

Introduction: The ethics of auditing

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Accountancy and auditing are complex and technical processes. Ethics, in contrast, might be considered relatively simple. The difficult part of ethics, it may be argued, is not knowing what we ought to do, but getting ourselves, and others, to do the right thing. Truthfulness, honesty, care, loyalty, integrity: we know what they require, but we do not know if and how these requirements can be met. If this is indeed the case, and we want to promote ethical auditing, then we need to attract decent people into the profession, train them well, and not subject them to more temptation than they can cope with. Beyond that, all that is required is a code of ethics laying down minimum standards of professional conduct, with a complaints and disciplinary process to deal with any errant behaviour that comes to the attention of professional bodies, such as CPA Australia and the Institute of Chartered Accountants, who jointly issue a Code of Professional Conduct for the guidance of their members.

There is sufficient truth in this scenario to explain, but not to justify, the minimal attention that is given to ethics in the training of accountants and auditors, despite the growing international literature on the subject (Albrecht 1992; Maurice 1996; Morse & Blake 1998), and the absence of ethical debate and concern within the profession. Provided the expertise is there, it is assumed that ordinary moral sensibility, together with the good example of senior colleagues, can take care of the ethical side of the business. Attention to the ethics of auditing engages the professional firms only with respect to risk minimisation in relation to the serious illegal activities of the occasional 'bad apple' and the likelihood of legal liabilities and a general concern for their reputation. In these circumstances, it is understandable that research into the ethics of accountants and auditors is focussed on discovering how to maximise compliance with generally accepted principles of professional conduct.

If this analysis of professional attitudes is now somewhat out of date (see, for instance, Howieson, Chapter 13; Duska & Duska 2003), this is because of the exceptional publicity given to auditing failures revealed in the disastrous collapses of major corporations, whose accounting practices are revealed to have been seriously deficient and downright dishonest, not to say often unlawful and even criminal in more than a merely technical sense (Clarke, Dean & Oliver 1997; HIH Royal Commission 2003). The crisis of public confidence in the accounting profession arising from these events is perceived as a threat not only to the business of auditors but to business itself. If there have to be unexpected major corporate insolvencies before serious auditing irregularities come to light, what trust can we have in the reliability of the accounting and auditing standards

and procedures generally? And, more specifically, if we cannot trust an audit, has it any value?

Gross auditing failures can always be dismissed as atypical lapses deriving from the wickedness of key players involved. This feeds off the assumption that ethical problems relate to occasional non-compliance with agreed standards of professional conduct. Yet focussing on ethics in the context of auditing catastrophes reveals that determining what is ethical or legal in auditing is not such a simple matter after all (see McBarnet, Chapter 2). We may easily elicit a large measure of agreement as to the relevant moral values and their accompanying virtues, such as truthfulness, honesty and law-abidingness, but what these should be taken to mean with respect to conduct in the context of assessing the financial reports of business organisations turns out to be far from clear when we get down to the – not very fine – detail. Determining what is and is not ethical in auditing turns out not to be simply a matter of detecting fraud, corruption and other criminal conduct.

Ethical disagreement about auditing arises, in part, because there is no agreement as to what the central purpose of an audit is. And since the ethical significance of the conduct of individual players in the audit depends on the moral justification of the system in place, disagreement about the purpose of the audit generates disagreement about how audits ought to be conducted. This means that, although ethics in auditing does involve the conduct of auditors, any serious attempt to assess that conduct must take account of the nature and purpose of auditing and the economic and social functions it is intended to serve. Evaluating auditor performance requires, for instance, raising questions as to what constitutes conformity with official guidelines and the standard of professional practice, and about the attitude of those involved to auditing and accounting rules, legal and otherwise, and the ways in which they are interpreted and applied. It requires reference to the systems for decision-making and control within auditing firms, and the openness and honesty of the corporations under audit. All this goes far beyond seeking conformity with obvious and agreed standards and conduct. Beyond these matters, the ethics of auditing involves a critique of the content of legal and professional norms and the regulatory system within which they feature, including the adequacy of the legal frameworks in which accounting and auditing takes place. Do the existing professional cultures and accounting norms adequately serve the ends that justify the existence of the economic system they purport to serve?

In raising the complex interrelationship of issues concerning how auditors ought to behave, what rules and principles they ought to adopt and follow, and how to promote a culture in which we can expect compliance with these norms, it is helpful to classify the ethical issues that arise in relation to auditing by distinguishing three spheres of activity; (1) the practice of auditor(s), (2) the manage-

ment and culture of auditing firms, and (3) the setting of auditing standards and laws.

