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Ethical Framework of the Accounting Control System – A Literature Review

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Abstract: It is important to understand that present ethical framework is drawn from the corporate governance framework which is based on compliance of laws and rules. It is not directly linked to values, ethics, and moral standards. Businesses are owned by owners/ investors and run by managers.As there is conflict between ownership and control therefore, corporate governance problem arises. There is an ethical breach not only on the part of the managers but also of the owners. With this background, this paper seeks to review the available literature to understand the concept of ethics, morality and business ethics in correct perspective. It further studies relevant areas such as ethics and morality of managers, their role in ethical leadership, organizational and individual ethics, ethics in accounting and finance and new perspective in business ethics.

Keywords: Ethical Framework, Corporate Governance, Business Ethics, Morality, Organizational and Individual Ethics.

1. INTRODUCTION

First of all ethical framework needs to be understood in correct perspective. Extensive study is done to understand the concept of ethics and morality. We are studying business ethics within the ambit of applied ethics. To understand this ethical framework, we need to first explain the nature of study of business and the nature of ethics. This study focuses on the perceptions of managers in general and perceptions of stakeholders of accounting system in particular as they are responsible for ethical or unethical practices. We would like to know how important is it for company that it's accounting and reporting is done by those who adhere to ethical standards. The users of this information are not only stockholders but also the creditors, suppliers, customers and government etc. So the accounting system caters to not only the shareholders but also to all other stakeholders because organizations use resources of the society. This calls for review of literature regarding the perceptions of those responsible for direction and control of the company.

It will be of interest to study the findings in the field of creative accounting. Preparers of financial statements are in a position to manipulate the view of economic reality presented in those statements to interested parties. Indian case of Satyam can be studied regarding creative accounting phenomenon.

There is difference between individual ethics and organizational ethics. We also need to explore the study that throws light on new perspective of business ethics as distinguished from personal ethics.

2. OBJECTIVES OF THE REVIEW/STUDY

(1) To review the studies done in the area of ethics and morality so as to understand, measure and know the factors influencing the perception of manager's ethical behavior.

(2) To review the studies related to individual and organizational ethics.

(3) To study work related to code of ethics, their importance, effectiveness and communication.

(4) To study the work done in the area of ethics in accounting and finance.

(5) To review the new perspective of business ethics and corporate responsibility.

3. LITERATURE REVIEW: TRADITIONAL VIEW

Traditional approach starts from a perspective where ethics has been equated to individual ethics. Early authors have restricted their studies to this area whereas new perspective is path breaking study which views it more as corporate responsibility.

3.1 Ethics and Morality

Solomon (2003) maintained in his work that sound ethics is necessary for long term survival of the firm. His twenty years' experience of consultancy led him to conclude that people face situations where it is difficult to make choices. He used

"Aristotelian approach" to explain his ideas. According to him "corporations like an individual is embedded in society" and corporate values such as "honesty and fairness" must be translated into action. Today's national and international business world must work in tandem by sharing values and having mutual trust; otherwise they are not going to stay together for long. He argues that profit and ethics must go hand in hand which will lead the organization onto the path of success. Solomon both examines the ways in which inadequate values actually destroy businesses, and exposes the false beliefs that encourage unethical business practices. Solomon's handbook is full of list of virtues which may help small managers and struggling executives facing dilemmas of ethics.

Posner (2010) asserted in "three decade's perspective of values of American Managers" that values is important in organizational life, and its impact has increasingly been recognized over the decades. Some claim that "values have become one of today's most commonly referred term" (Argandona, 2003, p. 15). Others have supported the view that as we try to understand the value system of managers, we tend to understand their beliefs, attitudes, and behaviors. While modeled more than three decades ago, the assertion of Schemidt and Posner (1984) that the direction and vigor of corporate American managers cannot be fully understood without trying to understand more about the values and convictions of the members, seems equally relevant today. The managers believed that it was important for them to understand the values of members properly to get the commitment from other members of organization. He also argued that values can't be seen; rather it is manifested in opinions, attitudes, desires and preferences. He found that at a personal level, most of the managers believed that their values were clearer than those were five years ago. Fifty-four percent of all managers were of the view that more time should be spent on examining personal values. He found that 65% believed that there is need to pay more attention to values in managing businesses.

3.1.1 Manager's Perception of Ethics and their Influence

Numerous studies have been conducted that describe how employees perceive their work environment. The work environment that surrounds an employee is influenced by the value system imbibed by the members of organization.

