Determining Whether an Accounting Firm Is Ethical

A Useful Checklist

By Miriam Gerstein

If accountants are asked whether they and their accounting firm are ethical, most will probably answer affirmatively. Indeed, prior research has shown that most accountants think they are more ethical than others (Mahzarin R. Banjai, Max H. Bazerman, and Dolly Chugh, "How (Un)ethical Are You?," *Harvard Business Review*, 2003, pp. 56–64; Ronald B. Morgan, "Self- and Co-Worker Perceptions of Ethics and Their Relationships to Leadership and Salary," *Academy of Management Journal*, 1993, pp. 200–214). But the general public, whose skepticism is fueled by accountants' perceived roles in recent major business debacles, does not necessarily share this view.

Ethical behavior does not occur automatically. Researchers agree that maintaining an ethical organization and a high level of ethics among individual accountants requires concerted effort and care (Max H. Bazerman, George Loewenstein, and Don A. Moore, "Why Good Accountants Do Bad Audits," *Harvard Business Review*, 2002, pp. 96–102). This discussion delineates the best practices that foster an effective ethical culture and enforce ethical behavior in public accounting firms. It can act as a managerial checklist to help CPA firms achieve ethical excellence in serving the public.

Ethics Codes

An accounting firm must be built on core ethical principles, and values must be part of the organization's culture (Item 1 in the sidebar, *Ethics Checklist for CPA Firms*). The ethical success of every firm hinges first on its creation of a set of ethical values that are embedded in the organization's core and manifested in its goals and policies. This informal set of policies is insufficient on its own, however; a formal methodology for implementing and upholding ethical values must be in place as well. Those principles must be embodied in a formalized ethics code (Checklist Items 1 and 2).

A code of ethics is a "a distinct and formal document containing a set of prescriptions developed by and for a company to guide present and future behavior on multiple issues of at least its managers and employees toward one another, the company, external stakeholders and/or society in general" (Muel Kaptein and Mark S. Schwartz, "The Effectiveness of Business Codes: A Critical Examination of Existing Studies and the Development of an Integrated Research Model," *Journal of Business Ethics*, 2008, pp. 111–127). In addition to complying with the AICPA's Code of Professional Conduct, many firms have instituted their own professional ethics codes. Such a prescriptive code assists in guiding the everyday actions of management and employees, thereby ensuring that a core set of ethical values is upheld consistently throughout the organization.

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But studies have shown that ethics codes created by legal departments are often ineffective because they do not address the day-to-day challenges faced by organizational players (Max Messmer, "Does Your Company Have a Code of Ethics?," *Strategic Finance*, 2003, p. 14). To ensure relevance, companies should include members of all levels of the organization in the formulation of the code, and they should review the code frequently to keep it current (Checklist Item 2).

Effective Communication

The mere existence of an ethics code will not bring about change unless it is communicated to and applied by members of an accounting firm. But simply distributing a code does not ensure that it will be read, and many companies fall prey to the "print, post, and pray syndrome" (Gary R. Weaver, Linda Klebe Trevino, and Philip L. Cochran, "Corporate Ethics Practices in the Mid-1990's: An Empirical Study of the Fortune 1000," *Journal of Business Ethics*, 1999, pp. 283–294).

Although accountants may participate in continuing professional education (CPE) courses in ethics, a firm should disseminate the contents and importance of its unique code of ethics, which can be tailored for its particular type of practice. This can be performed on an ongoing basis via training sessions, e-mails, newsletters, and discussion groups. Many researchers have encouraged these and other forms of communication at regular intervals in order to emphasize the gravity that management attaches to the issue and to facilitate compliance with a firm's ethical code (Mark John Somers, "Ethical Codes of Conduct and Organizational Context: A Study of the Relationship between Codes of Conduct, Employee Behavior and Organizational Values," *Journal of Business Ethics*, 2001, pp. 185–195).

The majority of studies indicate that although there is a positive relationship between the existence of ethics codes and ethical decision making, this benefit exists only when the code is embedded in the organization's culture via clear executive commitment to its integration and enforcement in day-to-day practices (Betsy Stevens, "An Analysis of Corporate Ethical Code Studies: Where Do We Go from Here," *Journal of Business Ethics*, 1994, pp. 63–69). To serve its purpose, the code's effective and frequent communication by management and its placement in the organizational psyche are essential.