Ethically, things may seem relatively straightforward at the level of the individual auditors engaged in the practice of auditing. Auditors ought to carry out their standard procedures carefully, diligently and punctually in accordance with their instructions and the appropriate auditing standards and procedures. The virtues of integrity, objectivity, independence, confidentiality, upholding technical and professional standards, competence and due care, which are all highlighted in the Australian Code of Professional Conduct, seem particularly appropriate in this first sphere.

Even supposing the adequacy of such categorisations of virtues (Libby & Thorne 2004), putting these virtues into practice is not a simple matter. There may be morally relevant problems for practicing auditors when tasks are set that go beyond what the time and expertise available render feasible. In these circumstances, should those involved seek to disguise the limitations of their work, thereby risking the displeasure of their superiors and hazarding their career prospects, or should they just do what they can, perhaps in the dim awareness that their superiors might prefer not to be informed of weaknesses in the process that they are not themselves in a position to remedy?

The options available to the hard-pressed auditor may be analysed purely in terms of self-interest. How hard to work, how often to seek assistance, how open to be about difficulties – these may be regarded as tactical questions within a career strategy that is aimed at personal advancement and material gain, questions best approached through a calculation of the short- and long-term benefits of alternative courses of action for the individuals concerned. These calculations may turn out to be in conflict with more evidently moral or ethical questions: considerations of fairness to other members of the team, obligations to employers, duties to clients, and perhaps a concern for other groups who may rely on the audit for one reason or another.

Only a little reflection is required to demonstrate the difficulty of balancing such a variety of considerations. What weight, if any, should be given to self-interest in such circumstances? Some would say none at all. Morality is all about considering other people, not calculating one's own gains and losses. Yet there is also a powerful moral tradition that endorses the idea of people having duties to themselves which may be balanced against duties to others. And every system of morality has a place for legitimate self-interest. Even if we put self-interest to one side, similar problems arise when we consider the interests of other people and try to think through how to approach employees' duties to their colleagues, their employers and the public. Are all these interests morally relevant? If so, how can these be compared? And when making such comparisons, should we

consider short- or long-term consequences, and what sort of consequences are morally salient anyway?

At this point it is easy to fall back on a few simple maxims. Individual auditors should work as hard as they can, in accordance with their instructions, and they should always make a full report to their superiors of any problems they encounter. Slacking, fudging and dissemblance are simply wrong. If there are complex moral balances to be taken into account, this is not something that should affect practicing auditors at work. Their duties are clear and they should do their best to fulfil them. It is also almost certainly in their long-term self-interest so to do. But that is not a calculation for them to make.

A similarly firm line may be taken to another ethical dilemma that is said to be endemic in auditing. This arises when pressure is brought to bear on the auditor not to draw attention to irregularities or problems that have emerged in the course of the audit, pressure that is often related to a real or perceived threat to the future commercial relationship between the auditee and the auditor. This is a manifestation of what is a straight conflict of interest at the core of the standard auditee/auditor relationship – that the auditor is financially dependent on the auditee (see Spence, Chapter 6). The integrity of a professional auditor might suggest that such pressure is always to be totally resisted, but the legitimate need to earn a living, and retain clients in a way that the auditor's employers have a right to expect, mean that there will always be some moral reason to compromise on such matters from time to time.

The more robust approach to such moral dilemmas is characteristic of 'deontology', the view that morality is all about duty and duty is all about not wronging other people (Fried 1978; Nagel 1986, Chapter 10). Ethics, according to the deontologist, is a matter of understanding and following certain general imperatives or rules, such as the Ten Commandments: 'work hard', 'tell the truth' and 'be kind' are examples of such moral imperatives. Moral rules are held to be binding independently of the consequences of putting them into practice. Murder is wrong, full stop. It is not for us to calculate the consequences of truthfulness, just to be truthful. A moral person knows what is right and must be what is right simply because it is right (Kant 1953).

The standard view is that deontology (or 'rule-morality') comes into direct conflict with 'consequentialism', the theory that an act is right or wrong depending on its consequences for all those affected by the action, including the agent in question (Mill 1910 (1861)). The most famous brand of consequentialism – 'utilitarianism' – holds that the consequences that matter morally are pleasures and pains, the morally right act being that which maximises the balance of pleasure over pain, with each person's hedonic experiences being given equal weight in the calculation. This is summed up in Jeremy Bentham's famous commitment to

‘the greatest happiness of the greatest number’ (Bentham 1948 (1823)). Other consequentialists argue that other types of consequence may feature in moral calculations, including, most typically, well-being in the sense of ‘interests’, and within economics, ‘wealth’ – either in monetary terms (‘welfare economics’) or with respect to consumer goods.

