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Ethics and the Auditing Culture: Rethinking the Foundation of Accounting and Auditing

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ABSTRACT. Although the foundation of financial accounting and auditing has traditionally been based upon a rule-based framework, the concept of a principle-based approach has been periodically advocated since being incorporated into the AICPA Code of Conduct in 1989. Recent high profile events indicate that the accountants and auditors involved have followed rule-based ethical perspectives and have failed to protect investors and stakeholders – resulting in a wave of scandals and charges of unethical conduct. In this paper we describe how the rule-based traditions of auditing became a convenient vehicle that perpetuated the unethical conduct of firms such as Enron and Arthur Andersen. We present a model of ten ethical perspectives and briefly describe how these ten ethical perspectives impact rule-based and principle-based ethical conduct for accountants and auditors. We conclude by identifying six specific suggestions that the accounting and auditing profession should consider to restore public trust and to improve the ethical conduct of accountants and auditors.

KEY WORDS: accounting, accounting ethics, audit/auditing, business ethics, ethics, ethical conduct, financial accounting and auditing, model of ten ethical perspectives, principle-based accounting, rule-based accounting

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The investing public has historically relied upon audited financial statements when making investment decisions and has depended upon auditors and the accounting profession to confirm the accuracy and completeness of financial information (Kane, 2004). Because recent high profile financial disasters involving accounting fraud have suggested that the auditors involved in monitoring these firms have not honored what the public has perceived to be their appropriate role, the public has become less trusting of the auditing profession's ability and/or willingness to protect investor interests (Cullinan, 2004). According to Miller and Bahnson (2004) auditors have a responsibility to be ‘‘gatekeepers'' to protect the investing public, but many auditors have failed to honor their gatekeeper role with a resulting increase in risk passed on to investors. When auditors are willing to compromise their independence or overlook key information in order to retain a client, then the objectivity of the auditor and the accuracy of the client's financial statements are immediately suspect (cf. McLean and Elkind, 2003).

Although accounting was once considered by the public to be highest in integrity among all professions (Pearson, 1988), the regard that this profession enjoyed has deteriorated in the wake of a succession of high profile scandals (Herron and Gilbertson, 2004). Despite the fact that scholars and practitioners

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have suggested that auditing and accounting become more principle-based than rule-based (Cheney, 2002; Keim and Grant, 2003), business schools continue to focus on a rule-based model in teaching (Dyckman et al., 2001; Gordon, 2001). Accounting supervisors are decidedly rule-based in their mental models (Sweeny and Roberts, 1997), and CPAs tend to follow a rule-based approach ''even when it was not the course of action they considered to be morally right (Herron and Gilbertson, 2004, p. 505).'' In the same way that the profession has relied upon Generally Accepted Accounting Principles (GAAP), accountants and auditors need to endorse and apply Generally Accepted Ethical Principles in order to regain public trust (cf. Paine, 2003).

The primary objectives of financial reporting is to provide financial information to current and potential investors, creditors, and stakeholders that is (1) useful in making well-reasoned investment, credit, and financial decisions; (2) helpful in assessing amounts, timing, and degree of certainty of future cash flows; and (3) accurate in reporting the economic resources and obligations of a business (Dyckman et al., 2001). To ensure that these objectives are followed, the American Institute of Certified Public Accountants (AICPA) ''prohibits a member of the American Institute of Certified Public Accountants from expressing an opinion that financial statements conform with generally accepted accounting principles if those statements contain *a material departure from an accounting principle* promulgated by the Financial Accounting Standards Board (FASB) (italics added) (FASB, 1985, p. 151)'' and if the financial statements would be misleading.

A fundamental problem has been that the high profile cases involving accountants for firms like Enron and WorldCom, and auditors at Arthur Andersen have centered on what constitutes a ''material departure.'' The AICPA notes that accounting professionalism ''requires much more than compliance with specific rules'' but encompasses ''a pattern of conduct – indeed a pattern of thinking – that results in the performance of all professional activities with competence, objectivity, and integrity'' (AICPA, 2002: Sect. 51.02).'' Unfortunately, evidence from the recent past suggests that far too many accountants, auditors, and executives have misrepresented financial information, participated in fraudulent financial deceptions, and hidden behind loopholes in the law that have been rule-based (Imhoff, 2003; McLean and Elkind, 2003).

