



*A Contemplation of the Importance of Ethics and its
Implementation in the Accounting Profession*

*Including a Special study of the Growing UAE Economy and
with it the increasing Role of Accounting Ethics within the
Country.*

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DEDICATION

To My Parents & Family.

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PREFACE

Timely and reliable accounting information is essential. Not only firms themselves but the markets they serve, and particularly the investment community, depend on it. Accounting data and their interpretation must be above suspicion and to be sure of that, corporations and other users of accounting information must be certain that accountants subscribe to and practice morality set to high standards.

In the past four to five years we have seen many scandals that diminished investor confidence and raised concerns about the erosion of corporate responsibility. Non-profit agencies violated their donors' trust. Multinational corporations collaborated with corrupt and ineffective governments and schools struggled with issues of violence, respect and bullying. We can also see the hope offered by emerging corrective measures and increasing public outcry for ethical accountability in professions, organizations and governments.

Different aspects of ethics are explored here, starting with the meaning of ethics in general and the relation of morals and values to ethical behaviour. Further, the implication of ethics in the business world is ascertained. It is also learnt how ethics forms a basic tenet of professionalism and hence extended to the accounting profession. The meaning of ethics in the profession of accountancy is further extended with a discussion of fairness and integrity.

A critical analysis of the challenges faced by accountants in incorporating ethics is then undertaken. Here, it shows a variety of ethical dilemmas faced by accounting professionals while performing their roles. How creative accounting (as called in the UK) or manipulative accounting (as called in the US) or fraudulent reporting in general are unethical and against public interest?

While there has been a lot of work and study in the recent years in the West, relating to increasing the awareness of ethical issues in the accounting profession and businesses as well, there has been no comprehensive or detailed study in this respect of in the countries of the Middle East. If we consider international accounting literature or even accounting studies in general, very little is known about accounting practices and accounting regulations in the Middle East, specially the United Arab Emirates. As the UAE economy flourishes and as it welcomes multi-national companies, it becomes necessary to adopt International Accounting Standards. As the small to medium family based businesses transform into bigger public limited companies, there emerges a need for businesses to be accountable and to cater to public interest. There, then arises the need for ethical behaviour, especially in the Accounting Profession, this study attempts to fill this gap.

With so much said about the need for incorporating ethics in the accounting profession, it is needless to say that there have been efforts undertaken by various standard setting boards by governments and also participation by private accounting institutions all over the world, specially the US. Then the study continues with the analysis of the efforts of these institutions and the role that ethical codes play.

Even UAE is stepping up the efforts in this regard. The Ethics Resource Centre (ERC)¹ has set up its base in Abu Dhabi the capital of UAE in 1998 and recently a year ago the Dubai Ethics Resource Centre was set up to propagate formal ethics programs in business organizations within the country. They undertake programs to further personal responsibility and ethical leadership in young college students too.

1 The ERC seeks to: inspire individuals to act ethically towards one another; inspire institutions to act ethically, recognizing their role as transmitters of values; and inspire individuals and institutions to join together in fostering ethical communities. The ERC has been active in the debate regarding the role of corporate officers and directors in the wake of recent scandals. Among the ERC's clients have been the World Bank, International Finance Corporation, Lockheed Martin, BellSouth, Merck Pharmaceuticals, United Way of America, the Department of Defense, and the International Brotherhood of Teamsters. For further information regarding the ERC, see <http://www.ethics.org>.

There remains much to be done -- and a substantial part cannot be achieved solely through government-imposed regulations. Also it is important to note that although professional code of ethics can be developed, ethics cannot be regulated. Hence the emphasis on the need for teaching accounting ethics, not only in colleges and universities but also through continued training in business organizations too.

CHAPTER ONE

INTRODUCTION

Learning from Past Experiences

While addressing the issue of frauds by companies using manipulations in accounting procedures in the recent past, the first case that dawns our minds is that of Enron which occurred in 2002. Given below is a brief account of this case.

On October 16, 2001, Enron Corp. announced that it was reducing its after-tax net income by \$544 million and its stockholders' equity by \$1.2 billion. Enron announced on November 8, 2001 that it was restating its previously reported net income for the years 1997-2000, because of accounting errors. The result of this restatement was a reduction in stockholders' equity of \$508 million. Within a month equity was lower by \$1.7 billion (18 percent of the \$9.6 billion previously reported on September 30, 2001).

On December 2, 2002, Enron, one of the largest companies in the US filed the largest bankruptcy in US history, under Chapter 11 of the United States Bankruptcy Code. Enron used accounting practices to hide company debt. They allowed senior officers to cash out stock options while employees accounts were frozen. They assured employees of financial stability yet declared bankruptcy shortly after. The company had used thousands of off-the-book partnerships to hide nearly \$1 billion in debt and to inflate profits. They decided to waive a code of ethics because of the potential interference with *making a buck*.

As catastrophic as this event may have been, it proved to be only the beginning of a series of stunning revelations of accounting irregularities by major corporations that were the darlings of Wall Street: WorldCom, AOL, Metromedia Fiber Networks, Qwest Communications; the list goes on and on.²

Even today we hear many stories where there are frauds committed by accountants, one such recent incident is that of the Kodak Accountant charged with fraud as reported in The New York Times, Knowledge Network dated 7th May, 2005.³ A corporate tax accountant at the Eastman Kodak Company has been accused in federal court of channeling more than \$4 million in kickbacks into a personal business over the last six years. The accountant, Mark Camarata, 42, who oversaw the company's state and local tax assessments, was charged with mail fraud and money laundering. Since 1999, Mr. Camarata authorized inflated payments to three companies he had hired to help reduce Kodak's tax payments, and in return, he received more than \$4 million in kickbacks, which he diverted into his own shell business, an assistant United States attorney, Richard Resnick, said that Mr. Camarata is the only person who has been charged, but the investigation is still under way.

Can these calamities be a manifestation of the greed spreading in the business community? This was mentioned in the statement given by the Federal Reserve Chairman, Alan Greenspan's as:

“the infectious greed [that] seemed to grip much of our business community,”⁴

2 See Appendix I for a list of accounting scandals in 2002. Accounting The Corporate Scandal Sheet, Penelope Patsuris, 08.26.02. Available at <http://www.forbes.com/2002/07/25/accountingtracker.html>, last visited 4th June 2005.

3 See Appendix II. 'Kodak Accountant Charged With Fraud' by The Associated Press, 7th May, 2005. <http://college4.nytimes.com/quests/articles/2005/05/07/1245165.xml>, Last visited 25th May 2005.

4 'Federal Reserve Board's Semiannual Monetary Policy Report to the Congress Before the U.S. S. Comm. on Banking, Housing., and Urban Affairs', 107th Cong. (2002) (statement of Alan Greenspan, Chairman, Federal Reserve), available at <http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm>, last visited 10th May, 2005.

which, on July 16, 2002, Greenspan impugned as responsible for the stock market's woes?

Is it the **foolishness** of investors, coupled with the bursting of the **stock market's bubble** or the **depleted morality** of the Chief Executive Officers (CEOs)?

Is it the tendency to "cook" the books? Perhaps the collapse could be ascribed to the failure of the "gatekeepers": the auditing profession. **Why did the watchdogs misbehave?** Is it because of moral turpitude? And are the bright line financial reporting standards perchance the other culprits, encouraging designs to circumvent them and making it easier for auditors to acquiesce in some accounting and disclosure playfulness?

Sifting through all these causes can be a nightmare to anyone. It may be tempting to suggest that all have contributed to the situation in varying degrees, but such a sweeping conclusion offers no constructive policy remedies. Effective crisis resolution requires sharp distinctions. It is indisputable that a depleted reservoir of ethics contributed to disaster. But little can be done in the short run to fill the ethics reservoir. Not all remedies are equally effective. For example, although we all may be enraged that certain individuals and companies violated our trust, prosecution and ultimate punishment may not adequately deter wrongdoing: intentional misrepresentation is difficult to discover or prove. Overhauling the regulatory structure and adding layers of supervision and monitoring by the government would be at best inefficient and socially wasteful. After all, in the US, the Securities and Exchange Commission (SEC) already had vast authority to monitor and punish.⁵ If honesty and ethical values are pursued by CEOs,

⁵ The US SEC has the authority to establish generally accepted accounting and auditing standards, to review the financial statements registered with the SEC, by most publicly traded corporations, to discipline CPAs who sign such statements (by rejecting statements they sign or by suspending or barring the CPAs from SEC practice), and to conduct investigations and recommend possible criminal inquiries to the Department of Justice.

CFOs, and the Auditors, it could lead to better quality audits, more transparent and truthful financial statements, fewer shareholders' losses.

Ethical and moral values provide a foundation to society on how to function, live and work within the society. The ethics of the business world has come a long way since the last century. Ethical standards and expectations have risen tremendously. The business world of accounting has always addressed the rights and wrongs of the industry, but only currently has been held responsible. White collar crime is on the rise and the recent events of the Enron scandal, the state of disarray of the accounting firm of Arthur Andersen and the Martha Stewart stock trades have left the consumer wondering how the business world views and enforces ethical issues. Determining the degree to which business has complied with established standards has presented a real problem.

Today, individuals in management accounting and financial management constantly face ethical dilemmas. We find that many managers and executives are unclear about their ethical standards. Practitioners of management accounting and financial management have an obligation to the public, their profession, the organization they serve, and themselves, to maintain the highest standards of ethical conduct. The purpose of ethics in business is to direct individuals to abide by a code of conduct that help increase and maintain public confidence in the products and services that organizations offer.

Ways of Accounting Manipulation

Listed below are some of the ways in which manipulations in accounting have been made:

Big bath charges: These include improper liability accruals often made under the guise of a restructuring, merger or in the name of conservatism. Some of

these charges include improper write offs of assets to avoid future charges to earnings. We have seen instances where changes to business plans, strategies and technologies were made and, instead of properly adjusting asset depreciable lives, the registrant took a large asset write-down at a later date.

Creative acquisition accounting: The high level of merger activity has left us with companies charging off almost the entire purchase price of a business, calling it "in process research and development." Some of these companies, however, previously reported very little or no research and development expenditures. Some of the merger transactions also have resulted in large liabilities being added to the companies' balance sheets with equal amounts of goodwill being created. Some of these accounting entries clearly appear to lack business or economic sense.

Cookie jar reserves: Simply put, these are reserves set aside in good times or under the guise of a large one time charge. Later on they are often bled back into earnings when needed.

Revenue recognition (principle of GAAP): The number of reported instances of companies improperly booking revenues has become an embarrassment to all of the accounting profession. A substantial majority of accounting-related enforcement cases involve revenue recognition. It seems as if all too often we are seeing instances of revenue recognized improperly when:

- Delivery of the product to the end user's site has not occurred.
- Agreements have not yet been accepted and executed by the customer.
- The seller has to complete remaining obligations, such as installation or training.
- The customer unilaterally can terminate or cancel the agreement.
- "Just in time" arrangements exist, with FOB delivery terms, and revenue is recognized prior to arrival at the delivery destination.
- Upfront fees are recognized immediately upon receipt notwithstanding an agreement to provide services, discounts or products during an ensuing membership period.

Exemplification of Ethics in Accounting

Since 2002, countless articles appeared in newspapers, scholarly and trade journals that address ethical issues with accounting. Various discourses of ethics within accounting have also been taking place, which have increased the awareness and visibility of the issue of 'ethics in accounting' not only within practitioner, academic and student circles but also amongst the public at large. Some of these activities include:

- the funding of "centres of ethics" and the sponsorship of ethics conferences by public accounting firms,
- the formation of academic journals dealing with accounting ethics,
- the production of training videos dealing with ethical behaviour and
- the increased discussion of professional ethics in practitioner journals such as CA Magazine and Journal of Accountancy.

The 'ideological effect' of these discourses, however, has been to encourage one of the following two beliefs. The first is the belief that current institutional actions simply demonstrate that 'professional' ethics have always been, and continue to be, a cornerstone of the accounting profession. The second is the belief that 'professional' ethics and ethical codes have evolved and progressed and hence, ethical behaviour has improved as a consequence of these changes introduced in response to previously identified shortcomings.

Morality in Accounting

The accounting profession is involved in the production and/or the verification of accounting information, deemed vital to users' decision making and to an efficient working of capital markets and national economies. The complete reliance on the resulting accounting information derives from the belief held by the general public about the high moral standards used by accountants in the

accomplishment of their duties. Therefore morality in accounting is the crucial factor that helps accounting professionals maintain their high and prestigious occupations and their **perceived high level of integrity**. A good appreciation of the morality issues in accounting is instrumental to a better use and reliance on accountants and accounting data.

Accounting firms have come to see auditing not as a governmental mandate and matter of public trust, but rather as an opportunity to garner consulting and other business fees from the very management from whom they purport to be independent. Auditing has become a loss leader, sometimes far less, of the big accounting firms' fees from a large company, thus making them increasingly likely to bless sham transactions and whatever else it takes to let shareholders accept their performance.

Accountants along with the corporations should avoid actual or apparent conflicts of interest and advise all appropriate parties of any potential conflict. They should refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically.

Accountants, especially auditors must refuse any gift, favor, or hospitality that would influence or would appear to influence their actions. They should recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

They must be able to communicate unfavorable as well as favorable information and professional judgments or opinions. They should refrain from engaging in or supporting any activity that would discredit the profession.

Those working within the career of accounting should acknowledge the moral distinctions of right and wrong when keeping books, conducting audits, and managing accounts of any size firm. Accountants are to be dependable and trustworthy to the stockholders and consumers as well. If any of these trusts are broken, then not only has the firm suffered, but nations as well.

Considerations for Incorporating Ethics

People are not born with innate desires to be ethical or to be concerned with the welfare of others. At some point in life, ethics must be taught. A formal ethics program is probably the most promising way to go about that. Infact, it is quite essential that ethics training begins at the college and university level. It equips students with reasoning skills and enables them to make sound decisions. Ethics training should be an incessant one, it should continue at the organization level too.

An unethical culture permeates society and that culture spreads to financial reporting. The Accounting profession will continue to accept unethical behavior because many in society do not agree that it is unethical. Hence there is a need for business ethics to be an 'integral part of society'.

If a company has an ethic code simply because senior executives believe that it is great public relations, chances are the words are not worth the paper they are printed on. It is as essential to maintain a good ethical program within organizations. This can be done by recruiting and retaining top-quality people and fostering a more satisfying and productive work environment for employees. Organizations can also do this by building and sustaining a company's reputation within the communities in which it operates as it will help the company develop a good moral among the employees. Management should maintain the trust of employees to ensure continued self-regulation. Companies need to legitimize an open dialogue concerning ethical issues and providing ethical guidance and resources for employees before making difficult decisions. To have an effective ethics program, naturally an organization must spell out what its values are within the entire organization. Many companies mistake their mission statements for value statements; they must spell out what the mission and vision is.

Today, in the business world; there is a need to find concrete ethical systems to enforce. A need to investigate our sense of right and wrong in the business world. Society has placed laws upon us to make sure we abide by the right standards. Accounting is an ethically precarious profession, and to be an effective accountant and especially an auditor, one must understand something of our human nature. Therefore, the profession must equip its members with a strong sense of ethical awareness. This is accomplished through education and regulations in ethics. This may be found as an effective way to ensure that our businesses and our accountants are doing their jobs ethically.