In all moral choices there is a tension between doing what is right according to the rules and working out what is right according to the consequences. It is dogmatic to say that one is characteristically more moral than the other, yet trite to hold that an adequate moral approach requires a measure of both ingredients. The trouble is that appeals to consequences do undermine a commitment to rules, and an absolute commitment to rules drives out what may be seen as a proper sensitivity to the social consequences of conduct. Moreover, allowing people to pick and choose between rules and consequences opens the way for self-serving choices that are determined by the self-interest of the particular agent. This is central to auditing ethics and regulation, as it is to ethics in general (see Campbell, Chapter 5; Tweedie 1988).

However, the sharp contrast between rules and consequences can be misleading, especially in a technical field such as auditing. One attempted compromise between deontology and consequentialism, a compromise that seeks to avoid the twin problems of partiality and insensitivity, is ‘rule-consequentialism’. According to rule-consequentialism, individuals ought to follow pre-established moral rules when making particular decisions, but the rules themselves should be determined by consequentialist moral reasoning (Hare 1981; Smart & Williams 1973). This analysis is certainly an improvement on the sort of pure deontology in which the moral rightness of rules is simply ‘intuited’. Many rules are quite evidently justified in terms of the good consequences that flow from their general application. However, problems remain to the extent that at least some rules (such as not killing one innocent person to save the lives of many innocent persons) appear to have a powerful non-consequentialist basis. And, even for rule-consequentialists, questions still arise as to whether it is ever right to depart from a rule in a specific case because of its exceptionally bad consequences. There is also controversy over the question of who has the authority to decide which rules should be adopted – albeit on the grounds of their perceived beneficial consequences – and at what point in time they may engage in such rule-making and rule-reform.

In matters of private morality, both making exceptions to rules in particular cases and changing the rules themselves is something for each individual to consider and determine, although they must be prepared to take the consequences in terms of other people’s responses to their behaviour. But when it comes to working within an organisation or carrying out a public function, there are moral and practical constraints that go along with such involvement. Organisa-

tions must have their internal rules, and those offering a service to the public have to take notice of what are regarded as the legitimate expectations of society. In such circumstances, individuals have less room for manoeuvre with respect to the moral stances that they take. In these contexts, authorities normally set the rules and, as a matter of individual morality in collective circumstances, it is up to those involved to follow them in all but exceptional circumstances.

Thus, in the case of the hard-pressed auditors, it would appear that they ought to take a deontological or rule-morality approach to their work-related moral choices, whereas those who set the rules within or for the organisation might be expected to take a more consequentialist view, at least when making the rules. It may be, therefore, that as we ascend the ladder of authority within an organisation, the moral choices become more consequentialist, and therefore more open and more complex. And beyond the organisation, there are further hierarchies of standard-setters, professional bodies and regulators, culminating in the State, which has the political and perhaps the moral right to establish the legal rights and duties of all individuals and groups within a society.

This hierarchy of authority with the associated differences in moral reasoning seems to apply in most institutional settings. The ethics of organisational life must assume that, on the whole, members of organisations have a moral obligation to conform to the organisational or community rules that they had no part in creating. And it is certainly true that moral choices have to be made by those in authority that are much more complex than those that arise for others lower down in an organisation. Further, there is no doubt that joining an organisation – rather like being a member of a society and a citizen of a country – does involve a certain commitment to abiding by the rules of such entities.

However, it is a defining feature of morality – at least within the Western tradition, with its stress on individual autonomy (Kant 1953) – that all moral persons have, ultimately, to make up their own minds as to what is morally right and wrong, and this includes deciding whether or not to conform to socially and institutionally authoritative moral norms. Notwithstanding that there are moral reasons to abide by the rules of the group, there is always an overriding moral responsibility for the individual to accept or reject those reasons in particular circumstances. Where they judge the rules to be grossly immoral, or the consequences of following generally beneficial rules in certain circumstances are on balance morally unacceptable, then every moral agent has a duty to make up their own mind as to how they ought to act.

It is therefore a general feature of ethics that no one can entirely excuse themselves by saying that they were just following the rules or obeying a higher authority or doing what everyone else is doing. Ethics begins and (some would hold) ends with individual responsibility. This is particularly the case with

members of a group or profession which is publicly committed to following certain values that transcend their own self-interest and the normal obligations that apply to all competent human beings. In such circumstances, there is something like a collective obligation to uphold these professional values that includes both a commitment to follow the rules of the profession in a way that serves the values of the profession, and a duty to resist and if necessary disobey rules that the individual member believes to be morally wrong in the context of those values, even when they carry the imprimatur of higher authority.

