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Ethics in Accounting-Need of Present Day

Abstract

Ethics in accounting are concerned with how to make good and moral choices in regard to the preparation, presentation and disclosure of financial information.The ethics of a business is currently a high profile issue owing to sensational corporate scandals that had taken place in many countries causing extensive damages to the economy and society. These corporate scandals question the morality of businessmen in general and accountants in particular. It is argued that the accountants have been the main contributors to the decline in ethical standards of a business.

Present paper attempts to cover History, Philosophical theories of ethics, Ethical practices incorporated, accounting scandals, causes and Current issues. Finally it is concluded that Ethics has become a key area of concern in accounting at present owing to the series of corporate scandals that had taken place in the world questioning the credibility of the accounting profession. These scandals have placed in doubt the effectiveness of contemporary accounting, auditing and corporate governance practices, for which accounting profession is responsible for. Thus, recognition of the accounting profession is closely linked with the maintenance of highest ethical standards.

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Introduction

Ethics in accounting are concerned with how to make good and moral choices in regard to the preparation, presentation and disclosure of financial information.The ethics of a business is currently a high profile issue owing to sensational corporate scandals that had taken place in many countries causing extensive damages to the economy and society. These corporate scandals question the morality of businessmen in general and accountants in particular. It is argued that the accountants have been the main contributors to the decline in ethical standards of a business. International Federation of Accountants (IFAC) in its research report titled as ‘Rebuilding public confidence in financial reporting – an international perspective’ (2003) issued in the aftermath of the collapse of Enron and WorldCom in 2002 concluding that financial scandals experienced in the recent times were symptoms of deeper problems and identified that improvement of ethical standards, adequacy of financial management, reporting mechanisms, audit quality and strengthening of governance regimes as means to improve public confidence in financial reporting. The accounting profession has a responsibility towards these areas, whose deficiencies have led to corporate scandals and collapses. Hence, today, ethical conduct of accounting professionals has become a topical issue. During the 1990s and 2000s, a series of financial reporting scandals brought this issue into the forefront. An accountant working in the public or private sector must remain impartial and loyal to ethical guidelines when reviewing a company or individual's financial records for reporting purposes.

The concept of ethics

The word ‘ethics’ is derived from the Greek word ‘ethos’ (character) and Latin word ‘moras’ (customs). Taken together these two words define how individuals choose to interact with one another. Thus, ethics is about choices. It signifies how people act in order to make the ‘right’ choice and produce ‘good’ behaviour. It encompasses the examination of principles, values and norms, the consideration of available choices to make the right decision and the strength of character to act in accordance with the decision. Hence, ethics, as a practical discipline, demands the acquisition of moral knowledge and the skills to properly apply such knowledge to the problems of daily life.

History

Luca Pacioli, the "Father of Accounting", wrote on accounting ethics in his first book published in 1494. Ethical standards have since then been developed through government groups, professional organizations, and independent ompanies. These various groups have led accountants to follow several codes of ethics to perform their duties in a professional work environment. Accountants must follow the code of ethics set out by the professional body of which they are a member. United States accounting societies such as the Association of Government Accountants, Institute of Internal Auditors, and the National Association of Accountants all have codes of ethics, and many accountants are members of one or more of these societies.

In 1887, the American Association of Public Accountants (AAPA) was created; it was the first step in developing professionalism in the United States accounting industry. By 1905, the AAPA's first ethical codes were formulated to educate its members. During its twentieth anniversary meeting in October 1907, ethics was a major topic of the conference among its members. As a result of discussions, a list of professional ethics was incorporated into the organization's by laws. However, because membership to the organization was voluntary, the association could not require individuals to conform to the suggested behaviors. The AAPA was renamed several times throughout its history, before becoming the American Institute of Certified Public Accountants (AICPA) as it's named today. The AICPA developed five divisions of ethical principles that its members should follow: "independence, integrity, and objectivity"; "competence and technical standards"; "responsibilities to clients"; "responsibilities to colleagues"; as well as "other responsibilities and practices". Each of these divisions provided guidelines on how a Certified Public Accountant (CPA) should act as a professional. Failure to comply with the guidelines could have caused an accountant to be barred from practicing. When developing the ethical principles, the AICPA also considered how the profession would be viewed by those outside of the accounting industry

