full disclosure and accountability.

### ATO, ASIC and deeming on buybacks

An area of concern for some is the tax treatment of share buyback schemes. These have been extremely popular in the last decade and while keeping the overall value of the firm unchanged have provided windfall gains to shareholders who sell and share price gains for those who hold on. At issue here is the tax treatment of amounts paid for the buyback itself.

In 2005 Rio Tinto announced a buyback of shares at a discount to the market price of \$47, but because shareholders were deemed to have sold their shares at \$4 they made a huge capital loss, and the amount received over \$4 was deemed to be a franked dividend giving shareholders and additional tax break.<sup>52</sup> Tax Commissioner Michael Carmody told a Senate Estimates Committee that share buybacks were a difficult area of tax law to administer as companies could split the buyback amount into whatever proportion of capital and dividend they desired.

Fair treatment of all taxpayers.

Conflict of interest (private interest versus public interest).

Issue – fair treatment of all taxpayers.

### Charities

After the Bali bombings, the Red Cross launched an appeal to help the victims. There was criticism of the way in which victim funds were being handled by the Red Cross as there was no public accountability over how the amounts raised were being spent. A *Sydney Morning Herald* investigation found that of the \$14.5m Australians donated to the Bali bombing victims only about \$4m has reached them so far. It appeared that some of the money was spent on operating costs and some was reserved for future programs.

The Red Cross has had other financial accountability issues elsewhere. In the US a fundraiser in Louisiana was caught padding her own bank account with donations, an executive in Maryland forged signatures on purchase orders meant for disaster victims, and in New Jersey a chief executive and his bookkeeper stole over \$1m in Red Cross funds.<sup>53</sup>

Public accountability.

Conflict of interest (needs of charity versus needs of clients) – self-interest dominates.

Issues – accountability and truth telling.

49. L Minchin, 'Plagiarist claim angers uni group', *The Age*, 7 July 2002.

50. M Thompson, 'Crisis talks as university chief comes under pressure to quit', *Sydney Morning Herald*, 6 April 2004.

51. M Priest, 'Magistrate, judge in copycat furore', *Australian Financial Review*, 24 March 2006.

52. A Kohler, 'Think buyback, and avoid tax', *The Age*, 23 March 2005, transcript, [www.theage.com.au/news/Alan-Kohler/Think-buyback-and-avoid-tax/2005/03/22/111254024591](http://www.theage.com.au/news/Alan-Kohler/Think-buyback-and-avoid-tax/2005/03/22/111254024591)

53. CBS News, 'Disaster strikes in Red Cross backyard', [www.cbsnews.com/stories/2002/07/29/eveningnews/main516700](http://www.cbsnews.com/stories/2002/07/29/eveningnews/main516700)

## Employment

Two issues should be mentioned here – firstly, the extent of lying in the curriculum vitae of job applicants and, secondly, the proliferation of fake credentials.

In research carried out in 2004, 21 per cent of respondents to jobs in the banking, finance and public sectors had practised CV fraud. Of that 21 per cent, 60 per cent told lies of omission (previous crimes) and commission (fictitious jobs), and the researchers received comments such as 'I'm a career person. The way I see it, everyone else has a chance to lie and if I don't take it then I've missed out'.<sup>54</sup> The case of Dr Jayant Patel, the surgeon at Bundaberg base hospital allegedly linked to the deaths of 87 patients, is an extreme example of what can happen when job applicants lie.<sup>55</sup>

Thanks to the growing importance of credentials for professional advancement and the ease of internet access, the use of phoney credentials is growing. A 2004 US Government Accountability Office report found 463 federal employees with degrees from three 'degree mills', including 28 senior-level employees. In recent years, doctors, teachers and business administrators have been exposed for having fraudulent degrees. In NSW, Glen Oakley trained as a mortician's assistant but held jobs including director general of a state government agency and boss of Newcastle Ports Authority, helped by three fake university degrees.<sup>56</sup>

If people tell lies in their CVs, then what is the state of accounting education in our university sector?

Telling the truth.

Conflict of interest (cheating to get on) – self-interest dominates.

Issues – disclosure and truth telling.

## Business education

**University staff academic misconduct.** In 2003 a sessional lecturer with the University of Newcastle made an allegation of corrupt conduct in connection with the handling of plagiarism in assignments submitted by postgraduate students enrolled at an offshore campus of the university. ICAC established that the then head of the university's Graduate School failed to apply the university's plagiarism policy or undertake any proper investigation of the original plagiarism allegations. The Business School head, Dr Paul Ryder, and his deputy Dr Robert Rugimbana, had the assignments in which the plagiarism had been identified re-marked. ICAC established that they were motivated by a desire to avoid any potential adverse consequences that the plagiarism allegations may have had on the university's offshore program. ICAC determined that Dr Paul Ryder and Dr Robert Rugimbana engaged in corrupt conduct by breaching their duty to the university in having the assignments in question re-marked contrary to university policy and without any proper investigation as to the truth of the plagiarism allegations.

**University student academic misconduct.** If local students observe that academic misconduct by some groups of students (especially international fee-paying students) essentially goes unpunished, as the Newcastle case illustrates, then it is likely that other students will take a leaf out of their books.

Academic misconduct among business students has been demonstrated to be prevalent in both American and Australian universities.<sup>57</sup> Observations of increasing academic dishonesty in the US is attributed to the changing nature of universities, with bigger cohorts and greater competition and an increased perception by students that universities are now credentialing institutions. Other research indicates that those who cheat at university are more likely to believe that business people act unethically and be accepting of such unethical behaviour.<sup>58</sup>

It is probable that student perception about what constitutes ethical behaviour in the business world will influence their behaviour when they enter it. A significant question is whether accounting students have a high or low tolerance for unethical behaviour in both themselves and their peers.

Telling the truth.

Conflict of interest (profit versus standards) – self-interest dominates.

Issues – truth telling

Telling the truth.

Conflict of interest (passing versus understanding) – self-interest dominates.

Issues – ethical values of students, knowledge and skills development.

54. J Ireland, 'CV renegades', *Sydney Morning Herald*, Radar Section, 20 April 2005.

55. R Mancuso, 'Dr Death escaped screening', *The Age*, 31 May 2005.

56. ICAC Investigation, 'Glen Oakley – use of fraudulent qualifications', 2003, [www.icac.nsw.gov.au/index.cfm?objectid=6338B442-FF65-6658-5173D4AAD4CFDAB2](http://www.icac.nsw.gov.au/index.cfm?objectid=6338B442-FF65-6658-5173D4AAD4CFDAB2)

57. See D McCabe & L Trevino, 'What we know about cheating in college', *Change*, Jan/Feb 1996 and Nonis and Swift, 'An examination of the relationship between academic dishonesty and workplace dishonesty', *Journal of Education for Business*, vol 77, no 2, 2001.