It follows that, while all accountants and auditors have moral reasons to conform to the norms of conduct accepted as authoritative in their profession, nevertheless all accountants and auditors, even those with limited experience and seniority, have an obligation to take a critical attitude to their own and their colleagues' conduct and to the rules and procedures that define and govern their professional practice. The appropriate ethical attitude for rank and file members of a profession towards rules of practice may appear quite straightforward, but this is not the case. The straightforward aspect is rule compliance: that the rules are there to be followed conscientiously and meticulously without the intrusion of the practitioners' personal opinions as to what these rules should be or departures prompted by inattention or lack of effort. The complicating factor is that this attitude of deference to rules should not be a matter of blind obedience to their authority, but should be based on an awareness of the rationales behind having such rules and the purposes that the activity in question is designed to serve.

Awareness of rule rationales is possible only after a professional education that enables the qualified professional to understand what accounting and auditing systems are designed to do, and the role that their constitutive and regulative rules play in enabling them to fulfil these purposes. The importance of such awareness is not primarily a matter of motivating compliance, although knowledge of the function of rules does promote rule-following (see Plummer, Chapter 12). Its significance lies more in its contribution to the understanding of rules and how they are best interpreted and implemented in particular circumstances. Some accounting procedures are purely computational and can be understood and applied without an appreciation of the larger purpose of the exercise in which they feature. However, these rules are all normally related to other rules in which the categorisation of what is being subjected to arithmetical analysis involves judgments that are far from mechanical. The 'creative' or flexible accounting practices that typify the seedy side of much contemporary business practice involve stretching the conceptual boundaries of what counts as 'interest' as distinct from 'capital expenditure', or whether this or that business entity is a 'subsidiary' from a legal point of view (see McBarnet, Chapter 2).

The categorisation of financial transactions requires transparency and consistency so that the processes involved can be duplicated, and can thus be used to make

meaningful historical and cross-organisational comparisons between the financial standing of companies. An appreciation of the importance of consistency in rule-interpretation involves an appreciation of the purpose of accounting practices, whether this be internal control, provision of data relevant to rational business decision-making, or external assessments of profitability.

For these reasons, it is as much the consistency of the rule-application as the content of the rules themselves which ensures the validity of the process and the comparisons that are derived from it. The ethics of rule-interpretation and rule-following here are a function of the value of the particular accounting or auditing system and the purposes it serves – thus the importance in an audit of checking that accounting systems are consistently following pre-established categories in the representation of their financial position. It is this that enables those using the accounts to make meaningful and reliable comparisons between the performance of different companies. It follows that conformity to the rules that determine how business phenomena are to be financially represented is a crucial accounting and auditing virtue. It is not only a technical accounting failure not to follow such rules, but a moral failure in that it undermines the purposes that justify external accounting, and hence also the worth of auditors' reviews of such accounts. This point is often lost in emotive critiques of moral 'legalism' (Maurice 1996, p. 18), which might be better directed at those who try to twist the rules to suit their own illicit ends (see McBarnet, Chapter 2) than those who seek to promote the benefits of consistency through competent rule-interpretation and a commitment to rule-conformity.

Not all departures from ordinary accounting standards are due to incompetence or lack of awareness of the nature of the process. Sometimes accounting deviations and failure to pick them up and respond to them on the part of auditors is brought about by the self-interest of the auditee (and maybe also auditor) in giving a false and misleading view of their financial situation (and on the auditor's part, in putting the commercial relationship with the auditee in jeopardy). Indeed, the core ethical issue of external accounting is that there is a vested interest on the part of companies to misrepresent their financial position in order to maintain or attract investment and enhance the (short-term) profitability of the company. The fundamental ethical issue in auditing is that there is a business interest on the part of auditors to collude with the auditee who is the source of the fees from which they derive their income.

Here we come to the need for rules of a different kind; not rules that govern the presentation and inspection of accounts so that they can be reliably used for comparative purposes, but rules that are designed to counter the tendency of companies and their auditors to depart from or manipulate accounting and auditing standards in their own illicit financial interests. With respect to auditing, these rules are designed to promote what is called 'auditor independence' – that

is, to promote both the reality and the appearance of an objective assessment of the truth or accuracy of the auditee's accounts. Such rules may prohibit auditors having a financial interest in the company being audited, or providing non-audit services to that company. These rules are designed to ensure the trustworthiness of the process in itself, so that it is not contaminated by extraneous factors. Thus, in accordance with professional norms and legal requirements, no one may audit the financial reports of an organisation in which they have a financial interest. To break this rule is immediately to bring the independence of the audit into question. These are rules that have a significance that derives from their application in each and every case because the consequences of ignoring the rules are directly harmful to the exercise in question. This is independent of any contribution this may make to the consistency, and hence the validity, of a system.

