

Ethics and Auditing

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Tom Campbell and Keith Houghton
(Editors)



THE AUSTRALIAN NATIONAL UNIVERSITY

E P R E S S

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Contents

List of contributors:	ix
Foreword: Restoring public trust: <i>Bill Edge</i>	xiii
Introduction: The ethics of auditing: <i>Tom Campbell</i>	xxi
I. Approaches to the critique of auditing	1
1. Governance and accountability: a legal approach to auditing: <i>Stephen Bottomley</i>	3
2. 'Perfectly legal': a sociological approach to auditing: <i>Doreen McBarnet</i>	25
3. Public oversight: an international approach to auditing: <i>Roger Simnett and Alana Smith</i>	45
4. The role of markets: an economic approach to auditing: <i>Jane Hamilton and Donald Stokes</i>	63
5. True and fair to whom?: a philosophical approach to auditing: <i>Tom Campbell</i>	85
II. Auditor independence	109
6. Conflicts of interest in auditing: are they conducive to corruption?: <i>Edward Spence</i>	111
7. Attachments between directors and auditors: do they affect engage- ment tenure?: <i>Nicholas P Courtney and Christine A Jubb</i>	129
8. Where were the gatekeepers? Corporate collapses and the role of accountants: <i>Barry J Cooper</i>	159
9. Management economic bargaining power and auditors' objectivity: <i>Carolyn A Windsor</i>	177
10. Criticisms of auditors and earnings management during the Asian economic crisis: <i>Shireenjit Kaur Johl, Christine A Jubb and</i> <i>Keith A Houghton</i>	193
III. Beyond the auditor: the search for solutions	219
11. Auditor independence: regulation, oversight and inspection: <i>Keith A Houghton and Christine A Jubb</i>	221
12. Improving ethical judgment through deep learning: <i>Kay Plummer</i>	239
13. Can we teach auditors and accountants to be more ethically com- petent and publicly accountable?: <i>Bryan Howieson</i>	265
14. Do auditor provided non-audit services (APNAS) fees impair auditor independence?: <i>Christopher Ikin</i>	289
Conclusion: Restorative strategies: <i>Keith A Houghton and Colin Dolley</i>	331
Index	337

List of figures

9.1. Individual complex decision-making model of auditor independence	185
10.1. Histogram of change in earnings per share since prior year – prior year earnings performance threshold	209
10.2. Histogram of change in earnings per share – loss avoidance threshold	211

List of tables

1. Sample topics to be covered in a code of conduct	xvii
2. Elements of a code of conduct framework	xvii
7.1. Example of measurement of ALOCKYRS	136
7.2. Summary of auditor tenure and auditor change models used in prior literature	137
7.3. Variable measures	142
7.4. Sample criteria	143
7.5. Descriptive statistics	145
7.6. Pearson correlation coefficient matrix (N = 200)	147
7.7. Hypothesis 1 – Auditor tenure as a continuous measure Tobit regression (dependent variable = AUDTEN)	148
7.8. Hypothesis 2 – Logistic regression (dependent variable = CATTEN) (N = 200)	151
10.1. Sample selection criteria	202
10.2. Descriptive statistics and univariate tests	204
10.3. Pearson's correlation N = 600	206
10.4. OLS regression	207
10.5. Descriptive statistics by period and year for change in earnings per share (Δ EPS) and earnings (EPS)	209
12.1. A comparison of Rest's (1999) schema with Kohlberg's (1976) six-stage model of moral development	242
12.2. Ways of teaching ethics	247
12.3. Mean SPQ scores of Australian accounting students	249
12.4. Mean scores of each class	254
12.5. Correlations of variables using the combined classes	255
12.6. Mean scores of males and females	255
12.7. DIT P Score means of college/university students from a range of disciplines and countries	255
13.1. The principle of beneficence	280
13.2. The principle of justice	280
13.3. The principle of respect for persons	280
13.4. Nature of ethics	285

List of contributors

Stephen Bottomley is Professor of Commercial Law and Director of the Centre for Commercial Law at the Australian National University, Canberra. He is co-author (with Roman Tomasic) of *Directing the Top 500: Corporate Governance and Accountability in Australian Companies* (1993) and (with Tomasic and R. McQueen) *Corporations Law in Australia* (Federation Press, 2002).