58. R Lawson, 'Is classroom cheating related to business students' propensity to cheat in the real world?', *Journal of Business Ethics*, vol 49, no 2, 2004.

A recent study looked at the prevalence of academic dishonesty among accounting students relative to non-accounting students at four Queensland universities.<sup>59</sup> The research found that 23 per cent of all accounting students (81 per cent of non-accounting students) reported having engaged in at least one form of academic misconduct. For the serious form of cheating, misconduct by accounting students was greater than by non-accounting students, with 13.5 per cent of accounting students reported having received answers from another student in a test (7.9 per cent non-accounting). Fifteen per cent of accounting students reported giving answers to another student in a test (7.5 per cent non-accounting), and 16.2 per cent reported writing an assignment for someone else (9.4 per cent for non-accounting). Student misconduct behaviour appears to be driven by a number of factors including the likelihood of being caught, pressure to achieve good grades, time pressures and the desire to help friends.

In the same study students were asked about reporting misconduct by other students. Sixty-three per cent of accounting students indicated that they would not report fellow students (67 per cent of non-accounting students), and only 18 per cent reported that they would be likely to report the misconduct. However, 94 per cent of accounting students stated that they had never reported anyone for academic misconduct mainly through fear of being responsible for the punishment of another. At the universities involved, only seven per cent of accounting students were actually reported for cheating, much lower than the self-reported incidence of cheating.

## 1.7 Conflicts of interest and truth telling

With the AWB affair rolling on, it is clear that telling the truth is something many people in positions of responsibility and others seeking to enter positions of responsibility seem capable of doing only under the extreme pressure of an inquiry's questioning and the accumulating evidence of who knew what and when. Questions were not asked, people have very defective memories of relatively recent events, and appear to have looked the other way when the AWB was selling wheat to Iraq. Many of those involved – directors, managers, Department of Foreign Affairs and Trade officials, government ministers – seemed to have a conflict of interest between enforcing foreign policy sanctions against Iraq and promoting Australian wheat exports.<sup>60</sup> Coming down in favour of the latter, evidence about the existence of the illegal payments to the Hussein regime were simply not accumulated or were erased, so that they did not exist as part of our collective wisdom about what had occurred.

The research on the incidence of university student academic misconduct is of significance for the accounting profession. Poor ethical attitudes among accounting students raises the issue of the ethical development of accountants if graduating students carry the same values into their professional work. At what stage is intervention to (a) test the ethical values of those entering the accounting profession and (b) develop the moral attitudes of those entering the accounting profession, going to occur, if at all?

59. M Brimble & P Stevenson-Clarke, 'Prevalence of and Penalties for Academic Dishonesty: Perceptions of Australian Accounting Students', Griffith Business School, 2005.

60. M Steketee, 'Sanctions on the truth', *The Weekend Australian*, 25–26 March 2006.

## 1.8 Rationalisation and socialisation of corruption in organisations

People often wonder why people who are apparently ethical in their private lives can be found to have acted so unethically in their business lives. One of the most plausible explanations is given by Ashforth, Anand and Joshi (2004) who analyse the roles played by rationalisation and socialisation strategies in allowing perpetrators of unethical activities to believe that they are moral individuals who have a well-defined ethical code of practice. The rationalisation and socialisation strategies that are outlined in Figure 4 are used to gain acceptance and perpetuation of corrupt practices in organisations.

Figure 4: Rationalisation and socialisation strategies

Strategy	Description	Example
<b>Rationalisation of action</b>		
Denial of responsibility	There is no alternative choice.	'What can I do? It's the way this firm operates. I must meet my targets.'
Denial of injury	Victimless crime.	'It's only a little (stationery, cleaning materials, furniture). No one was harmed as the insurance will cover any losses.'
Denial of victim	A form of revenge. Victim deserved treatment.	'I only took them because the firm has treated me unfairly.'
Social weighting	Law is wrong. There are worse examples.	'Breaking this law is justified as it is a bad law. At X Corporation some staff take large inventory items. A little stationery is nothing.'
Appeal to higher loyalties	There are higher-order values at stake such as mateship and loyalty to colleagues.	Lie to demonstrate loyalty to the boss, colleagues – e.g. police officers to get convictions.
Balancing the ledger	Good points accrued allow the odd deviant behaviour.	'I worked overtime and earned the right to use (internet, mail, phone) for personal use.' Overbilling of clients by professionals. 'They need us.'
<b>Socialisation of newcomers</b>		
Co-optation	Induce change of attitude to unethical behaviour.	Cost (unethical behaviour) swamped by benefits (big fees, prestige).
Incrementalism	Introduce newcomer to unethical behaviour one increment at a time.	Gifts for minor indiscretions (ignoring under-supply of materials), with bigger gifts as indiscretions increase.
Compromise	Newcomer pressured into unethical behaviour as short-cut solution to pressing issues.	

Source: based on Anand, Ashforth and Joshi, 2004, pp 3–6.

Such rationalisations and socialisations are more likely to occur in a culture that accepts such practices, and where life inside the organisation is separated from life outside the organisation, and where euphemisms are used to hide the language of bribery and corruption.<sup>61</sup>

How likely is it that accountants will be swept up in these rationalisation and socialisation activities in organisations? Bruns and Merchant discovered that accounting managers in firms applied very loose definitions of business ethics which led them to adopt practices not explicitly prohibited by generally accepted accounting principles, or that appeared to deviate only in minor ways. Earnings managed through accounting manipulations (change in accounting methods) were seen as less ethical than earnings managed by changing operation decisions (bring forward sales, deferring expenditure).<sup>62</sup>

In a replication of the Bruns and Merchant study in Australia by Shuttleworth, what was noticeable was the lack of consistency in viewing a particular operating or accounting manipulation as either ethical or unethical. Also, there was a lack of consistency in viewing all operating manipulations as ethical or all accounting manipulations as unethical.<sup>63</sup>

61. V Anand, BE Ashforth & M Joshi, Business as Usual: The Acceptance and Perpetuation of Corruption in Organizations, *Academy of Management Executive*, 18(2): pp39-55, 2004.

