Financial reporting regulations, ethics and accounting education

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ABSTRACT

It is important for accounting students to understand the interrelationship between personal ethics, professional ethics and financial reporting regulations. Ethics begins in accountability on multiple fronts: to the individual; to those who rely on that person, e.g., family, colleagues, employers, and investors; those the person leads at work, e.g., staff and teams; and those who lead the individual, e.g., management, parents and spouses. There is a critical need for balance between all the expectations placed on an individual's ethical behavior so that the individual's integrity has both internal and external integrity – including the investors, the profession and society in general.

Accounting students also need to understand the importance of integrity in dealing with financial reporting, which is articulated by the Sarbanes-Oxley (SOX) Act and the prescriptions of the Treadway Commissions' Committee on Sponsoring Organizations (COSO). SOX governs financial reporting of public companies with debt or equity outstanding that are registered with the Securities and Exchange Commission (SEC). The key section of SOX that deals with integrity is Section 302 which presents factors involved with certifying disclosure controls and Section 404 which addresses factors involved with certifying management's internal control system. The act reinforces the concepts of auditor independence, corporate governance and financial disclosures. It also created criminal penalties for non-compliance and calls for companies to adopt a control framework such as those prescribed by COSO to help assure a company's financial reporting integrity.

With Sarbanes-Oxley Congress responded with more robust measures to insure the integrity of financial reporting. In the words of previous Securities and Exchange Commission Chairman William Donaldson:

> *Simply complying with the rules (SOX) is not enough. They should, as I have said before, make this approach part of their companies' DNA. For companies that take this approach, most of the major concerns about compliance disappear.*

Accountability, taking responsibility for one's actions, begins in the individual and transfers over to integrity in the workplace. Accountability motivates individuals and sharpens their focus. It also encourages innovation to stretch beyond the norm. The absence of accountability is likely to result in floundering, failure and lost opportunities. There will likely come a time during one's audit career when he or she will have to make a tough call to do the "right thing" or avoid the "easy way" – as an auditor, controller,

CFO or regulator. The choice one makes reflects the personal code of ethics that the individual has created and transferred to the workplace. The process of accountability begins with the individual and ultimately ends with the individual's determination of what is ethical or the right thing to do in a particular situation.

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INTRODUCTION

The history of the need for ethics education for accountants begins with the failure of the technology bubble followed by the collapse of Enron, WorldCom and Arthur Anderson among others (Rockness and Rockness, 2010). The resulting lack of confidence in financial information led Congress to enact the Sarbanes-Oxley (SOX) Act in 2002, including the creation of the Public Company Accounting Oversight Board (PCAOB), both of which renewed pressure for accountants to have ethics education to improve the chances that practicing accountants make ethical decisions when confronted with difficult choices. Despite this regulatory intervention, financial failures continued as evidenced by the 2008-2009 corporate collapses such as Lehman, Bear Stearns, Wachovia, AIG, Fannie Mae and Freddie Mac. Clearly there is another dimension to integrity that goes beyond compliance with regulations.

The question to be addressed in this paper focuses on the issues associated with the development of an ethical orientation to decision making. It is believed that ethical individuals are a critical element if organizations are to "...make this approach (compliance with SOX rules) part of their company's DNA" as was prescribed by former SEC chair William Donaldson. It will address the origins of moral conflict in accountants' decision making and consider approaches that could help in the development of the successful resolution of ethical dilemmas. It is difficult to gauge whether the situation in the accounting profession is worse today than in earlier times or simply disappointing when compared to the public's expectation of their behavior. Most research views this as a combination of the context in which decisions are made and the personal values of the individual making the decision. As Alan Greenspan, the former Federal Reserve Board chair, commented, "It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously." Effectively the opportunities for unethical behavior have increased as well as their consequences to investors and the public in general.

The Sarbanes-Oxley Act of 2002

SOX has been recounted and evaluated from many different perspectives (Deloitte, 2012; Srinivasan, 2005; Staubus, 2005). It was passed into law on July 30, 2002 to "…..protect investors by improving the accuracy and reliability of corporate disclosures (U.S. Government, 2002). SOX prescribes a new set of expectations placed on corporate financial reporting and the independent auditors who perform the attest function on annual corporate financial statements – the company's financial position at a set point in time (the balance sheets) and for the reported years: the results of operations (the income statement), the changes in cash from all sources (the statement of cash flows) and the changes in all equity accounts (including the statement of changes in retained earnings).

