Ethical Accounting: The Driver in Recovering Markets

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Abstract The unethical behavior by accounting professionals and corporate managers and the resulting growing epidemic thereof is a topic of increasing concern for the regulators and standard-setters worldwide. This assumes significance on account of the recovering phase of economies since global meltdown in 2008. Ethics are a key area of concern in accounting at present on account of series of corporate scandals that have taken place in the world questioning the credibility of the accounting profession and management behavior. The present paper deals with the concept of ethical accounting and highlights the relevance of "ethical" (quality) aspect of accounting (earnings) in financial reporting practices of the corporate. It further discusses its implications on the role of accounting professionals for corporate reporting and the regulatory machinery for its promotion.

Keywords Accounting · Ethics · Quality · Earnings · Shareholders

1 Introduction

Agency theory (Jensen and Meckling 1976, p. 311) states that 'the firm is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals... are brought into equilibrium within a framework of contractual relations.' This agency framework promotes a self-serving behavior by the management and tempts them to report discretionary financial numbers and thus, leading to unethical or poor quality accounting.

Schipper (1989) propounds that the informational perspective is a key element underpinning the study of creative accounting phenomenon. The managers may choose to exploit their privileged position for personal gain, by reporting the financial numbers in their own favor. Creative accounting is a process of manipulating the numbers by accountants in financial statements to report the desired figures

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of business. It is also referred to as Earnings management. Goel (2014) draws attention to the quality aspect of reported numbers in corporate enterprises in India.

It may be difficult for individual stakeholders to notice the effect of accounting manipulation due to lack of professional competence. That's why ethical accounting (earnings) becomes crucial in such context, particularly on account of growing shareholders awareness for fair and ethical accounting practices by the corporate. The contribution of the present study lies in the fact that it positions the informational perspective of the financial reporting process which is often misused by the corporate for numerous reasons with the help of professional accountants. The paper stresses on the relevance of ethical accounting by the corporate and practitioners and quality of financial reporting.

2 Ethical Accounting

Ethical accounting refers to quality reporting by the corporate enterprises with the help of accounting professionals which is fair and transparent. Simply put, it implies zero creative accounting. Cohen (2003) defines accounting quality as 'earnings quality, i.e. the degree of accuracy of accounting numbers in depicting the financial health of a business and determining the future operating cash flows. Reliability is a critical factor of financial reporting quality. According to Cheung et al. (2010), reliability is analyzed based on the qualities of faithful, verifiable, and neutral information. Gajevszky (2016) highlights the relevance of quality of the financial reporting process for sound corporate governance.

Ethical accounting is an alarming issue because of corporate scams happening every now and then, leading to erosion of shareholders' wealth. These corporate scandals question the morality of corporate in general and accountants in particular. It is argued that the accountants are majorly responsible for the decline in ethical accounting practices of a business. The accountant's role is to provide useful information to various stakeholders about the economic affairs of an entity in which they have an interest. This creates conflicting interests for accountants as well. For example, it is the responsibility of an accounting firm, appointed by a company for preparing financial statements, to provide accurate information to shareholders and other users, even the information affects the clients' interests. Enron and WorldCom around 2000 and Satyam in 2008 highlighted the importance of ethical reporting, audit quality and governance for improving public confidence in financial reporting.

Ethics refers to a code or moral system that helps you in deciding right and wrong. The word 'ethics' is derived from the Greek word 'ethos' (character) and Latin word 'moras' (customs). These two words combined together define the interaction between individuals. Thus, ethics expresses how people behave for making the 'right' choice and leading to 'good' behavior. Fleet (1991) defines Ethics as the standards or morals set by a person himself about right or wrong. Nwakpa (2010) proposes that ethical behavior is a desired conduct or moral or legal behavior, whereas unethical behavior is nothing but the bad behavior, or in extensive form, an illegal act punishable by law.

3 Ethics and Professional Practice

The accounting professionals need to demonstrate highest level of ethical standards in their practices on account of the professional requirement. They have to be fair and transparent in their behavior to all the stakeholders, particularly potential investors who rely on their professional judgment and make their decisions. These decisions in turn affect the resource allocation process of an economy. According to Bayat (2008), professional ethics in accounting and audit is the subset of business ethics and business ethics is the subset of morality in economic life. There is absolutely no room for unethical behavior in the professional world. This becomes critically important for listed companies in the interests of shareholders. Therefore, the professional accounting bodies have developed a code of professional conduct, rules or standards for ensuring the ethical behavior by the accounting practitioners. These rules form the basis of professional ethics for accounting practices globally.

According to Keeler (2009), "Greed and fear"—the two most powerful forces in modern capitalism. They have pervaded the social system, especially the financial sub-system in most economies of the world. Greed on the part of corporate management, and fear on the part of professionals are typical examples. The accountants' involvement with large corporate frauds in all times reflects that they have not demonstrated an ethical behavior in their relationship with the corporate. They are too much driven by the "corporate greed" and ultimately end up a ginny—pigs in their hands. There are multiple reasons, such as job security, compensation, survival and growth. They focus too much on the end-result, rather than ethical side of accounting. This leads to 'earnings management", i.e. window-dressing which ultimately leads to wrong decision-making by the stakeholders.

Let us explore a situation wherein, you have recently been employed as an accounting executive by an MNC. One of your responsibilities is to help in the preparation of financial statements of the company. The company's major lending bank, International Savings Bank, requires quarterly financial statements, ending June 30, 2015. During the month of May, the company spent INR 80,000 on a promotional campaign for one of their products. This total cost was shown as promotional expense. The company's Director-Finance tells you to remove this cost from Income statement and instead to treat this as a 'development expense' in the Position statement ending June 30. This results in a better financial strength of the company to the bank. In this case, there are no laws broken or ethical lines crossed by a company and discretion is exercised by the management in reporting an item for one of the stakeholders, i.e. the bank. This refers "creative accounting." However, it is the accountant's ethical duty to project accurate information to the stakeholders.