Philosophical theories of ethics

Decision making based on intuition or personal feeling does not always lead to the right course of action. Therefore, ethical decision making requires a criterion to ensure good judgment. The philosophical theories of ethics provide different and distinct criteria for good, right or moral judgment.

Three prominent philosophical theories of ethics are utilitarianism, rights and justice. They are normative theories of ethics, which provide a principle or standard on how a person ought to behave towards others by considering the right and wrong of an action. These normative theories are divided into two broad classifications, consequential and non-consequential. Consequential theories define 'good' in terms of its consequences, and a best known example is theory of utilitarianism. In contrast, non-consequential theories define 'good' not by its consequences but by its intrinsic value and the best known examples are the rights and justice theories. These theories are described below.

The theory of utilitarianism

According to this theory, the ethical alternative is the one that maximizes good consequences over bad consequences. Jeremy Bentham, who is considered as the father of utilitarian ethics, defines utilitarianism as the greatest happiness principle (the principle of utility), which measures good and bad consequences in terms of happiness and pain. He wrote as follows in his book 'An Introduction to the Principles of Morals and Legislation':

"Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do, as well as to determine what we shall do. On the one hand the standard of right and wrong, chain of causes and effects, are fastened to their throne. They govern us in all we do, in all we say, in all we think."

The theory of rights

The theory of rights stems from the belief that people have an inherent worth as human beings that must be respected. Therefore, according to this theory, a good decision is one that respects the rights of others. Conversely, a decision is wrong to the extent that it violates another person's rights. In general, the rights can be divided into two categories: (1) natural rights (rights that exist independently of any legal structure) and (2) Legal rights and contractual rights (rights that are created by social agreement). The natural rights are commonly known as human rights or constitutional rights.

Among many natural rights, the right to the truth is important to the function of accounting. The users of financial statements have the right to truthful and accurate financial information when making choices on alternative investment strategies. This right imposes a moral obligation on the accountant and the reporting entity to prepare and issue, true and fair financial statements. On the other hand, legal and contractual rights are important in the accountant-employer and the accountant-client relationships. These contractual relationships mean that employers and clients have a legal right to 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.

The theory of Justice

Understanding this theory requires understanding various notions of justice. Generally, justice is described as fairness, which refers to the correlation between contribution and reward. However, fairness alone cannot define the term justice. There are also other forms of justice, which include equality (assumes that all people have equal worth), procedural justice (concerns with due process) and compensatory justice (addressed the loss from a wrongful act). However, a comprehensive theory incorporating these various domains of justice has yet to be developed.

Accounting Scandals

Accounting ethics has been deemed difficult to control as accountants and auditors must consider the interest of the public (which relies on the information gathered in audits) while ensuring that they remained employed by the company they are auditing. They must consider how to best apply accounting standards even when faced with issues that could cause a company to face a significant loss or even be discontinued. Due to several accounting scandals within the profession, critics of accountants have stated that when asked by a client "what does two plus two equal?" the accountant would be likely to respond "what would you like it to be?" This thought process along with other criticisms of the profession's issues with conflict of interest, have led to various increased standards of professionalism while stressing ethics in the work environment.