Accountants occupy a wide variety of executive and non-executive roles in industry, commerce and the public sector. Accountancy is a discipline that involves not just the mechanical application of accounting expertise, but it increasingly involves making complex judgements, both quantitative and qualitative, that demands the highest standards of integrity and objectivity. Ethical considerations are therefore of utmost importance to all accountants.

As debates proliferate in regards to ethics and accounting, it is essential to define ethics within the accounting profession. This study attempts to draw a conclusion on the role of ethics and its implementation into the profession and the need to provide ethical education to accounting students and continuous ethical education in business organizations also.

CHAPTER TWO

THE MEANING OF ETHICS IN BUSINESS AND THE ACCOUNTING PROFESSION

What is Ethics?

Ethics is derived from the Greek word "ethos" meaning "way of life," It is a branch of philosophy that studies and recommends the fundamental principles and basic concepts of what is considered morally good and bad, right and wrong in human conduct. Some would also include in ethics how we ought to interact with nature and animals. Different areas of ethics such as business, law, or medicine are simply ethics associated with these specific kinds of activities.

Merriam-Webster's Dictionary defines ethics as:

"...the principles of conduct governing an individual or a profession: the discipline dealing with what is good or bad or right and wrong, or with moral duty and obligation; a particular theory or system of moral values....."⁶

There are many definitions as to what ethics encompasses:

- The discipline dealing with what is good and bad and with moral duty and obligation.

⁶ See Appendix III - Definition of 'ethics' as in the Merriam-Webster Dictionary. Available at: <http://www.m-w.com/cgi-bin/dictionary?book=Dictionary&va=ethics>, last visited 20th May, 2005.

- Decisions, choices, and actions we make that reflect and enact our values.
- A set of moral principles or values.
- A theory or system of moral values; and/or a guiding philosophy.

Values, Morals & Ethics

Values are our fundamental beliefs. They are the principles we use to define that which is right, good and just. Values provide guidance in determining the right versus the wrong, the good versus the bad. They are our standards. Another way to characterize values is that they are what an individual believes to be of worth and importance to their life (valuable). Values do not encompass all beliefs, just the beliefs that define importance and worth. According to Frank Navran, ERC's Principal Consultant, values can be categorized into three areas: Moral (fairness, truth, justice, love, happiness), Pragmatic (efficiency, thrift, health, variety, patience) and Aesthetic (attractive, soft, cold, square).⁷

Morals are the values that we attribute to a system of beliefs that help the individual define right versus wrong, good versus bad. These typically get their authority from something outside the individual -- a higher being or higher authority (e.g. government, society). Moral concepts, judgments and practices may vary from one society to another. Morals also change over time within a given society as that society changes.

Ethics is the study of what we understand to be good and right behavior and how people make those judgments. When one acts in ways that are consistent with our moral values we will characterize that as acting ethically. When one's actions are not congruent with our moral values - our sense of

⁷ Ethics Resource Centre, 'Ask The Expert' by Frank Navran, ERC's Principal Consultant, while giving his answer to the question: "What is the difference between ethics, morals and values?" available at: http://www.ethics.org/ask_e4.html, last visited 18th May, 2005.

right, good and just - we will view that as acting unethically. Defining what is ethical is not an individual exercise however. If it were then one could have argued that what Hitler did was ethical since his actions conformed to his definition of right, fair and good. The ethics of our decisions and actions is defined societally, not individually. Ethics is not a discipline bound up in history, but is a living, organic study of humanity and its evolving sense of rightness, goodness and justice.

Ethical values provide the foundation on which a civilized society exists. Without the foundation, civilization collapses. On a personal level, everyone must answer the following question: What is my highest aspiration? The answer might be wealth, fame, knowledge, popularity, or integrity. But if integrity is secondary to any of the alternatives, it will be sacrificed in situations in which a choice must be made. Such situations will inevitably occur in every person's life.

Many ethicists say there's always a right thing to do based on moral principle, and others believe the right thing to do depends on the situation, ultimately it's up to the individual on what they do and on what they believe to be the right thing is. Sometimes the right thing is not necessarily the best thing to do. Many philosophers consider ethics to be the science of conduct. Missing in most discussions of ethics is the fact that, by definition, ethics is the part of philosophy that deals with the practical application of those actions over which we have control.

While ethical decisions may appear to be strictly subjective, they are made in the context of personal as well as professional lives. Individual ethical conduct must be carried out in conjunction with other individuals as well as within the context of the organization. The individual dealing with a personal ethical response to a given situation does so within an organizational structure which itself has defined certain responses as ethical or unethical. When significant differences exist between the ethical beliefs of the individual and that of the organization, conflicts arise. The same is true when differences exist between the company and the societal context in which the company operates.

Ethics in Business

Business ethics is exactly the same as normal ethics, and that is, knowing what is right or wrong, and learning what is right and what is wrong in a business environment. Then doing the right thing, but the right thing is not as straightforward as explained in many business ethics books. Most ethical dilemmas in the workplace are not simply a matter of should she steal from him or should he lie to his boss?

Businesses cannot function without ethics. Society dictates a set of rules and conformities and as all businesses strive after common goals it means that these goals can only be achieved on the basis of standards, values and morals in society. As in society, standards and values are spontaneously formed once people come together and start 'behaving', likewise, business life becomes exactly the same and that's when morals come into effect, and when businesses decide on implicit or explicit ways to achieve certain goals. This behaviour is passed down and filtered to a group of stakeholders who have an interest in the company. These parties usually are: personnel, customers, suppliers, subcontractors, shareholders, society and those who speak on behalf of the environment and future generations. Hence we can say that businesses in general are working on the basis of an ethics.

Businesses have power through their ability to spend vast amounts of money. They have the ability to enhance or change situations that the common individual does not. As organizations affect many people, they have obligations to their employees, consumers, community and the world. They have a responsibility to conduct business in a way that is not harmful and which positively benefits as many people as possible and themselves. Although this sounds simple, it is easier said than done as there will always be a conflict of interest between various groups of people. Any decisions made by businesses need to be made with an informed awareness of the specific situation and then act according to some sort of system of principals.

A 1987 popular movie portrayed the unscrupulous dealings of people involved in securities trading based on nonpublic (inside) information. A key character, portrayed by actor Michael Douglas, in a dramatic scene says, "Greed is good!" The implication is that greed is an acceptable motivation and that business people will do anything to make money, including engage in unethical behavior.

The American Heritage Dictionary of the English Language, defines greed as:

“an excessive desire to acquire or possess more than what one **needs** or **deserves**, especially with respect to material wealth.”⁸

In reality, greed is unacceptable, and unethical behavior will destroy a firm's ability to make money. Although the goal of any firm should be to increase its owners' wealth, to do so requires the public's trust. In the long run, that trust depends on ethical business practices.

Creating an ethical business culture should not be viewed as a sacrifice. Ethical analysis must be institutionalized as an integral input into all phases of the decision making process. Indeed, it is good business to be open and honest with your shareholders. It is good business to have fair dealings with your business partners. It is good business to reward employees for being honest and ethical. It is good business to be known as a company that deals fairly in its business transactions. It is good business for shareholders to know that a company not only has a code of ethics but that the code is followed every day. It is also good business to select CEOs and Presidents largely based on their integrity and commitment to ethical behavior. Hence, the need to foster and sustain high levels of ethical behaviour within organizations.

⁸ AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2002), available at <http://education.yahoo.com/reference/dictionary/index.html>.

Ethics and Professionalism

Defining a professional, Webster's Online Dictionary characterizes that person as one

"...conforming to the technical or **ethical** standards of a profession or an occupation."⁹

Professionals are expected to maintain 'high standards of achievement and conduct.' Therefore, ethics is very much an appropriate philosophical mode of analysis and is integral to the definition of a profession. Many professionals in ethics say that new ethical beliefs are state of the art legal matters, and that what becomes an ethical issue of today is then later made into a law.

Why, compared to other occupations, have professionals been able to differentiate themselves in terms of wealth, status and autonomy over their domain of labour. One suggestion is that professions are those occupations that have successfully negotiated a 'corporatist bargain' with the state whereby the state grants the occupational group both a jurisdictional monopoly and regulatory authority for this jurisdiction. In return for these quasi-state powers, the profession agrees to 'regulate' the behaviour of its members. One of the targets for regulation is the skill level of members since a corporatist agreement is, in part, based on the presumption that occupational group members possess knowledge that is cognitively exclusive and not easily mastered by lay people. It is also presumed that this knowledge is socially useful - a form of moral knowledge that is of benefit to the community. This concern for the public good places the professional in a quasi-judicial capacity and justifies a profession's claims to professionalism. Professionals set higher moral standards for themselves than do non-professionals and are consequently 'morally superior' and hence deserving of higher status.

⁹ See Appendix IV - Definition of a 'professional' as in the Merriam-Webster Dictionary. Available at <http://www.m-w.com/cgi-bin/dictionary?book=Dictionary&va=professional&x=23&y=10>, last visited 20th May, 2005.

Professionals rely upon their own expertise and judgment rather than opinions, biases, or emotions of other persons. Independence, as an ethical concept, is prominent in the accounting profession. Indeed, all professionals should be independent in that they should not subordinate their judgment to make a client happy.

The professional should give no utilitarian weight to the happiness of the client. Some professionals, including accounting professionals, may succumb to this temptation. Let us consider the medical profession as an example of how utilitarian weight may be given to the well-being of the client as opposed to the happiness of the client. Suppose a patient comes to his doctor complaining of pain and requests a strong prescription painkiller by name. In the doctor's judgment the pain is illusory. Moreover, he knows that the painkiller requested by the patient is potentially addictive. In his judgment the risks of prescribing such a medication far outweigh any benefits to the patient. He therefore ought to refuse to grant the request even if he knows that this will displease the patient and that he may choose another doctor. The sort of independence illustrated by this case means independence from the expressed will of the client. Because a key tenet of the whole notion of professionalism is that the professional has greater experience, ability, or familiarity with a certain area than a client, the professional should not subordinate professional judgment to client desire as a matter of ethical principle.

The designation "professional" is highly desired in our society and has been for centuries. What is it about being professional that makes it so desirable? One pervasive aspect is the notion of community. Advocates of any profession attempt to set the professional apart from wider society. This is accomplished first through technical knowledge, then through an informal dynamics and language game that springs forth in the formative stages of professional development.

Professions are thus exclusive in nature. This exclusiveness makes the professional designation more valuable to its members. This value comes

from both the obvious economic rewards available to successful professionals and from certain privileges granted by society to professions.

Professions rigidly guard entry. One who seeks admittance must demonstrate understanding of and acceptance of the profession's language game. The knowledge possessed by each profession is a source of power for that profession. Through their publications, meetings, examination syllabi, and other activities, various professional associations have historically played a role in defining and furthering the technical aspects of the profession, deciding who is competent to practice in that profession and elaborating the discourse carried on by that particular profession.

Ethics in the Accounting Profession

Ethics is particularly pertinent as a foundation of the accounting profession. Indeed, the importance of ethical conduct to accountants cannot be overstated. It has always been recognized that accounting is a special profession as far as public interest is concerned. Nowhere has this point been made as sharply as by former Chief Justice Warren Burger, of the US Supreme Court, while addressing the case against Arthur & Young Company in 1984:

“By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This “public watchdog” function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.”¹⁰

¹⁰ See Appendix V for a details of the case - United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984). Available at <http://news.findlaw.com>.

In the realm of accounting, any consideration of the client's interests must be subordinated to a greater duty - the duty owed to third parties and to the public. Books and records must be prepared carefully and honestly. Transactions must be recorded in accordance with corporate policies and procedures. This makes the business information accurate and reliable, which is of critical importance to the decision making process and the proper discharge of financial, legal and reporting obligations by organizations.

To follow an ethics based approach, the following are essential:

- The concern with the moral judgments involved in making moral decisions about what is morally wrong and right or morally good and bad.
- To override the self-interest.
- Based on impartial considerations

Ethical behavior plays a far more critical role in the attestation of auditors to financial statements. Ethical behavior is a necessary condition for investors to benefit from the auditors' product—the credibility of the auditors' attestation to financial statements. Society can consume the output of goods provided by businesses (such as automobiles, tobacco, perfumes, etc.) managed by unethical individuals, although this may not be true to the same extent in the case of 'modern economy' businesses that supply knowledge products. Yet society cannot rely on the financial reports of these businesses if it perceives a possibility of misrepresentation. Thus, society would not be able to use auditors' attestation services without perceiving the auditors to be ethical. Hence, in addition to the skill and competence required to detect misrepresentations or omissions in financial statements, for auditors it is of equal or even greater importance to possess the ethical trait of rendering an honest opinion.

As professionals, accountants / auditors perform an essential role in society. Consistent with that role, they have responsibilities to all those who use their professional services. They have a continuing responsibility exercise sensitive professional and moral judgements in all their activities and to cooperate with

each other to improve the art of accounting, maintain the public's confidence, and carry out the profession's special responsibilities for self-governance. They should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on their objectivity and integrity to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on accounting professionals.

Clients and investors are becoming increasingly aware of ethical issues, a situation that makes reform in the accounting industry a necessity to ensure public confidence in the integrity of the accounting profession.

CHAPTER THREE

FAIRNESS & INTEGRITY IN ACCOUNTING

Throughout its history, accounting has been a moral discourse partially reflecting the moral order of the world in which it was practiced. The injustices that have occurred with the accounting profession reflect the current state of morality in the society.

Michael Josephson, described six key terms¹¹ that specify the essence of universal ethics as:

“trustworthiness, respect, responsibility, fairness, caring and citizenship and Ten Universal Values¹² as: honesty, integrity, promise-keeping, fidelity, fairness, caring, respect for others, responsible citizenship, pursuit of excellence, and accountability.”

When societal values are deteriorating, maintaining high ethical standards in accounting and business grows increasingly difficult. People will undoubtedly ask, if everyone else is cheating, then how can an ethical person possibly succeed? Nevertheless, the real question is, how does one measure success? Some measure success by the accumulation of wealth or power. Making a lot of money may be an acceptable goal, but money most assuredly does not guarantee a truly successful life. This can be explained better by a popular story as follows:

11 See Appendix VI – ‘Ethicist Michael Josephson chats online’, Monday, 8th November 2004 at Lawrence Journal World : www.ljworld.com.

12 Josephson, Michael, in Chapter 1 of ‘Ethical Issues in the Practice of Accounting’, 1992.

"HOW DO YOU MEASURE SUCCESS?"

A popular story recounts a meeting that took place at the Edgewater Beach Hotel in Chicago in 1923. Attending this meeting were nine of the richest men in the world at that time: (1) Charles Schwab, President of the world's largest independent steel company; (2) Samuel Insull, President of the world's largest utility company; (3) Howard Hopson, President of the largest gas firm; (4) Arthur Cutten, the greatest wheat speculator; (5) Richard Whitney, President of the New York Stock Exchange; (6) Albert Fall, member of the President's Cabinet; (7) Leon Frazier, President of the Bank of International Settlements; (8) Jessie Livermore, the greatest speculator in the Stock Market; and (9) Ivar Kreuger, head of the company with the most widely distributed securities in the world.