Rich (1990), asked financial accountants about their work environments. He found that respondents felt pressure to achieve targeted net income and return on investment. It was a survey conducted on 326 managerial accountants and 264 people who were working as controllers to ascertain the prevalence of corporate codes of conduct. The objective was to see the effect of formal codes of conduct on ethical behavior as a result of following the recommendations of the Treadway Commission. Many respondents to the survey expressed that they were under pressure to achieve a targeted net income and return on investment (ROI). It was quite surprising that the pressure to achieve a targeted net income and ROI was higher in firms with formal codes of conduct than in those firms without formal codes.

Posner and Schmidt (1987), sought to investigate various issues with 1498 managers in America in three decades, for example, "how ethical they felt their organizations were and whether their personal principles must be compromised for the organization's sake." In addition, their decision criteria for two scenarios involving ethical implications were articulated. He suggested that the distinction between personal and organizational values becomes minimal not only as one advances higher up the organizational ladder, but also the longer one is employed by an organization. Posner and Schmidt (1987) found that managers employed by an organization for at least ten years, as well as senior managers, were less tolerant of fraudulent practices.

Harris (1990) examined the ethical values of managers at different level of the organization. He also explored how gender, education and years of experience had effect on managers' values, their perceptions of work environment and professional associations influence their personal values. Results indicated that hierarchical level influence their individual ethical values. While respondents, as a whole, had mixed feeling regarding perception of the organization's and professional associations' influence on their values, sales/ service persons were under pressure to change their values in order to achieve company goals. It was found that top managers were less tolerant of fraudulent behaviors than other levels of managers within the organization because they have to deal with these types of ethical dilemmas.

D'aquila (2001) did not reveal notable correlation between perceptions of management's ethical standards and job tenure whereas Harris (1990) and Kelley et al. (1990) both indicated a relationship between the two. Harris found that managers having job tenure for at least ten years were tolerant of fraudulent, but not of coercive practices. Employees in large organizations are expected to pay attention to ethical issues when dealing with others. They take note of the fact when management compromises ethical standards to achieve short term business goal but are not likely to report. This finding is consistent with COSO's (1999) finding that large corporations are least likely to experience fraudulent financial reporting.

Joseph M. Larkin (2000) surveyed the internal audit department of a large financial services organization. Respondents were asked to recognize and evaluate ethical and unethical situations often encountered in practice. For the most part, respondents viewed themselves as more ethical than their peers. This study explored a previously unexplored profession, namely, the internal auditing profession.

3.1.2 Measuring Perceptions about Management's Ethical Standards

An attempt has been made by D'aquila (2001) to measure financial accountants' perceptions of management's ethical standards. This has been done by including both- management's actions and management's expectations of the employee. It is noteworthy to find that financial accountants have more positive attitudes about management's expectations of them in comparison to what they perceive about management's own actions in terms of ethical behavior. It is essential for managers to understand employee perceptions, so that they can create organizational environments that promote ethical decisions.

Her study finds that there is strong relation between employee perceptions and management level. CFOs more strongly believe that management expects them to pay attention to ethical issues when dealing with others. Their perceptions are in conformity with research by Harris (1990), who also indicated that managers at more senior levels are less compromising of fraudulent behavior. They feel less pressure to compromise personal ethics in pursuit of achieving organizational expectations. Responsibility of financial information report by the organization is on CFO. It was expected that their behavior will be followed by other employees of the organization. It is good that these individuals perceive strong expectations to pay attention to ethical issues. These expectations force CFOs to pay attention to ethical issues. Their role as an employee with ultimate responsibility for financial reporting may strengthen CFO's belief to act according to company's expectations.

It is interesting to note the more positive responses about management's expectations obtained from supervisors and controllers. Supervisors, followed by chief financial officers, and then controllers, are of the opinion that they are expected to pay attention to ethical issues. Responses followed a somewhat similar pattern when respondents were asked about management's own actions regarding ethical behavior.

3.1.3 Factors Influencing Management's Ethical Conduct

Rodriguez-dominguez, Gallego-alvarez, and Garcia-sanchez (2009), in their study have observed that being in board makes top management more discretionary in deciding ethical issues. We can also say, their participation in ownership does not allow them from being dismissed as managers, and they are interested in overall ethical behavior of the organization. Moreover, they may use codes of ethics to limit the actions of managers; they could be putting an unethical policy strategically to complement their entrenchment strategy where ideas are not changeable.