Tom Campbell is Professorial Fellow at the Centre for Applied Philosophy and Public Ethics (CAPPE), Charles Sturt University, Canberra, and Visiting Professor at the School of Law, King's College, London. He was formerly Professor and Dean of Law at the Australian National University and Professor of Jurisprudence at the University of Glasgow. His books include *Justice* (Macmillan, 2001) and *The Legal Theory of Ethical Positivism* (Dartmouth, 1996).

Barry J. Cooper is Professor of Accounting Education at the Royal Melbourne Institute of Technology (RMIT). After gaining experience as an auditor, Professor Cooper joined RMIT University in 1972, where he taught auditing and financial accounting. He was Head of Accountancy at Hong Kong Polytechnic from 1987 to 1991, and at RMIT University from 1993 until 1997, when he took leave to join CPA Australia as National Director, Member Services. He returned to RMIT University in December 2000. Professor Cooper has undertaken a number of research projects and published in the areas of auditing, ethics and accounting education.

Nicholas P. Courtney is an honour's graduate of the University of Melbourne. His research focuses on audit and governance. After graduation, Nick became a member of the specialist accounting firm Korda Mentha and worked on one of Australia's most high-profile administration and liquidation projects – that of Ansett Airlines. He now works in the accounting profession in the United Kingdom.

Jane Hamilton is a Senior Lecturer at the University of Technology (UTS), a position she has held since 2000. Prior to joining UTS, Jane held appointments at La Trobe University and Bendigo College of Advanced Education. Before joining the tertiary education sector in 1989, Jane worked for the National Australia Bank. Her research background is in financial accounting and auditing, and she has recently submitted a Ph.D. thesis for examination at Monash University. She is a member of CPA Australia. Ongoing research projects are partially funded by the Co-operative Research Centre for Technology Enabled Capital Markets and the School of Accounting at UTS.

Keith A. Houghton is the Professor of Business Administration and Dean of the Faculty of Economics and Commerce at the Australian National University. Keith is a member of the Australian Audit and Assurance Standards Board, and

is one of the two independent reviewers of the Australian practice of the accounting firm Peat Marwick Mitchell & Co (KPMG). He regularly provides expert evidence on audit quality and financial reporting in litigation and commercial arbitration matters. He was twice called to give evidence to the recent Australian parliamentary inquiry into auditor independence.

Bryan Howieson is a Senior Research Fellow at the University of South Australia in Adelaide. His interests are in financial reporting, accounting standard-setting, and professional ethics and corporate governance. Bryan has published extensively, including a monograph for the Australian Accounting Research Foundation. He has undertaken a number of consultancies in the private and public sectors in the areas of financial reporting and codes of conduct. He has also served in various ethical policy and educational roles for the Institute of Chartered Accountants in Australia. Bryan is on the board of the Accounting and Finance Association of Australia and New Zealand, and is Vice-President-at-Large of the International Association for Accounting Education and Research.

Christopher Ikin is Associate Director of the Australian National Centre for Audit and Assurance Research at the Australian National University, having spent many years as an auditing practitioner, including a period as a partner of an antecedent firm to one of the present Big Four auditing firms. He was also engagement partner for one of Australia's largest manufacturing companies.

Shireenjit Kaur Johl is a Ph.D. graduate of the University of Melbourne and is currently a senior member of the Faculty of Management at the Multimedia University of Malaysia.

Christine A. Jubb is Professor of Accounting at Deakin University. She has previously lectured at Monash University and the University of Melbourne, and was seconded to the Australian Accounting Research Foundation during 2001 and 2002 as Second-in-Charge of the Foundation.

Doreen McBarnet is an Economic and Social Research Council Professorial Fellow and a fellow of Wolfson College. She is based at the Centre for Socio-Legal Studies, where she runs the centre's research programme on business and the law. She is also a fellow of Oxford University's Said Business School, where she runs the core course on corporate responsibility for the MBA. Major publications include *Conviction* and (with Chris Whelan) *Creative Accounting and the Cross-eyed Javelin Thrower* (Wiley, 1999).

Kay Plummer is a Senior Lecturer in Accounting at the Charles Sturt University (CSU) and a Senior Research Fellow of the Australian Centre for Co-operative Research and Development. Prior to joining CSU she lectured at UTS, has held senior positions in Technical and Further Education (TAFE) NSW, and has undertaken two volunteer projects for the Australian Executive Service Overseas Program. She has worked in auditing for KPMG.