Twenty-five years later, (1) Charles Schwab had died in bankruptcy, having lived on borrowed money for five years before his death. (2) Samuel Insull had died virtually penniless after spending some time as a fugitive from justice. (3) Howard Hopson was insane. (4) Arthur Cutten died overseas, broke. (5) Richard Whitney had spent time in Sing-Sing. (6) Albert Fall was released from prison so he could die at home. (7) Leon Fraizer, (8) Jessie Livermore, and (9) Ivar Kreuger each died by suicide. Measured by wealth and power these men achieved success, at least temporarily."¹³

Many people think of fame and fortune when they measure success. However, at some point in life, most people come to realize that inner peace and soul-deep satisfaction come not from fame and fortune, but having lived a life based on integrity and noble character. President Lincoln put it this way: "Honor is better than honors." At a Congressional Hearing on ethics in July 2002, Truett Cathy, founder of Chik-Fil-A, quoted Proverbs 22:1: "A good name is more desirable than great riches; to be esteemed is better than silver or gold." Living an honorable life really is more satisfying than fame and fortune.

13 BUSINESS AND ACCOUNTING ETHICS - Dr. Katherine T. Smith, Business Author Dr. L. Murphy Smith, CPA, Professor of Accounting, Texas A&M University, June 21, 2003, <http://acct.tamu.edu/smith/ethics/ethics.htm>, last visited 12th May, 2005.

What is Fairness?

Just defining “fairness” seems somewhat challenging at times. The problem with this definition is that it needs to be referenced with the subject matter concerned as it can take various meanings. Fairness is usually related to the concept of justice. This involves what is right and equal. Interpreting this is a problem, due to the limitations of human experience and the balance of all desired good. Fairness can be interpreted as being equal in provision, in opportunity or in result. From each point of view, the other point of view may seem unfair. In general it is said that ‘Fair’ means free from favoritism or self-interest or bias or deception; or conforming with established standards or rules or the ability to make judgments free from discrimination or dishonesty. It also means impartial, that is showing lack of favoritism. Examples could be "a fair referee"; "fair deal".

The Concept Fairness in Accounting

Fairness is best understood in the professional accounting literature and pronouncements as an expression of the neutrality of the accountant in the preparation of financial reports. Fairness judgments are taken for granted in accounting although their clear meaning is not well specified. Two generally accepted meanings concern the idea of neutrality in preparation and presentation of financial reports and the idea of justice in outcome.

The first suggestion of the use of fairness in accounting was made by D. R. Scott in 1941 when he listed it as a principle of accounting and stated:

"Accounting rules, procedures, and techniques should be fair, unbiased and impartial. They should not serve a special interest."¹⁴

Since then, the fairness concept has become an implicit ethical norm. In general, the fairness concept implies that accounting statements have not

14 Scott, D.R. ‘Fairness in Accounting’, 1941.

been subject to undue influence or bias. Fairness implies that the preparers of accounting information have acted in good faith and employed ethical business practices and sound accounting judgment in the presentation, production, and auditing of accounting results.

Judgment concerning the "fairness" of the overall presentation of the financial statements should be applied within the framework of generally accepted accounting principles (GAAP). Without this framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements. By definitions of both the American Institute of Certified Public Accountants and the US Securities Exchange Commission, financial statements that do not conform to GAAP are not presented fairly and are presumed to be misleading or inaccurate.

What is Integrity?

Integrity is a primary principle and prime virtue. It is steadfast adherence to a code of moral or ethical values, utter sincerity, honesty, and candor; incorruptibility, and the quality or state of being complete or undivided.

Integrity includes honesty. Honesty, for example, includes being candid, open, truthful, and free from deception and deceit in all actions - telling the truth, even when doing so may be difficult, and being forthcoming with all relevant facts and information in reports. The concept of 'assuring full disclosure' also may be referenced in the context of 'honesty'.

Integrity is defined as:

“the quality or state of being of sound moral principle; uprightness, honesty, sincerity.”¹⁵

15 Available at <http://www.summit.org/resource/dictionary/>

The Concept of Integrity in Accounting

According to the key definitions of the Institute of Internal Auditors in US:

“**Integrity** means the characteristic of data and information being accurate and complete and the preservation of accuracy and completeness by protecting the data and information from unauthorized, unanticipated, or unintentional modification.”¹⁶

According to Article III, ET Section 54 of the AICPA Code of Professional Conduct:

“Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.

Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

Integrity also requires a member to observe the principles of objectivity and independence and of due care.¹⁷

Whenever a client (compilation, review or especially an audit) asks a professional accountant / auditor to bend the rules, or argues that the rules should be interpreted in a way that the accountant / auditor believes is not

16 Available at http://www.theiia.org/index.cfm?doc_id=852, last visited 12th May, 2005.

17 Article III, ET Section 54 of the AICPA Code of Profession Conduct, available at: http://www.aicpa.org/about/code/et_54.html.

consistent with the spirit of the rule, that client is asking the accountant / auditor to forgo his or her integrity. The financial reports produced by accountants would be of little value to the public unless the accountants maintain their independence. Independence has always been associated with integrity and objectivity. Since faults on financial statements may be the result of either a honest mistake or a lack of integrity it is imperative to associate the notion of independence with the objectivity and integrity.

In discharging their professional responsibilities, accountants/auditors may encounter conflicting pressures. They must use professional judgment to make sure the treatment of the item in question is not misleading. As professionals, they have an obligation to maintain high standards of technical competence, fair dealing and integrity. In resolving those conflicts, they should act with integrity, guided by the precept that when they fulfill their responsibility to the public, clients' and employers' interests are best served.

Reasons for Bias in Accounting

Judgment is determined by several factors, including:

- Knowledge of proper ethics.
- Defining materiality as to what could be misleading in a set of financial statement.
- Setting aside client expectations

According to Bazerman, M. H., G. Loewenstein and D. A. Moore,¹⁸ there are three structural aspects of accounting that create substantial opportunities for bias to affect judgment and three behavioral aspects that amplify the unconscious bias.

18 Bazerman, M. H., G. Loewenstein and D. A. Moore. 2002. Why good accountants do bad audits. Harvard Business Review (November): 97-102.

The structural aspects include:

Ambiguity - When the possibility to interpret information in different ways exists, people tend to reach self-serving conclusions. Accounting is full of ambiguity. In one survey 67% of audit partners reported that they negotiated with 50% or more of their clients on how to account for various items.

Attachment - Companies fire accounting firms that deliver unfavorable audits. Audits are frequently used to build relationships that lead to consulting services. Attachment breeds bias.

Approval - The bias to approve of a clients accounting methods. Self-serving biases increase when people are endorsing other biased judgments that equate with their own biases.

The behavioral aspects include:

Familiarity - People are much less willing to harm individuals that they know, particularly paying clients.

Discounting - Immediate consequences tend to receive more emphasis than delayed outcomes, particularly when the delayed outcomes are uncertain. Critical audit reports produce immediate adverse consequences, but the cost of an unjustified positive report is distant and uncertain.

Escalation - Minor indiscretions and errors created by unconscious bias may evolve into conscious corruption.

Just as good deeds in life create unforeseen blessings, I believe it is fundamental that honesty, integrity and fair dealings will ultimately create business success.

The Benefits of Ethical Behaviour

Good ethics does not always translate into good business, but over time, people do understand how the organization does business. With a good ethics program in the organization, it would enable them to distinguish between the ethical and the merely legal. Asking whether something is legal is only the first

step in determining whether it is ethical. In fact, making an activity illegal may often be society's way of ratifying its much earlier decision about what is unethical.

A 1987 survey of corporate executives administered by Touche Ross revealed that two thirds believed that high ethical standards improve a firm's competitive position but felt that 'increased concentration on short-term earnings' and 'decay in cultural and social institutions' are major threats to business ethics.¹⁹

Employees of companies with strong ethics programs are much more likely to think highly of their company's ethical performance. Companies who train their employees concerning ethical issues that may surround the business will be most likely to report any misconduct within the company to the proper authorities. Building and sustaining a company's reputation within the communities in which it operates maintains the trust of employees to ensure continued self-regulation, providing ethical guidance and resources for employees prior to making difficult decisions and aligning the work efforts of staff with their company's mission and vision.

There may be internal costs to a company failing to deal with the impact that unethical behavior may have on employees. When employees are faced with significant conflicts arising from differences between personal and corporate ethical value systems, they may be faced with a choice of living with this conflict or choosing to work elsewhere. Both of these choices can result in real costs to the employer. When the employee chooses to stay with the company, these conflicts may have adverse effects on productivity through reduced quality of work performance, absenteeism, strained relationships, and low morale. Those who choose to resign also represent a cost since they could be most likely to be individuals whose work performance may be superior.

19 "Ethics Pay," Wall Street Journal, Sept. 29, 1987, p. 1.

A written code of corporate conduct strengthens the corporate ethical climate by signaling to all employees, the standards for conducting the company's affairs. Well-defined ethical standards and guidelines for acceptable behavior promote ethical decision-making at all levels of the organization and help resolve ethical dilemmas that arise. Advantages are that such codes foster a strong ethical climate, helping to create a work environment that appeals to company personnel at all levels. With an effective code, a company's employees may be more highly motivated, and the company may be able to attract and retain better employees. In an era when loyalty between organizations and their customers seems less enduring, a company's concern for a strong ethical climate also may generate a positive image outside the organization, which can lead to increased business opportunities.

Finally from an economic standpoint, unethical behavior could be defined as purely self-interested behavior that inflicts harm on others. It characterizes a self-interested individual who prefers a course of action associated with some benefit while the damage caused to others is large²⁰ Within a business, the objective of stockholders is to maximize value. Accounting can be viewed as part of the necessary self-controls instituted by representatives of stockholders (boards of directors, BODs)—assuming BODs' interests are aligned with shareholders' interests—to bound the feasible actions that managers and employees can take. The cost-benefit trade-off involves balancing the increased cost of more elaborate accounting and internal controls against the benefits of more efficiently directed self-interested behavior.

20 See Kenneth Koford & Mark Penno, *Accounting, Principal-Agent Theory, and Self-Interested Behavior*, in *ETHICS AND AGENCY THEORY* 127 (Norman E. Bowie et al. eds., 1992). This is the definition of unethical behavior generally articulated or implied in the economic literature.

CHAPTER FOUR

CHALLENGES FACED BY ACCOUNTANTS IN INCORPORATING ETHICAL VALUES

"Does your Accountant owe his Loyalty to You or to the Law?"

This question was posed in *Newsweek* during the summer of 1989 in response to an emerging court case in St. Louis, USA, that involved an accountant's relationship to his client, a pizzeria owner. From 1982 to 1985 the accountant performed auditing and other tasks for the pizzeria owner and received more than \$50,000 for his services. At the same time, the accountant was secretly giving details of his client's financial life to IRS (International Reporting Standard) special agents. The pizzeria owner was eventually indicted on charges of tax evasion.

The pizzeria owner filed a case against his accountant and his attorney argued that accountants should respect client privacy and sued him in federal court. The attorney argued that "a client has a right to feel he's getting undivided loyalty and confidentiality from his accountant." Many believe that codes of professional conduct in accounting²¹ sustain the attorney's contention.

21 A code of professional conduct is a voluntary assumption of self discipline above and beyond the requirements of the law. It serves the highly practical purpose to notify the public that the profession will protect the public interest. The code mainly includes independence, integrity and objectivity in the practice of public accounting, competence and technical standards, responsibilities to clients, responsibilities to colleagues and other responsibilities and practices. One of the cornerstones of the profession of public accountancy is the high ethical standards of its members. High standards are essential in achieving public trust and confidence and this trust can be maintained only if the public is confident that the profession can regulate itself and discipline those members who violate

The prosecutor in St. Louis disagreed and stated that "the accountant has a moral and legal obligation to turn over information."

Conflicts of value, disagreements about codes and regulations, and dilemmas of loyalty are encountered every day by professionals. Among other duties, accountants are pledged to truth telling and have clear responsibilities to exercise *good judgment* and *honesty* in their professional work. But what happens when professional duties come into conflict with moral principles? And how, indeed, are accountants to sort out such problems, no less resolve them?

Ethics, in its broader sense, deals with human conduct in relation to what is morally good and bad, right and wrong. To determine whether a decision is good or bad, the decision-maker must compare his/her options with some *standard of perfection*. This standard of perfection is not a statement of static position but requires the decision-maker to assess the situation and the values of the parties affected by the decision. The decision-maker must then estimate the outcome of the decision and be responsible for its results. Two good questions to ask when faced with an ethical dilemma are, "*Will my actions be fair and just to all parties affected?*" and "*Would I be pleased to have my closest friends learn of my actions?*"

Accountants - Their Roles & Responsibilities

Accountants find themselves performing tasks daily in an environment governed by a complex set of rules, principles, and practices. In performing their tasks they are asked to take a certain role. The concept of a role is that the actions and activities assigned to or *required* or *expected* of a person or group. It can also be stated as normal or customary activity of a person in a

or ignore these standards. A Code guides its members in the performance of their professional responsibilities and expresses the basic tenets of ethical and professional conduct. It calls for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

particular social setting, for example "the function of a teacher"; "the government must do its part"; "play its role" It describes the repeatable patterns of social relations which, are not mere physical facts and which are structured partly by the rules of acceptable behavior in the society in question.

In performing their roles, accountants not only face formal or legal rules of behavior but also moral elements created by specific situations. By accepting certain roles, accountants accept at the same time the resulting obligations and *moral responsibilities of roles*.

Let us consider the following situation where you are asked to participate in a consulting assignment for the ACME Cigarette Company, which is about to expand its foreign production. You are vehemently anti-smoking, believing it to be a major health hazard. You are especially concerned about the exporting of cigarettes and the advertising being done in Third World countries. Should you ask to be removed from the team undertaking this job? Should you raise this "social responsibility" issue higher up in the firm?

Psychologically people interpret information in ways that benefit their self interest even when they are trying to be objective and impartial. People tend to discount the facts that contradict the conclusions they *want* and embrace the facts that support their *own viewpoints*.

George W. Bush even proclaimed that "The era of low standards and false profits is over." But some authors²² say it's not that easy. A more destructive problem is *unconscious self-serving bias* that can cause even honest meticulous accounting professionals to unintentionally distort audits.

By its very nature as a community, the accounting profession contains dynamic and living relationships. In turn, these human relationships inevitably

22 Bazerman, M. H., G. Loewenstein and D. A. Moore. 2002. 'Why good accountants do bad audits?', Harvard Business Review (November): 97-102.

lead to ethical conflicts and to ethical dilemmas. Human relationships are complex; so too are the ethical conflicts and dilemmas that arise from these relationships. No simple solution can be proposed for any class of ethical conflict. Each must be judged and analyzed on its own merits.

However, there are no absolute rules of conduct for accounting professionals that will answer all dilemmas. But identifying moral conflicts, thinking them through, discussing them with colleagues and others, and utilizing the tools of ethical analysis are useful, in fact indispensable ways of tackling ethical issues.

