

# 12

## Ethics In Accounting And Finance

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### Learning Objectives

After reading this chapter you should be able to understand,

- ◆ the importance of ethics for a finance and accounting professional;
- ◆ the various principles which need to be adhered to by finance and accounting professionals;
- ◆ the concept of ethical dilemma and conflict resolution;
- ◆ the various threats which can be faced by a finance and accounting professional while working as an auditor, consultant or an employee in an organisation;
- ◆ the various safeguards which need to be adopted to counter threats.

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*"A business that makes nothing but money is a poor kind of business."*

HENRY FORD

### 12.1 Introduction

Finance and Accounts is perhaps the only business function which accepts responsibility to act in public interest. Hence, a finance and accounting professional's responsibility is not restricted to satisfy the needs of any particular individual or organisation. While acting in public interest, it becomes imperative that the finance and accounting professional adheres to certain basic ethics in order to achieve his objective.

Until recently, various surveys conducted globally had ranked finance and accounting professionals very high in terms of professional ethics. However, various accounting scandals witnessed during the past few years have put a serious question mark on the role of the finance and accounting professional in providing the right information for decision making, both within and outside their respective organisations. In companies such as Enron, World Com, Tyco, Global Crossing, Adelphia, Quest, Xerox and most of the late dotcoms, the accounting information used by the Finance Department was false and manipulative.

What was the role of finance and accounting professionals in all these high profile failures? Of course there were a few professionals who were directly involved in fraudulent activities, however, the majority, at most of the times, refused to challenge what they had already known.

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Enron is a classic example of such behaviour. Months before Enron Corp declared bankruptcy, an employee of the name of Sherron Watkins sent the company's top executive (Kenneth Lay) a message which had detailed information of the accounting hoax in the form of the now famous 'off the book liabilities'. However, instead of taking note of what was mentioned in the message, the management of the company demoted Sherron. It is well known now, that, like Sherron, hundreds of finance and accounting employees at Enron knew about the happenings but preferred to remain silent. Hence, most of them did not lie, but neither did they disclose the truth nor did they attempt to correct the misleading and confusing information. Shouldn't they have blown the whistle the way Sherron did? Was the behaviour of these employees un ethical? Cases like Enron exist in plenty, *example* World Com, Global Crossing, Xerox, Qwest and many other companies have been known to have created accounting entries with the sole purpose of making their financial statements look attractive thereby inviting further investments from unsuspecting individuals and organisations.

### 12.2 Ethics and Ethical Dilemma

*The word Ēthikos* (Ethics) imbibes within itself both individual behaviour and community culture. Various individuals would be having different opinions on the same subject because of which what is perceived as right by one may be considered wrong by the other. Hence, doing what one thinks is right, may not always be the right thing to do! This is the essence of the term 'Ethics' which may be defined as '*those moral principles which guide the conduct of individuals*' irrespective of the differences of opinions amongst individuals. Ethical behavior implies such course of actions which are taken after giving due thought to their impact on the society and other stake holders. Hence when accounting and finance professionals at Enron did not report of the wrongs which they believed were being done at the top, their behaviour amounted to being unethical in spite of the fact that they were not directly involved in any of the fraudulent or manipulative activities. In contrast, when Cynthia Cooper, Vice President – Internal Audit of World Com found wrong accounting entries resulting in inflated profits, she immediately reported the matter to the Board of Directors, this, in spite of the fact that she was reporting against seniors whom she had come to admire over the past so many years of working together. These two *examples* mentioned above provide an insight into the meaning of Ethical dilemmas. Ethical Dilemmas exist when finance and accounting professionals need to choose from amongst alternatives and there are (1) significant value conflicts among differing interests, (2) actual alternatives which can all be justified and (3) significant consequences to all stakeholders. Let us consider an *example* of a finance and accounting professional who has been asked to provide a profit forecast which needs to be given to a banker for a much wanted loan to be utilised in launching a new product. The company has not been doing well for the past few years and without this loan there is a likelihood of its closing down. However, the loan can only be availed if the banker is convinced that the projected profitability shall be at least ₹ 50,00,000 per annum. A optimistic projection of the profits shows that if everything goes extremely well the company may be able to make profits of ₹ 50,00,000, however, a realistic assumption provides a much lower figure. In such a situation the concerned professional will need to resolve the dilemma of the type of profit

forecast to be provided to the banker. In case he gives a realistic projection the company may not get the loan and perhaps may need to close down. On the other hand if he makes a optimistic projection, he may be misleading the banker. There is no right answer to such a situation. Both actions proposed have got there own risks.