This situation may be reversed by having more of outside directors on the Board. Their presence in preparing ethical code as a document which guides the behavior of the corporation's members may help. The reasoning for this conduct is that they are impartial and have wide experience and a sense of moral and legal obligations.

Besides, outside or independent directors defend the interest of stockholders and their future contracts are strongly influenced by their current associations with whom they are working. These results are supported by Webb (2004), who reported that outsiders have a higher level of orientation toward corporate social responsibility. These results are supported for outside directors in UK where they are found to be more discretionary regarding their corporate responsibility but no significant difference was found regarding ethical and legal aspect of corporate social responsibility, according to Ibrahim and Angelidis (1995).

3.2 Organizational and Individual Ethics

Elango, Paul, Kundu, & Paudel (2010)**,** in their research article "Organizational Ethics, Individual Ethics, and Ethical Intentions in International Decision-Making" explored the impact of both individual ethics and organizational ethics on ethical intention. The focus was on international scenario because this provided more scope for ethical decision-making. It requires harmony of both organizational and individual ethics to achieve congruence which helps in enhancing corporate governance. Their combined effect was measured on ethical intention. The congruence was referred to as "person-organization fit" by Liedtka (1989). The term "value congruence" was used to describe the internal consistency held by organization and values held by individual. The greater the value congruence within the organization, the more influential it was in shaping the responses of individuals faced with ethical dilemmas.

It is interesting to find how value congruence of organization and individual influences the behavior of person dealing with ethical dilemma. For instance, an organization having strict accounting compliance policies may influence in adhering to it for the fear of being punished for non-compliance. The relationship between individual values, organizational ethics and ethical decision-making is quite complex and multi-dimensional. Most of the researches either talk of individual or organizational ethics separately rather than taking the effect of both simultaneously (Ambrose et al., 2008).

It was found that managers use both individual ethics and organizational ethics in making their ethical choices. Also younger managers were more influenced by organizational ethics than older managers. No significant relationship was found between management level and ethical intention. There were other factors such as societal influence, organizational policies and procedures and leaders influence that had an impact on ethical choices.

The study has significant implications for corporate governance studies. The study suggests that companies trying to achieve corporate governance should have effective internal control mechanism. There is close coordination between individual and organizational ethics. The close relationship between individual ethics and ethical intention suggest that managers should have high moral values. A strong relationship between the two should design ethics program to create strong ethical culture.

3.3 Code of Ethics

According to Stevens (2008), Enron, Tyco, and WorldCom had unwholesome cultures that lacked ethical valuesinspite of having code of ethics in place. At Enron, the fake numbers were entered into books and still the company culture rewarded strong financial performance at any cost. Former WorldCom chief executive Bernie Ebbers believed he was beyond the code and acted as if it didn't matter. Tyco's culture allowed its top executives to incur massive expenditure. Employees should adapt themselves to code, should be supported and rewarded for observing the code, and follow managers and executives in the organization behaving consistent with the code. Organizations should develop strong cultures to avoid the offensive behavior demonstrated by executives in Enron and Tyco.

3.3.1 Importance of Code of Ethics

A code of ethics is certainly a very important ingredient of a firm's ethical dimensions. Managers need to educate employee with the help of code of ethics regarding ethical issues. This can also be useful in telling employees about management's expectations concerning their conduct (Schwartz, 2004). Such efforts by firms are consistent with the guidelines for compliance and ethics programs issued by the United States Sentencing Commission (USSC).

Manager's responses towards compliance of codes are important. Employees are sensitive to issues regarding justice, so violations must be addressed and repercussions communicated to all. Kickul (2005) noted if an employee is not trusted enough, it makes him sensitive to fairness issues. It is essential that code implementation should be effective at top level. In a recent article Schwartz, Dunfee, and Kline (2005) note that corporate boards need to set the tone in organizations. The corporate strategy requires that valuing ethics should come from the top level.

McKinney, Emerson, & Neubert, (2010), in their study "The Effects of Ethical Codes on Ethical Perceptions of Actions Toward Stakeholders" point out the necessity of adopting ethical codes and have stated that "Corporate executives are responsible for obeying the law, and should be held accountable for any illegality. But they cannot and should not be expected to do anything more…" (Reich, 2007, p. 211). Organizational members are likely to follow the established rules of the legal system. Whereas, a more extensive approach would be to create an ethical business climate by creating 'rules of the game' or codes of conduct that include expected behaviors for the benefit of stakeholders.