Although the AICPA adopted language that called for a principle-based approach to accounting and auditing in 1989 (Herron and Gilbertson, 2004), the conceptual framework for the technical preparation of financial statements has continued to be portrayed as a pyramid with a foundation based on technical standards describing the criteria for determining how revenues and expenses are measured and identifying when those revenues and expenditures are recognized (Dyckman et al., 2001, pp. 30–33). Moving up this pyramid, the objectives of comparability and consistency of financial statements and the relevance and reliability of information are emphasized but the identification of guiding principles or values is notably absent.

In assessing this accounting pyramid, one is struck by the fact that the pyramid does not incorporate the importance of the ethical principles upon which financial statements must be based – despite the pronouncements formalized in the 1989 AICPA Code. FASB has assumed that professional accountants would follow the ethical intent of the audit standards and would not compromise those standards to ''please'' clients. Unfortunately, the events of recent history have confirmed that financial staff and auditors can be seduced by economic self-interest and can fail to honor their obligations to the investment community.

Examples from Enron and Arthur Andersen

In describing the extent of the financial reporting deception perpetrated at Enron, McLean and Elkind (2003) point out that financial staff, analysts, auditors, bankers, and the executives who were involved knew that Enron's market value was built upon fabrication rather than reality and that its financial statements did not accurately represent Enron's financial status. McLean and Elkind (2003, p. 230) summarize the nature or Enron's financial misrepresentations:

> ''The circle of people who knew – or should have known that Enron's glittering surface masked a different reality was surprisingly large.

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> Much of what Enron did – such as generating billions in off-balance-sheet debt – was out in the open. Many of the analysts knew full well that the company's earnings far outstripped the cash coming in the door. The bankers and investment bankers, who worked for the same firms as the analysts, certainly understood what Enron was doing; indeed, they MADE (Chief Financial Officer, Andy) Fastow's deals possible. The credit rating agencies knew a lot. The business press, which could have looked more closely at Enron's financial statements, couldn't be bothered; the media was utterly captivated by the company's transformation from stodgy pipeline to new economy powerhouse. And of course there were any number of Enron's own employees who could see for themselves how the company was making its numbers. And yet, they all chose not to make the logical leap, to see where it was inevitably headed. Instead, they all chose to believe.''

Enron financial staff who structured the financial mechanisms and financial statements and the Arthur Andersen auditors who certified Enron's financial statements appear to have operated under a cloak of moral self-deception (Arbinger, 2000) while consistently maintaining the position that their actions did not constitute the ''material departure from accounting pronouncements'' that FASB declared to be specifically prohibited (McLean and Elkind, 2003). As McLean and Elkind (2003, p. 142) noted in their explanation of the Enron machinations, Enron's financial staff had hired former FASB staff who had written the accounting rules in ''gaming the system.'' McLean and Elkind (2003, p. 142) explain the Enron manipulated the process in subverting FASB rules and Generally Accepted Accounting Principles (GAAP):

> ''Interpreting those rules has always been more art than science, reliant in no small part on the good faith of those applying them in everyday situations. For very smart people who saw the rules as something to be gotten around, well, it wasn't all that hard to do – in fact; some former Enron employees argue that the rules themselves provided a road map. And Enron, which prided itself on employing only the very smartest people, took that view further than any company that's ever existed. ''We tried to aggressively use the literature to our advantage,'' admits a former Enron accountant. ''All the rules create all these opportunities. We got to where we did because we exploited that weakness.''

The mental model of these Enron employees was that they were doing exactly what they should be doing in complying with a rule-based framework for accounting – because their view of morality was consistent with a legally based *intentional amoral management* model (Carroll and Buchholtz, 2003, p. 185). As Carroll and Buchholtz (2003, p. 185) have suggested, those who follow this perspective ''simply think that different rules apply in business than in other realms of life.''

Unfortunately, this intentional amoral management approach creates a form of moral hubris – a moral blind spot of self-deception (Arbinger, 2000) based upon a form of egotistical ''abstract greed'' (Solomon, 1993, p. 39). Solomon (1993, p. 84) explained in detail the mythical profit motivation that seemingly justified this ''business is business'' Solomon, 1993, p. 84 conceit in pursuit of abstract greed. The end product of the behavior was a warped distortion that McLean and Elkind (2003, pp. 142–143) report:

> Here's how another former employee describes the process: ''Say you have a dog, but you need to create a duck on the financial statements. Fortunately, there are specific accounting rules for what constitutes a duck: yellow feet, white covering, and orange beak. So you take the dog and paint its feet yellow and its fur white and you paste an orange plastic beak on its nose, and then you say to your accountants, 'This is a duck! Don't you agree that it's a duck?' And the accountants say, 'Yes, according to the rules, this is a duck.' Everybody knows that it's a dog, not a duck, but that doesn't matter because you've met the rules for calling it a duck.''