Independent auditors examine the design and compliance of internal control systems as well as the documentation to support financial statements which are generated by the management of the company and offered to various public constituencies, including investors. These results in the auditors' opinion on the overall fairness of the

information contained in the financial statements -including footnotes which disclose additional details supporting the information contained in the primary financial statements. There remains a continuing problem with the proscriptions offered by SOX. A contribution to the breakdown in the intended effectiveness of SOX can be attributed to organizations that fail to make compliance with the requirements of Sox, especially Sec. 404 on Internal Control, a transformational event. Those organizations that take a minimalist approach of mere regulatory compliance run the risk of having history repeat itself with a further breakdown of established internal control systems and confidence in the financial statements they generate. The decision to follow the letter rather than the spirit of SOX can be viewed as an example of an ethical dilemma being unsuccessfully resolved.

SOX mandated that beginning with the 2004 year end, SEC filing companies need to have documented major process and internal controls. They must also test the effectiveness of their established controls to insure compliance with the prescribed systems. These two steps require an assessment of both the design effectiveness and operating effectiveness of the internal control system. Furthermore, both corporate management and independent assessors must certify that the internal control systems are designed and operating effectively. They must also disclose material weaknesses that are discovered and promptly remediate any significant control deficiencies. Additionally, companies are required to develop a process for ongoing maintenance of control documentation and an ongoing testing program.

In summary, Sarbanes-Oxley's goals for companies were to have full compliance in a cost effective manner resulting in a well controlled financial reporting process with clear ownership of responsibilities. Internal control over financial reporting involves a process designed by management to provide reasonable assurance as to the reliability of financial reporting and preparation of financial statements for external purposes in accordance with Generally Accepted Accounting Procedures (GAAP) in the United States. These financial statements should include procedures to insure maintenance of records to fairly reflect transactions. The controls should further assure that receipts and expenditures are authorized by management and that assets are safeguarded and presented properly in financial statements.

National Committee on Fraudulent Financial Reporting

Integrated controls are designed by management after an assessment of the corporation's operating environment. An approach to assessing manage-ment's evaluation of the control environment is offered by the National Committee on Fraudulent Financial Reporting (aka the Treadway Commission) which was established in 1985. The Treadway Commission chartered the Committee on Sponsoring Organizations (COSO) – formed and funded by five sponsoring professional accounting organizations: the Institute of Management Accountants, the American Institute of Certified Public Accountants, Financial Executives International, the Institute of Internal Auditors and the American Accounting Association – to work together to develop integrated guidance on internal control systems. The COSO model suggested five interrelated components that include:

1. Controlling the environment in the organization by assessing the tone at the top, i.e., the corporate control consciousness that exists;
2. Conducting a risk assessment at both the activity and entity levels;
3. Documenting the control activities including policies, procedures and practices;
4. Designing information and communication to integrate the other components; and
5. Monitoring established practices to assess the degree of compliance and the quality of the organization's performance over time

The COSO framework dovetails with Section 404 of SOX regarding issues of ethics which prescribes risk assessment, documentation and testing of controls and the identification of material weakness. Since there may be economic consequences to identifying material weaknesses, there may be pressure on issuers to bypass all or part of established protocols that may report these weaknesses. When corporations experience material weaknesses, lenders decrease their use of financial covenants and financial-ratio-based performance pricing and substitute alternatives such as price and security protections and credit-rating-based performance pricing provisions. Lenders increase the interest rates that corporations must pay in order to borrow money (Costello and Wittenberg-Moerman, 2011). As a result, there is a potential adverse material financial impact of full compliance with the regulations.