### 12.3 Potential Conflicts

*For a finance and accounting professional working as consultant or auditor*

A finance and accounting professional in public practice should take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may give rise to threats to compliance with the fundamental principles. For *example*, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client. More examples of such threats are discussed later.

*For a finance and accounting professional working as an employee*

A finance and accounting professional has a professional obligation to comply with certain fundamental principles which have been detailed below. There may be times, however, when their responsibilities to an employing organization and the professional obligations to comply with the fundamental principles are in conflict. Ordinarily, a finance and accounting professional should support the legitimate and ethical objectives established by the employer and the rules and procedures drawn up in support of those objectives. Nevertheless, where compliance with the fundamental principles is threatened, a finance and accounting professional must consider a response to the circumstances. As a consequence of responsibilities to an employing organization, a finance and accounting professional may be under pressure to act or behave in ways that could directly or indirectly threaten compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organization. A finance and accounting professional may face pressure to:

- ◆ Act contrary to law or regulation.
- ◆ Act contrary to technical or professional standards.
- ◆ Facilitate unethical or illegal earnings management strategies.
- ◆ Lie to, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:
  - ◆ The auditors of the employing organization; or
  - ◆ Regulators.
- ◆ Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for *example*:

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The financial statements; Tax compliance; Legal compliance; or Reports required by securities regulators.

### 12.4 Creating an Ethical Environment

In light of the various corporate scandals mentioned above, the following three points need to be addressed for creating a sound ethical environment in any company. They are,

1. *Ensuring that employees are aware of their legal and ethical responsibilities.*

Ethical organisations would have policies to train and motivate employees toward ethical behaviour. This would require initiation from the top. A number of companies, both in the West and in India have been known for their quality and soundness of their Ethics programmes. Companies like Raytheon make ethics training compulsory for everyone. Similarly Texas Instruments has a well drafted Ethics programme from as long as 1961. In India Wipro was amongst the pioneers to establish an organised set of beliefs which would guide business conduct. This was done as early as 1970s. In the process the company has established an Integrity manual which helps employees take ethical decisions when faced with choices.

2. *Providing a communication system between the management and the employees so that any one in the company can report about fraud and mismanagement without the fear of being reprimanded.*

Ethical organisations need to provide facilities for employees through which they could communicate with responsible positions for reporting frauds, mismanagement or any other form of non routine detrimental behaviour. In India Wipro has introduced a helpline comprising of senior members of the company who are available for guidance on any moral, legal or ethical issues that an employee of the company may face.

3. *Ensuring fair treatment to those who act as whistle blowers.*

This is perhaps the most important and sensitive issue. When Sherron had raised questions at Enron, she was demoted. Similar fate would have met all those who had followed Sherron. Fair treatment to whistle blowers is a basic necessity to check fraud. It is reassuring that two of the three persons of the year, selected by the popular Time magazine were accountants from Enron and World Com who had dared to blow the whistle, however, needless to say that the appreciation is much more needed from within the company rather than outside.

### 12.5 Reasons for Unethical Behaviour

A creation of a proper ethical environment requires a proper understanding of the reasons which lead to an unethical behaviour. Four such reasons are discussed below-.,

1. *Emphasis on short term results.* This is one of the primary reasons which has led to the downfall of many companies like Enron and WorldCom. Manipulating accounting entries to depict good profitability can help companies raise further capital from the market

2. *Ignoring small unethical issues:* It is a known fact that most of the compromises we make start are small however they lead us to large problems. Similarly, companies need to develop an environment where small ethical lapses are taken seriously so that they do not repeat in the future. Otherwise, toleration of such small lapses could lead to larger problems.
3. *Economic cycles:* When Enron was doing well, no one had bothered to understand its actual financial position. There were no question marks on its financial statements. However, when the economy took a downward turn, finance and accounting managers took decisions which were compromises over the established code of conduct. This was done to reflect a financial position which would keep the investors in the market satisfied. All this resulted in a huge crisis and the ultimate fall of this US Giant. Hence, to prevent disclosure of ethical problems in times of depression, company need to be extremely careful and vigilant during good times.
4. *Accounting rules:* In the era of globalisation and massive cross border flow of capital, accounting rules are changing faster than ever before. The rules have become more complex and it is difficult to identify deviations from these complex set of requirements. The complexity of these principles and rules and the difficulty associated with identifying abuse are reasons which may promote unethical behaviour.