Roger Simnett is Professor at the University of New South Wales. Roger's research interests cover a range of financial accounting and auditing topics, including auditor decision processes, development of specialist skills, corporate governance and financial disclosure issues. He was a member of the Auditing and Assurance Standards Board from 1995 to 1999, and currently serves as Associate Editor for *Accounting & Finance*. He is on the editorial boards of a number of accounting journals. In 2002, Roger was elected as the first academic onto the International Auditing and Assurance Standards Board.

Alana Smith is a first class honours graduate from the University of New South Wales. Her current position is Accountant, Group Finance, QBE Insurance Group.

Edward Spence lectures in moral philosophy and applied and professional ethics in the School of Communication, Charles Sturt University, Bathurst. He holds an honours degree and a Ph.D. degree in philosophy from the University of Sydney. Edward is a Research Fellow at the Centre for Applied Philosophy and Public Ethics (CAPPE) in Canberra. Prior to taking up philosophy, Edward was a practicing accountant. He is the architect, founder and producer of the 'Philosophy Plays' project, whose aim is the introduction of philosophy to the general public.

Donald Stokes is Professor of Accounting at UTS, a leading party in the Co-operative Research Centre for Technology Enabled Capital Markets. Donald is one of the leading international researchers in the economics of auditing markets. He has been involved in delivering research for industry partners including PricewaterhouseCoopers, Altium Ltd, the Securities Industry Research Centre for Asia-Pacific, the Australian Centre for Global Finance, Computershare, Credit Suisse First Boston, the Australian Stock Exchange, ABN Ambro, the Australian Securities Investment Commission, the Australian Auditing and Assurance Standards Board, the Australian Accounting Research Foundation and the NSW Department of Information and Technology Management. Donald has served as President of the Accounting Association of Australia and New Zealand (1997-98) and on editorial boards of international research journals.

Carolyn A. Windsor has been Senior Lecturer in the Faculty of Commerce and Management at Griffith University, Queensland, since receiving her Ph.D. Prior to Carolyn's academic career, she worked for 15 years in administrative and management positions. She is a member of the Australian Society of CPAs, as well as of international accounting bodies such as the American Accounting Association and the European Accounting Association. Carolyn has published papers on accounting and auditing in top international journals. She was recently awarded the competitive Velux Visiting Professorship Program to research auditor independence at the University of Southern Denmark in 2004.

Foreword: Restoring public trust

Bill Edge, *PricewaterhouseCoopers*

Australian Auditing and Assurance Standards Board (2002-04) Chairman

Enron, Parmalat, WorldCom, HIH – these corporate failures and accounting scandals have shaken the foundations of investor confidence in the transparency, integrity and accountability of corporations and capital markets. There has also been public disquiet about the role professional auditors and audit firms have played in these corporate scandals.

The consequences for many of the players in the market for financial information have been enormous; reputations both of key individuals and organisations are in ruins, jobs have been lost, and pension funds have been wiped out. The damage, both economic and social, has been incalculable, and the implications are far-reaching for corporate management, company directors, audit firms and the investing public.

An array of factors contributed to these events, but one thing is for certain – the billions of dollars in corporate value lost was due in significant part to unscrupulous management and boards of directors that failed to meet their responsibilities. The accounting profession, including auditors, also played a major role in these events. While the story behind these corporate failures is always complex, a lack of ethical behaviour by many individuals is a big part of it.

For the audit profession, these developments have again highlighted the gap between public expectations and the reality of the role of the auditor. With Enron in particular, the public perception was that the auditor should have acted as a control on unscrupulous management practices. The conclusion reached by many members of the public (and parliamentarians) was that the auditors failed in this responsibility because their independence from the management of Enron was compromised. While it is by no means as simple as that, the audit profession must acknowledge and address these types of perceptions, or indeed facts, if it is to restore trust in both the capital markets and itself.

The biggest challenge ahead for auditors is to identify *how* ethical behaviour can be – and be seen to be – restored, as it is this that will be the basis for the reconstruction of public trust in the profession and in the practice of auditing. This book does not purport to provide all the answers, but it highlights the importance of ethics and provides some thought-provoking commentary on the means in which ethical behaviour can be embedded in our personal and professional culture – one of the essential components to restoring public trust.

The response: regulation, regulation, regulation ...