In order to prevent this, COSO suggests steps that organizations should take to ensure that internal controls are maintained. First, organizations must gauge the significance of the identified weakness and take action to correct significant weaknesses as soon as possible. Next, it must be validated that the correction is effective by retesting the revised system. All material weakness, identified and resolved, (but not substantial weakness) must be reported to the responsible management and the corporation's audit committee. Substantial weaknesses must follow all of the prescriptions for material weaknesses and additionally be reported to the SEC and the investing public – anyone who has cause to rely on the integrity of the entity's financial reports.

The COSO framework was designed to inspect, analyze and make recommendations to prevent a disconnect between what happened in the organization and what is reported by public companies in their financial statements. The COSO framework has several key proscriptions that lend themselves to becoming ethical choice points. The framework envisions internal control as an ongoing process to faithfully represent the financial affairs of a business entity– not a means to engineer fictitious financial results. It defines internal control as a process involving decisions made by people at all levels of the organization. Internal control is not merely rules, regulations, policies, manuals or reports. In order to be effective, internal control must be part of an organizational life and culture that emphasizes doing the right thing – from the macro organizational decisions to the micro processing of individual receipts and disbursements with appropriate supporting detail in an organization's accounting system.

COSO has emphasized the importance of the *control environment* – the top/down creation of an organizational life focused on ethical decisions at all levels. The conscious internalization of control provides both discipline and structure to financial reporting activities. Control environment factors include integrity, ethical values, management's operating style, the delegation of authority and the organization's program for developing and promoting people. According to COSO, internal control is more than compliance

with rules and regulations – it begins and ends with the ethical values of individuals. Errors in personal judgment, collusion among employees or coercion by top management may override internal control. The COSO framework recognizes that there are complex and multiple opportunities for internal control breakdowns resulting in fraud to occur in financial reporting and it offers a model to monitor weaknesses that develop as well as the means to correct them as soon as possible (Staubus, 2005).

THE FORMATION OF INDIVIDUAL ETHICS

Staubus (2005) observed that "….. accounting failures are failures of individuals to perform their fiduciary duties, to fulfill their responsibilities to behave ethically (p. 5)." Accountants' continued involvement in the major corporate scandals of the past twenty years suggests that accountants have not complied with the expected ethical standards of the profession. Accountants' failure to reflect ethically on the dilemmas they encounter in their work may lead them to make wrong decisions (Senaratne, 2013). It has been suggested by groups such as the International Education Standards Board (IAESB) that accountants should be trained to be sensitive to moral dimensions of the ethical dilemmas they face in their work. The Framework for International Education Standards for Professional Accountants (2009) states:

> …the overall objective of accounting education should be to develop competent professional accountants, who possess the necessary (a) professional knowledge, (b) professional skills, and (c) professional values, ethics and attitudes (Senaratne, 2013, p. 4).

The IAESB states that developing ethical behavior should begin early in an accountant's education and be re-emphasized throughout his/her career. Ethics should not just be four hours of continuing professional education (CPE) taken every few years; it should be a lifelong process. Furthermore, an understanding of the moral implications of decisions is necessary to move the accounting profession beyond the rules-based approach of legislation designed to improve behavior without considering the failed moral and ethical underpinnings of the profession (Stephens, Vance and Pettigrew, 2012).

Providing quality accounting services to clients and investors is affected by economic factors but also extends into the dynamics of the ethical decision making process. Ethical decisions can lead to conflicts and dilemmas arising from different beliefs and values inherent in the various roles individuals play in their personal and professional lives. It has been argued that accountants have been the main contributors to a corporation's declining moral environment (Senaratne, 2012). However, a corporation's value dilemmas are affected by experiences, traditions and the values of society – not merely the personal idiosyncrasies of individual practitioners.

The Structure of Values

Concepts of ethics are shaped by personal, societal and professional values (Senaratne, 2012). "Individuals within any society confront and possess a myriad of values. A *value* is defined as any discrimination of importance as to priority or degree,

made by individuals and held over time (Achenbaum, 1983). A value is therefore a long-standing choice that dictates belief, action or commitment. Values are sometimes consciously recognized and espoused; others may be unrecognized and in conflict; while still others may go unrecognized or unarticulated" (Kermis, 1987). Individuals may behave unethically, but be unaware of it, a concept referred to as *ethical blindness* (Palazzo, Krings & Hoffrage, 2012).