Ethics Program

The code of ethics should be just one part of an organization's overall ethics program. This should include ethics classes and workshops that train employees in the firm's ethical expectations and obligations (Checklist Item 3). Accounting firms might also need a program to build ethical skills and awareness for managers and executives. Such across-the-board training sessions can have a profound positive impact on the firm's ethical culture. Successful ethics training should include case studies, in addition to the rules and regulations outlined in the code (Checklist Item 4).

Ethical Leadership

Successful implementation of an ethics code hinges on the "continuous presence of ethical leadership" (Mark Schwartz, "How to Minimize Corruption in Business Organizations: Building and Sustaining an Ethical Corporate Culture," *Crime and Corruption in Organizations: Why It Occurs and What to Do About It*, ed. Ronald J. Burke, Cary L. Cooper, and Ed C. Tomlinson, Gower Publishing, 2010, p. 274). An accounting firm's management must show that it adheres to ethical standards and that it is not above the code; indeed, even minor breaches of ethics by managers can seriously undermine employees' adherence to an ethics code (Checklist Item 5). In addition, managers have the responsibility to keep the ethics conversation open and on the table at meetings and during more informal conversations as well (Checklist Item 6). Management must clearly inform employees that ethical concerns are a priority and that managers wish to be notified of breaches in order to address them. In practice, management must emphasize that ethical standards are to be incorporated into all decision making—not just used as a checklist after the discovery of controversial actions. Ethics must become a public part of the accounting firm's practices and integrated into all key decisions (Checklist Item 7).

There are many subconscious unethical biases and patterns that managers might incorporate into their professional conduct, such as implicit prejudice, in-house favoritism, and overclaiming credit. Banjai, Bazerman, and Chugh maintain that simple ethical training is insufficient to counteract such vices in the accounting workplace because they are surprisingly prevalent and difficult to identify. As a result, strong counteractive steps must be taken to rid the workplace of these insidious patterns of behavior. Managers must make an effort to become aware of their own prejudices, work actively to remove stereotyping from their workplace, and understand the mindset of others when making policy decisions (Checklist Item 8).

Managers might sometimes look away from employees' unethical behavior when it is in their own interest. For example, partners in a firm might remind auditors that it is important to retain clients, even when those clients are engaging in unethical behavior. This delegation of "dirty work" results from a subconscious desire to ignore the unethical behavior of others when it is to one's own advantage. Managers must become aware of this negative tendency and actively encourage ethical behavior by emphasizing that unethical behavior—even if it contributes to the firm's bottom line—will not be condoned (Checklist Item 9). Because unethical behavior has been found to be more prevalent when it is rewarded, managers must make sure that employees do not feel the need to be unethical in order to succeed.

In "Through the Ethics Looking Glass: Another View of the World of Auditors and Ethics," published in the *Journal of Business Ethics* in 2006, Roger Martin pointed out that the most important factor determining the success of internal controls in an organization is the "control environment"—that is, is the people who set the controls in place and the environment in which they operate (Checklist Item 10). If the individuals responsible for creating and implementing the controls are themselves unethical, no internal controls can be effective; in fact, research has shown that although internal controls are important, they cannot eliminate fraud on their own (Howard Rockness and Joanne Rockness, "Legislated Ethics: From Enron to Sarbanes-Oxley, the Impact on Corporate America," *Journal of Business Ethics*, 2005, pp. 31–54). Management is responsible for instituting a system of accountability, in which there is a process for

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ETHICS CHECKLIST FOR CPA FIRMS

1. Is the organization built on core ethical principles and values? Are these a part of the organization's corporate culture?
2. Are these principles embodied in a formalized ethics code created by an interdisciplinary team of management and employees?
3. Is there an ethics program in place that includes training and ongoing discussions to help maintain ethical awareness and compliance with the code?
4. Does the ethics program incorporate case studies that help employees relate the code to their professional responsibilities?
5. Do managers demonstrate their adherence to the code in all its detail?
6. Do firm members discuss ethics at meetings and during informal conversations?
7. Does the training program emphasize the importance of incorporating ethics in all day-to-day decisions in the organization?
8. Do managers take concrete steps to remove stereotypes and combat subconscious ethical biases, including implicit prejudice, in-house favoritism, and overclaiming credit?
9. Do managers make clear to employees that they do not condone unethical behavior, even when such behavior will be beneficial to the organization's bottom line?
10. Are there internal controls in place to prevent breaches of ethics?
11. Is there a consistent protocol for identifying and handling unethical behavior?
12. Does the firm have strong policies that reward ethical behavior and penalize unethical behavior?
13. Does the firm's code clearly explain what to do in situations where strict adherence to confidentiality standards contradicts the ethical guidelines?
14. Does the firm provide a clear venue for discussions of ethical questions or dilemmas?
15. Can whistleblowers safely and anonymously report unethical behavior?
16. Is there a designated individual responsible for investigating, documenting, and resolving ethical issues?

identifying and handling breaches of ethics (Checklist Item 11).