3.3.2 Effectiveness of Codes:

According to Stevens (2008), culture and effective communication are key elements for a code's success. If a corporate culture is intertwined with corporate code and its leaders adopt ethical code, they are likely to be successful. Codes must be communicated effectively to be successful. There must be discussions between employees and management which is important for successful implementation of ethical codes. On the other hand codes are no guarantee that will positively impact employee's behavior and deter them from taking unethical actions. A study of 202 Fortune 500 codes showed little evidence that there is any connection between code and behavior. He concluded that codes did not promote self-regulation. Cleek and Leonard (1998) later concluded that codes of ethics did not determine or influence an employee's ethical behavior. Empirical studies suggest either mixed results (Loe et al., 2000; Marshall et al., 1998) or a lack of effectiveness. Weeks and Nantel (1992) were of the view that only well communicated codes promote ethical behavior in organizations.

3.3.3 Communication of Codes of Ethics

Trevino et al. (1999) stressed that open discussions of ethics in the organization is a positive step towards promoting effectiveness of codes. Powerful leaders who share their values with others positively affect the code and resultant behavior. Somers (2001) noted that management accountants found less wrongdoing in organizations with corporate codes and respondents in organizations without formal codes were more aware of wrongdoing. Awareness, understanding and communicating codes is important.

Effective communication is essential for ethical code effectiveness. Both Adams and Rachman-Moore (2004) and Weeks and Nantel (1992) emphasized the correlation between codes and communication. They noted that effectiveness of codes depended on effectiveness of channels of communication. So communication is the key, but channels are also important. Success and failure of codes depend upon the way an ethical code is communicated. Schwartz (2004) stated that the codes should be readable, relevant and should have a positive tone.

Codes should act as powerful organizational instrument for discipline and sanctions must be applied when codes are violated. Employees see and hear organizational actions and they respond to internal messages. Nitsch et al. (2005) describes the frustration and anger that develops in organizations where code violations go unreported. Codes are effective only to the degree that code violations are appropriately sanctioned. Organizational leaders, who ensure that justice prevails in organizations, are trusted and are able to strengthen members' commitment to the code.

3.4 Ethics in Accounting and Finance

Horomnea and Pascu (2012) in their study "Ethical and Morality in Accounting Epistemological Approach" stress the importance of ethics and morality in the accounting environment, by arguing that it takes an ex-ante (before the event) analysis or followed by an ex-post (after the event) analysis, to explain the ethical links between the multitudes of areas. The failure of complying the moral principles and norms of the contemporary world, has led to chaos and lack of provision in the economic plan. Their approach was to establish the connection between business, ethics, morality, professionalism and accountability. There is interdependence in the objectives of accounting and morality in business. If there are no ethical and moral principles in accounting, it would create such conditions where "legal fraud" will be committed. An accounting system without rules and ethical principles is a weak system which reduces the quality of financial information. Horomnea subscribed to the view that accounting should give true and fair view as suggested by virtue ethics of being ethical and moral in the first place. The most important question is –whose responsibility is it to implement ethical and moral principles? The answer to this is entire staff- individually and collectively. And they should be guided by three R's- respect, responsibility and result. Respect should be there for people, organizational resources and environment. Responsibility should be towards clients, colleagues, company, personal and social responsibility. Result means understanding the way they have been achieved which is as important as result itself.

Merchant (1987), studied actual cases of deceptive reporting and interviewed executive with financial reporting or audit responsibilities. Merchant emphasized the importance of moral guidance by management in terms of written Codes and their communication, role models, realistic performance targets and caution regarding high incentive for financial performance.

According to Gayle (2013), organizational performance can be improved if accountants possess the knowledge of emotional intelligence and virtual ethics. These soft skills have been reported to be beneficial in other professions also by contributing to effective organizational performance. With the globalization of business, the technical knowledge required to encompass the soft skills of accounting professionals have increased significantly since the early 1990s. Accounting professionals are now required to provide other functions such as information facilitation in addition to technical tasks such as bookkeeping, financial analysis, auditing, and tax preparation. This creates greater need of having the soft skills of emotional intelligence and virtual ethics.