Clearly audit firms are subject to the same ethical duties as practising auditors with respect to the observance of the accounting rules and standards that serve to make audits useful to their end-users. However, firms have additional collective responsibility to provide support and guidance for individual auditors in carrying out their tasks and working with auditees. The provision of adequate resources and training, the creation of a culture that supports auditor integrity, and the subordination of maximising profit to the maintenance of auditing standards are amongst the particular responsibilities of auditing firms. Lacking that leadership, employee auditors and junior partners cannot be expected to sustain ethical conduct in the field.

Traditionally, rules of both kinds, those establishing accounting and auditing procedures and those establishing auditing independence, have their origins within the domain of the accounting and auditing profession. In theory this has meant that auditing firms as well as individual auditors have been subject to the governance of the profession as a whole, or a plurality of professional bodies, although the recent dominance of the profession by a few exceptionally large accounting firms has blurred the practical distinction between accounting firms and accounting bodies. The ethical issues that arise in the setting of standards, and how they are to be enforced, have all the complexity of consequentialist reasoning in institutional settings, with the additional problems of identifying which consequences matter, and for whom. At this point, the interests of the auditor's clients have to be juxtaposed with the public interest in having a reliable auditing system. Working that out is a highly technical matter, but these technicalities do not exclude – indeed, they ought properly to be at the service of – the moral justifications that underpin the economic and social system of which the audited companies are part.

This need for taking a broader view has bearing on a particular ethical issue that arises where the professional bodies may be tempted to adopt or recommend rules and standards that benefit the auditing profession at the expense of the

public interest (see Simnett & Smith, Chapter 3). Perhaps on account of this 'moral hazard', accounting and auditing standards and the regulation of the auditing process have increasingly been shared between professional bodies and governments intent on shoring up the public's trust in the professional conduct of auditors. This co-regulation (rather than 'self-regulation') model is explored in Part II of this book. It is a topic that adds another layer of moral complexity, for governmental views of ethical auditing may differ from those of some of the more professional groups, thus creating not only moral disagreement, but also a moral dilemma on the part of auditors as to whether or not they ought to conform to legal requirements where these conflict with what they see as their duty to their profession.

This brief overview of the complexities that arise in considering what constitutes an ethical audit does something to explain the scope and methodology of this book. The subject matter of the chapters that follow includes (but transcends) the moral dilemmas facing the practicing auditor, and takes in not only the moral duties of audit firms in relation to supporting and managing auditing practice, but the normative issues that confront both professional and governmental regulators in deciding what the auditing standards should be and how these standards are to be monitored and enforced.

These substantive issues are approached via a number of different disciplines and theoretical perspectives. Most contributions come from academic auditors with considerable professional experience who have conducted empirical and theoretical research on auditing practice and its regulation. They deploy a variety of techniques, including behavioural and economic empirical methodologies, drawing on a diversity of experience in the practice and governance of auditing. These are supplemented by legal, philosophical and sociological contributions that place professional auditing expertise in the wider context that is, I argue, required for addressing the ethics of auditing.

The book is divided into four parts. Part I, 'Approaches to the critique of auditing', introduces the themes of the book from the point of view of a practitioner, a sociologist, a lawyer, an economist, an international regulator and a philosopher. Part II, 'Auditor independence', addresses the current crisis in auditing via the core concepts – independence and conflicts of interest – deployed in this area, and presents empirical evidence relevant to this debate. Part III, 'Beyond the auditor: the search for solutions', brings together chapters that focus on audit regulation and ethical education for accountants. 'The Conclusion, Restorative strategies', summaries the very disparate themes arising out of the book and cautions against both complacency and the hasty application of symbolic regulatory changes.

The objective of the book is not to provide an ethical primer for auditors or a systematic account of auditing ethics, but to stimulate critical thought and openness to empirical evidence by bringing out the moral and institutional complexities of the auditing function. No ethical quick fixes are offered and no one line of reform is suggested, but all the chapters raise important arguments that bear on the ethical problems that confront professional auditors, their clients, regulators and the public, whose interests ought to be paramount in the crafting and implementation of acceptable auditing standards and practices.

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