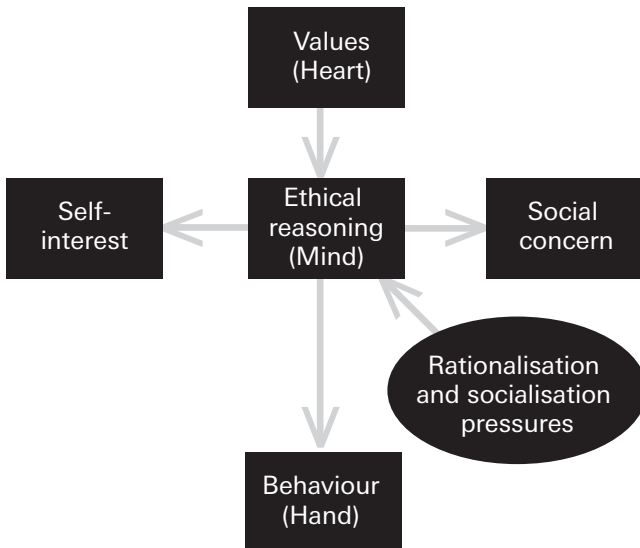
62. See WJ Bruns Jr & KA Merchant, 'The Dangerous Morality of Managing Earnings', *Management Accounting*, vol 72, no 2, 1990, pp 22–25 and KA Merchant & J Rockness, 'The Ethics of Managed Earnings: An Empirical Investigation', *Journal of Accounting and Public Policy*, vol 13, pp 79–94.

63. D Shuttleworth, 'Ethics and Earning Management', *Honours Dissertation*, 2006.

## 1.9 Summary issues and questions

From the foregoing analysis, we can model the ethical conflicts people in organisations find themselves embroiled in and raise relevant issues and questions that should be addressed by those involved. Figure 5 models the relevant elements of and influences on ethical decision making.

Figure 5: Elements of and influences on ethical decision making



The conflicts arise at the ethical reasoning stage where individuals and groups have to determine the appropriate course of action. It is in this process – the application of intelligence to a particular situation – that conflicts and pressures get the better of many decision makers. It is in this area that there appears to be a gap in the education of many highly-trained professionals, including accountants. They have received no training in dealing with ambiguous and often ethically-loaded problems.<sup>64</sup>

The accounting profession prides itself on monitoring and accrediting all suppliers of professional training for would-be accountants. However, training in ethical reasoning – an integral component of any professional judgment – is excluded from this professional training.

The sorts of issues that should be addressed in professional training include the following:

- (i) Who are the relevant stakeholders in any decision? How are they affected by:
  - a. Doing nothing?
  - b. Any possible action?
- (ii) What types of conflict are we (am I) faced by in the following situations?
  - a. (Un)shared version of the 'truth'
  - b. Between self-interest and social responsibility (interests of other stakeholders)?
  - c. Between personal values and requirement of laws and ethical codes?

- (iii) What means are available for resolving any conflict?
  - a. Open questioning of all concerned
  - b. Public disclosure of conflict.
- (iv) Are there sanctions that can be imposed on wrongdoers?

If there is evidence of widespread lack of ethical conduct by people in authority, then some serious questions need addressing:

### (a) What influence do these examples have on public perceptions of ethical conduct in dealing with conflict of interest?

There are two possible reactions of the public. First, they can become sceptical of any behaviour by business people, politicians and academics being ethical. The view becomes that unethical behaviour is the norm. Secondly, they become numb to the constant round of revelations and stop focusing on it or demanding better behaviour. Both moves are dangerous. Lowering the accountability requirements make life easier for the perpetrators of unethical behaviour but the inevitable backlash will come – at the ballot box, in purchasing decisions or education decisions.

### (b) How are these conflicts between personal interest and the interests of the community being perceived by society today?

A significant amount of public relations machinery is being used by groups such as politicians and businesses to paint black activities white. Societal response tends to be delayed, but can be extreme when applied. Reputation is what is at stake for many individuals and enterprises. When it is lost, recovery is long-delayed or may never eventuate.

### (c) Are there any trends emerging?

The trend appears to be towards more reporting of unethical activity with a smokescreen being applied where possible to mask the nature of unethical activity. Whether there is more actual unethical activity is difficult to determine. Certainly the perception is that there is more unethical activity taking place.

### (d) What are some possible consequences?

Over long periods of time, the trend has been towards more ethical behaviour in societies like Australia. Slavery and child labour no longer exist, blackbirding was abolished, children are no longer taken from Aboriginal parents, and equal opportunity in employment is a given, even if it may be difficult to implement always. Thus, any move towards unethical behaviour is likely to be temporary. There will inevitably be a backlash – if only because one political party can make mileage out of it at another's expense.

### (e) How do these examples affect accountants?

Accountants are expected to serve the public interest. We tell the world that is what we do. If accountants are found to have been acting unethically the reaction will be swift and severe. The rapid demise of Arthur Andersen, one of the big accounting firms of the twentieth century, occurred because its clients no longer had faith in its ability to do the job for which it was being paid – giving credibility to the financial statements of major stock exchange listed companies. So, what is the situation with the ethical conduct of accountants? The next section will deal with this issue.

64. CR Baker, 'What do we mean by accounting for the public interest?', *Fourth Asia Pacific Interdisciplinary Research in Accounting Conference*, Singapore, 2004.

## Section 2 Accountants, ethical conduct and dealing with conflict of interest

### 2.1 How are accountants perceived in society?

Polls that deal with the image of professional and other employment groups are conducted regularly. Questions such as 'How would you rate the honesty and ethical standards of the people in these different fields?' are used to assess the relative standing of professional groups.

In the US, the image of accountants received a battering with the collapse of Enron, as the following Gallup Poll scores indicate (Figure 6):

**Figure 6: Image of the US Accounting Profession – Gallup**

	Very positive	Somewhat positive	Neutral	Somewhat negative	Very negative	No opinion	Net score
	A	B	C	D	E	F	A+B-D-E
Aug 2001	10	37	40	7	1	5	39
Aug 2002	7	24	32	19	12	6	0
Aug 2003	8	37	37	10	4	4	31
Aug 2004	6	29	45	12	3	5	20
Aug 2005	9	33	40	11	3	4	28

The scores indicate that accountants' image dropped to zero in 2002 but recovered quite quickly in the US after the collapse of Enron. The harm inflicted by the Enron crash did not seem to be long-lasting.

One of the problems with these polls is that image can be manipulated with effective advertising and public relations activity, so it is difficult to judge whether the scores truly reflect community views regarding the image of accountants.

However, in another series of polls conducted in the US (Harris Poll) on the social prestige of 17 professional groups, accountants ranked last in all surveys conducted since 1997, and the scores attributed to accountants have not improved since. The Harris Poll focuses on prestige, rather than image, which they define as being 'strongly associated with respect, public service and good work. Professions with high prestige are those which are widely seen to do great work which benefits society and the people they serve' (Figure 7).

**Figure 7: Prestige of the US Accounting Profession – Harris**

	1997	1998	2000	2001	2002	2003	2004	Changes since 1997
Doctor	52	61	61	61	50	52	52	0
Teacher	49	53	53	54	47	49	48	+1
Accountant	18	17	14	15	13	15	10	-8
Lawyer	19	23	21	18	15	17	17	-2

Using the Harris Poll<sup>65</sup>, accountants appear to have a problem with their prestige that no amount of public relations activity is changing.