The response of governments worldwide to corporate scandals has been greater regulation. This response is often taken in the name of supporting the need for protecting the public's interest. Attention has been focused on flaws in the capital market and reforms to corporate reporting and accounting/auditing that may rectify them.

Stock exchanges, global and local accounting and auditing standard-setters, institutional investors and other stakeholders have called for transparency and accountability in corporate governance, business ethics and corporate reporting. New laws and best practice guidance require strict monitoring of auditor independence, codes of ethical conduct, more disclosures, and CEO/CFO certification of various key statements in corporate reports. The aim of these requirements is to ensure effective checks and balances are in place so that good corporate governance and business ethics are observed.

Regaining trust

Why regulation isn't the only answer

Regulation alone will not regain public trust. Confidence in the capital markets depends on confidence that the reporting and regulatory process will deliver accountability and transparency. This in turn depends on integrity – and integrity depends on one's core ethical beliefs and behaviours.

A state of mind: ethical behaviour

Ethical behaviour is not simply conforming to legal and professional rules; it is a state of mind, the following of unwritten principles, a culture of 'doing the right thing'.

An individual's interpretation of ethical behaviour is influenced by a variety of factors including industry and company guidelines, social and economic pressures, laws and regulations, and the surrounding values and beliefs. These influences develop a set of written and unwritten principles which are drawn on when faced with an ethical dilemma.

Auditors face ethical questions on a daily basis, and in a way that is unique to our profession. Arguably the underlying principle of the auditing profession's ethics is independence. Auditors must balance their duty to their clients, their profession, society and numerous other stakeholders. An actual or perceived conflict of interest may arise as a result of these competing interests and lead to public distrust – a familiar sight in recent years. Confidence is quickly lost and slowly regained in these instances.

By the time people enter their professional careers, their personal ethics have been largely shaped. However, these ethics can be reinforced or, conversely, strained or even shattered by the corporate culture in which they work. It is essential that audit firms – and, for that matter, all organisations – entrench a culture that fosters ethical behaviour.

The framework for rebuilding public trust: an ethical code of conduct

It is inevitable that an auditor will be faced with ethical decisions during the course of their career. It is therefore fundamental that appropriate and professional decision-making protocols and behaviours are ingrained in the culture in which they work.

A strong code of professional and personal ethical guidelines is a critical starting point to embedding ethical behaviour. The accounting bodies in Australia each have a code of conduct to provide authoritative guidance on professional conduct. The codes set out general guidelines on concepts such as independence, competence and honesty, as well as statements addressing specific issues of professional behaviour. These guidelines are backed with the power to monitor and penalise non-conforming members.

Similarly, staff and partners of the Big Four auditing firms operate within global codes of conduct, which articulate the principles of integrity and accountability by which generations of audit professionals have been guided.

Written codes of conduct that are comprehensive and clear are now seen as an essential element of good governance and ethics for all organisations.

Codes of conduct are pro-active statements about an organisation's position on ethical and compliance matters. They are not usually legally binding and they are not a complete or exhaustive list. The essential elements of a code should include:

- an emphasis on communication and training around core values
- building a culture that motivates responsible business conduct
- encouraging employees to ask questions about ethics and report potential violations, without fear of reprisal
- values that are clear and meaningfully reinforced
- the establishment of confidential reporting frameworks to encourage communication and protect whistleblowers
- incident management processes that support due process and consistent enforcement
- processes in place to monitor the program as well as emerging standards and risks to ensure ongoing improvement.

Leading ethical and compliance programs enable forward-thinking, continuous improvements and effective change management. Common attributes of successful programs include:

- ‘tone at the top’ board management styles
- a values-driven code of conduct
- whistleblower protection
- integration of business processes.

‘Tone at the top’ board management styles

‘Tone at the top’ is characterised by the board and senior management (or, in an audit firm, its leadership team and the partnership) having a strong, unified vision of ethics and the purpose of the ethics program. Management are delegated responsibility for the planning and implementation of effective ethics and compliance policies, with board-leadership team oversight ensuring the implementation occurs and ongoing corporate responsibilities are met.

The board-leadership team must live by the code of conduct, just as they expect all others in the organisation to live by it. People in an organisation pick up quickly on how the ‘the top’ deal with outliers of the ethical code. The board-leadership team must infuse an organisational culture of ethics, and effective communication is essential to achieve this culture.