## 12.6 Fundamental principles relating to Ethics

Certain fundamental principles need to be adhered with for behaving in an ethical manner. These principles have been summarised below;

1. *The principle of Integrity:* The dictionary meaning of integrity is veracity. Accordingly, the principle calls upon all accounting and finance professionals to adhere to honesty and straight forwardness while discharging their respective professional duties. In addition the following acts of responsibility would help comply with the Integrity principle,
  - ◆ Avoid being involved in activities which would impair the goodwill of the organisation
  - ◆ Communicate adverse as well as favourable information with those concerned
  - ◆ Refuse any gift or favour which could influence actions taken or to be taken
  - ◆ Refuse to get involved in any activity which would adversely affect the achievement of an organisations objective.
  - ◆ Avoid conflicts and advise related parties on apparent conflicts which could arise in the future.
2. *The principle of objectivity:* This principle requires accounting and finance professionals to stick to their professional and financial judgement. They should not allow bias, conflicting interests or undue influence of others to override their business judgements . They should communicate information fairly and objectively in such a way that the communication with the end user is complete and transparent.

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3. *The principle of confidentiality:* This principle requires practitioners of accounting and financial management to refrain from disclosing confidential information related to their work. Such information may be however be disclosed to their subordinates and care should be taken that the latter maintains confidentiality. The only exception to this principle is when there are requirements to disclose information under a legal obligation or because of some statutory ruling.

4. *The principle of professional competence and due care:* Finance and accounting professionals have a need to update their professional skills from time to time. This has assumed a greater significance in the modern day competitive environment where updated knowledge and skill shall ensure that the client or employer receives competent professional services based upon current and contemporary developments in the related areas.

5. *The principle of professional behavior:* This principle requires accounting and finance professionals to comply with relevant laws and regulations and avoid such actions which may result into discrediting the profession.

## 12.7 Threats

The dynamic environment in which businesses operate today may usher a broad range of circumstances because of which compliance with the abovementioned fundamental principles may potentially be threatened. Such threats may be classified as follows:

- (a) Self-interest threats, which may occur as a result of the financial or other interests of a finance and accounting professional or of an immediate or close family member;
- (b) Self-review threats, which may occur when a previous judgment needs to be reevaluated by the finance and accounting professional responsible for that judgment;
- (c) Advocacy threats occur when a professional promotes a position or opinion to the point that subsequent objectivity may be compromised;
- (d) Familiarity threats occur when a finance and accounting professional has close relationships in the work environment and such relationships impair his selfless attitude towards work.
- (e) Intimidation threats occur when a professional may be prohibited from acting objectively by threats, actual or perceived.

## 12.8 Examples of circumstances creating above mentioned Threats.

Circumstances leading to the actual happening of the various threats are given below. Students may note that this is not an exhaustive list and has been provided to give a basic idea

*Self interest threat for finance and accounting professionals working as consultants or auditors*

- ◆ A financial interest in a client or jointly holding a financial interest with a client.
- ◆ Undue dependence on total fees from a client.
- ◆ Having a close business relationship with a client.

- ◆ Concern about the possibility of losing a client.
- ◆ Potential employment with a client.
- ◆ Contingent fees relating to an assurance engagement.

*Self interest threat for finance and accounting professionals working as an employee*

- ◆ Financial interests, loans and guarantees in the company the professional is working.
- ◆ Incentive compensation arrangements
- ◆ Inappropriate personal use of corporate assets.
- ◆ Concern over employment security
- ◆ Commercial pressure from outside the employing organisation

*Self review threat for finance and accounting professionals working as consultants or auditors*

- ◆ The discovery of a significant error during a re-evaluation of the work of the finance and accounting professional.
- ◆ Reporting on the operation of financial systems after being involved in their design or implementation.
- ◆ Having prepared the original data used to generate records that are the subject matter of the engagement.
- ◆ A member of the assurance team being, or having recently been, a director or Officer of that client.
- ◆ A member of the assurance team being, or having recently been, employed by the Client in a position to exert direct and significant influence over the subject matter of the engagement.