What is the situation in Australia? The Morgan Poll (Figure 8) also focuses on professional image which they define as having a high standard of ethics and honesty.

**Figure 8: Image of the Australian Accounting Profession – Morgan**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	Changes since 1997
Doctor	66	69	74	71	75	80	80	80	79	+13
Teacher	64	71	71	70	74	79	79	77	74	+10
Accountant	43	43	49	45	51	45	50	51	50	+7
Lawyer	29	26	34	29	32	30	31	33	32	+3

65. Note that Harris Polls go back to 1982 but not for all professional groups. The period from 1997 seemed appropriate as it coincided with interest in corporate governance, the dot-com boom and collapse and Enron.

Figure 9: Satisfaction with UK Accounting Profession – Mori

	1999	2000	2001	2002	2003	2004	Changes since 1999
Doctor	41	36	36	37	41	39	-2
Teacher	33	28	26	28	34	34	+1
Lawyer	11	10	9	9	11	11	0
Accountant	11	11	9	10	12	9	-2

The Morgan Poll indicates that accountants, while having a lower professional image than doctors or teachers, are regarded more favourably than lawyers, and have improved their image in the last nine years.

In the UK, Mori asked consumers how satisfied they were with the services of certain professions (see Figure 9). Accountants ranked much lower than doctors or teachers, and were going backwards in terms of the satisfaction given.

In summary, we can say that accountants in Australia have a better social image than accountants in other countries, and have been improving their image over recent years. There is, however, no opportunity for complacency, as the image of accountants in other countries may exert some influence here, and accountants are still a long way behind the caring professionals such as doctors and teachers. There is also the worry that image, which can be managed to some extent, and prestige, which is difficult to manage, are perceived differently by society at large, and there may be a need to monitor the level of prestige accruing to accountants in society.

## 2.2 How did the ethical rules for the accounting professional develop to date? What were the influences on and reasons for the development?

A professional code of ethics can be seen as a means of combating market failure for accounting services. Accountancy services are in great demand and it is difficult for an individual client to ascertain whether the skills of the accountant whom they have hired are commensurate with the demands of the client. The provision of sub-standard accounting services may directly hurt not only the client, but indirectly any shareholders, employees, suppliers, customers and lenders of the client. As well, poor performance by individual accountants reflects badly on the whole profession, as the American Institute of Certified Public Accountants (AICPA) discovered when Enron collapsed and sent Arthur Andersen into a tail spin.

The ethical rules adopted by the accounting profession were not codified by the Institute until 1967. As education was reserved for gentlemen, rather than gentle women, in the late nineteenth and early twentieth centuries, high educational (professional examinations) and financial (unpaid articled clerkships) barriers to entry were probably initially seen as sufficient to keep unethical persons out of the ranks of professional accountants.

The resolutions of the General Council of the Institute on ethical issues were brought together in a 'Code of Ethics' booklet in 1938.<sup>66</sup> The code focused heavily on the protocols to be observed when there was a change in a professional appointment and prohibitions on advertising and conducting a business inconsistent with that of a chartered accountant. The booklet was later withdrawn because members regarded it as a set of Institute rules rather than a guide to good conduct. The Institute reiterated its view that ethical conduct was a state of mind rather than compliance with specific written words, and members were expected to comply with the spirit of ethical conduct rather than the letter of the law.<sup>67</sup> However, the Institute did promote a paper written by Harold Chancellor on professional ethics<sup>68</sup> which was reproduced in the Members' Handbook in the 1960s and 1970s. Chancellor focused on the main attributes of a professional accountant, these being competence, integrity and independence. Members were judged as competent by keeping abreast of contemporary developments in accounting. Their integrity was protected by keeping the affairs of any particular client confidential. Independence was seen as the ability to maintain one's own office, have a range of clients and accept no gifts from clients or be paid on the contingency of the financial results portrayed.

66. WE Smith, *Code of Ethics*, The Institute of Chartered Accountants in Australia, Sydney, 1938.

67. Foreword to *Members' Handbook*, 16 November 1959.

68. HW Chancellor, *Professional ethics of the chartered accountant in Australia*, NSW Division Congress, Katoomba, July, 1959, published as a separate booklet, 3rd ed, 1970.

Ethics was defined as '[t]he science of human dignity in its widest sense' and '[t]he basic principle of right action'. Chancellor went on to state that '[e]thics are fundamental things that must be done or not done', and that '[e]thics, are in the main, a state of mind arising from one's moral principles'.<sup>69</sup> The fundamental rules relating to the use of a member's profit sharing, etc. were elaborated on by Chancellor.

The first codification of ethical rules of conduct came in 1967 when the past rulings of the General Council were codified, in effect refuting the earlier view that behaviour should not be codified. In 1975, the first Ethical Rulings on Professional Conduct were issued as B Statements in the Members' Handbook. The foreword to the statement repeated Chancellor's definitions of ethics, with one major addition, a ruling, B12, on independence, that briefly outlined the Institute's view on independence in that it reflected the integrity of the individual and that members must not only be independent but be seen to be independent.

In 1983, the ethical rulings were withdrawn, following the enactment of the *Trade Practices Act 1974* and the establishment of the Trade Practices Commission which refused to authorise professional fee schedules in use by the professional bodies, and the restrictions on competition that were evident in the code of ethics. The replacement ethical rulings in the AER section reiterated that ethics was a state of mind arising from an individual's moral principles. It went on to state that they should become an inherent part of professional life, but that members sometimes erred in their interpretation of matters requiring ethical consideration so they needed the code of ethics for guidance.<sup>70</sup> Paragraph 5 stated that adoption of ethical rulings did not ensure compliance, so disciplinary measures would be enforced for members not complying.

This was the first use of a professional ethics code as part of a public relations machinery. A mandatory set of rules backed by sanctions against members for non-compliance was to be used as an indicator to the public (stated in paragraph 4) that non-compliance with the ethical code would be investigated.

The fundamental principles that remain today were set down in the AER Ethical Rulings: integrity, objectivity, independence, confidentiality, technical standards, professional competence and ethical behaviour (see the Appendix for an explanation of each principle). The rulings spelled out the nature of conflicts of interest. Conflicts were identified as the conflict between personal interest and the client, and any conflict between the interests of one or more clients that a member was required to disclose.