Ethical Lines may Blur

We all recognize the difference between right and wrong, even in today's complex society. Or do we? Consider the following questionable situations, for example, and decide what course of action would be appropriate to you in your role as Chief Accountant (CA) and business advisor.

1. Sharon runs the family's retail clothing store chain, which she owns with her five cousins. Several of the stores need to be renovated, and Sharon awards a contract for the work to her husband James, a carpenter, without requesting any outside or competitive bids.
James subcontracts the work to another construction company for half the contract price, oversees this company's work, and retains the remainder of the money as a construction management fee. As the company CA, what is your responsibility to the cousins who are not aware of the costs or the circumstances of the renovations?
2. When Bentley started working in the family's hotel business, he enjoyed attending "Classic Car" shows with his father, who was something of an amateur collector. Bentley bought his first "Bentley" ten years ago with funds from an annual bonus. Since his father's death, however, Bentley

has used company funds to purchase five more cars of this make, and now has one of the finest collections in the country.

Bentley keeps the cars in a temperature-controlled garage at the company's offices, and one of the employees, who is a skilled mechanic, maintains them as part of his job. The problem is that Bentley's brother, Royce (an equal shareholder in the hotel company with Bentley), has just found out that the cars were purchased with company funds and are maintained as a corporate expense, and is extremely annoyed about it. How can you help the brothers come to a reasonable agreement as to what is a legitimate business expense and what is not?

Are these people knowingly crossing the line, or are they just confused about business ethics? Sometimes, there are additional facts, not readily apparent, to explain particular actions. Many a time personal self-interest overshadows an ethical action. It is when expectations are fuzzy, communication is poor, and accountability and oversight are unclear that ethical decisions become perplexing.

More Examples of Ethical Dilemmas

- An example of ethical ambiguities in the decision making area occurs when companies are investigating whether to outsource any part of the production process. In addition to the obligations to stockholders, does the company have any responsibilities to the workers, suppliers, and the community in which they are currently located? Moreover, assume a company's production costs would be lower in other countries than its own because the pollution control laws could be less stringent and therefore cheaper to comply with. Should the lower costs justify the possible increased health and safety risks that could occur in the company's new location? To resolve this issue, the accountant could follow the guidelines of Sir Adrian Cadbury who argues that for an action to be considered

ethical, it must be open to public scrutiny and that the manager would not be embarrassed if the action were made public.²³

- Accountants are involved in the preparation and presentation of budgets. One ethical issue facing accountants revolves around pressures from individual departments or divisions to use the budgeting process to maximize their share of allocated corporate resources. If the accountant develops an unrealistic budget, this could result in needless investment in unnecessary equipment or the production of excess inventory. Using stakeholder analysis (which analyzes the decision in terms of all affected parties both internal and external to the company) the accountant could evaluate this effect in terms of possible future layoffs, lost opportunity cost of a more effective use of corporate resources in other segments of the business, and possible loss of wealth to the stockholders when actual earnings don't meet expectations.
- Another activity we explore is the role of accountants in helping control and motivate employees' performance. One major accounting technique used to evaluate and subsequently reward performance is the ubiquitous Return on Investment (ROI). To artificially boost ROI a manager could defer discretionary expenditures such as R&D, maintenance, advertising, and employee development. In addition, the manager could raise ROI by keeping the asset base low as a result of not investing in new and perhaps needed long-term operating assets.

These actions constitute an ethical problem for accountants because an accounting tool is being distorted to promote a favorable evaluation of a manager.

23 Cadbury, Sir Adrian. "Ethical Managers Make Their Own Rules," Harvard Business Review, September- October, 1987.

The Iniquity of Creative Accounting / Earnings Management

Accountants can use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business. This process has come to be commonly referred to as 'creative accounting' particularly in the United Kingdom or as 'earnings management' particularly in the USA. Creative accounting involves 'fiddling' and 'figures which have been changed' to achieve 'misrepresentation' by 'sleight of hand' to transform figures from 'what they actually are'.

Creative accounting arises because of the following reasons:

1. Firstly by the *exercise of choice* between permitted alternative accounting policies. An example would be in choosing whether to write off or capitalize research and development costs.
2. Secondly by *applying bias* in the making of accounting estimates. An example would be in the estimation of asset life for depreciation purposes.
3. Thirdly by *structuring transactions* in such a way as to manipulate the accounts. For example, in a sale and leaseback arrangement the sale proceeds of an asset might be artificially depressed or boosted with an equivalent adjustment to related rental payments.
4. Finally by *timing genuine transactions* so as to manipulate the accounts. For example, if an investment with a historic cost of \$1 million has a market value of \$3 million, then managers can time realisation to boost profits in the year of their choice.

The first two of these might be termed 'accounting manipulation'. The problem of defining an accounting policy choice as 'manipulative' and therefore 'creative' is that where accounting regulation permits such choice then this is likely to reflect legitimate debate over the issue concerned. Thus it is not the individual policy choice in itself that constitutes 'manipulation' but the *intention*

behind it. One way to identify a tendency towards a ‘creative’ bias in company accounts is to consider the impact of its overall selection of accounting policies.

Opinion on Creative Accounting from Major Countries

In a report by Amat and Blake (1996) on a survey of Spanish auditors’ views on creative accounting, and comparing his with a similar survey in the UK reported by Naser (1993) as shown in Table 1 below, two key responses were sought. It is striking that in Spain as well as in UK, both the importance and the legitimacy of creative accounting appear to be viewed similarly.

Table 1. Summary of results on auditor’s attitudes towards creative accounting

<u>Question</u>	<u>Agree or Strongly Agree</u>	
	Spain	United Kingdom
Do you consider the use of creative accounting to be a serious problem?	65.5%	64.3%
Do you consider that the use of creative accounting is a legitimate business tool?	31%	35.7%

Similarly in the USA, the then senior partner in Price Waterhouse, termed the creative accounting approach to be ‘fraudulent’ (Conner 1986, p78).

In Australia, Leung and Cooper (1995) reported that in a survey of 1500 accountants, what the three most frequently cited ethical problems were, they are as shown in Table 2 below. It is striking to note that creative accounting ranks above tax evasion as an issue.

Table 2: Three most frequently cited ethical problems

	% of respondents
Conflict of interest	51.9 %
Client proposal to manipulate accounts	50.1 %
Client proposal for tax evasion	46.8 %

Source: Leung and Cooper (1995)

The difference in accountants’ attitudes to creative accounting depends on the motivation of management. Creative accounting based on motives of self-

interest attract more disapproval than where the motivation is to promote the company.

Fraudulent Financial Reporting

Fraudulent financial reporting is indeed a serious problem. Infrequent though its occurrence arguably may be, its consequences can be widespread and significant.

National Commission on Fraudulent Financial Reporting, in its report of October, 1987²⁴, defines fraudulent financial reporting as:

“**intentional** or **reckless** conduct, whether act or omission, that results in materially misleading financial statements. Fraudulent financial reporting can involve many factors and take many forms. It may entail gross and deliberate distortion of corporate records, such as inventory count tags, or falsified transactions, such as fictitious sales or orders. It may entail the misapplication of accounting principles. Company employees at any level may be involved, from top to middle management to lower-level personnel. If the conduct is intentional, or so reckless that it is the legal equivalent of intentional conduct, and results in fraudulent financial statements, it comes within the Commission's operating definition of the term fraudulent financial reporting.”

When fraudulent financial reporting occurs, serious consequences ensue. The damage that results is widespread, with a devastating ripple effect, sometimes. Those affected may range from the immediate victims-the

24 From October 1985 to September 1987, the National Commission on Fraudulent Financial Reporting studied the financial reporting system in the United States. Their mission was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence. The Commission was a private-sector initiative, jointly sponsored and funded by the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Financial Executives Institute (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants (NAA). The six-member Commission was independent of the sponsoring organizations.

company's stockholders and creditors-to the more remote-those harmed when investor confidence in the stock market is shaken. Between these two extremes, many others may be affected: employees who suffer job loss or diminished pension fund value; depositors in financial institutions; the company's underwriters, auditors, attorneys, and insurers; and even honest competitors whose reputations suffer by association.

Factors Enticing Manipulative Accounting

When societal values are deteriorating, maintaining high ethical standards in accounting and business grows increasingly difficult. People will undoubtedly ask, if everyone else is cheating, then how can an ethical person possibly succeed?

Stephen Zeff in an article entitled "Does the CPA Belong to a Profession?"²⁵ raised two issues that may adversely affect the CPA's professional status. The first issue he discusses is that diversified services draw firms into competition with other disciplines that have few or no professional/competitive restraints. He suggests that this may erode the professional judgment of the accountant. They face issues of *competition* and *diversification* that impinge on their ability to maintain an appropriate professional response to ethical questions.

Zeff also argued that ethical and judgmental problems might arise because of the increase in a *rule-dominated practice*. The problem of a rule-dominated practice is that it may lull us into a false sense of what is right and wrong by viewing decision making through a legal/illegal lens. Here the concern becomes one of form over substance with ethical decision making being replaced by legal decision making.

25 Zeff, Stephen A. (1987) "Does the CPA belong to a profession?", Accounting Horizons, June. He was editor of The Accounting Review in 1977-82 and was president of the American Accounting Association in 1985-86.

Fraudulent financial reporting usually occurs as the result of certain *environmental, institutional, or individual* forces and opportunities. These forces and opportunities add pressures and incentives that encourage individuals and companies to engage in fraudulent financial reporting and are present to some degree in all companies. If the right, combustible mixture of forces and opportunities is present, fraudulent financial reporting may occur.

- A frequent incentive for fraudulent financial reporting that improves the company's financial appearance is the *desire to obtain a higher price from a stock or debt offering* or to meet the expectations of investors.
- Another incentive may be the desire to *postpone* dealing with financial difficulties and thus avoid, for example, violating a restrictive debt covenant.
- Other times the incentive is *personal gain*: additional compensation, promotion, or escape from penalty for poor performance.
- *Situational pressures* on the company or an individual manager also may lead to fraudulent financial reporting. Examples of these situational pressures include:
 - Sudden decreases in revenue or market share. A single company or an entire industry can experience these decreases.
 - Unrealistic budget pressures, particularly for short-term results. These pressures may occur when headquarters arbitrarily determines profit objectives and budgets without taking actual conditions into account.
 - Financial pressure resulting from bonus plans that depends on short-term economic performance. This pressure is particularly acute when the bonus is a significant component of the individual's total compensation.

The Role of Ethics towards Reliable Financial Reporting

The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management - starting with the chief executive officer - sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start within the reporting company.

When a company raises funds from the public, that company assumes an obligation of public trust and a commensurate level of accountability to the public. If a company wishes access to the public capital and credit markets, it must accept and fulfill certain obligations necessary to protect the public interest. One of the most fundamental obligations of the public company is the *full and fair public disclosure* of corporate information, including financial results.

The independent public accountant who audits the financial statements of a public company also has a public obligation. The independent public accountant's responsibility extends to the company's stockholders, creditors, customers, and the rest of the investing public. The regulations and standards for auditing public companies play an important role in safeguarding that public trust and auditors *must* adhere to those standards.

A weak corporate ethical climate exacerbates unethical situations. Hence firstly, it is necessary for companies to establish the proper environment, one in which fraudulent financial reporting is less likely to occur. A strong corporate ethical climate at all levels is vital to the well being of the organization, all its constituencies, and the public at large. Such a climate contributes importantly to the effectiveness of company policies and control systems and helps influence behavior that is not subject to even the most elaborate system of controls. The role that ethics plays in decision making goes beyond the legal dimension and must concern itself with whether or not

the decision meets the value orientation of the company as well as the environment in which it operates.

Consequently, a strong corporate ethical climate emphasizing accountability helps to protect a company against fraudulent financial reporting. The objective of acting ethically, which translates into improving one's competence and acting in the general public's best interests, will also result in the greater long-term profitability of the business.

Ethical decision making should be an integral part of sound business decision making and as having a positive effect on its long-term financial success. The well-known management analyst Peter Drucker goes further, encouraging a company to turn a social problem into an economic opportunity and benefit rather than viewing it as a cost to be absorbed.²⁶

The past four to five years or so have witnessed an unprecedented attempt by the government organizations and private institutions in various developed as well as fast developing countries to encourage and sustain high levels of ethical behavior in the accounting profession. The growing economy of the United Arab Emirates, a Middle Eastern country has also been quite active in following these footsteps. The next chapter attempts to draw attention to this country's fast changing economy and its endeavor towards ethical issues.

26 Drucker, Peter. "The New Meaning of Corporate Social Responsibility," California Management Review, Winter, 1984.

CHAPTER FIVE

Tapping the Need for Fostering Accounting Ethics in the Growing Economy of the United Arab Emirates

The United Arab Emirates - Background Information

The United Arab Emirates (UAE) is a federation of seven emirates located on the Arabian Peninsula. The UAE has a coastline and seaports inside as well as outside the Strait of Hormuz, which is the entrance to the Arabian Gulf. Its area is about 30,000 square miles (77,700 sq km), SW Asia, on the E Arabian Peninsula, bordered by the Persian Gulf (N), the Gulf of Oman (E), Oman (S), Saudi Arabia (S, W), and Qatar (NW). The land is largely hot, dry desert. It comprises the seven emirates (in fact, sheikhdoms) which are Abu Dhabi (with 80% of the area, which is its capital), Dubai, Sharjah, Ajman, Umm Al Qaiwain, Fujairah, and Ras Al Khaimah.

The population was more than 4 million in 2003²⁷. Foreign-born workers, mostly from Asia, attracted by the petroleum boom outnumber the indigenous population, Sunni Muslim Arabs. Expatriates form 80% of the population and 93% of the labor force. The official language is Arabic, but Farsi and English are widely used.

Each emirate has its own ruler and retains a high degree of autonomy within the federal system. The president of the UAE is chosen by the Federal

27 See Appendix VII – ‘UAE Population by Emirate, 1998 – 2003’ From The IMF Country Report No. 04/174, UAE: Statistical Appendix, June 2004. page 16.
Also included in – ‘Selected Economic Indicators’ from the Statistical Bulletin of the Central of UAE, Quarterly July-Sep 2004, Volume 24, No. 3, page 6.

Supreme Council, which is composed of the rulers of the seven emirates. The Abu Dhabi ruler, Shaikh Zayed Bin Sultan Al Nahyan, was the first President of the UAE since the country's foundation in 1971. In addition to the Federal Supreme Council, the federal structure includes the Council of Ministers, a Federal Judiciary, and the Federal National Council (FNC), which is a consultative body of 40 members representing the seven emirates. The FNC does not have the power to legislate, but it can summon ministers, and it performs an oversight function. Overall governmental authority is invested in the Supreme Council, which consists of the seven sheikhs; a majority of five (including both Abu Dhabi and Dubai) must agree to any action.