"Values are formed in many different ways and attain varying degrees of importance for individuals, groups and society as a whole. Values may be legislated by the government, taught by religious or social groups, or formed within the family. Some values are important at one time or in one setting, while less important at another time or with another group" (Kermis, 1987). Unethical decisions result from an interplay between personal traits of the decision maker and the relevant aspects of the situation (Trevino, 1986).

Ethical conflicts and dilemmas "may be either soluble or insoluble and usually occur in situations that include uncertainty" (Kermis, 1987), difficulty or time pressure (Palazzo et al., 2012). "Dilemmas, however, are by definition always insoluble and require a group or individual to choose between two equally balanced alternatives. Typically, when confronting a dilemma one is faced with the situation of making a choice that requires either rejecting a desirable goal or action, or accepting an undesirable goal, action or consequence. Although value dilemmas are always insoluble, some may be somewhat ameliorated. When ethical dilemmas are clarified, individuals have a better means of examining the level and type of value conflicts they are confronting" (Kermis, 1987).

Many unethical decision-making models assume that people decide rationally and are able to evaluate their decisions from a moral point of view (Palazzo et al., 2012; Staubus, 2005). However, recent research suggests that people may behave unethically without being aware of it, i.e., they are ethically blind (Palazzo et al., 2012). They may actually think they are doing the right thing. This type of behavior has led to the public's outrage over the unethical decisions of accounting professionals becoming so commonplace. This may be due in part to compliance with the rules that are provided in the Professional Code of Conduct which is not grounded in an understanding of the ethical and moral principles that lie behind them – in the wrong hands, rules can provide the cover for the perpetration of what might be considered unethical. As stated in Rockness and Rockness (2005):

> When professional accountants focus solely on compliance with the rules, they may easily lose sight of the moral implications of their actions and may often use the rules as a justification for unethical behavior. It is often convenient to confuse what is legal with what is the right thing to do. Further, rules are unmanageable and people can only remember them and use them if they understand the principles underlying the rules (p. 90).

Early models of unethical decision making (Trevino, 1986) suggested that ethical failures were the result of the personal traits of a decision maker plus situational characteristics. This assumed that individuals were rational actors in a moral point of view. More recently, however, unethical decisions are seen as intuitive and automatic

while ethical decisions are rational and deliberate. The ethical dimensions of a decision might not be visible at the time the decision is made – they may only be seen in reflection. The process of unethical decision making proceeds as follows:

1. People deviate from their own values and principles;
2. They assume that this is context-bound and therefore temporary; and
3. Ethical blindness is unconscious. The individual is not aware he/she has deviated from their values or principles (Staubus, 2005).

The individual knows the difference between right and wrong in a given situation, weighs the positive and negative incentives against his/her personal interests, and sees more advantage in the unethical behavior (Ashkanaszy et al., 2006). Unethical practices may be seen as routine when perceived through the lens of the decision maker who may be willing to do unethical behavior if asked to do so by a legitimate authority figure such as upper management (Milgram, 1974; Werhune et al, 2011). Peer or majority pressure – the Arthur Anderson way – may produce strong social pressure to conform to "less than ethical" behavior. Time pressure may also constrain the cognitive resources need for an ethical assessment and lead people to use simple decision strategies, e.g., managerial decisions are often time sensitive and favor speed over accuracy (Palazzo et al., 2012; Solomon & Brown, 1992; Kermis & Mahapatra, 1985).

"There are many ways of classifying values, but for this discussion, four general categories will be presented" (Kermis, 1987):

1. social values – those generally considered to be sanctioned within a society;
2. institutional values – those sanctioned by particular institutions such as accounting firms, corporations and government;
3. professional values – those generally sanctioned within a particular profession such as accounting, law or medicine; and
4. personal values – those held by an individual based on life choices, responsibilities and experiences (Kermis, Bellos and Schmidtke, 1987; Senaratne, 2012).