> And there was the ultimate problem. With Enron's financial team working feverishly to exploit the rules, there was no one willing to say that the duck was still a dog. Because they could come up with plausible rationales for why

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a given structure was technically valid, *they believed they were on the right side of the law.* They were, in fact, *proud of what they were doing.* (Italics added).

As McLean and Elkind report (2003, p. 143), Enron's accountants were doing what they thought every other company was doing and should be doing, "except that they were doing it better and smarter, because they were Enron, where everything was done better and smarter." Unfortunately, Enron's employees may have been smart about bending the rules, but "they were not smart at all about understanding where all that bending was taking them (McLean and Elkind, 2003, p. 143)

This summation of Enron's accounting machinations and the implicit ethical self-deception that it exemplified summarizes the vulnerability implicit within a rule-based accounting and auditing perspective. Enron's financial staff and auditors pursued an accounting path that may have complied with a distorted manipulation of accounting rules but clearly violated the intent of accurate and objective financial reporting.

"CPA firms, their managing partners who determine firm values and policies, their audit supervisors perhaps vying to maximize engagement profitability in their quest for a partner appointment, and individual employees who are unsure where the ethical lines of an audit should be drawn all face normative and instrumental choices as they make audit-related decisions in a fiercely competitive marketplace (Imhoff, 2003)." Beasley and Hermanson (2004, p. 12) note that under these present conditions "top managers and other employees can rationalize certain questionable behaviors that subsequently escalate into outright fraud." They cite a number of "gray zone" behaviors that are "not completely acceptable, but not clearly inappropriate" that range from boosting revenues through special payment terms to "pressuring customers to accept orders before the end of an accounting period, bill and hold schemes, private side agreements, and even booking revenues that do not exist (Beasley and Hermanson, 2004, p. 12)"

Imhoff (2003, pp. 120–121) concluded that the accounting profession has "increasingly provided managers with incentives to manage earnings and to delay and/or conceal bad news." Auditors are finding themselves working closely with the managers they audit – placing auditors under tremendous pressure if they seek to retain client business for both audit services and supplementary nonaudit services provided by their firm (Imhoff, 2003, p. 123). At the same time, the events of the past three years have put the audit profession under a white-hot spotlight while the Sarbanes-Oxley Act has mandated that auditing firms be held accountable to new standards – although the operational meaning of those standards is subject to interpretation by the newly created Public Company Accounting Oversight Board (PCAOB) (Constantini, 2004).

Despite increased emphasis on principle-based verbiage about audit independence, the creation of the PCAOB, and establishment of additional rule-based standards on audit firms, the decision to act ethically in conducting audits is likely to be made internally within each firm and followed by a careful review of commonly held ethical perspectives that may provide a valuable insight into why auditors and auditing firms are seduced by a rule-based interpretation of their audit responsibilities.

Ten perspectives of business ethics

Hosmer (1994, p. 20) has suggested that "ethical principles are not subjective measures that vary with cultural, social, and economic conditions; they are objective statements that transcend countries, religions, and times. They are the basic rules or first principles that have been proposed to ensure a 'good' society. A 'good' society is one in which people willingly cooperate for the benefit of all." We suggest that the duties owed by accountants and auditors are fundamental and essential and must be based upon (1) ethical principles that do not change – regardless of the company involved, the verbiage used in audit standards, or the financial benefits accruing to those who might be tempted to forego their duties, and (2) a commitment to honor duties to society that encompass the public interest and welfare of all stakeholders.

Hosmer (1994) has assisted business scholars and practitioners by providing a summary of ten distinct and often-cited ethical perspectives that reflect the thinking of moral philosophers. Hosmer's (1994) summary provides a context for understanding why

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TABLE I
Ten ethical perspectives