UAE Economic Trends & Outlook

The economy is dominated by oil, first exploited in the 1960s. Prior to oil, the UAE had a subsistence economy that consisted of fishing, date cultivation, livestock, small-scale trading, and pearling. Oil exports rank among the world's largest, and oil revenues have made the per capita income one of the world's highest. There are also rich natural-gas deposits. The UAE now is a prosperous country of global economic significance. Nominal GDP in 2002 was approximately US \$64.7 billion, and per capita GDP was in excess of US \$18,400, according to UAE Central Bank statistics.²⁸ The surplus in trade balance rose by 45.7% in 2003, as compared to 2002, to reach AED 78.3 Billion against 53.7 Billion in 2002. The value of total exports and re-exports(FOB) grew from AED 191.6 Billion in 2002 to AED 241.8 Billion in 2003.²⁹

28 See Appendix VIII for Tables of GDP at Basic Prices by Economic Sectors, from the Statistical Bulletin of the Central of UAE, Quarterly July-Sep 2004, Volume 24, No. 3, pgs. 45-46.

29 See Appendix IX for Tables of balance of Payment & Foreign Trade, from the Statistical Bulletin of the Central of UAE, Quarterly July-Sep 2004, Volume 24, No. 3, pgs. 49 & 51.

GDP historically has been highly dependent on oil prices and has therefore followed a roller coaster pattern during the past 20 years, soaring during the 1970s and declining precipitously during the 1980s. These swings in national income have caused the authorities to look for ways to diversify the economy, particularly in Dubai, where oil reserves are dwindling. These attempts at diversification have met with considerable success. Government spending of past, present, and future oil revenues, along with proceeds of overseas investments derived from oil revenues, remains the engine that powers the economy. Oil revenue in 2002 accounted for nearly 20% of GDP, and equaled roughly 50% of export earnings and 90% of government revenue.³⁰

The 'Principal Growth Sectors' in the UAE consist of the oil sector. UAE oil production capacity is currently at 2.3 million barrels per day (mb/d) and the Abu Dhabi National Oil Company (ADNOC) plans to expand the UAE's capacity to 3.0 mb/d by 2006. As part of the effort to continue to improve and sustain output, ADNOC has tendered the privatization of a 28 percent stake in the offshore Zakum Development Company (ZADCO). Although US suppliers dominate the oil drilling industry, competition from European and Japanese firms, such as IFP, BP, Technip, John Brown, Kvaerner, Mott McDonald, Balfour, Tebodin, Pencol, Pritchard, Stork Engineers and Contractors, Mitsui, Chiyoda, and Mitsubishi is intense. Current active contractors are Snamprogetti, Technip, NPCC, CCC, SK Engineering, ABB Lummus, Al Nasr Irrigation and Pan Arabian.

The scarcity of oil and gas reserves in the UAE's northern emirates has led to continued attempts at economic diversification. The non-oil sector of the UAE's economy actually accounts for more than twice the oil sector's direct contribution to GDP and this has helped insulate the country from the full effect of fluctuating oil prices. Important non-oil sectors under development include tourism, manufacturing, air travel and cargo services. Government

30 "UAE economy on the fast track" By Nadim Kawach, Bureau Chief Gulf News 20-10-2003 available at : http://www.datadubai.com/uae_economy.htm, last visited 28th May, 2005.

investments in public utilities, development of financial services, strong demand for re-exports and an open economic system - free movement of capital, and financial stability - have contributed to the growth of the non-oil sector in recent years.

Business Environment in the UAE

The UAE has a mixed economy, with the most productive assets owned by the governments of the individual emirates. While considerable scope is given to private enterprise, the legal regime favours UAE nationals over foreigners.

UAE Federal commercial laws promote national ownership of business throughout the country. Foreign businesses must have a UAE national sponsor. Agency and distributorship laws require that a business engaged in importing and distributing a foreign-made product must be owned 100 percent by a UAE national. Other businesses must be at least 51 percent owned by nationals. Companies located within the UAE's twelve free zones are exempted from agency/distributorship, sponsorship, and national ownership requirements. However, if they lack 51 percent national ownership, they are treated as foreign firms and subjected to these requirements if they market products in the UAE.

UAE federal government steps toward privatization have been tentative. Abu Dhabi Emirate, however, has initiated and maintained an ambitious program to privatize the emirate's power and water sector. In April 1997 the Abu Dhabi government gave the go-ahead for power and desalination projects to be carried out as Independent Power Projects (IPP), which have significantly widened investment opportunities for domestic and foreign investors.

In recent years the UAE has run budget deficits. In 1994, the UAE budget deficit as a percentage of GDP was 7.9%; in 1998 that figure grew to 16.6%, largely attributable to a 34% drop in oil revenues that year. Although much

higher oil revenues in 2000 allowed the government to pay down the deficit to 3.8%, the fiscal deficit ballooned in 2001 due to a weakening of oil prices. Domestic borrowing finances deficits, principally by overdrafts from banks in which government entities have an ownership share, and by liquidation of interest from overseas assets.

The UAE Federal Government has no official or commercial foreign debt. Some individual emirates have foreign commercial debts, and there is private external debt. There are no reliable statistics on either, but the amounts involved are not large. The foreign assets of the Abu Dhabi and Dubai governments and their official agencies are believed to be significantly larger than the reserves of the Central Bank. It is conservatively estimated that assets of the Abu Dhabi Investment Authority (ADIA) total more than \$125 billion.

There is no income tax in the UAE Foreign banks pay a 20% tax on their profits. Foreign oil companies with equity in concessions pay taxes and royalties on their proceeds. There are no consumption taxes, and no customs duties on most products traded within the GCC. The GCC implemented on January 1, 2003 a common external tariff of 5% for many goods.

All emirates have modern seaports. The port of Jebel Ali in Dubai is the *largest man-made port in the world*. Goods are imported by sea and distributed by truck within the UAE and to nearby locations in neighboring GCC countries. As part of its drive to diversify its economy away from oil to regional trade, Dubai has developed free zones at two main seaports and its international airport. There are now 12 free trade zones in the UAE, half of which are located in Dubai.

The UAE has a fairly well developed and modern infrastructure. Land transportation is by road and an asphalt highway network links all major cities. Authorities in Abu Dhabi and Dubai are busily engaged in widening roads and replacing worn stretches. There is presently no rail system in the UAE - although Dubai has finalized plans for metro system - nor any domestic air

transportation network. All of the emirates, however, with the exception of Ajman and Umm Al Quwain, have modern airports.

In 2002, The Dubai Development and Investment Authority (DDIA)³¹ was established in the emirate of Dubai. The main focus of DDIA's strategic projects is to attract Foreign Direct Investment (FDI) to Dubai and mobilize domestic capital for its economic growth. As per internal analysis, Dubai attracted FDI of approximately US\$ 2 billion in 2002 with an average annual growth rate of 11% between 1993 and 2002. This FDI figure corresponds to 15% of the total investments into capital formation of Dubai. Due to the strategic projects launched in 2003 and 2004 FDI is estimate to significantly increase from this figure, e.g. Dubailand and Dubai Healthcare City alone have attracted FDI of US\$ 1 billion in 2004 which is a clear indication for the economic growth that Dubai is currently experiencing.

Foreign companies and individuals have not traditionally been permitted to own land or real estate in UAE. All property must be rented or leased for the purposes of running a business. Recently, however the Government of Dubai and other emirates too has relaxed this and today *freehold residential ownership* is possible for expatriates in some of the spectacular projects being developed along Dubai's coastline including Dubai Marina, the Palm Islands, Emirates Hills and Emirates Lakes. This has encouraged foreign investment in the country.

Hence, it is due to its strategic situation as a trading hub between the Asian and the Western countries, trade and businesses have flourished in the UAE. The Government investment towards infrastructure and other opportunities provided have complimented it further. Moreover, the tax-free economy remains an attraction of great importance to many businesses too. Higher oil

31 The Dubai Development and Investment Authority (DDIA) was established by the virtue of a decree in April 2002. DDIA is entrusted with catalyzing growth and economic development of the Emirate of Dubai, which is strategically located at the crossroads between Europe and Asia. To learn more about DDIA visit <http://www.ddia.ae>.

receipts and the continuing strong growth in property, trade, investment and tourism look set to continue for the foreseeable future.

The Need to Enhance Ethical Behaviour in Business and Profession in the UAE.

As more and more *global entities* with international ethical standards are entering the region calls for increased transparency and better business ethics are being heard louder by the day. In the Gulf, the concept of ethics is growing in importance.

Heightened *economic integration* and security concerns are placing unprecedented demands for transparency on the traditionally closed banking sector. In addition, with many private companies and family-owned businesses converting into *equity firms*, it is only a matter of time before they begin to feel the need to access capital markets.

The country is recently opening up to the *stock market*. The UAE's first stock exchange, the Dubai Financial Market (DFM), opened on 26 March 2000 and consequently also the Abu Dhabi Stock Exchange. They are regulated by the Emirates Securities and Commodities Market Authority. The DFM was established to create a *fair, efficient and transparent marketplace* that serves the interest of the national economy. The role of foreign investors at the DFM is expected to grow over time. Emaar Properties was the first listed company to open its shareholding to foreigners by allowing them to own shares followed by Emirates Airlines. Other listed companies are also expected to follow suit. Foreign institutional investors have been showing very active interest in investing in the market. It had also mentioned by Ahmed Humaid Al Tayer, Minister of Communications, at the Emirates Bank International's 23rd annual general meeting about the growing stock markets as:

“This further consolidates the UAE's position as a financial centre, and provides investors with more opportunities to contribute to and share in the prosperity of the national economy.”³²

Currently, there are about 100 public joint stock companies in the UAE. Fifty-one companies are listed on the two stock exchanges, 34 on the Abu Dhabi Securities Market and 17 on the Dubai Financial Market. A UAE federal government regulation that requires all local joint stock companies to list their shares on an authorized exchange within a year and the upcoming new listings would boost UAE's market capitalization to a new high this year. This would require proper financial reporting and true & fair disclosures of the company's operations and position.

Another important aspect to be noted here is that UAE being an Islamic country encourages Islamic Banking. Islamic Banking made its debut over a quarter a century ago. At present, 200 Islamic banks and financial institutions operating in 27 Muslim countries and 16 non-Muslim countries are managing a portfolio of about \$200 billion. The structure of Islamic Banking gives much importance to ethics and values like honesty & welfare of society. The magazine 'Law News' the February 2005 issue emphasizes the same as follows:

“Structure of a Model Islamic Bank:

The total implementation and success of Islamic banking in a country includes reshaping of society, restructuring of the economic system and reframing of the laws according to the dictates of Islam. The most important and difficult task, however, is the reformation of society which has to be undertaken as an on-going process. We therefore, need to change our priorities and atleast as much emphasis should be laid on improving the ethics, honesty and values of the society as is being done for expansion of riba-free banking. This is believed to create a conducive

32 See Appendix X – ‘Stock market 'will reinforce UAE's financial position', Gulf News, 23rd March 2001.

environment for more and more financing under profit and loss sharing system of Islamic banking.”³³

Consequently, it would also be time to worry about business standards, as foreign investors would be *reluctant to invest* in local companies unless systems to ensure transparency are in place and standards of disclosure are met with a higher degree of accountability.

UAE - Stepping it's Pace towards Business & Accounting Ethics

Federal Law no. 22 of 1995 governs the registration of accountants and auditors in the UAE. There is no local professional body of accountants but many of the large international accountancy firms have offices in Dubai. Under Federal Law No 13 of 1988, all commercial companies are required to keep financial records, while Federal Law No 18 of 1993 specifies the books and records that must be kept by traders.

“Although the business environment has undergone a radical transformation in the region, the topic of ethics in business is hardly new to us,” says Alex Zalami, executive director at the Dubai Ethics Resource Center (DERC). “In fact, this part of the world is perhaps better known for some of the socially-rooted and religiously-inspired values that often direct business conduct. [A person's] word is worth more than a thousand contracts. Therefore, the social and value infrastructure is already there to support the development of formal systems of addressing integrity in business conduct.”

An increasing number of corporate houses are beginning to realise the importance of ethics and providing knowledge resources and value added services to stakeholders and a platform for active regional contribution to the development of global integrity standards. In the UAE, the path towards this is

33 See Appendix XI – ‘Structure of a Model Islamic Bank’, cover story Law News , issue No. 51, February 2005, pages 3 & 4.

being paved by the **Dubai Ethics Resource Center (DERC)**³⁴ which was launched on 13 October 2004 to raise the level of awareness of organizational ethics. The Centre is associated with the Washington-based Ethics Resource Centre and funded by Merck Company Foundation.

DERC also works with the youth – college-level business students to work with the faculty to help them design and deliver business ethics courses. They work to empower students to deal with issues of integrity at the workplace and prepare them for that task by presenting topics like ethics and leadership, ethical decision-making, personal responsibility, corporate responsibility and so on.

The Dubai International Financial Centre³⁵ was approved the Federal Cabinet in December, 2003 to position Dubai as a universally recognized hub for institutional finance and as the gateway to the region for capital and investment. By applying its fundamental principles of *Integrity, Transparency and Efficiency*, it offers a truly unique business environment that will enable world-class financial institutions, professional service firms and corporations to operate regionally and globally out of Dubai with significant competitive advantages. Hence it has to introduce a fully transparent operating environment complying with global best practice, internationally accepted laws and regulatory processes and a world class independent regulatory agency.

In the UAE too, there is growing awareness of the importance of responsible business conduct, as evidenced by the new standards from the **Ministry of Education**. Business Ethics has become a *mandatory course* in all business colleges and schools, with the Ministry of Education declaring that it will not accredit any business certificate unless the curriculum includes this new course.

34 To know more about DERC and its activities visit <http://www.dubai-ethics.ae>.

35 To know more about DIFC visit : <http://www.difc.ae>.

The Accountants & Auditors Association³⁶ was established in 2002 to undertake the necessary measures for developing and consolidating the rules and standards for the practice of the profession of accounting and auditing in the country. To ensure the implementation of these standards by professionals in the accounting field. To prepare the studies pertaining to the rules and ethics of the profession and submit them to the competent authorities to impose them upon the practitioners of the profession. Accountants and Auditors Association of the UAE and Talal Abu Gazaleh & Co. International sign agreement. In July, 2004 the Association and the Talal Abu Gazaleh & Co. International have signed an agreement to improve and enhance the level of proficiency in accounting and auditing in the country.³⁷

There is a trend of implementing the international standards to keep pace with developed world. The elite of UAE youth is becoming aware of the need to enhance ethical behaviour in the profession of accounting and auditing.

With the recent realization of the extent and gravity of the problems that unethical aspects in accounting bring, there has appeared widespread action too. Efforts by governments and private institutions in various countries cannot be overlooked. The next chapter deals with the role of such organizations in incorporating ethical behaviour in the accounting profession.

36 To know more about this association and its activities visit : <http://www.aaa.org.ae>

37 See Appendix XI – ‘Accountants and Auditors Association of the UAE and Talal Abu Gazaleh & Co. International sign agreement’ 19th July, 2004, By Anne-Birte Stensgaard, News Editor, AME Info, available at <http://www.ameinfo.com/42875.html>, last visited 17th May,2005

CHAPTER SIX

THE ROLE OF PROFESSIONAL INSTITUTIONS IN INCORPORATING ETHICS IN THE ACCOUNTING PROFESSION

The company and its management are the key players in the financial reporting system; they bear the *primary responsibility* for the preparation and content of the financial statements. Financial statements are management's representation as to the company's financial position and results of operations. Several *oversight bodies* that establish financial reporting standards and monitor compliance with those standards influence the reporting function. The company engages independent public accountants to *render an opinion* as to whether the financial reports fairly present the company's financial position and results of operations in conformity with established standards.