Conceptual Framework for Values in Conflict

"Within the United States are a number of social, institutional, professional and personal values that create conflicts and dilemmas because they can be mutually contradictory. Five sets of American values illustrate the potential for these contradictions:

1. democratic utilitarianism
2. individual rights and self-fulfillment
3. the right to truth
4. equality; and
5. efficiency in work and production" (Kermis, 1987)

Democratic utilitarianism refers to the social value of making decisions that produce the greatest good for the greatest number (Senaratne, 2012). "Under this value system, conflicts can occur when people try to identify whether the greatest good for the greatest number refers to what people want, what they need, or what they "should" receive. Within the utilitarian ethic, however, there is always a conflict between an individual's right to pursue pleasure (and avoid pain) and the rights or needs of the group" (Kermis, 1987). Regarding accountants, ethical decisions require the consideration of all possible consequences of a decision for all parties affected by it (Senaratne, 2012).

"Within American society, many individual rights are guaranteed within the Constitution. The value of allowing a person to pursue self-fulfillment is inviolable as long as the individual causes no harm to anyone else" (Kermis, 1987). In the corporate and accounting failures of the past decade, the pursuit of self-fulfillment resulted in harm to society as well as the accounting profession. Another right to be considered is the right to truth – the users of financial information have the right for truthful and accurate information that is fairly presented when making decisions on investments and/or investment strategies (Senaratne, 2012). This right places an obligation on accountants to present fair and truthful financial statements. As Senaratne (2012) states:

> *…legal and contractual rights are important in the accountant-employer and the and accountant-client expect professional and competent service from the accountants. In turn, the accountants have a corresponding legal duty to perform their tasks to the best of their ability within the constraints of their expertise (p. 3).*

Another value existing in financial reporting is the value of equality or justice, which states that everyone deserves to be treated the same and should possess the same rights, i.e., the correlation between contribution and reward and the assumption that all people have equal worth. There are numerous examples in which equality of treatment and access is not provided because of factors related to race, gender and age. In addition, the nature of accountants' work places them in a special position of trust to their clients, employers and the general public. These decisions affect the resource allocation process of the economy.

"A fourth value set, efficiency, arises from the science of economics. In economic terms, efficiency means maximum output for minimum input. This notion is often translated for public policy purposes into cost-benefit analysis which often result as a rationalization for cost-cutting. Efficiency requires that a more productive or effective worker or methodology should replace a less efficient one" (Kermis, 1987). Cost efficiencies may well lead to dilemmas based on the principles of equality and self-fulfillment. These situations lead to the questions, "What is the greatest good for the greatest number of people in these instances? Is the greatest good to be defined by the value of self-fulfillment, equality or cost-effectiveness?" (Kermis, 1987).

"From this type of situation one can see that a true value dilemma exists – choosing one set of values inevitably leads to rejecting another equally important value system" (Kermis, 1987). The values of the individual may come into conflict with the values or the profession or corporation. The values of the individual may be coerced by

the values of upper management and the values of upper management may also come into conflict with the values of the accounting profession. Additionally, research has suggested that the decline in ethics is largely cultural and reflects a failing system of morality beyond the profession's ethical rules (Stephens, Vance and Pettigrew, 2012; Fischman, Solomon, Greenspan and Gardner, 2004; Kohlberg, 1984).

The Public Policymaking Solution – The Sarbanes-Oxley Act of 2002

"It is axiomatic that the definition of the problem shapes the solutions that can be developed. Not only does public policy provide the dollar resources from which to deliver services, it also pronounces the broad goals to be achieved by the formal system and outlines the means whereby these goals can be achieved. Those responsible for the problem statement have considerable power in shaping the solutions proposed by the policy enacted. Social problems such as the financial crash of the early 2000's are not merely articulated by objective facts, but by how these facts are perceived by various parties to the policymaking process. In addition, broadly constructed problems and goal statements will tend to mask any differences in the perception of situations" (Kermis, 1987).

Many policy analysts "believe strongly that public policy should be based on a body of knowledge and that knowledge properly used can do much to solve social problems. This view of public policy in itself creates a conundrum because it runs counter to the way policy is made. Lindblom's classic work (1968) describes policymaking as consisting of two processes: rational analysis and the play of power" (Kermis, 1987). More recent research (Staubus, 2005; Palazzo et al, 2012) finds that individuals may create personal codes of ethics that may operate in times of stress based on intuitive, automatic processes rather than deliberate, analytical choices. Moreover, individuals often defer their own ethical judgments and assume the values/ethical choices of legitimate authority (Milgram, 1974; Fischman et al, 2004).