In 1997, the Institute and CPA Australia co-operated to publish a joint Code of Conduct that set out the fundamental principles of professional ethics that built on the AER Ethical Rulings of the Institute. In 2005, the two major professional accounting bodies, being members of the International Federation of Accountants (IFAC), agreed to adopt IFAC's Code of Ethics as a minimum code to be applied to their memberships. An Exposure Draft of the *Code of Ethics for Professional Accountants* was issued in May 2006 to members of both bodies. This is based on the IFAC code of ethics issued in June 2005.<sup>71</sup> The replaced code of conduct focuses on fundamental principles but excludes independence as a fundamental principle. The new code has three elements.

First, there are the fundamental principles (see Figure 10) but the revised fundamental principles will exclude independence which is addressed in a separate section dealing with members in public practice.

Secondly, there is what is called in the code 'a conceptual framework' that requires accountants to 'identify, evaluate and respond to threats to compliance with the fundamental principles' (paragraph 100.5). Where appropriate, accountants are to 'apply safeguards to eliminate the threats or reduce them to an acceptable level, such that compliance with the fundamental principles is not compromised' (paragraph 100.5). Threats are identified as emanating from self-interest, self-review, advocacy, familiarity and intimidation (paragraph 100.10). Safeguards created by the profession, legislation, regulation or in the workplace should be in place to increase the likelihood of identifying or deterring unethical behaviour (paragraph 100.14).

69. Chancellor, op cit, p 7.

70. The Institute of Chartered Accountants in Australia, AER Ethical Rulings, *Member's Handbook*, April 1983.

71. International Federation of Accountants, *Code of Ethics for Professional Accountants*, New York, June, 2005, [www.ifac.org](http://www.ifac.org)

Lastly, the code provides a method of dealing with ethical conflict resolution. Accountants are to apply a prescriptive questioning process to consider the:

- (a) Relevant facts
- (b) Ethical issues involved
- (c) Fundamental principles related to the matter in question, including the identification of threats to those principles
- (d) Established internal procedures which might represent safeguards against the identified threats
- (e) Alternative courses of action.

The fundamental principles in the revised code are summarised in Figure 10, where the *Code of Ethics for Professional Accountants* is compared with the code of ethics recommended to organisations by the Independent Commission Against Corruption (ICAC) as a means of combating corruption. Missing from any of the accounting codes are those attributes that would help an accountant maintain integrity and objectivity and a focus on the public interest, namely courage, openness, accountability and leadership.

**Figure 10: Mapping Codes of Professional Conduct – Fundamental Principles**

Institute of Chartered Accountants in Australia/ CPA Australia Existing code of professional conduct (2006)	Institute of Chartered Accountants in Australia/ CPA Australia/IFAC Proposed revised code of ethics (July 2006)	Independent Commission Against Corruption (ICAC)
Public interest Integrity Objectivity Competence and due care Confidentiality Ethical behaviour  <i>Conform to professional standards</i> <i>Independence</i>	Public interest Integrity Objectivity Professional competence and due care Confidentiality Professional behaviour	Public interest Integrity Objectivity  <i>Honesty</i> <i>Openness</i> <i>Accountability</i> <i>Courage</i> <i>Leadership</i>

Today, professional codes of ethics need to work hand in hand with relevant legislation. Auditing standards will be covered by the *Corporations Act 2001* from July 2006, and where they refer to a code of ethics that code will also be subject to the interpretation of the legislation in any dispute. Failure by accountants acting as company auditors has probably provided the greatest impetus for both the development of corporate legislation and codes of conduct governing accountants' ethical behaviour.

A major problem for accountants is that the conflict between self-interest and public interest is most extreme in their positions. Accountants with mortgages, families and other financial responsibilities will think hard before taking a decision that has an immediate, negative personal financial consequence. This is where the ICAC code is enlightening. Included in its code are honesty, openness, accountability, courage and leadership. These are often characteristics that are missing in those associated with unethical conduct as outlined above. There may be some need for the accounting profession to look at these characteristics and see how they are promoted among members.

Missing from the accounting or ICAC codes is a requirement for the individual to tell the truth as they see it. Yet as we observed in the examples of unethical conduct, an inability to tell the truth was one of the major ethical lapses. As mentioned previously, uniform defamation laws have dropped the public interest criterion and moved to rely on a truth criterion only. It has to be admitted that truth is a slippery concept in accounting, but bringing it into the code of ethics as a fundamental principle could bring accountants to focus on what truth statements they make and how they are relied upon.

In 1980, noted US accounting academic AC Littleton stated:

*'[I]t is the aspect of truth in accounting that gives it a moral connotation. Truth finding and truth reflecting are important parts of the function of accounting; and it is a primary duty of accountants to see that due effect is given to this fact.'*<sup>72</sup>

72. AC Littleton, *Structure of Accounting Theory*, American Accounting Association, Sarasota, Florida, 1980, p 10.

In an increasingly complex world of financial activities and arrangements, merely applying Approved Accounting Standards but not seeking the truth, nor reflecting on whether the financial statements accord with the understanding of reality as the accountant or auditor see it, is unlikely to be a usable defence for accountants in the long run. As a past-president of the American Institute of Certified Public Accountants put it:

*'What is needed is not just reform of the accounting laws, it is a rejuvenated accounting culture – both internally in corporate finance offices and externally in audit firms.'*<sup>73</sup>

### 2.3 How do accountants fare in the ethical reasoning game?

If a key to making ethical judgments and decisions is the level of ethical reasoning displayed by the decision maker, then it is reasonable to ask how good accountants are in bringing ethical considerations into their reasoning. Kohlberg, a seminal researcher in this area, allocated ethical reasoners to three categories – pre-conventional, conventional and post-conventional – with higher stages reached as people mature emotionally and intellectually<sup>74</sup> (see Figure 11). Reaching higher stages of moral reasoning is assumed to be a sequential process based essentially on age and maturity.

Figure 11: Stages of moral development and moral reasoning

Level	Focus	Stage	Attributes
3. Post-conventional	Universal care for others	6	Personal principle-driven action
		5	Community standards prevail
2. Conventional	Community duty	4	Law and rule follower
		3	Pleasing others
1. Pre-conventional	Self-centred	2	Self-interest
		1	Avoids punishment

Source: Dellaportos, Gibson, Alagiah, Hutchinson, Leung, and Van Homrigh, 2005, p. 44

Some evidence, mainly from the US, indicates that accountants rarely get beyond conventional moral reasoning, with auditor ethical judgment being most influenced by rule-based reasoning, with accountants focusing on compliance with standards<sup>72</sup>, and with moral reasoning declining as accountants progress to higher levels in their firm. Does this mean that accounting attracts people who cannot progress beyond a conventional level of ethical reasoning, or is there a deficiency in accounting education, or are there problems with the Kohlberg model?

Kohlberg's analysis is based on his support for Piaget's assertions that cognitive development consists of a sequence of qualitatively different stages of intellectual development. Piaget's theory of cognitive development was a biological theory that assumed that cognitive development was sequential and invariant with no regression.