Bhasin (2013) elaborates that "the fraud committed by the founders of Satyam in 2009, is a perfect example of the fact how people are guided by ambition, and hunger for power, money, fame and glory. Organizations of all types and sizes are subject to fraud. On a number of occasions over the past few decades, major public companies have experienced financial reporting fraud, resulting in turmoil in the capital markets, a loss of shareholder value, and, in some cases, the bankruptcy of the company itself. Although, it is generally accepted that the Sarbanes-Oxley Act has improved corporate governance and decreased the incidence of fraud, recent studies and surveys indicate that investors and management continue to have concerns about financial statement fraud".

The paper goes on to investigate Satyam's case and the lessons learnt therefrom. The 2009 Satyam scandal in India highlighted the nefarious potential of an improperly governed corporate leader. As the case continues, and we count its effects, the whole economy can feel it, we keep hoping that corporate world learn some lessons and some positive steps are taken.

4. LITERATURE REVIEW: A NEW PERSPECTIVE

So far business ethics has been seen in terms of ethics and morality of individuals. It has been understood as if the organization's ethics is equal to personal ethics of those running the organization. The emphasis has been how managers can improve ethical leadership by learning about their own values. How they perceive their environment and effects of their perception on employees have been well documented. Business ethics in the past has been seen as personal or individual ethics of those who are running the organization. We started from a perspective where ethics has been equated to individual ethics. More aware have talked about ethics as managerial ethics. Still more evolved have discussed business strategy or policy. There is need to move from individual ethics to organizational ethics.

Most of the studies were talking about business ethics as personal ethics, until a path breaking study by Murthy (2007), "Business Ethics and Corporate Responsibility- A New Perspective". The paper stresses the need to understand Business ethics as organizational ethics. It starts with refuting the controversial statement of Peter Drucker which stated that there was no separate ethics for business. The paper makes distinction between business philosophy and philosophy of business. Business philosophy is about where the company would like itself down the line whereas philosophy of business is an area of study. According to Murthy (2007), "the business philosophy may or may not include ethical dimension in it, but the philosophy of business necessarily and clearly is concerned with the ethical foundation of business as a discipline." This fact is supported by the study of Hoffman and Moore (1982), "In his 'what is business ethics?' Peter Drucker accuses business ethics of singling out business unfairly for special ethical treatment, of subordinating ethical to political concerns, and of being, not 'ethics' at all, but 'ethical chic'." Murthy asserts that Peter Drucker's denial of business ethics rests on basic misunderstanding of this field.

He quotes Klempner (2006) regarding the philosophy of business- "Understanding the rules and conventions of business is one of the main tasks for the philosophy of business. In one of its forms, this is known as 'business ethics'. The other main task understands how business is possible…" There is a drastic change in philosophy of business which leads to new perspective between business ethics and corporate social responsibility. A new concept emerges which is called Corporate Responsibility. This term is composed of three things (a) good governance (b) corporate social responsibility or CSR (c) environment accountability. The top managers need to achieve the integrated approach of all three of these through organizational transformation. There is a need to bring out a strategy which addresses the issues at international level and provide standards which are measurable and unbiased.

5. CONCLUSION

Solomon (2003) and Corvino (2006) talked about individual ethics or morality of managers. Schemidt and Posner (2010) who studied three decades perspective of American managers said that values are important in organizational life. Rich (1990), studied work environment of financial accountants and found that respondents felt pressure to achieve targets. Harris (1990), D'aquila (2001) and others examined effect of classification variables on the ethical values of mangers. Yates (2011) explored the relationship of ethical leadership with job satisfaction, organizational commitment, and organizational citizenship behavior.

Stevens (2008), Schwartz (2004), McKinney, Emerson, & Neubert, (2010) stressed the importance of code of ethics in an organization. Cleek and Leonard (1998) later concluded that codes of ethics did not determine or influence an employee's ethical behavior.

Horomnea and Pascu (2012) stress the importance of ethics and morality in the accounting environment. Merchant (1987) studied actual cases of deceptive reporting and interviewed executive with financial reporting or audit responsibilities. Bhasin (2013) investigates Satyam's case in Indian scenario and dwells upon the lessons learnt through this case.

Not much literature was found in the area of organizational ethics. The literature does not stop at business ethics being discussed as individual ethics. "Business ethics and corporate responsibility –A new perspective" presented by Murthy (2007) has been discussed as a path breaking literature in this paper.

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