To understand the role various professional accounting institutions around the world, play for incorporating ethics, it is helpful to know how financial reporting has evolved in many countries around the world.

The Evolution of Financial Reporting

Financial reporting was, to start with, mainly *internal reporting*. Early financial reports can hardly be called external, they were a means by which the owners could get an insight into their income and capital. The company was a part of

and managed by its owners. One could hardly distinguish between internal and external financial reports.

From the early 1800s as the scale of companies increased, private capital alone was insufficient to finance business activities, so capital was gathered from people outside the company. The owners *delegate the managing* of the company to the directors and provide them with the necessary authority. The directors are *accountable* towards the owners for their deeds, decisions and policy. The external financial report provides a means *of rendering account of this authority*.

Financial reporting evolved from internal to external reporting, but for a long time external reporting meant providing information within the borders of a specific country. Because national environments have different characteristics, standard setters and accounting bodies have chosen different alternatives for recognition and measurement and presentation policies which best fitted their national environments. Although the general mission to provide information on the financial position of a company and its result is similar in most countries, many differences occur due to *environmental* and *cultural influences*.

The difference in *providers of finance* (creditors/insiders versus equity/outside) is the key cause of international differences in financial reporting. In countries such as Germany, France, Italy, Belgium, banks became the major supplier of extra funds. Companies in these countries relied more on *debt* to finance their activities than on equity. In contrast in the UK and the US the extra funds tend to be provided by *shareholders*, often by many shareholders for small amounts.

Shareholder-oriented versus credit-oriented countries.

<i>Shareholder oriented</i>	<i>Credit/family/state oriented</i>
United States	Germany
United Kingdom	France
The Netherlands	Belgium
Sweden	Italy
Australia	Spain
Canada	Portugal

Source: adapted from Ordelheide and KPMG (2001), Comparative International Accounting (1998) and 'Financial Accounting: an international introduction (2001)

In countries where companies are largely financed through equity, financial statements will have an investor or *shareholder orientation*. This means that financial statements must provide the kind of information that will enable a potential shareholder to make the best investment decision. In countries where companies rely more on debt financing, the financial statements have a *creditor orientation*. In those countries information provided through the annual accounts must be useful to judge whether a company is able to repay its debt.

Further, in countries with a tradition of *common or case law* (e.g. USA, Australia) details of accounting regulation are delegated to governmental agencies (e.g. SEC) which in turn might delegate their authority to a private accounting standard setting body (e.g. FASB). In countries with a tradition of *code law* (e.g. France, Germany) commercial law and tax law contain detailed accounting rules. The legislative bodies in those countries have been very reluctant to delegate authority to the private standard setting bodies that were set up only recently in France and Germany. Both, the French Comité de Reglementation Comptable (CRC) and the German Accounting Standards Committee (GASC) do not have the ultimate power to issue accounting rules but have to ask for governmental approval. Thus, legislators and governments in those countries are determined to retain control of the process of accounting regulation.

The Importance of a ‘Code of Ethics’

What are Codes of Ethics? Codes of Ethics or informally known as ethical codes, are one of the primary methods of direct behaviour regulation available to professional associations. They provide on-going guidance for practicing professionals, by simplifying the moral universe and by providing a framework for evaluating courses of action. In this way, ethical codes function as a form of *hegemonic leadership*, circumscribing and influencing the behavioural practices. The meaning of ethics and ethical codes are not *stationary* nor should ethical codes necessarily be read in terms of a narrative of linear progress and evolution.

A few definitions given below will help to better understand ‘a code of ethics’:

Definition of Code of Ethics from the Ethics Resource Centre:

“A central guide and reference for users in support of day-to-day decision making. It is meant to clarify an organization's mission, values and principles, linking them with standards of professional conduct. As a reference, it can be used to locate relevant documents, services and other resources related to ethics within the organization.”³⁸

Section 406(c), the Sarbanes-Oxley Act, 2002 defines a ‘code of ethics’ as:

“such standards as are reasonably necessary to promote—

1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- 2 full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
- 3 compliance with applicable governmental rules and regulations.”

38 The Glossary section of the Ethics Resource Centre available at <http://www.ethics.org/glossary.html>. Last visited 28th May, 2005.

The ERC seeks to: inspire individuals to act ethically towards one another; inspire institutions to act ethically, recognizing their role as transmitters of values; and inspire individuals and institutions to join together in fostering ethical communities. The ERC has been active in the debate regarding the role of corporate officers and directors in the wake of recent scandals. For further information regarding the ERC, see www.ethics.org.

Hence, we can say that a code of ethics outlines *a set of fundamental principles*, whether or not they are the basis for operational or legal requirements or prohibitions. A code of ethics is a value-laden document, not one designed for expedience.

Why have a ‘Code of Ethics’? The main reason for having a code of ethics is not to provide a cookbook solution to every practice-related problem, but to aid in the decision-making process for situations that involve ethical questions.

Employee adherence to a code of ethics is a relatively simple and effective means of informing individuals, and their company’s current and prospective shareholders, of the importance of *integrity* and *honesty* to financial reporting.

Fraudulent financial reporting is indeed a serious problem. Infrequent though its occurrence arguably may be, its consequences can be widespread and significant. Although fraud in any form can be difficult to deter, fraudulent financial reporting can be reduced, by following ethical principles.

While standards of conduct can be established and enforced, we must recognize that *ethics cannot be legislated*. Many of the actions that triggered the events during 2002 did not result from failure of the standards but from failure of individuals to apply the standards in a sound, honest, and ethical way.

History and Current Position of Ethical Standards & Regulations in the UK

The first definitive standards for financial reporting were developed in the UK by the **ASC**³⁹. These standards were known as Statements of Standard Accounting Practice (SSAPs).

39 Abbreviation for Accounting Standards Committee (ASC) renamed to Accounting Standards Board (ASB)

In 1990 following a review on the formation of accounting standards the Government announced the establishment of a new **Financial Reporting Council (FRC)**. The FRC was charged with promoting good financial reporting through two subsidiary bodies. These were:

1. The Accounting Standards Board (ASB), that replaced the ASC
2. The Financial Reporting Review Panel (FRRP).

On its creation the ASB adopted a number of SSAPs that had been issued by the ASC so that they were brought within the legal definition of accounting standards according to the Companies Act 1985. Consequently some SSAPs are still in force today.

The ASB was and is assisted by an Urgent Issues Task Force (UITF). The UITF was established to investigate areas where conflicts or unsatisfactory interpretation of an accounting standard or Companies Act provision exists or may develop in the future. The FRC is now the UK's independent regulator for corporate reporting and governance. The FRC is the single independent regulator of the accounting and auditing profession as well as being responsible for issuing accounting standards and dealing with their enforcement.⁴⁰

The Accountancy Foundation was created in 2000 as the main body in a system of non-statutory regulation of the accounting profession. Major operational boards of the Accountancy Foundation included the

- Ethics Standards Board (ESB) whose had the role of identifying and setting the agenda for the development of ethical standards by the accountancy bodies of the Consultative Committee of Accountancy Bodies (CCAB).
- Auditing Practices Board (APB).

The CCAB consists of six members who are

- The Association of Chartered Certified Accountants (ACCA)

40 To know more about UK Standard Setters visit <http://www.icaew.co.uk>.

- The Chartered Institute of Management Accountants (CIMA)
- The Chartered Institute of Public Finance and Accountancy (CIPFA)
- The Institute of Chartered Accountants in England and Wales (ICAEW)
- The Institute of Chartered Accountants in Ireland (ICAI)
- The Institute of Chartered Accountants of Scotland (ICAS)

ACCA publishes the ACCA Rulebook⁴¹ - The third section covers 'Rules of Professional Conduct' and includes a section on the ethical responsibilities of members in business.

CIMA's website includes information on their Ethical Code within a section on Professional Standards.⁴²

CIPFA issues its Standard of Professional Practice (SoPP)⁴³ on Ethics and sets out the overall standards of professional conduct for its members. As a professional accountancy body operating under a Royal Charter, CIPFA has an obligation to regulate the professional conduct of its members (including student members) in the public interest. It is responsible for defining the professional, ie ethical and technical, standards with which Chartered Public Finance Accountants are expected to comply and to take action where an individual member's conduct falls below the standards to be expected of a professional accountant.

ICAEW - ICAI – ICAS: The Guide to Professional Ethics of the ICAEW is wholly compatible with the code of ethics of the International Federation of Accountants (IFAC). It is shared with the other two Chartered Accountant bodies of the ICAI and the ICAS. It includes a 'Code of Behaviour' through a

41 The full text of the ACCA's rulebook is available online with an easy to use explorer style menu system and a quick search utility at <http://rulebook.accaglobal.com>.

42 CIMA's Ethical guidelines are available to view/download as a 27 page document in PDF format available at : <http://www.cimaglobal.com/cps/rde/xchg/SID-0AAAC564-6CB41EB3/live/root.xsl/1117.htm>.

43 To know more about CIPFA SoPPs visit <http://www.cipfa.org.uk/>.

series of individual "Statements", dealing with basic professional essentials as Objectivity and Independence, Confidentiality and Conflict of Interest, Change of Appointment, Practice Promotion etc. The Guide also deals with ethical issues relating to specialist fields of practice, in particular Insolvency and Corporate Finance.⁴⁴

Although the ACCA, CIMA & CIPLA have developed their ethical requirements separately, the ESB is in the process of developing a common statement of their core ethical requirements.

On 22nd December 2004 the **Auditing Practices Board (APB)** issued International Standards on Auditing (ISAs) (UK and Ireland) & International Standard on Quality Control (ISQC) (UK and Ireland) that contain basic principles and essential procedures as well as related guidance in the form of explanatory and other material, including appendices.

The APB announced the publication of the new Ethical Standards on Integrity, Objectivity and Independence to apply to audits of financial statements for periods commencing on or after 15 December 2004 in a press release entitled "APB Finalises Ethical Standards For Auditors on the new standard" on 17th December 2004.⁴⁵

History and Current Position of Ethical Standards & Regulations in the US

As a profession in the United States, accounting began to evolve largely from British influence before the American Revolution. In 1887, the American

44 To know more about the Guide to Professional Ethics of ICAEW visit http://www.icaew.co.uk/index.cfm?AUB=TB2I_25930,MNXI_25930.

45 To read more about this press release visit: <http://www.frc.org.uk/apb/press/pub0687.html>. Last visited 29/5/2005.

Association of Public Accountants, a predecessor of the American Institute of Certified Public Accountants (AICPA), was formed in part to raise the professional standards of accountants. Subsequent to the stock market crash of 1929 the Congress passed the Securities Acts of 1933-1934 which later led to the establishment of the Securities and Exchange Commission (SEC).

In the US there are two major standard setting bodies which are responsible for setting the uniform minimum standards of, and guidelines to financial accounting and reporting, known as Generally Accepted Accounting Principles (GAAP). They are the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB).

1. Governmental Accounting Standards Board (GASB)

GASB is a government organization, its mission is to establish and improve standards of *state and local governmental* accounting and financial reporting that will result in useful information for users of financial reports and guide and educate the public, including issuers, auditors, and users of those financial reports.⁴⁶

2. Financial Accounting Standards Board (FASB)

FASB is a *private-sector organization*, empowered to establish financial accounting and reporting standards since 1973. Although this function legally resides with the Securities and Exchange Commission (SEC) for public companies, the SEC has traditionally provided the private sector with the opportunity for self-regulation through FASB.⁴⁷

Another important organization, which needs mentioning here, is the **Securities & Exchange Commission (SEC)**. The Office of the Chief

46 To know more GASB see Appendix XII, 'Facts About GASB 2004-2005' Available at the official GASB website <http://www.gasb.org/>, last visited 9th May 2005.

47 To know more about FASB see Appendix XIII, 'Facts About FASB 2005' Available at the official FASB website <http://www.fasb.org>, last visited 29th May 2005.

Accountant (OCA)⁴⁸ is a stand-alone office within the Commission, and the Chief Accountant reports directly to the Chairman. It is responsible for establishing and enforcing accounting and auditing policy to enhance the transparency and relevancy of financial reporting, and for improving the professional performance of public company auditors in order to ensure that financial statements used for investment decisions are presented fairly and have credibility.

Professional accounting organizations recognize the accounting profession's responsibility to provide ethical guidelines to its members. Major Institutions in the US include:

American Institute of Certified Public Accountants (AICPA): The AICPA is the largest national, professional association of certified public accountants in the United States, with more than 350,000 members in business, industry, public practice, government and education. The AICPA created an Ethics Decision Tree⁴⁹ that could be a model for organizations in defining a path for employees to follow when they are concerned about possible lapses in compliance with the ethics code in the company. The AICPA maintains and enforces a code of professional conduct for public accountants⁵⁰. The AICPA's first principle of professional conduct states: "In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities." Those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services - all in a manner that demonstrates a level of professionalism. The Revised Version of the AICPA

48 To know more about OCA of SEC, visit <http://www.sec.gov/info/accountants/ocasubguidance.htm>, last visited 29th May 2005.

49 See Appendix XIV – 'Ethics Decision Tree', AICPA - 2002, available at http://www.aicpa.org/download/ethics/bai/decision_tree_bai.pdf

50 The Code of Professional Conduct of the AICPA can be viewed at <http://www.aicpa.org/about/code/index.htm>, last visited 25th May 2005.

Professional Code of Ethics has been extended to include CPAs employed in private sector. By including all CPAs, the Code ensures that the title "CPA" universally carries high standards of professionalism and ethics.

The Institute of Management Accountants (IMA): Individuals in management accounting and financial management have a unique set of circumstances relating to their employment. To help them assess their situation, the IMA has developed the "Standards of Ethical Conduct for Members."⁵¹ To aid its 100,000 members in resolving ethical dilemmas, the Institute of Management Accountants recently established an "ethics hotline."⁵² Ethics counselors offer confidential advice, solace, and comfort to management accountants who may have no other place to turn for help.

Institute of Internal Auditors (IIA): The IIA publishes an official Code of Ethics⁵³ that includes principles and rules of conduct. The IIA states that the Code's purpose is: "...to promote an ethical culture in the profession of internal auditing."

The National Association of Accountants (NAA): the world's largest organization of management accountants has also been actively involved in promoting ethical behavior among accountants in the private sector. The NAA's Standards of Ethical Conduct for Management Accountants has emphasized the obligation of management accountants to organizations they serve, their profession, the public, and themselves to maintain the highest standards of ethical conduct.

51 See Appendix XV - 'Standards of Ethical Conduct for Members' – IMA, A brief Summary.

52 The Institute of Management Accountants (IMA) offers an ethics hotline service. Members of IMA and financial professionals can contact this hotline for free, confidential guidance on ethical issues. They can call 1 800-638-4427, extension 1662 for this service. The hotline was founded by Howard L. Siers (former chair, Committee on Ethics) and began service in 1991. Its purpose is to provide guidance to those in the profession that find themselves in an ethical dilemma.