Riegel<sup>76</sup> suggested that people could operate simultaneously at different levels of cognition, switching back and forth between them. If this were the case then Piaget's stages would become **descriptors of styles of mental activity rather than stages of development**. Kohlberg's stages could also be the same with people moving backwards and forwards between the stages. The stages could be in competition with each other causing ongoing conflicts for each person to resolve.

For accountants to satisfy professional obligations for integrity and objectivity of judgment, it would appear that some form of self-directed ethical reasoning based on values is necessary. If accountants do not have self-directed principled reasoning capabilities at the post-convention level, the consequences are that they will be less resistant to client pressures or rationalisation strategies and may tend to accept that rule following is sufficient to discharge their duties.

How then can the professional accounting bodies encourage ethical decision making by their members and help to move accountants beyond Kohlberg's *'conventional'* style of ethical reasoning towards a more introspective *'post-conventional'* style? One method that deserves further investigation is to help its members engage with a model of ethical thinking, such as that proposed by Lonergan in his seminal work *Insight*.<sup>77</sup> This would require some educational intervention at the university and/or professional year stages of an accountant's education, and preferably both.

73. B Melancon, 'AICPA president calls for rejuvenated accounting culture', Address at Yale Graduate School of Management, 2002, www.aicpa.org

74. L Kohlberg, 'Stages and sequences: The cognitive development approach to socialization', in D Goslin (ed), *Handbook of socialization theory and research*, Sage, Chicago, 1969, pp 347–480.

75. LA Ponemon & DRL Gabhart, *Ethical Reasoning and Accounting in Auditing*, CGA Canada Research Foundation, Vancouver, 1993.

76. KF Riegel, 'Dialectic Operations: The Final Period of Cognitive Development', *Human Development*, 1973, 16.

77. B Lonergan, *Insight: A Study of Human Understanding*, Harper, New York, 1958.

## 2.4 What examples are there of conflict of interest in the accounting profession in recent years?

### 2.4.1 Financial reporting and the management of earnings

Profit has become a measure so important that we must now conveniently forget that it is, and always has been, a slippery, tentative measure at best. The tentative nature of profit is exacerbated by accounting standards that provide an array of profits and losses that can be calculated from the same set of data. This change can be viewed from two perspectives. First, the accountant or auditor can say 'Well if there are 600 ways of reporting profits so long as I stay within the letter of the law, I can justify my actions'.

The second way of viewing these changes is to observe that it puts ever more onerous responsibilities on the shoulders of accountants and auditors to be sensitive to the methods adopted in financial statements and it requires them to be aware when techniques used flow over into potentially unethical, if not illegal, domains. The former view may have become more dominant over the last 30 years or so.

Example	Conflict of interest
<p><b>Enron</b></p> <p>Every decade or so there are company collapses in which senior management (including senior accountants), directors and auditors are implicated. Enron's collapse in 2001 had a big effect on regulation, codes of ethics for directors and auditors both in the US and in other countries using the market system of control, such as Britain, Canada and Australia. Enron engaged in two activities that rendered their financial statements useless as control devices. Non-consolidated entities controlled by senior executives in Enron were the source of significant one-off profits as well as the holders of significant Enron debt. In energy dealings acquisitions were accounted for using mark-to-market accounting and profits brought to account in the year of acquisition, substantially inflating profits earned. The off-balance sheet special partnerships were disclosed in footnotes, but their significance was not understood. It appears that Enron's accounts complied with the letter of US accounting rules (generally accepted accounting principles or GAAP). Enron took with it one of the major auditing firms, Arthur Andersen, after allegations of document shedding. The Sarbanes-Oxley Act 2002 was passed to restore public confidence in US stock markets. It provided for the establishment of a public company accounting oversight board (PCAOB), the prohibition of some non-audit services by audit firms, rotation of audit partners, a one year delay before an audit partner can work for a client, and the signing of statutory declarations by the CEO and CFO that the financial statements present fairly the performance and financial condition of the company.</p>	<p>Self-interest of executives versus interest of investing public.</p> <p>Issues – manipulation and concealment of the truth.</p> <p>Auditor conflict – fees from other services.</p>
<p><b>Harris Scarfe</b></p> <p>In April 2001, the directors of Harris Scarfe Holdings Limited, operator of over 20 retail department stores in South Australia, Victoria and Tasmania, appointed a voluntary administrator. In the six months to 31 January 2001 half-yearly profit had declined by 45 per cent, but this was not the cause of the company's apparent demise. Rather, the board had discovered that management had deliberately provided to them and the public a false view of the financial position of the company over the previous six years.</p> <p>The company created artificial profits by acquiring new stores and revaluing assets upwards. In total Harris Scarfe paid around \$3m for assets that it recorded in its accounts at over \$11m. Profits were also manipulated by overstating prepaid expenses and understating liabilities.</p> <p>The shares in the company were suspended by the Australian Stock Exchange and then delisted. The Australian Securities and Investments Commission (ASIC) commenced an investigation into the company's collapse and laid charges against the main executives of the company, chairman Adam Trescowthick, the chief operating officer, Daniel McLaughlin, and the chief financial officer, Alan Hodgson.</p> <p>Hodgson played a major role in falsifying accounts and reports, allowing the company to appear financially healthy and continue trading when it had severe liquidity problems. Hodgson was jailed for six years for dishonesty offences related to the retailer's collapse.</p> <p>The liquidator of Harris Scarfe Holdings Limited declared in 2003 that there was no prospect of shareholders recovering any money from the liquidation. The stores were sold into a new entity and still operate.</p>	<p>Self-interest of executives versus interest of investing public.</p> <p>Issues – manipulation and concealment of the truth.</p>

## HIH

The HIH insurance group collapsed in March 2001 with losses of around \$5bn. A major criticism of HIH was that it failed to report large sums of looming liabilities. The most significant item in the accounts of a general insurance company is its provision for outstanding claims from policyholders. The company's owners and other stakeholders could not easily measure the amount that needed to be provided for outstanding claims. When the claims made against HIH mounted, the amounts provided for claims proved to be inadequate, and HIH had difficulty meeting its obligations to policyholders. HIH collapsed because it failed to provide enough to cover outstanding claims. If shareholders and creditors had known the true extent of provisions needed to meet claims, the company's profit would have been much smaller, and they may have been less willing to buy shares in, supply goods and services to or make loans to HIH. In such circumstances shareholders and creditors may have avoided the losses incurred when the company's actual financial position was disclosed.