Ethical perspective	Summary of ideas	Driving value	Moral implications	Accounting and auditing application
Self-Interest (Protagoras)	Society will be better off if we pursue our own self-interests without interfering with the rights of others.	Perceived personal self-interest.	Self-serving bias may color weighting of values.	Self-serving bias was at the heart of the recent debacles involving Enron, WorldCom, etc.
Utilitarian benefits (Bentham and Mill)	A law or an act is "right" if it leads to greater net social benefits than social harms.	Pursuit of the greatest good for the greatest number.	Self-interests, conflict, and harm are difficult to assess.	Long-term and short-term benefits may be worlds apart – and may not have readily apparent consequences.
Personal virtues (Plato and Aristotle)	Individuals must adopt a set of standards that govern relationships and that model virtuous behavior.	Others are owed proper treatment.	Virtuousness may be difficult to both define and attain.	Keim and Grant (2003) suggest that key virtues of courage and integrity preserve auditing's intent.
Religious Injunctions (St. Augustine)	Compassion and kindness must complement honesty, truthfulness, and temperance.	Reciprocity and compassion build comm unity	Religious attainment of excellence is rarely achieved.	The Golden Rule, identified as a key religious construct, applies to auditing intent.
Government Requirements (Hobbes and Locke)	Basic rules are derived from a central authority that has the ability to enforce those rules.	Law representing the minimal moral standards of society.	Rules and laws are often inadequate at articulating ethical practices or intent.	Governmental and professional FASB standards have traditionally been rule-based in practice.
Universal Rules (Kant)	Inspired rules govern action resulting in greater good for society.	Rules that eliminate the self-interest of those deciding.	Rules must be applicable to everyone.	Rules and principles must intermesh to achieve desired intent.
Individual Rights (Rousseau and Jefferson)	An agreed upon list of guaranteed rights ensure freedoms.	Actions that protect individual guaranteed rights.	Eliminating the decision maker's bias is not possible.	Stakeholder rights may not have been part of the measured outcome but are becoming more important.
Economic Efficiency (Adam Smith)	Maximize the output of needed goods and services by setting marginal revenues equal to costs and maximizing profits.	Economic efficiency.	Basic rights are meaningless without core essentials of food, clothing, and shelter.	Auditing must be thorough enough to identify the costs to society for financial misrepresentations.
Distributive Justice (Rawls)	Never take an action that harms the least among us in any way.	Disadvantaged owed a Social Contract.	The market may unjustly distribute goods and services.	Misreporting in financial statements and audits may harm society – evidenced in the aftermath of recent events.

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TABLE I

Continued

Ethical perspective	Summary of ideas	Driving value	Moral implications	Accounting and auditing application
Contributing Liberty (Nozick)	Never take action that interferes with the rights of others for self-development and self-fulfillment.	Rights of liberty within the constraints of the law.	Liberty may be perceived as more important than justice.	The auditor protects the public interests so that the public's rights are not violated.

moral and ethical duties inherent in business must be clearly articulated, rather than be purely procedural, mechanistic, or rule-based. Table I summarizes Hosmer's ten ethical perspectives and includes brief commentary that we have added to explain how each of the ten perspectives might apply to auditing and financial reporting.

A review of these ten perspectives provides valuable insight into the ethical assumptions and driving values that impact business decisions, including the implications of these perspectives on auditing and financial reporting. These perspectives also provide insights about why the ethical foundation of auditing and financial reporting should extend beyond the rule-based model that has historically predominated the auditing process (Imhoff, 2003).

The Self-Interest ethical model is often associated with the agency theory of governance in which key decision-makers with superior information opportunistically pursue self-interest with guile (Williamson, 1975). Although agency theory often suggests that incentives should be established to ensure that key players act ethically, the audit relationship serves to increase pressure on the auditor to help the client circumvent accounting rules (Imhoff, 2003). As noted in previously cited examples at Enron (McLean and Elkind, 2003), Enron CFO Andy Fastow and his cohorts manipulated accounting rules, created off-balance sheet financial instruments that distorted revenues and pressured Arthur Andersen's auditors to validate these financial misrepresentations. Although the long-term financial results were ultimately disastrous to Enron, Arthur Andersen, and the investing public, these accounting distortions were profitable for the short-term for both Enron and Arthur Andersen – the apparent justification for violating the "material departure" intent of financial reporting.

The flawed logic causing Enron and Arthur Andersen to justify a rule-based and short-term Utilitarian Benefits ethical model is well analyzed in Brandt's (1992) discussion of utilitarianism. Brandt (1992, p. 131) noted that a moral code must be based on both the duties owed to society and rules that would allow for potential conflicts in obligations when duties may be owed to several parties. In the case of auditors and accountants at Enron and Arthur Andersen, the perception of self-interest and financial benefits to internal stakeholders allowed for rationalization and self-deception (Arbinger, 2000) that permitted those responsible to reconcile misrepresenting the true financial status of the companies involved and to overlook their financial and moral duties to the investing public. Hiding behind a legalistic misrepresentation of the intent of GAAP, the accountants and auditors precipitated what has been retrospectively called fraudulent conduct (Callahan, 2004) that clearly does not meet the moral code standard called for by Brandt (1992).