53 To know more about IIA visit <http://www.theiia.org/>, last visited 27th May 2005.

American Accounting Association (AAA): which promotes worldwide excellence in accounting education, research and practice has issued recommendations that standards for ethical conduct be included in the curricula of schools of business and accounting.⁵⁴

Committee of Sponsoring Organizations of the Treadway Commission (COSO): COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance.⁵⁵

Moving Towards Globalization of Accounting Standards

For several decades we observe that in many key industries companies are increasingly confronted with *worldwide competition*. They have responded to this challenge with strategies of globalization. As a result, the leading companies now operate on a global basis with subsidiaries in all important countries or regions. The pressure to globalize is also felt by many focussed small and medium sized enterprises that are suppliers of components or specialized services to the giant multinational companies. For many companies especially from smaller countries like Switzerland or Scandinavia, the importance of the home market is almost negligible. In the past few years, we observe increasing cross border merger activities that have resulted in companies (e.g. ABB, DaimlerChrysler, Aventis) that no longer can be regarded as national groups.

Globalization strategies are not restricted to operating and investing activities but increasingly also involve *financing*. Foreign listings are not new to US multinationals or many of the large European companies being traded at home as well as on other major European and Asian stock exchanges (such

54 To know more about the AAA visit <http://aaahq.org/index.cfm>, last visited 25th May 2005.

55 To know more about COSO visit <http://www.coso.org/>

as London, Frankfurt, Paris; Hong Kong, Tokyo). For companies focussing their financing strategies on the international investment community, accounting reports serve as means of external communication.

From the above, it seems to be obvious that the use of only one set of global accounting principles would facilitate *internal and external communication*. The history of international accounting standards really began in 1966, with the proposal to establish an International Study Group comprising the Institute of Chartered Accountants of England & Wales (ICAEW), American Institute of Certified Public Accountants (AICPA) and Canadian Institute of Chartered Accountants (CICA). In February 1967 this resulted in the foundation of the Accountants International Study Group (AISG), which began to publish papers on important topics every few months and created an appetite for change. Many of these papers led the way for the standards that followed, when in March 1973 it was finally agreed to establish an international body writing accounting standards for international use. Promoting the harmonization of accounting rules has been the mission of regional bodies (e.g. European Union (EU), Nordic Countries) and international bodies (e.g. IASC) for over more than 25 years. National (e.g. FASB) or regional (e.g. EU) standard setters have designed strategies to have their accounting rules applied beyond their respective jurisdictions.

International Standards, Codes and Frameworks: Do they matter?

Recent data indicate that the influence of these international guidelines is slowly growing, and that there is an increase in the adoption of common standards by the private sector. Their influence can be seen in the content of the 1,000 or more company codes of conduct that currently exist, and the more than 1,500 non-financial documented reports produced annually worldwide since 2003.

Also, national governments are starting to ensure that companies adhere to standards both at home and abroad and have prepared guidelines for companies to follow to prepare reports, including Australia, Belgium, Denmark, France, Netherlands, Hong Kong, Japan, United Kingdom, Canada,

Germany and South Africa. In the United Kingdom, for example, it became a legal requirement as of 1st April 2005, for all quoted companies to file an Operating Financial Review that should include information on environmental, social and community issues. The corporate governance recommendations of the King Code II in South Africa include reporting on non-financial issues applicable to all companies listed on the Johannesburg Stock Exchange. The Sarbanes-Oxley Act in the United States includes non-financial aspects of risk and reporting. The Danish Government as early as 1999 devised The Social Index, a self-evaluation tool for both public and private companies to measure their social responsibility.

Many countries are in the process of converging with the IFRS. According to the 'Scoop Independent News of New Zealand', the Government of New Zealand had doubled its budget for 2004, for the funding for development and adoption of international accounting standards.⁵⁶

In the US, there are efforts towards convergence of the two standard-setting bodies the FASB & the IAS, efforts towards a single set of high-quality accounting standards that can be used both domestically and internationally.⁵⁷

Recently an article in the newspaper 'The Trusted Professional' 1st April, 2005 'Global Accounting Harmonization: A Challenging Change' stated that all members of the EU will be required to adopt the IFRS since Jan, 2005. Also approximately 2000 listed companies in the United Kingdom alone will need to convert from U.K. generally accepted accounting principles (GAAP) to IFRS this year. Several other major countries, including Japan, Russia and

56 See. Appendix XVI.'Boost for Accounting Standards Review Board' Thursday, 10th June 2004, 11:09 am Press Release: New Zealand Government, Scoop Independent News, visit <http://scoop.co.nz/stories/PA0406/S00147.htm>, last visited 28th May 2005.

57 See Appendix.XVII. 'Toward Convergence -Historic First Meeting between the Financial Accounting Foundation and the International Accounting Standards Committee Foundation. Article from The FASB Report, 30th June, 2004.

Australia, have made similar decisions to harmonize their accounting standards with IFRS.⁵⁸

International Accounting Standard Setters

The two major international bodies that play a great role in setting international accounting standards are:

1. International Accounting Standards Board (IASB), which issues IFRS and
2. The International Federation of Accountants (IFAC)

International Accounting Standards Board (IASB)

Statements of International Accounting Standards issued by the Board of the International Accounting Standards Committee (IASC) between 1973 and 2001 are designated "International Accounting Standards" (IAS).

The International Accounting Standards Board (IASB) announced in April 2001 that its accounting standards would be designated "International Financial Reporting Standards" (IFRS).⁵⁹ Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards issued by the IASC.

International Financial Reporting Standards (IFRS) are standards and interpretations adopted by the International Accounting Standards Board (IASB). They comprise:

- International Financial Reporting Standards (IFRSs);
- International Accounting Standards (IASs); and

58 See Appendix XVIII 'Global Accounting Harmonization: A Challenging Change' by Susan Thetford, *The Trusted Professional*, the Newspaper of New York State Society of Certified Public Accountants (NYSSCPA), 1st April, 2005, Vol 8, No. 6.

59 To know about the summaries of the standards visit <http://www.iasb.org/standards/summaries.asp>, last visited 29th May 2005.

- Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC) and approved by the IASB.

International Federation of Accountants (IFAC)

IFAC is the global organization for the accountancy profession. It works with its 163 member organizations in 119 countries to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members represent 2.5 million accountants employed in public practice, industry and commerce, government, and academe. Its structure and governance provide for the representation of its diverse constituencies and interaction with external groups that rely on or influence the work of accountants.

It's mission is to serve the public interest, to strengthen the worldwide accountancy profession. To contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the *international convergence* of such standards and speaking out on public interest issues where the profession's expertise is most relevant.

IFAC, through its Code of Ethics,⁶⁰ encourages accountants worldwide to adhere to these same values. IFAC describes its code of ethics as intended to 'serve as a model on which to base national ethical guidance. It sets standards of conduct for professional accountants and states the fundamental principles that should be observed by professional accountants in order to achieve common objectives.' The Ethics Committee of IFAC has released an updated version of its Code of Ethics for Professional Accountants (2001), featuring new requirements on independence.

60 To know more about the Code of Ethics of the IFAC, visit <http://www.ifac.org/Store/Details.tpl?SID=9560085866929>. Last visited 30th May, 2005.

Fédération des Experts Comptables Européens (FEE): The FEE publishes information on the current issue of Ethics and Regulation of the Profession.⁶¹ This includes information on worldwide issues in professional ethics, along with representations made by FEE to international organisations and governments.

Committee on Auditing (EU) - established by the European Commission in 1998 to take an overall view of issues including audit regulation and independence, with the power to issue directives where necessary.

Organizations are working towards the development of a single set of high quality accounting standards to be used in the preparation of transparent and comparable financial reports throughout the world. The IASC has made major accomplishments in its work, but it is clear that a great deal remains to be done in the future. Convergence on the highest quality standards is a goal that should be established and achieved.

Efforts for Adopting International Accounting Standards in the UAE

To support a growth in Foreign Direct Investment (FDI), the Dubai **Development & Investment Authority (DDIA)**⁶² also fulfills *policy development and advocacy role*. This means that the policy development team of DDIA reviews the regulatory landscape of Dubai and the United Arab Emirates on an ongoing basis. In 2004, DDIA specifically reviewed and developed recommendation on the 'Auditing and Accounting Standards' and the Investment Law which are both crucial to facilitate FDI into Dubai.

61 To know about the Ethics and Regulation of the Profession from FEE visit <http://www.fee.be/issues/ethics.htm>. Last visited 31st May, 2005.

62 The Dubai Development and Investment Authority (DDIA) was established by the virtue of a decree in April 2002. DDIA is entrusted with catalyzing growth and economic development of the Emirate of Dubai, which is strategically located at the crossroads between Europe and Asia. To learn more about DDIA visit <http://www.ddia.ae>.

Another boost for the use of International Accounting Standards in the Arab world came from the embrace and encouragement of the **Arab Society of Certified Accountants (ASCA)**⁶³ to the use of IASs in 2004.

On June, 2004, the Governor of UAE Central Bank opened region's first **International Financial Reporting Conference** in Dubai. It was organized by the International Accounting Standards Board (IASB) and was attended by some of the accountancy industry's most prominent figures. The conference was followed by workshops instructing delegates on how to implement the latest changes to IFRS/IAS and thus ensure that the financial statements of their organisations comply with the latest international financial reporting standards.⁶⁴ In his speech Sultan bin Nasser Al Suwaidi, Governor of the Central Bank of UAE emphasizing the importance of adopting IAS said:

“Now it is the turn of non-banking companies to adopt the internationally accepted accounting standards and practices. It will have a major impact on attracting foreign portfolio investments, the growth of the domestic stock markets and the overall GDP growth.”⁶⁵

Another major event which took at in the UAE, at the time of this study was the **‘World Accounting Summit’** from 29th May to 1st June 2005, at the Jumeriah Beach Hotel Conference Centre in Dubai. The World Accounting Summit brought together for the first time in the Middle East, senior representatives from the global standards setters, the major accounting

63 ASCA was established in London in 1984 as an Arab professional institution with an international character (www.ascasociety.org/english/society.htm, 2004). The ASCA includes members from all the Arab world.

64 See Appendix XIX – ‘Governor of UAE Central Bank opens region's first International Financial Reporting Conference’, from AME Info -the ultimate Middle East business resource, posted by Anne-Birte Stensgaard, News Editor, posted on 7th June, 2004. Available at <http://www.ameinfo.com/news/Detailed/40816.html>, last visited 7th June, 2005.

65 See Appendix XX – ‘Adoption of IAS to attract foreign investors: Suwaidi – UAE’, from Khaleej times – 8th June, 2004. Available at Middle east North Africa – financial network, <http://www.menafn.com>, last visited 26th May, 2005.

associations worldwide, the principal advisers to multinational companies as well as key users and preparers of financial statements. This event sought to aid finance professionals in their efforts to apply IFRS, improve financial reporting and enhance ethical accounting and corporate governance. In his speech Graham Ward, President of the US-based International Federation of Accountants (IFAC) emphasized that uniform accounting standards would fight fraud. He stated that:

“A multiplicity of accounting creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of international standards, of the highest quality, set in the public interest by an international expert body, which transparently consults with and recognizes the legitimate interests of the international community.”⁶⁶

More than 100 countries have adopted IFRS so far, and all companies listed in the European Union must now apply the framework. Companies in Bahrain, Jordan, Lebanon, Kuwait and Qatar follow IFRS by law, but it is mandatory for only UAE banks to abide by it.

Mr. Alex Zalami, Executive Director for Dubai Ethics Resource Centre (DERC) presented DERC at the World Accounting Summit Conference and addressed an essential topic on enhancing corporate governance and corporate responsibility through better reporting and how it helps increase the consistency, clarity and transparency of corporate information.

The above mentioned events show that the fast growing economy of UAE is all ready to embrace international accounting standards and also recognizes the importance of ethical behaviour in the professional which will give importance to public interests and ultimately attract foreign investment and further economic growth.

66 See Appendix XXI – ‘Uniform accounting standards will fight fraud’ from AME Info, posted by Anne-Birte Stensgaard, News Editor, 25th May 2005. Available at <http://www.ameinfo.com/news/Detailed/60978.html>, last visited 7th June, 2004.

Much More than Just Ethical Standards & Regulations

As we have seen that a lot of efforts have been put in by governments and private institutions in most countries around the world towards reliable accounting, either through standards or codes of ethics. In spite of the existence of a wide range of ethics codes, it has done little to reduce the volume of corporate scandals. Even firms which emphasize proper policies run astray. There is a lack of emphasis on the cost of unethical behavior. If firms, shareholders, and professions are shown the value of ethical behavior, more ethical behavior will be practiced.⁶⁷

Standards were issued mostly to plug exploitable loopholes. The problem was then, and still is now, the *perverse incentives* causing the abuses, not the detailed standards. Both the abuses and the detailed standards they triggered were symptoms of the bad incentives. It is simply wrong to think that the rules caused the abuses.

While the immense work of the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) is highly commendable, only the issuance and adoption of IAS does not mean the same thing as *rigorous interpretation and application* of those standards. Management is responsible for implementing and properly applying generally accepted accounting standards. The auditors, professional organizations, and regulatory bodies supplement management's front-line role.

A Code of Ethics must not be used as decorations but as 'agents of change'. They are useful but only when they are 'bought into' by the people in question, who must be involved in drafting them. Training programs for all must be conducted which should be highly participating and involving discussions of hypothetical situations. Mere lectures or handouts would be ineffectual.

67 Dobson, John 'Why Ethics Codes Don't Work', *Financial Analysts Journal*, November/December 2003.

Even if a country's local auditing standards do not require equivalent procedures to International Accounting Standards, accounting professionals should assume the *responsibility to adhere to the highest quality practices* that the public associates with their profession. The laws of countries typically prescribe minimum requirements; they do not prohibit from doing *more* than the minimum.

The Ethical Standards follow a principle-based approach as opposed to the rule-based approach (which are the regulatory standards) as it is often inflexible and can become out of date as circumstances change. An ethics-based approach creates a more enduring framework. It establishes basic ethical principles governing the conduct of an accountant, which he would then have to apply to the particular circumstances using professional judgement. However, the effectiveness and credibility of the ethics-based approach upon the clear identification of all the relevant ethical principles for example: 'to act with integrity, objectivity and due care' and also the recognition of those considerations upon which public confidence depend for example: 'transparency and accountability'. Such identification and recognition can come only with *basic education* and further *continuous training* of the ethical issues. The next chapter therefore emphasizes on the need for better ethical education.

CHAPTER SEVEN

BETTER ETHICAL EDUCATION

The Need for Ethics in Academia

We have seen through the previous chapters, the importance ethical behaviour in business and accounting. Also we have acknowledged the efforts of governments and private organizations towards protecting public interest. Yet we hear quite often of accounting scandals in organizations. There is a need to educate students and professionals of the essential ethical principles.

The twenty-sixth president of the United States, Theodore Roosevelt, said it best: "To educate a person in mind and not in morals is to educate a menace to society." Instilling a maximum level of ethical values and sensitivity in students is what accounting educators should be striving for. There are some basic ethical guidelines to which everyone can agree, whether a person derives ethical values from religious principle, history and literature, or personal observation and experience.