*Self review threat for finance and accounting professionals working as an employee*

Such threats occur when business decisions or data is subjected to review and justification is required to be given by the same professional who was responsible for taking such decisions or preparing that data.

*Advocacy threat for finance and accounting professionals working as consultants or auditors*

- ◆ Promoting shares in a listed entity when that entity is a consultancy or a financial statement audit client.
- ◆ Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

*Advocacy threat for finance and accounting professionals working as an employee*

When furthering the legitimate goals and objectives of their employing organizations finance and accounting professionals may promote the organization's position, provided any statements made are neither false nor misleading. Such actions generally would not create an advocacy threat.

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### *Familiarity threats for finance and accounting professionals working as consultants or auditors*

- ◆ A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- ◆ A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a position to exert direct and significant influence over the subject matter of the engagement.
- ◆ A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.
- ◆ Accepting gifts or preferential treatment from a client, unless the value is clearly insignificant.
- ◆ Long association of senior personnel with the assurance client.

### *Familiarity threats for finance and accounting professionals working as an employee*

- ◆ A finance and accounting professional, in a position to influence financial or non financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- ◆ Long association with business contacts influencing business decisions.
- ◆ Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

### *Intimidation threat for finance and accounting professionals working as consultants or auditors*

- ◆ Being threatened with dismissal or replacement.
- ◆ Being threatened with litigation.
- ◆ Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

### *Intimidation threat for finance and accounting professionals working as employees*

- ◆ Threat of dismissal or replacement of the finance and accounting professional or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported for external use as well as for decision making purposes.
- ◆ A dominant personality attempting to influence the decision making process, for *example* with regard to the exclusion of irrelevant costs from projected cost estimates.

## 12.9 Safeguards

It is important to have safeguards which may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the finance and accounting profession, legislation, regulation or an employing organization, shall ensure an ethical environment. Safeguards that may eliminate or reduce the abovementioned threats to an



acceptable level fall into two broad categories:

- (a) Safeguards created by the profession, legislation or regulation; and
- (b) Safeguards in the work environment.
- (c) Some of the safeguards created by the profession, legislation or regulation are as follows
  - ◆ Educational, training and experience requirements for entry into the profession.
  - ◆ Continuing professional development requirements.
  - ◆ Corporate governance regulations.
  - ◆ Professional standards.
  - ◆ Professional or regulatory monitoring and disciplinary procedures.
  - ◆ External review by a legally empowered third party of the reports, returns, communications or information produced by concerned professionals.
- (d) Safeguards in the work environment are as follows.
  - ◆ The employing organization's systems of corporate oversight or other oversight structures.
  - ◆ The employing organisation's ethics and conduct programs.
  - ◆ Recruitment procedures in the employing organisation emphasizing the importance of employing high caliber competent staff.
  - ◆ Strong internal controls.
  - ◆ Appropriate disciplinary processes.
  - ◆ Leadership that stresses the importance of ethical behavior and the expectation that employees will act in an ethical manner.
  - ◆ Policies and procedures to implement and monitor the quality of employee performance.
  - ◆ Timely communication of the employing organisation's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.
  - ◆ Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organization any ethical issues that concern them without fear of retribution.

## 12.10 Ethical Conflict Resolution

While evaluating compliance with the fundamental principles, a finance and accounting professional may be required to resolve a conflict in the application of fundamental principles. The following needs to be considered, either individually or together with others, during a conflict resolution process,

- (a) Relevant facts;

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- (b) Ethical issues involved;
- (c) Fundamental principles related to the matter in question;
- (d) Established internal procedures; and
- (e) Alternative courses of action.

Having considered these issues, a finance and accounting professional should determine the appropriate course of action that is consistent with the fundamental principles identified. The professional should also weigh the consequences of each possible course of action. If the matter remains unresolved, the professional should consult with other appropriate persons within the firm or employing organization for help in obtaining resolution. During times where a matter involves a conflict with, or within, an organization, finance and accounting professional should also consider consulting with those charged with governance of the organisation, such as the board of directors.

It may be in the best interests of the professional to document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.

If a significant conflict cannot be resolved, a professional may wish to obtain professional advice from the relevant professional body or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality. For *example*, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant should consider obtaining legal advice to determine whether there is a requirement to report.

If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional should, where possible, refuse to remain associated with the matter creating the conflict. The professional may determine that, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.