The classic perspective of the Virtue Ethics ethical model is that membership within a social community carries with it both rights and obligations that require individuals to demonstrate virtuous behaviors (Manville and Ober, 2003). That behavior transcends compliance within a set of rules and rises to the level of a citizen's commitment to the welfare of society – consistent with the notion of commitment to a "good society" suggested by Hosmer (1994, p. 20). Solomon (1992) has suggested that a virtue ethics approach ought to be at the foundation of business ethics based upon Aristotelian duties owed to society by the business community.

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Cameron (2003a,b) also has suggested that business ethics based upon a virtuous commitment to the welfare of others can lead to increased productivity, profit, and quality. Keim and Grant (2003, p. 405) have called for a virtue-based approach to auditing, and have observed that trust in accounting and auditing systems "develops only through experience in dealing with that system and through examination of the outcomes of the system." They emphasize that reliance upon virtues is critical because "professionals will be expected to consistently reach ethical decisions when faced with dilemmas in financial reporting and auditing." These are dilemmas that rules-based systems cannot adequately address.

The religious injunction perspective of St. Augustine imposes both a "letter of the law" and a "spirit of the law" approach to ethical conduct. McKernan and MacLullich (2004) have suggested that ethical duties of love and justice – based upon distinctly religious roots and religious obligations – should serve as the ethical foundation for auditing and accounting professions. Hilliard (2004) has noted that, in the aftermath of Enron, religious foundations for ethics have been increasingly discussed among business leaders and that the importance of a religion-based approach to ethics has been advocated by a variety of authors. Although the concept of a religion-based ethical model may not seem to apply directly to financial reporting and auditing according to some perceptions, the concept of honoring duties owed to others – particularly in following the Christian notion of honoring the "spirit of the law" clearly applies (McKernan and MacLullich, 2004).

The Governmental Requirements ethical model, the rule-based and legalistic approach to duties owed – is generally considered to be the minimum ethical standard required and is sometimes considered ethically dangerous ground (Carroll and Buchholtz, 2003). Pincus (2000, p. 253) notes that rule-based accounting systems can lead to ethical problems (1) when 'anything goes' if not expressly prohibited, or (2) when rules meant to serve as guides to right behavior "lead accountants down the path of least resistance." The rule-based and legalistic approach to financial reporting and auditing has also been described as the root cause of the frauds committed by Enron, Arthur Andersen, and WorldCom (Callahan, 2004; Cheney, 2004). The efforts of the AICPA to amend its code have been based upon a belief that the code "contained too many technicalities providing opportunities for finding loopholes (Herron and Gilbertson, 2004, p. 500)." Albrecht and Sack (2000) cite the focus on technical and rule-based aspects of auditing to be one of the major deficiencies of the accounting profession and call for major revisions in the teaching of accounting and auditing to make it less rule-based.

The Universal Rules model of Kant forms the foundation of the principle-based approach to an ethical decision process that has begun to receive expanded attention in the accounting profession (Herron and Gilbertson, 2004; AICPA, 2002). Gaa (1990) suggests that a principle-based approach needs to be the foundation of the thinking of auditors in reviewing financial statements, and he proposes a principle-based model for auditing. The enactment of the Sarbanes-Oxley Act has widely been described as an effort to move from a rule-based to a principle-based approach to financial reporting and auditing (Schipper, 2003). Herron and Gilbertson (2004, p. 503) note that empirical evidence suggests that accountants inherently follow a mental model emphasizing organizational norms and following rules and that this commitment to rules increases the higher a person rises in rank within an accounting firm (cf. Ponemon, 1992; Shaub, 1994). Schipper (2003) took the position that, despite their tendency to be rule-based in practice, accountants and auditors point to GAAP and FASB standards as principle-based – even when their behaviors tend to focus primarily on a legalistic approach to following rules.

The Individual Rights ethical model acknowledges duties owed to others and incorporates the concept of obligations to stakeholders articulated by a variety of scholars (Carroll and Buchholtz, 2003; Donaldson and Dunfee, 1999). Donaldson and Dunfee (1999) explained that the duty of those who govern is to honor an implied social contract that incorporates a set of ten "hypernorms" – or universal rights – owed to others. Lea (2004) has noted that these rights encompass obligations that include the welfare as well as the liberty of others. Verschoor (2004, p. 17) laments the failure of business leaders and auditors who have recently violated the rights of investors and

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the public, but suggests that the rule-based Sarbanes-Oxley legislation intended to close the door on the misuse of power is likely to be ineffective. Like other scholars, Verschoor (2004, p. 17) has concluded that lacking "ethical concerns, creative minds will find a way to circumvent the spirit of any law." The Individual Rights model of business ethics encompasses elements of stakeholder theory that overlap with the Virtue Ethics and Universal Rules models.