A Royal Commission into HIH was established by the federal government and conducted by Justice Neville Owen. Owen's report into the failure took evidence that the 1999 published results were overstated by \$1bn. He said that the company's auditors, Arthur Andersen, should share some of the blame for the collapse. The management of HIH had lied to the auditors but, as well, accounting standards were not complied with. Owen said that, in certifying HIH's financial statements as 'true and fair', in 'virtually every instance of controversy [Arthur Andersen] ultimately yielded to management's view of the accounting treatment to be adopted, which invariably had the effect of overstating profitability and understating liabilities'. With former partners of Arthur Andersen on the board of HIH and assuming a pressure to generate work from the company, Owen stated that there was a perception that Arthur Andersen was not independent of HIH.

The Royal Commission into the collapse of HIH has put the spotlight on the appropriate relationship between auditors and their clients, and how the independence of auditors from their clients can be maintained.

Self-interest of executives versus interest of investing public, employees, suppliers.

Issues – manipulation and concealment of the truth.

Auditor conflict – fees from other services.

As Senator Paul Sarbanes put it when talking about Enron:

*'The collapse of the Enron Corporation brought to the surface grave defects in our accounting, auditing and corporate governance practices. They were not random. They were not just the work of the proverbial "few bad actors". On the contrary, they were systemic and structural deficiencies. They undermined the integrity of our markets, caused massive losses to individual investors, contributed to weakening the economy and resulted in the collapse of investor confidence.'*<sup>78</sup>

Time will tell us whether regulations such as the *Sarbanes-Oxley Act 2002* will prevent another Enron.

### 2.4.2 Legal obligations versus the public interest

In 2005, it transpired through his whistleblowing ex-bookkeeper, Roy Hilliard, that Steve Vizard, then on the board of Telstra, had engaged in insider trading through a company operated by his accounting firm, Bentleys. No criminal charges of insider trading were brought against Vizard. It has been reported that no charges were laid because his ex-accountant, Greg Lay, on legal advice, refused to sign a witness statement against his former client.<sup>79</sup> The question addressed by the Institute was whether Lay had brought the profession into disrepute by his refusal to sign a witness statement. A series of (differently constituted) disciplinary committees in the Institute decided that he had not.<sup>80</sup>

### 2.4.3 Audit

**Enron and the demise of Arthur Andersen.** On 2 December 2001 Enron filed for Chapter 11 bankruptcy protection. It had grown rapidly by taking advantage of the deregulation of gas and electricity markets in the US in the 1990s. Its 1994 sales were just \$10bn, yet by 2000 its sales were over \$100bn, much of which occurred from trading in energy derivatives.

In hindsight, it is obvious that the company was not performing as well as its financial statement portrayed and, to make the financial statements look good, the company engaged in a series of accounting manipulations, such as the following:

- > **Wash/roundtrip trades** – by selling to yourself (with no counterparty) it is possible to increase asset values and revenue
- > **Mark-to-market for energy transactions** – this increased revenues, as market prices were rising
- > **Recognise revenue on energy deals** when first enacted rather than when finalised using net present value techniques, and most importantly
- > **Using off-balance sheet special purpose entities (SPE)** to facilitate all of the above.

What must be remembered is that all transactions undertaken apparently complied with the letter of US GAAP.

78. P Sarbanes, Acceptance Speech, Paul H. Douglas Ethics in Government Award, University of Illinois, 18 June 2003.

79. E Sexton, 'Lay acted on legal advice: company breaks silence on Vizard', *The Age*, 10 August 2005.

80. See 'No case to answer against Greg Lay', The Institute of Chartered Accountants in Australia, 14 December 2005 [www.icaa.org.au/news/index.cfm?id=A11669109](http://www.icaa.org.au/news/index.cfm?id=A11669109)

We need to ask whether the situation could have been understood better. The answer is yes, even though hindsight is always 20:20. Just by analysing the company's cash flows, an intelligent analyst must have wondered how Enron could survive on cumulative negative operating cash flows, as the following table indicates:

	1998	1999	2000
EBITDA	2,205	1,672	2,808
Operating profit	703	893	979
Operating cash flow	(205)	(815)	(2,306)

So why were the auditors content to accept Enron's calculations and assertions and not do the due diligence that the situation deserved? One answer was that Enron was regarded as one of the plum audit jobs in the US. The fees involved and spin-off consulting fees made it an essential client for the firm. As the variety of rules available for applying accounting policies are numerous, an accountant needs a strong justification to choose one method over another that management might choose because it increases profit, helps meet market (and broker) expectations, helps keep share prices higher, and feeds directly into management reward schemes (via bonuses and share options). Accountants and auditors also have careers to pursue and families to feed, so the pressure not to rock the management boat is extremely strong unless they have some mechanism available to them to help them to stick to a preferred policy choice which they believe better reflects reality. Here we are back again at the accountant's view of 'truth' and 'reality' which are concepts from which, at bedrock, accountants cannot escape.

#### 2.4.4 Extent of out-of-court settlements for audit error

Was Arthur Andersen a rogue audit firm at the time of the Enron catastrophe, or was it just unlucky to get caught? Andersen had a reputation for effective ethics training for its staff, and had had since the mid-twentieth century when managing partners, such as Leonard Spacek, wrote passionately about the role of ethics in the profession. But what happens if significant institutions, like the audit profession, on which society depends for economic progress and fairness in dealings begin to become corrupted? It can be asserted that we have seen such developments in the last two decades with company management manipulating financial results while their companies received clean audit reports. In the US, between 1997 and 2000, 700 companies were required to restate reported earnings by the Securities and Exchange Commission (SEC).<sup>81</sup> All the leading audit firms made out-of-court settlements, so the issue of Arthur Andersen and Enron may be just one of degree.

How many Enrons and audit restatements will it take to bring the accounting profession to its knees, or will it never happen because no-one cares? All we know is that if society loses its trust in the fair dealings of accountants and auditors the repercussions can be swift and extreme.

#### 2.4.5 Taxation

The saying that there are only two certainties in life – death and taxation – has changed over the last two generations with a giant tax advisory industry helping people such as Kerry Packer pay the minimum amount that they are required in taxation, thus thwarting the Australian Taxation Office's (ATO) efforts to charge every taxpayer their fair due. In a recent article, an ex-director of PBL, Richard Walsh, expressed dismay at the proto-canonisation on the death of his ex-boss, a person he remembers who followed the philosophy 'Whatever it takes', that is, if it is legal, do it, and hang any moral argument. Thus, the famous claim that citizens had a right to pay as little tax as could be legally enforced against them. This is an individualist, simplistic concept of obligation, but one that appears to be embraced by many in the corporate world.

In the US recently, KPMG pleaded for its very existence after being fined \$456m for selling questionable tax schemes. KPMG accepted an external monitor to head off an indictment of the firm.<sup>82</sup> We do not know what effect the tax planning industry has on society's trust in accountants. Most of it is out of sight, but adverse publicity, prosecutions and questioning of the values at stake are likely to take their toll.