The role of accountants is critical to society. Accountants serve as financial reporters and intermediaries in the capital markets and owe their primary obligation to the public interest. The information they provide is crucial in aiding managers, investors and others in making critical economic decisions. Accordingly, ethical improprieties by accountants can be detrimental to society, resulting in distrust by the public and disruption of efficient capital market operations. From the 1980s to the present there have been multiple accounting scandals that were widely reported on by the media and resulted in fraud charges, bankruptcy protection requests, and the closure of companies and accounting firms. The scandals were the result of creative accounting, misleading financial analysis, as well as bribery. Various companies had issues with fraudulent accounting practices, including Nugan Hand Bank, Phar-Mor, WorldCom, and AIG. One of the most widely reported violation of accounting ethics involved Enron, a multinational company, that for several years had not shown a true or fair view of their financial statements. Their auditor Arthur Andersen, an accounting firm considered one of the "Big Five", signed off on the validity of the accounts despite the inaccuracies in the financial statements.]When the unethical activities were reported, not only did Enron dissolve but Arthur Andersen also went out of business. Enron's shareholders lost $25 billion as a result of the company's bankruptcy.] Although only a fraction of Arthur Anderson's employees were involved with the scandal, the closure of the firm resulted in the loss of 85,000 jobs

Indian Scenario

The past few years have seen several headline-grabbing incidents of corporate fraud in India. There were the Harshad Mehta and Ketan Parekh cases, followed by the Unit trust of India case. And now, we have seen the Satyam and World Bank-Wipro cases that have not just tested the Indian business framework, but also sent ripples across the global scene. It is imperative that we take notice of this growing systemic problem and understand its motivations and methods.

Causes

Fraudulent accounting can arise from a variety of issues. These problems usually come to light eventually and could ruin not only the company but also the auditors for not discovering or revealing the misstatements. Several studies have proposed that a firm's corporate culture as well as the values it stresses may negatively alter an accountant's behavior. This environment could contribute to the degradation of ethical values that were learned from universities.

Critics claimed that, by allowing the firms to advertise, the business side overstepped the professional side of the profession, which led to a conflict of interest. This focus allowed for occurrences of fraud, and caused the firms, according to Arthur Bowman, "... to offer services that made them more consultants and business advisers than auditors." As accounting firms became less interested in the lower-paying audits due to more focus on higher earning services such as consulting, problems arose. This disregard for the lack of time spent on audits resulted in a lack of attention to catching creative and fraudulent accounting.

Ethical practices incorporated-

The Introduction of Official Standards

Prior to 1929, there were no official standards for accounting practices and ethics. Accountants were not obligated to disclose profits and losses of companies, and were beholden to no one other than the corporation for which they worked. Robert H. Herz, Chairman of the Financial Accounting Standards Board, notes that, “The idea of setting official standards for accounting, reporting and disclosure took shape in the aftermath of the 1929 stock market crash and the Great Depression.” That idea resulted in the creation of the United States Securities and Exchange Commission. In the years afterward, more standards and ethics practices were created and implemented.

Sarbanes -Oxley Act of 2002 provides for improvement in quality and transparency in financial reporting, independent audit and accounting services for the listed companies creation of Public Accounting Oversight Board and increased corporate responsibility.

India

Clause 49 of The Listing Agreement of Securities & Exchange Board of India (SEBI)

It mandates a listed company to adhere to corporate governance norms. Although it is not applicable to non-listed companies, many companies have adopted corporate governance in their own interest. It mainly deals with the full disclosure- a principle which has an ethical flavor.

Companies Auditors Report Order (CARO) 2003 amended in 2004

CARO mandates many issues relating to ethical governance. Auditors of those companies (whose paid up capital and reserves exceed Rupees 50 lakhs as at the commencement of financial year concerned or average annual turnover exceed Rupees 5 Crores for a period of 3 consecutive Financial Year immediately preceding the Financial Year concerned) have to report whether the companies have internal audit systems commensurate with the size and nature of the business. It is almost impossible for a statutory auditor to audit all transactions of his client within a short period of time. Therefore CARO uphold auditor’s ethics and helps in governing the task of audit ethically. There are many issues in CARO that basically deals with ethical governance.