A values-driven code of conduct

The code of conduct must be clearly written and outline both management and key stakeholders’ values. The code must be meaningfully communicated to employees and associated parties. A sample of topics covered by the accounting bodies’ codes of conduct includes:

- fundamental principles
 - public interest
 - integrity
 - objectivity
 - independence and conflicts of interest
 - confidentiality
 - competence and due care
- other matters
 - resolution of ethical conflicts
 - advertising, publicity and solicitation
 - changes in professional appointments
 - incompatible business
 - opinion requests.

A further sample of the key topics that individual organisations, including auditing firms, might cover in their codes of conduct are listed in Table 1:

Table 1. Sample topics to be covered in a code of conduct

Affirmative action/equal opportunity/non-discrimination	Financial reporting/record-keeping	Product safety and suitability
Antitrust/fair trading/competition	Gifts and entertainment	Professional development
Bribery and kickbacks	Insider information and trading	Protection of proprietary and confidential information
Community service and philanthropy	Intellectual property/copyrights	Responsible supply chain
Compensation and benefits	Joint ventures and strategic alliances	Sexual and other harassment
Conflicts of interest	Media relations and public image	Substance abuse
Corporate giving	Money-laundering and fraud	Travel and expense reporting
Corporate governance and structure	Personal use of company assets	Union relations
Criminal convictions and civil actions	Political activities/lobbying/contributions	Use of communications tools
Employee health, safety and welfare	Privacy	Wage laws and fair labour practices
Environmental compliance	Private investments and outside business activities	Work/life balance

The code of conduct can be contained in a variety of materials, to ensure it is embedded into the organisational culture. Some suggested elements of a comprehensive code of conduct framework are listed in Table 2.

Table 2. Elements of a code of conduct framework

Introductory materials	Ethical conduct policies	Compliance administration
Organisational mission statement	Statement of relevant values and the policy's positive intent	Ethics and compliance certification form
Letter from the CEO	Clear and succinct statement of the policy	Directory of key contact persons
Statement of values/organisational principles	Brief examples of acceptable and unacceptable conduct	Links/references to related information
General statement of compliance with laws and regulations	Consequences of misconduct to the organisation and employees	Compliance and ethics reporting procedures (e.g., hotline / whistleblower protection)
	Reference to specific policies	Due process regarding ethics and compliance
		Decision-making assistance

Whistleblower protection

Whistleblower protection is one of the hot topics of corporate ethics. While it is a vital element of any corporate governance strategy, a whistleblower protection policy will not of itself work to ensure corporate ethics are observed. Employees will not utilise help lines or report misconduct if they are not satisfied that their actions will be supported, as the ramifications can be significant to an individual's personal and professional life.

For auditors, the focus must be on supporting audit teams in any dispute with a client. Audit partners must know that they will be protected – even rewarded – if they take a firm stance against an accounting practice they feel is potentially misleading.

Integration of business processes

Finally, integration of business processes ensures that the ethics and compliance program becomes operational and effective. This includes:

- developing clear policies and procedures
- communicating to, and training, employees about the code of conduct and related practices
- monitoring progress
- reporting to management/partners and the board-leadership team
- fine-tuning strategies
- communicating the company's successful performance to key stakeholders.

Measuring the effectiveness of ethics programs is difficult, but it is essential to ensuring ethical behaviour is integrated into the organisational processes. There are a number of ways to monitor and assess the successful embedding of ethical behaviours. Some of the more common performance indicators include:

- code of conduct awareness signatures
- helpline awareness, call resolution and trends
- adequacy of program documentation
- risk management and early detection
- consistency of enforcement
- ethical culture surveys and employee opinions
- management's response to issues raised.

Conclusion

Corporate governance, business ethics and effective compliance management are increasingly critical to an organisation's reputation and success. To regain public trust, safeguard reputation and grow market share, all organisations need to embed ethics and compliance into their culture and core business processes. They also need a mechanism so that they can be seen by the public at large to have these processes working effectively.

A framework and process for corporate governance, business ethics and compliance management that weaves together a 'top-down' approach to managing accountability with 'bottom-up' compliance processes is a large step in the right direction.

The ultimate success or failure of an organisation's code of conduct and business ethics program will rest upon the values and culture created by the board of directors or leadership team, and ultimately embraced by all its people.

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