Also, over the past 30 years, it is easy to chart the rise of tax avoidance schemes and the response of the ATO. Schemes tend to be outlawed, not on a matter of law of principle but on the effect on the government coffers. Thus, early users of schemes make major returns for little outlay. The current action of the ATO against international credit card schemes seems to follow this pattern. There also has been criticism of the inaction of the ATO and the Director of Public Prosecutions over tax avoidance schemes used by companies associated with ex-Reserve Bank Board member Robert Gerard.<sup>83</sup> A relevant question to ask is whether a cost-benefit basis of action by the ATO is one that is socially acceptable or will it lead to scepticism and distrust of government.

#### 2.4.6 Consultancy

Are auditor independence and professional auditing firm consulting compatible? Independence is regarded as the cornerstone of the auditing profession. The Big4 audit firms have argued strongly that auditor independence and consulting are not inherently incompatible. However, in the US, the SEC, post-Enron, pushed the idea that auditing and consulting were incompatible because they compromised the independence and integrity of the auditor. With auditing being regarded as the keystone of financial statement credibility, auditor independence is regarded as a keystone to auditor integrity. Without being subject to audits, financial statements would have little credibility, and financial markets would have increased difficulty in assessing risk and return when pricing stocks.

The threat to consulting has been headed off for now, but is likely to return. As independence is a state of mind, the profession needs to ascertain with what states of mind auditors undertake their work.

81. J Surowiecki, 2004, op cit, p 128.

82. J Glater, 'Settlement seen on tax shelters by audit firm', *New York Times*, 27 August 2005.

83. J Garnaut, 'QC's last over Gerard inaction', *Sydney Morning Herald*, 29 March 2006.

## 2.5 Truth in accounting

What happens if significant institutions on which society depends for economic progress and fairness in dealings begin to be seen by the community as corrupted? We have seen such developments in the past two decades with company management manipulating financial results while their companies receive a clean audit report. In the US, between 1997 and 2000, 700 companies were required to restate reported earnings by the SEC<sup>84</sup>, double the number of the previous triennium.<sup>85</sup> After Enron, US audit firms came under intense scrutiny. The conflict between auditing and consulting, working for the company you once audited, competition through low audit fees offset by larger consulting fees, being hired and fired by the client, and then being able to cite client confidentiality when client problems were exposed, all create potential if not actual conflicts for auditors.

Perhaps there is a need to re-analyse the relationship between truth and accounting numbers. When companies fail, and Enron is a stark example, investors can no longer take the reported numbers as indicators of the true performance and position of the company, and the reaction can be swift. Enron went from public disclosure that the SEC was investigating its financial disclosures to bankruptcy in six weeks.

Financial accounting textbooks once stated that reported profit was a tentative measure as it relied on myriad assumptions and judgments. No more. Profit is such an important input to setting share prices (as confirmation of the forecasts on which share prices are determined) that measurement issues tend to be ignored. Ray Chambers once estimated that there were 'a million sets of mutually-exclusive rules each giving a true and fair view of a company's state of affairs and profits'<sup>86</sup>. The situation would be more extreme today. Not only would there be more profit figures, but the variability would also be greater. If this is the case, reporting profit figures that best reflect economic reality requires a value judgment on behalf of the accountant as to what they believe is the truth of the company's performance.

Accountants cannot get away from such truth statements. *The Corporations Act 2001* specifically requires directors and auditors to comment on whether the financial statement gives a 'true and fair view'. This requirement has been interpreted to mean compliance with generally accepted accounting principles. So, when the principles change the truth changes also. The question must be asked whether this is a sufficient definition to protect accountants and the profession. The answer is probably no! The press and litigious shareholders and creditors will hound auditors and accountants when investors are induced to invest in companies on the basis of information that subsequently turns out to have been false.<sup>87</sup>

However, accountants cannot be left alone to solve this puzzle. The regularity of company failure over the past 50 years, despite the existence of a growing number of accounting standards and in the presence of unqualified audit reports, threatens the professional identity of a discipline that asserts that its expertise and societal value is contingent on the personal characteristics of objectivity, neutrality and independence. Unless the professional bodies develop effective strategies to oblige their members to pay some attention to and translate these characteristics into the choices they make in their accounting practices, the professional accounting bodies will continue to attract criticism.

## 2.6 Ethical reasoning education

As stated earlier, the ethical character and the notion of serving the public interest are fundamental to the survival and development of the accounting profession, yet almost no time is devoted to ethics education. It may be time to look at the development of ethics codes for the accounting profession and determine whether a further educational impetus is now necessary.

Using the model suggested in Figure 5, on the elements of and influences on ethical reasoning, it may be time for a renewed effort to determine the type of ethics training that accountants receive, to focus more on ethical reasoning by accountants, and to make some suggestions for developments for the future that will retain trust in accountants and protect the reputation of the accounting profession.

84. J Surowiecki, 2004, op cit, p 128.

85. D Hilzenrath, 'After Enron, new doubts about auditors', *Washington Post*, 5 December 2001.

86. Cited in G Dean, F Clarke & K Oliver, *Corporate Collapse, Accounting, Regulatory and Ethical Failure*, Cambridge University Press, 2003, pp 25–26.

87. For example, see T Sykes, 'Sons of Gwalia short on truth', *Australian Financial Review*, 20 August 2005 and C Cummins, 'Multiplex profit disappears', *Sydney Morning Herald*, 20 December 2005.

## Appendix: Code of Professional Conduct, the Institute of Chartered Accountants in Australia/ CPA Australia/ (at April 2006)

B1. Public interest	Members must safeguard the interests of clients or employers so long as these are not in conflict with the duty to the community and its laws. Public interest takes precedence where there is a conflict of interest.
B2. Integrity	Members must be straightforward, honest and sincere in their approach to professional work. Having integrity means more than being truthful. It requires the avoidance of deceit and being courageous enough to make a stand on the basis of this principle.
B3. Objectivity	Members must be fair and not let prejudice, conflict of interest, or bias override their objectivity.
B4. Independence	Members must be and should be seen to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.
B5. Confidentiality	Members must respect the confidentiality of information acquired in the course of their work and must not disclose information to a third party without specific authority or unless there is a legal or professional duty to disclose it.
B6. Conform to professional standards	Members must carry out their professional work in accordance with the technical and professional standards relevant to that work.
B7. Competence and due care	Members must perform professional services with due care, competence and diligence. A member has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.
B8. Ethical behaviour	Members must conduct themselves in a manner consistent with the good reputation of their profession and refrain from any conduct which might bring discredit to their profession.

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