It is imperative for a firm to reward ethical behavior and penalize unethical behavior (Checklist Item 12). Management's handling of ethics cases indicates its own level of integrity and the priority it places on ethical behavior. A serious and correct reaction to cases of unethical practice is crucial to the creation of a culture of ethics within an accounting firm; in turn, such a culture fosters ethical behavior. Perceptions of peer group behavior have been shown to have a greater influence on ethical decision making than an individual decision maker's belief system (Mary Zey-Ferrell, K. Mark Weaver, and O. C. Ferrell, "Predicting Unethical Behavior among Marketing Practitioners," *Human Relations*, 1979, pp. 557–569).

Confidentiality

The AICPA Code of Professional Conduct mandates that "a member in public practice shall not disclose any confidential client information without the specific consent of the client" (ET section 301). Although many accountants are aware of the need for client confidentiality, they might misjudge the extent of this responsibility. Accountants should be aware of the standard confidentiality practices of their state government, accounting board, and firm in order to ensure compliance. Interestingly, Barbara L. Adams, Fannie L. Malone, and Woodrow James noted that although accountants usually comply with the AICPA Code of Professional Conduct when making confidentiality decisions, those decisions do not always coincide with their opinions of what is morally correct ("Confidentiality Decisions: the Reasoning Process of CPAs in Resolving Ethical Dilemmas," *Journal of Business Ethics*, 1995, pp. 1015–1020). As a result, accountants often do not follow their ultimate moral imperative in their tendency to abide strictly by the code. An organization's ethics program should assist employees in learning to make morally correct decisions when faced with confidentiality dilemmas (Checklist Item 13).

Open Channels of Communication

Every accounting firm should encourage constructive communication in order to create an environment where employees feel free to raise concerns or ask questions regarding the appropriate legal or ethical

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course of action to take in a given situation. To deal correctly with situations where employees are unsure of the firm's policies or how to apply them, or where they have limited experience dealing with a specific scenario, they should be afforded a comfortable venue that facilitates queries or assistance (Checklist Item 14).

To encourage the reporting of ethical concerns, there should be a way to report activities anonymously. Whistleblowers must be certain of their safety in order to report ethical breaches with impunity (Checklist Item 15). An example of such a practice is KPMG's ethics and compliance hotline, which gives employees the option to remain anonymous while providing information. The hotline is administered by an external third-party provider that does not identify its callers. KPMG also designated an ombudsman to oversee "the investigation, documentation, and resolution of issues involving professional practice" (KPMG's Code of Conduct, 2010, http://www.kpmg.com/US/en/about/Documents/kpmg-code-of-conduct.pdf). Smaller companies that lack the resources to fund a third-party hotline should devise other ways to facilitate the anonymous communication of ethical misconduct. All firms should designate an individual who is responsible for investigating, documenting, and resolving ethical issues (Checklist Item 16).

Open lines of communication are an essential component of any ethics program. Research has shown that open communication within an organization promotes organizational trust and is of paramount importance in the institutionalization of ethics.

Promoting Trustworthiness

The purpose of accounting is to provide useful information for internal and external decisions. To be useful, information has to be trustworthy. All areas of accounting practice potentially pose ethical dilemmas that challenge accountants to produce honest information, even at the expense of the accountant's or the client's finances.

The prevention of unethical accounting behavior is a crucial managerial responsibility. The ramifications of unethical behavior in an accounting firm have far-reaching deleterious effects—not only for the culprits and their stakeholders, but also for society at large. Managers face great risks in terms of penalties and prison sentences for negligence or oversight when confronted with unethical behavior. Large accounting firms have folded over the exposure of their unethical practices.

Public accounting firms should consider the guidelines offered in this discussion when trying to raise ethical standards and, thus, contribute to an improved ethical business environment. By following these guidelines, all stakeholders can work together to ensure and maximize professional ethics. ❑

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