Consistent with the fundamental elements of an Economic Efficiency ethical model, the accounting and auditing professions are implicitly built around ensuring that a business is run both efficiently and profitably. Efficiency is commonly classified in terms of *Pareto efficiency* – the best use of resources so that no other use can improve one person's situation without harming another – and *informational efficiency* – wherein all participants or investors hold information in common so that price reflects that information (Shefrin and Statman, 1993, p. 21). Conducting an audit requires sampling enough financial transactions to be able to confirm that the financial statement fairly and accurately represents the financial status of the corporation and that financial systems comply with appropriate accounting practices (Dyckman et al., 2001). Imhoff (2003, p. 121) noted that CPA firms have been pressured to keep the costs of the audit low and to help firms to maximize their profitability, and to "develop financial schemes to help managers look like they are performing beyond the expectations of the shareholders." The Economic Efficiency model, in effect, asks auditors to balance a delicate set of potential ethical dilemmas: how they serve their client best without violating their duty to the public.

The Distributive Justice ethical model is based upon the relative distribution of outcomes or benefits and the degree to which that distribution is perceived as fair and equitable (Brady, 1990; Thibault and Walker, 1975). Empirical research has confirmed that conclusions about outcome-based fairness are impacted by perceptions about rule-based or procedural fairness (Lind and Tyler, 1988) and by perceptions about the nature of existing interpersonal relationships (Ambrose and Schminke, 2003; Caldwell and Clapham, 2003). As it applies to auditing and accounting, the Distributive Justice ethical model directly relates to the degree to which organizational stakeholders perceive that their share of the organization's resources are fair and equitable – and whether or not the rules by which the organization determines and assigns profits are "correct" (Schminke et al., 1997).

The application and interpretation of accounting and auditing rules – and pressures applied to maximize profitability as reflected in financial statements – become a natural part of the distributive justice equation. When personal perceptions become a critical element that affects relationships, including expectations about the auditor's role, the audit function is inevitably affected. Schminke et al. (1997) note that classic and predictable differences occur in organizations because of conflict between people who see the world as rule-oriented and those who view it as outcome-oriented.

The Contributing Liberty ethical model is a quasi-libertarian ethical perspective that emphasizes the centrality of individual rights while advocating minimal governmental influence (Votaw, 1974). The encompassing role of government, however, includes protection of society against fraud, theft, and contract violation (Nozick, 1974) – issues implicit within the scope of a business's duties to society and the auditor's responsibilities in asserting the accuracy of a firm's financial statement. A fundamental assumption of the Contributing Liberty ethical model is that individuals are entitled to the assets that they earn by providing benefits to others (De Gregori, 1979). The value of those assets is determined within the context of a free market, and individuals within a society should have a right to pursue goals that do not impinge upon the rights of others (De Gregori, 1979). To the degree that business executives or accountants would misrepresent the worth of their company in a financial statement or that an auditor would certify the financial health of a business entity in the face of reasonable knowledge that the company is not in the condition reported in the financial statement, those actions would violate the Contributing Liberty ethical model.

This review of these ten ethical perspectives confirms that there is clearly a conflict between rule-based and principle-based approaches to auditing and financial reporting, and that principle-based ethical models are necessary if auditors are to honor their gatekeeping and independence roles. As noted, although the Sarbanes-Oxley legislation created administrative mechanisms and additional rules for regulating the accounting profession, a review of these ten ethical perspectives seems to confirm

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recently voiced pessimism that a rule-based or mechanistic approach will resolve ethical dilemmas that occur in today's business culture (Callahan, 2004; Imhoff, 2003).

Suggestions for implementing principle-based ethics

Together with other scholars (Callahan, 2004; cf. Herron and Gilbertson, 2004; Imhoff, 2003), we share the perspective that a principle-based approach is necessary to significantly change the ethical behavior of the financial reporting and auditing profession, and note that despite the changes in the 1989 AICPA Code that incorporated principle-based language into the code, it is mere verbiage and lip service and not sufficient. Action-oriented dialogue involving practitioners, academics, enforcement staffs, boards of directors, and political decision-makers seems to be a critical step in implementing the changes necessary in the culture of today's business climate for any substantial change in the behavior of the accounting profession to occur. As part of that dialogue, we offer six suggestions that we think worthy of including in this discussion:

Mandating the teaching of business ethics to CPA candidates

If the integrity of the accounting profession is to be sustained, a reassessment of what constitutes ethical behavior, how such behavior is motivated, and the recognition of the rights and interests of affected parties is an ethical imperative for the profession (Dillard and Yuthas, 2002). An understanding of what constitutes ethical behavior–encompassing a detailed understanding of both rule-based and principle-based ethical perspectives and including Hosmer's model – needs to be understood by tomorrow's accountants and auditors who are today's accounting students at colleges and universities. The State of Texas has recognized the importance of teaching ethics to accounting students and requires candidates for the CPA exam to take a three-unit college level course in ethics prior to taking the exam. Eynon, Hill, and Stevens (1997, p. 1297) found that completion of an ethics course in college has a positive impact on the moral reasoning abilities of accounting students. Herron and Gilbertson (2004) also found a positive correlation between the level of accounting students' moral reasoning and their judgment about ethical accounting behavior.

Mandating that CPAs be required to complete continuing education courses in business ethics in order to retain their licenses

Research on moral development in the accounting profession suggests "that there are systemic characteristics of the accounting profession which inhibit an individual's moral development at worst or which inhibit retention of persons with higher levels of moral development at best (Herron and Gilbertson, 2004, p. 503)." Sweeney (1995) documents that accountants' level of moral development actually declines when they move from a supervisory level to partner level, and that levels of moral development are inversely related to rank within an accounting firm. Mandating that CPAs be required to complete continuing education courses in business ethics seems to be an important step in helping accounting and audit professionals confront this unacceptable pattern.

Urging CPA firms to conduct a periodic cultural audit of their firms to monitor attitudes about principle-based and rule-based ethics and to provide in-house training to firm members at all levels of the firm

The deterioration of levels of moral development within businesses and particularly within the accounting profession has been defined by a number of scholars to be systemic and patterned (cf. Beasley and Hermanson, 2004; Callahan, 2004; Imhoff, 2003). The accounting profession must demonstrate a willingness to evaluate itself seriously and become principle-based and committed to changing its culture – firm by firm – if the profession is to restore its credibility with the public. Conducting periodic cultural audits of accounting firms has been suggested by a number of scholars (Bean, 2004; Cunningham, 2004). Cultural audits can be a critical resource in identifying the impact of values, practices, and implicit assumptions on the behaviors of organization members (Schein, 1992). The deterio-

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ration of values in business must also be addressed at the internal level, with key corporate leaders acknowledging their roles in creating corporate cultures that reinforce ethical duties and principles (Callahan, 2004).

Encouraging the AICPA financially to support joint research between academicians and practitioners regarding audit practices, accounting firm culture, business ethics, corporate governance, and related concepts

Although the AICPA has formally endorsed verbiage about principle-based ethics since 1989 (Herron and Gilbertson, 2004), the profession must extend its commitment to reframing the profession's ethical practices. As the professional organization for auditors and accountants, the AICPA must lead out by supporting research endorsed by practitioners *and* academics. One-sided research that does not demonstrate insights or commitments of business practitioners – funded by the accounting profession whose reputation is at risk – is almost guaranteed to have minimal impact. The problems of business ethics are applied problems (Carroll and Buchholtz, 2003). A commitment to the many stakeholders affected by the auditing profession, therefore, must come from business itself (Imhoff, 2003).

Urging professional associations such as the AICPA, the business ethics society, and the academy of management to disseminate information to boards of directors and corporate audit committees about rule-based and principle-based ethics issues and their relationship to audit standards

Ultimately, boards of directors govern businesses – although these boards are often unduly influenced by CEOs who also sit on their corporate boards and influence its membership (Imhoff, 2003). Board incompetence, including failure to exercise due diligence and honor responsibilities owed to the investing public, was a significant part of Enron's meltdown (McLean and Elkind, 2003) and has been a topic discussed widely in academic and practitioner literature (Hanney, 2003; Uzun et al., 2004). Professional associations in the accounting profession and business ethics field can play a significant part in providing information to boards of directors and corporate audit committees about their role in monitoring corporate governance processes – including inevitable vulnerabilities that can occur as a result of ill-advised and poorly crafted incentive systems that may pursue short-term corporate profitability but spell long-term financial disaster.