The Role of Regulation in Accounting Ethics

The Sarbanes –Oxley Act of 2002 was designed to enhance public company governance, responsibility and disclosure. Of particular concern to this paper is Sec. 404 – Management Assessment of Internal Controls. This section had the following key components which require the annual report of corporations:

1. "to state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
2. to contain an assessment …of the effectiveness of the internal control structure and procedures of the issuer for financial reporting (Friedenberg, Hoyns and Nusbacher, 2002)."

Section 406 is also relevant as it contains statements regarding a Code of Ethics for Senior Financial Officers which also must be promulgated. The code of ethics means such standards as are reasonably necessary to promote:

1. "honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
3. compliance with applicable governmental rules and regulations (Friedenberg et al., 2002)."

The Role of Organizational Life in Accounting Ethics

"Organizational life and behavior also demonstrates the potential for value and ethical dilemmas and conflicts to impede the delivery of appropriate services to the organization's client group. While organizations are goal-seeking entities, they are both other-serving and self-serving. Accounting organizations, in particular, serve many interests. Not only do they serve the recipients of their services, they also serve the interests of their resource providers, their suppliers, and even their opponents" (Kermis, 1987).

Organization decision makers "may find themselves preoccupied with negotiating interests in favor of their organization's life" (Kermis, 1987), e.g., engagement partners in public accounting firms may find their personal values in conflict with the organization's values in efforts to secure clients. They may make choices, in the view of political economists, based on their own self-interest which of course is often considered the ultimate value issue. Because public accounting organizations exist for profit, it is clear that the value of efficiency must be pre-eminent in decision making. This preeminence will come into conflict with self-fulfillment rights (Staubus, 2005; Senaratne, 2012).

Professional accountants work within multiple organizations – their employers, their clients, their churches and other social entities, etc. The dilemmas in this context are most often between the proscriptions of professional practice and the exigencies of organizational life – the institutional values. Professional decisions are confounded by personal values. It is the mélange of these often conflicting values that makes situations so intolerable and are most likely to lead to professional burnout (Kermis et al, 1987).

"Professionals in organizations have a variety of alternatives to the decisions they make, from those that totally identify with and advocate for client interests, to those that follow organizational demands to the letter of the manual, the rule or regulation. The professional in an organization needs to be aware of the sources of conflicts and dilemmas that organizational life presents. Ultimately, the success of accounting professionals in organizations may depend on their acquiring a set of beliefs and values that helps them decide what is true, what questions need to be asked, and what is right or wrong in any situation" (Kermis, 1987).

CONCLUSIONS

The auditing situation leaves the accounting profession, client, auditor, regulators and society in a context immersed in ethical conflicts and dilemmas. This context may involve agonizing personal choices by individuals as they exercise the craft of their profession. Society and those involved in accounting education, research and practice

should rethink their policies in order to examine the value-laden assumptions on which such choices rest. Research has found that simply following the rules is not sufficient in many situations. Accounting education, both undergraduate and postgraduate, must train leaders of the profession who will be honest, trustworthy and of ultimate personal integrity.

The educational process must recognize that ethics is not simply being aware of a code of professional ethics. The development of competent accounting professionals will require approaches that impound the issues raised in this paper. Programs need to be designed that bring the issues and development of personal and professional ethics into the realm of a core competency required of all those entering the accounting profession.

The goal for future leadership can only be achieved if both the contextual and personal codes of ethics and their underlying basis are understood. The dilemmas leading to choices must be articulated so that individuals understand that there are consequences to the choices they make – as individual practitioners, as members of audit teams, or as employees in larger organizations. If this crucial examination is not performed, then the errors and fragmentation of the past are doomed to be repeated. As Psychologist Martin Bloom stated in 1981, "If we do not consciously impose identified values on ourselves and the world around us, then some set of values will be imposed by future events, whether we like it or not."

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