Companies act 2013 several clauses of Companies act pinpoint ethical governance and intent to manage the companies with fairness, equality and justice. One of the clauses talks about CSR which is considered to be a pertaining to ethical governance.

Current Issues

An accountant working in the public or private sector must remain impartial and loyal to ethical guidelines when reviewing a company or individual's financial records for reporting purposes. An accountant frequently encounters ethical issues regardless of the industry and must remain continually vigilant to reduce the chances of outside forces manipulating financial records, which could lead to both ethical and criminal violations. Knowing some of the issues presented in accounting ethics can help you ensure that you are considering some of the implications for the actions that you take with your own business

Fraudulent Financial Reporting

Most accounting scandals over the last two decades have centered on fraudulent financial reporting. Fraudulent financial reporting is the misstatement of the financial statements by company management. Usually, this is carried out with the intent of misleading investors and maintaining the company's share price. While the effects of misleading financial reporting may boost the company's stock price in the short-term, there are almost always ill effects in the long run. This short-term focus on company finances is sometimes known as "myopic management."

Misappropriation of Assets

On an individual employee level, the most common ethical issue in accounting is the misappropriation of assets. Misappropriation of assets is the use of company assets for any other purpose than company interests. Otherwise known as stealing or embezzlement, misappropriation of assets can occur at nearly any level of the company and to nearly any degree. For example, a senior level executive may charge a family dinner to the company as a business expense. At the same time, a line-level production employee may take home office supplies for personal use. In both cases, misappropriation of assets has occurred.

Disclosure

As a subtopic of fraudulent financial reporting, disclosure violations are errors of ethical omission. While intentionally recording transactions in a manner that is not in accordance with generally accepted accounting principles is considered fraudulent financial reporting, the failure to disclose information to investors that could change their decisions about investing in the company could be considered fraudulent financial reporting, as well. Company executives must walk a fine line; it is important for management to protect the company's proprietary information. However, if this information relates to a significant event, it may not be ethical to keep this information hidden from the investors.

Penalties

Penalties for violations of accounting ethics laws have increased greatly since the passage of the COMPANIES ACT. This legislation allows for harsh penalties for manipulating financial records, destroying information, interfering with an investigation and provides legal protection for whistle-blowers. In addition, chief executives can be held criminally liable for the misreporting of their company.

Pressure from Management

The burden for public companies to succeed at high levels may place undue stress and pressure on accountants creating balance sheets and financial statements. The ethical issue for these accountants becomes maintaining true reporting of company assets, liabilities and profits without giving in to the pressure placed on them by management or corporate officers. Unethical accountants could easily alter company financial records and maneuver numbers to paint false pictures of company successes. This may lead to short-term prosperity, but altered financial records will ultimately spell the downfall of companies when the Securities and Exchange Commission discovers the fraud.

Accountant as Whistleblower

An accountant may face the ethical dilemma of reporting discovered accounting violations to the Accounting Standards Board. While it is an ethical accountant's duty to report such violations, the dilemma arises in the ramifications of the reporting. Government review of company financial records and the bad press caused by an accounting scandal could cause the company's rapid decline and may lead to the layoff of thousands of employees. Executives and other corporate officers could also face criminal prosecution, leading to heavy fines and prison time.

Omission of Financial Records

A corporate officer or other executive may ask an accountant to omit or leave out certain financial figures from a balance sheet that may paint the business in a bad light to the public and investors. Omission may not seem like a significant breach of accounting ethics to an accountant because it does not involve direct manipulation of numbers or records. This is precisely why an accountant must remain ethically vigilant to avoid falling into such a trap.

Conclusion

Ethics has become a key area of concern in accounting at present owing to the series of corporate scandals that had taken place in the world questioning the credibility of the accounting profession. These scandals have placed in doubt the effectiveness of contemporary accounting, auditing and corporate governance practices, for which accounting profession is responsible for. Thus, recognition of the accounting profession is closely linked with the maintenance of highest ethical standards.

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