Can ethics be taught? Is it possible to make students exude ethics? The answer to these questions is yes, at some point in life, ethics *must* be taught. People are not born with innate desires to be ethical or to be concerned with the welfare of others. The role of the family and academia includes teaching children a code of ethical behavior that includes respect for parents, siblings, and others. Firstly, the family bears chief responsibility for ensuring that children will receive the necessary education and moral guidance to become productive members of society. The basic values such as honesty, self-control, concern for others, respect for legitimate authority, fidelity, and civility

must be passed from one generation to the next, a fundamental process of the family.

Education can influence present or future participants in the accounting profession by providing knowledge, skills, and ethical values that potentially may help prevent, detect, and deter fraudulent financial reporting. To encourage educational initiatives toward this end, changes in the business and accounting curricula as well as in professional certification examinations and continuing professional education are highly recommended. The curricula should integrate the development of ethical values with the acquisition of knowledge and skills. Students should realize that practices aimed at reducing fraudulent financial reporting are not simply defensive measures, but also make good business sense. As future participants in the system, students should gain a sense of what will be expected of them legally and professionally when they are accountable to the public interest.

A 1993 study (Frances McNair and Edward E. Milam, "Ethics in Accounting Education: What Is Really Being Done," *Journal of Business Ethics*, October 1993) reported that the average time covering ethics in an accounting course was a little over three hours. Historically, there have been many calls for increasing the level of ethics education in the accounting curriculum. These calls turned to screams in the wake of the corporate scandals of the past few years. Many of these screams are coming from accounting professors who are increasingly frustrated with the behavior of some accounting professionals.

Fostering Ethics - A Historical Listing

The significance of ethics has been displayed by a number of organized efforts that have taken place especially in the US which have recognized the importance ethical education.

- The first organized push to incorporate ethics into the business curriculum came in 1979, when the Association to Advance Collegiate Schools of Business (AACSB)⁶⁸ made ethics education a requirement for students in business education programs.
- A more specific focus on ethics in accounting education came from the Bedford Committee⁶⁹ in its report in 1986, *Future Accounting Education*, which stated, "Professional accounting education must not only emphasize the needed skills and knowledge, it must also instill the ethical standards and the commitment of a professional." It recommended that ethical standards be an integral part of accounting education. The general effort to develop in students a concern for individual needs and for the overall advancement of society must be given more emphasis. The report stated that accountants need to be creative, sensitive, and aware of the needs of society. While the circumstances within which they exercise professional judgment may change, the common thread running throughout these changing circumstances should be those characteristics that define the accountant as a professional.
- The National Commission on Fraudulent Financial Reporting (Treadway Commission) in 1987, indicated that curricula should integrate the development of ethical values with the acquisition of knowledge and skills.⁷⁰ It also recommended that students be exposed to ethical

68 AACSB International - The Association to Advance Collegiate Schools of Business is a not-for-profit corporation of educational institutions, corporations and other organizations devoted to the promotion and improvement of higher education in business administration and management. Organized in 1916, AACSB International is the premier accrediting agency for bachelor s, master s and doctoral degree programs in business administration and accounting. AACSB International has expanded its role as a source of information, training and networking for management educators to growing memberships outside the US. To know more visit: <http://www.aacsb.edu>.

69 Bedford Committee, 1986, *Future Accounting Education: Preparing for the Expanding Profession*. Issues in Accounting Education, Sarasota, FL, American Accounting Association.

70 Arthur Andersen & Co., "National Commission Fraudulent Financial Reporting, Summary of Recommendations," *Accounting News Briefs*, Vol. 13, No. 2 Supplement, April/May 1987, p. 4.

questions and that more emphasis be placed on the ethical dimension of financial reporting in the business and accounting curricula.

- In 1988, Cal Thomas made the following assessment: "If we want to produce people who share the values of a democratic culture, they must be taught those values and not be left to acquire them by chance."⁷¹
- In 1989, the AACSB increased the emphasis on ethics by requiring ethics to be taught within the major area of study in business programs.
- A 1990 article in the Wall Street Journal reported the results of a Gallup Poll that found 84% of public school parents wanted moral values taught in school and 68% wanted educators to develop strict standards of "right and wrong." As a result of parental pressure, some state legislatures and education departments are urging public schools to teach students values such as honesty, respect, and patriotism. Hundreds of business firms, such as Digital Equipment Corp. of Maynard, Massachusetts and Glendale Federal Bank of Glendale, California, have provided millions of dollars for such programs⁷²
- James Brackner, member of the IMA Committee on Ethics, once stated: "The universities are responding with an increased emphasis on ethical training for decision making. For the most part, however, they ignore the teaching of values. For moral or ethical education to have meaning, there must be agreement on the values that are considered 'right'.⁷³
- Accounting students should be taught about the ethical aspects so that they can make reasoned sound decisions. In June 1992, this was

71 C. Thomas, 'The Death of Ethics in America', Word Books, 1988.

72 Nazario, "Schoolteachers Say," Wall Street Journal, Apr. 6, 1990, pp. B1, B6.

73 James Brackner, member of the IMA Committee on Ethics, In the July 1992 issue of Management Accounting.

emphasized by Lynda Helps,⁷⁴ saying that ethics education would at least equip students with behavioral patterns of good moral decisions. Teaching ethics can provide reasoning skills as well as help the students understand their role in society and professional duties.

In response to these calls, educators have incorporated ethics into their curricula in a number of ways, often by using textbook cases, case problems, video presentations, and articles from various publications. Education literature supports the idea that people develop their ethics throughout life. This notion of continuing ethical development may be good news, but it also may explain how even the most ethical person engulfed in an unethical corporate culture may find it difficult to distinguish between what is proper behavior and what is questionable behavior in the eyes of an outsider. We need to consider that, because people develop their ethical values throughout life, an individual's ethics are subject to change negatively as well as positively, depending on the environment.

Ethics has always been part of the accounting curriculum, said Steve Goldfarb, manager of public relations for the American Institute of Certified Public Accountants, a professional organization in New York City. A significant portion of the CPA exam is based on the "understanding and interpretation of ethical standards," Goldfarb said, and the code of ethics is most often addressed in auditing courses.

Educators need to view their own classrooms as ethical territories and take on a broader responsibility, and a more activist role, in the ethical development of students. Academia should accept ethics as a research and teaching specialty equal to other areas of accounting. Stressing the importance of the fundamentals, character, integrity, and responsibility should be part of accounting education.

74 Helps, Lynda. Mphil, MRD, BA, FCMA, member of the Department of Accounting and Finance at Manchester Metropolitan University 'Should we teach ethics in accounting education?' *Management Accounting*, June 2002 v72 n6 p46.

Efforts towards Ethics Education in UAE

In the UAE, the Dubai Ethics Resource Centre and the Ethics Resource Centre in Abu Dhabi are striving towards encouraging ethical education in the country. They are motivating many universities and colleges by their shared desire to serve the community and to help them in fostering personal responsibility and ethical leadership in young college students who will be tomorrow's leaders. Recently on 18th April, 2005, a Memorandum of Understanding (MOU) was signed between the Dubai Ethics Resource Center (DERC), the Dubai Men's College, the Dubai University College, the Dubai Women's College, University of Wollongong in Dubai, Dubai Campus and Zayed University to partner in the development of a joint multi-faceted educational and character development program that shall be named 'Future Leader Program',⁷⁵

The main aims of the Program include:

- Enhancing the capacity of faculty to design and teach business ethics.
- Empowering students to confront ethical challenges and acquire ethical leadership attributes.
- Developing shared resources and regionally relevant reference material, including but not limited to, an online resource center.

Partner academic institutions will facilitate faculty involvement in the development and implementation of program activities and access by their student body to such activities, subject to their respective rules and regulations. The Dubai Ethics Resource Center will provide resources for the purpose of coordinating program activities, making available subject matter expertise and seeking funding support from the business community

75 See Appendix XXII – 'The Dubai Ethics Resource Center teams up with five local colleges and universities to launch the Future Leader Program' at the Dubai Chamber of Commerce & Industry (DCCI), 19th April, 2005, Online News Stand, available at <http://www.dcci.ae/contents.asp?Page=news1082>, last visited 11th June, 2005.

Ethics Training in the Workplace

Ethics training and education should be addressed both in academia and the workplace. Just as companies adopt models for decision-making in their approach to responsibility accounting or capital budgeting, it is imperative that they also provide a framework within which to evaluate the ethical implications of their decisions. Ethics education is more than studying the code of professional conduct, but rather a *process* whereby individuals become more consciously involved in making ethical decisions.

The process must include both *planning* and *control* in the same sense that we use the terms in other managerial models. The planning part of the process includes the development of the code of ethics and its incorporation into training and professional development programs. It includes making ethical analysis an 'input' into accounting-based decision making. The control aspect consists of regular reviews of the decision making process, channels for reporting problems, and inclusion of ethical issues as part of the evaluation and reward structure.

The Corporate Ethics Project of the Business Roundtable, in 1988, which included the CEOs of 200 major corporations, looked at 100 companies and how they dealt with the issue of corporate ethics. The project pointed to the 'crucial role of top management' and the necessity of providing constant leadership in tending to and renewing the values of the organization. Two other major findings of the Business Roundtable project were a deep conviction that a good reputation for fair and honest business is a prime corporate asset and that corporate obligations extend to a variety of constituencies or stakeholders. Recognizing that the human conscience is fragile, the Ethics Project emphasized the role that ethics plays in the company must be pervasive, extending to hiring, training, oversight, recognition and reward, review for adherence, and channels for reporting problems. They noted the growing conviction that "...strong corporate culture

and ethics are a vital strategic key to survival and profitability in a highly competitive era.”⁷⁶

In the year 2000, Robert J. Warth, CPA, as assistant professor in the College of Business at The Rochester Institute of Technology, discussed ethics in the profession, based on interviews with 17 C.P.A. firms. He addressed how ethics are viewed by accounting firms, and in the education and training within these firms.

From his study he made some important conclusions as below:

1. As important as the issue of ethics and ethical behavior is to the profession, there is lack of focus in dealing with the issue.
2. Even though the unanimous consent was that ethics was ‘essential and fundamental’ to the profession many firms failed to incorporate training on ethics but rather relied on colleges and universities to instill ethics and ethical behaviors in future employees.
3. Warth found that “in the area of ethics education and training, all firms except one said they rely primarily on colleges to cover the ethics and ethical behavior expected in the profession”.
4. Despite the heavy reliance on academia to provide such education, many firms could not verify the coverage of ethics in the curriculum from schools from which they recruit new hires.
5. While most firms did not offer training in ethics, there were programs in place to monitor staff compliance with ethical standards of both the firm and the profession. This was exercised by requiring an annual sign off by the staff.
6. Although there did not appear to be a procedure in gaining ethical employees, most firms did have a “formal procedure of review that included a checklist or questionnaire, interview, and background checks.
7. There was even evidence of the disapproval or dismissal of a client on ethical grounds.⁷⁷

76 The Business Roundtable, "The Rationale for Ethical Corporate Behavior," Business and Society Review, Winter, 1988.

The importance of addressing the issue of ethical behaviour within a company has been well established. Whether an organization chooses to respond to this concern strictly from a self-centered point of view, to reduce the threat of increased regulation or future litigation, or chooses to raise the issue to a higher, more altruistic goal, it appears that there are benefits to be gained both from an economic perspective and through the creation of a more healthy work environment. The goals of ethics education are creating an awareness of ethical dilemmas and providing methods of resolution.

Tremendous work has been done, but everyone still has a great deal more to do. There are no 'quick-fix' or 'one size fits all' solutions facing ethical dilemmas. There are many areas in which procedures could be streamlined and standards made stricter, but still there is no overall quick fix. From the lessons learnt in the past, nothing is more certain than that we all have much more to learn, hence the emphasis on better ethical education in academia and followed by continuous training in business organizations.

77 Warth, Robert J. "Ethics in the Accounting Profession: A Study". The CPA Journal New York Oct 2000.

CONCLUSION

By its very nature, any discussion of ethics is subjective. There are no easy answers to ethical questions and situations that confront the professional. This does not mean this topic can be ignored. Ethical questions have to be answered and the situations have to be addressed.

It is critical that accountants take an active role in helping the company to begin the process of *consciousness raising* and establishing an appropriate *corporate value system*. This will offer all employees, including the accountants, an institutional ethic within which these dilemmas can be resolved. Regardless of whether there are clear answers, there should be a clear process.

The issue of ethical decision making in business should only increase in importance in the near future. In our litigious society, companies which do not institutionalize ethics into their corporate culture could find themselves expending financial resources in the courtroom rather than on revenue-generating assets.

Accountants make implicit decisions and choices that affect the wellbeing of many people. They are making ethical judgments and they need to be able to make these judgements in such a way so that the wellbeing of many is not negatively affected. Accountants in practice also have to deal with a wide range of explicit ethical issues. The need for an ethical profession is in part determined by the *social contract* between the profession and society. The legitimacy and relevance of the accounting profession can only be maintained if the profession is ethical.

Accountants should strive to develop measures that will capture a company's long-term successes and failures and thus help create an atmosphere that will minimize the need for "creative accounting" to produce mere paper profits. To

prevent future government regulation, the accounting profession must ensure that the behavior of its members is impeccable.

Regulatory and law enforcement agencies provide the *deterrence* that is critical to reducing the incidence of fraudulent financial reporting. Many standards set by various bodies already has significantly raised corporate awareness of the problem and of the potential for detection and punishment. But improvements can and should be made.

Although educators are not generally considered participants in the financial reporting process, they have an important role in helping to *reduce the risk* of fraudulent financial reporting. Education can prepare business and accounting students to recognize the factors that can contribute to this type of fraud and the ethical values and good business practices necessary to guard against it.

It is very rightly stated by Mr. Paul B. Miller & Mr. Paul R. Bahnson that "There is much work to be done to prepare the next generation of managers and accountants so that they don't repeat the transgressions of their predecessors."

There is also a need to stress the importance of developing an ethical sensitivity in students in order to provide them with a keen, internalized awareness of the ethical status of their current academic environment and, subsequently, the corporate environments they encounter.

Hence it is concluded that no one answer to the problem of fraudulent financial reporting and manipulative accounting exists. Rather, improvement is needed in *all areas*. Fraud is as complex as human nature, and as society changes, the financial reporting system will change. As fraudulent financial reporting likewise evolves, so must counter responses. This study has attempted to demonstrate, that desired ethical behavior can be fostered by both enforcing strict adherence to the *Code of Professional Conduct* and by promoting and raising the *ethical consciousness* of the profession's members through continued education and training. It examines these issues and

suggests further research into ethical frameworks relevant for the practice and teaching of accounting that may suggest some answers to these problems. The cascading result of actions such as these would be a first step toward demonstrating that the accounting profession will once again exude ethics and integrity--in both perception and reality and in rebuilding the faith of investors who depend on accounting professionals for accurate, clear, timely and relevant financial information.

The task of achieving sustainable ethical behaviour in the accounting profession is a long and arduous one. That the stakes are high is beyond dispute. One thing is clear, if we all: governments, private sector, institutional organizations do not grasp the opportunity we now have to confront unethical aspects, then chances will pass. Consequently unethical activities could negatively impact growing economies and also impact negatively on various aspects of globalization. The stakes, surely could not be higher than they NOW ARE !!!