Increasing the funding of the enforcement division of the security and exchange commission with regard to the monitoring of corporate fraud

Laissez faire politics coupled with unwillingness on the part of national administrations to fund the Securities and Exchange Commission adequately has greatly undermined the ability of the SEC to monitor corporate fraud adequately (Callahan, 2004; Imhoff, 2003). Imhoff (2003, p. 122) note that, although a case can be made that the SEC has been both "underfunded and understaffed," it is also "not clear that the SEC has achieved all that it could have, given its role as the primary party responsible for the enforcement of securities regulations and financial reporting oversight." Callahan (2004) places the blame for the SEC's inadequacies at the feet of federal politicians who failed to fund the commission adequately, noting inadequacy in the numbers of prosecutors and actual inspectors. We note that Sarbanes-Oxley has increased the profile of accounting fraud, but unless the U. S. Congress adequately funds the enforcement arm of the SEC, it is unlikely that much will be done to deter business leaders who lack a principled ethical foundation.

These six suggestions address the broad spectrum of audit culture issues that make up the ethical perspectives of those who have historically played key roles in training accountants and auditors, planning audit processes, managing CPA firms, governing corporate businesses, and setting criteria for the enforcement of national audit standards in business. We propose this broad scale approach in acknowledgement of the fact that ethical deficits facing business are systemic and require change on all fronts (Callahan, 2004; Imhoff, 2003). A piecemeal incremental approach that does not require a fundamental and comprehensive change in thinking, to encompass both rule-based and principle-based ethical perspectives is unlikely to have much impact on the current business environment. Carroll and Buccholtz (2003) note that well-founded moral thinking incorporates obedience toward the letter and the spirit of the law and would view strictly

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rule-based thinking as a minimal standard of ethical behavior. It is this comprehensive perspective that encompasses the purpose behind the rules – the principles upon which guidelines are based – that is critical to enabling the accounting and auditing profession to reclaim a reputation of credibility in the public eye.

According to McLean and Elkind (2003, p. 406) when Arthur Andersen defended itself in the Enron scandal, its arguments were narrow and ''rules based, legalistic in the hairsplitting sense of the word.'' Although some of Arthur Andersen's arguments were ''arguably true – in the way that Enron itself defined truth,'' the significance of Arthur Andersen's message was

> ''that wealth and power enjoyed by those at the top of the heap in corporate America – accountants, bankers, executives, lawyers, and members of corporate boards – demand no sense of broader responsibility. To accept these arguments is to embrace the notion that ethical behavior requires nothing more than avoiding the explicitly illegal, that refusing to see the bad things happening in front of you makes you innocent, and that telling the truth is the same thing as making sure that no one can prove you lied.... Andersen viewed its responsibility as limited to ensuring that the transactions complied with individual accounting principles. And except where Enron lied, Andersen argues, they *did* technically comply. (McLean and Elkind, 2003, pp. 406–407).

It is this elitist view of ethics – a rule-based perspective that has conveniently overlooked the intent of the principles that serve as the foundation of business obligations – that has contributed to the loss of trust in American business. Until those who play key roles in American businesses incorporate a principle-based perspective toward ethical duties, the reputation and credibility of accountants and auditors is unlikely to change.

Conclusion

Although some scholars and business leaders have argued that ethics and morality are vague and fuzzy concepts that are difficult to translate, we agree with Paine (2003, 97) who has suggested that ethics and morality are ''a highly practical invention'' because society expects business and its leaders to fit within contexts that ''endow human activity with meaning, prescribe standards of behavior, and establish expectations for how we should treat one another.'' In this paper we advocate that executives, financial leaders, and auditors adhere to an ''ethical system (that) facilitates trust among its adherents and creates the necessary foundation for a cooperative endeavor (Paine, 2003, p. 97).'' We therefore suggest that a moral and ethical approach to business is ultimately pragmatic and that society has imposed on corporate leaders a set of moral obligations that includes ''responsibilities, aims, values and commitments (Paine, 2003, p. 98).''

For accountants and auditors to honor these imposed obligations, the audit must incorporate both a rule-based assessment of the financial condition of an audited entity and a principle-based evaluation of the financial health of a firm as an ongoing business entity and as a potential investment opportunity. The fundamental duties implicit in that role combine technical acumen and professionalism essential to achieve precision, clarity in providing enough information to insure transparency regarding the audited entity's financial condition, and completeness and independence in carrying out an audit comprehensive enough to insure the integrity of the audit report. The role of the audit function is ''covenantal'' to the degree that the audit profession represents itself as a guardian of public interest (Caldwell and Clapham, 2003: 249). As quid pro quo for being certified by society as professional and competent, auditors owe society a citizen's duty (Manville and Ober, 2003) to follow principles as well as rules faithfully. That ethical perspective will demand systemic changes requiring a substantial modification in the way that the business world views its duties and obligations.

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