4 Unethical Accounting Practices

Unethical accounting includes all layers of mismanagement of accounting numbers, ranging from 'earnings management' to 'financial frauds.' It could be misrepresentation of figures or the deliberate act of non-disclosure of complete information in the financial reports. This designing is usually done by employing a series of bookkeeping transactions within the generally accepted accounted principles. The objective of aforesaid manipulative practices could be personal benefit of the management or market pressure or contractual restrictions. Following are common unethical accounting practices.

4.1 Misappropriation of Assets

This is a very common practice, violating the accounting principle of 'business entity.' A business owner uses business assets for personal use, presuming they are his own. An accountant treats the use of business goods for personal needs as a drawing which is an implied loan to the owner. It must be paid back to the business. But, usually these corporate practices are deliberately overlooked in financial reporting. According to the Report to the Nation on Occupational Fraud and Abuse (ACFE 2008), asset misappropriation can be classified into different scheme, such as: skimming, cash larceny, fraudulent disbursements, and noncash larceny and misuse.

4.2 Premature Revenue Recognition

Recognition of revenue before it has occurred by the business is another common unethical accounting practice. According to Marquardt and Wiedman (2004), influencing the revenue recognition process is another way of earnings management. The recognition decision is based on the principle of 'transfer of ownership' which in turn depends on a critical event in the earnings cycle and ignoring this fact and recording revenue mere to boost sales figures doses not go well with regulators. Early recognition implies that the amount of revenue recognized is still highly uncertain because many risks have not yet been resolved. This is often done by the corporate to meet a pre-determined sales figure or to satisfy the lenders.

4.3 Channel Stuffing

This is a business practice in which company sends more inventory to its sales partners than could be sold by various means of discounts, deferred payment terms, etc. Channel stuffing temporarily boosts the accounts receivable for the company, but it always has the probability of sales returns. This ultimately deflates the value of the company's sales.

Raymond and Stempel (2014) states that Monster Beverage Corp (the energy drink maker) had to settle a $16.25 million charge with shareholders as they overstated the gains out of a distribution arrangement with Anheuser-Busch. There was an evidence of "channel stuffing" in the company's' results, wherein they made Anheuser distributors to sell too many drinks despite the fact that Anheuser had "practically abandoned" distribution of the said product line. This was around a year's inventory.

4.4 Cookie Jar Reserves

Cookie jar creation is another significant manipulative accounting practice that is employed by the corporate executives to create cash reserves in good years. This is used to offset poor earnings in bad years. The outside world gets convinced by those earnings and carries an impression that the company is consistently achieving its goals. Sweeney (1994) highlights that cookie-jar reserves involve both decreasing and increasing earnings. A common form of cookie jar treatment is to "recognize" a liability without its occurrence. For example, company executives may keep aside INR 50,000 for bad debts provision. The bad debts provision is shown as a liability in the balance sheet. Since these bad debts are never going to materialize, this amount is then recorded as income, ultimately inflating the company's net profit by the said amount.

The Economist (2010) states, "Dell was found by SEC maintaining "cookie-jar reserves" using Intel's money. According to SEC, Dell would have missed the earnings" forecast done by the analysts in every quarter between 2002 and 2006. This included a deal with Intel, a big microchip-maker. Under the deal, Dell had agreed to use Intel's central processing unit chips exclusively in its computers for which the payments were not disclosed. This leads to a penalty of $100 m for Dell."

5 Consequences of Unethical Accounting

Unethical accounting practices, as mentioned above, are motivated by multiple reasons of bonus, job pressures, financing or market pressures. They might not be always illegal, but they do have an adverse effect on the business in particular and society in general. In the short run, these harm the company's image and in the long run they can lead to complete erosion of shareholders" confidence in the company, leading to its close down. The long-term negative consequences as an outcome of these unethical practices can be discussed as follows.

5.1 Civil and Criminal Penalties

If company management is unethical to the point of financial fraud, the company could be subject to civil and criminal penalties. Healy and Wahlen (1999) describes how standard setters should decide on the accounting standards for reducing the possibility of earning management. There are fines and imprisonment for deliberately concealing and misleading the financial information under various Acts of SOX (US), SEBI Act (India), etc. For example, the investors of the company can successfully sue the company and its owners under *Indian Companies Act 2013* in the form of "class-action suit." Similar provision is there in various other countries as well. So, business owners should exercise caution, as ignorant of accounting practices and standards is not a defense for fraudulent reporting.

5.2 Loss of Reputation

If you operate your business in an unethical manner, it will definitely spread out. The customers would rather buy products of businesses that operate ethically, and support their communities. If your company does not operate ethically, customers and suppliers may not like to conduct business with you. Eventually, this destroys your business. Karpoff et al. (2008) discovers that for such businesses, the highest penalties are imposed by the market.

5.3 Loss of Human Capital

It's difficult to get good people work for you in today's world. Many good employees do not want to work for a company that is unethical. Kranacher et al. (2011) stresses upon the fact that losses arising from indirect costs, such as loss of productivity, adverse impact on employees' moral and others should also be considered as they also result from financial statements fraud. The accounting work needs to be performed ethically. If you pressure company accountants to behave unethically, they would not be able to uphold the standards of their profession, and they might risk loss of their license or credentials. Reputed accountants will not work for a company with unethical behavior.

6 A Case Study on Ethical Accounting Decision

The following case provides an example of 'ethical accounting vs. unethical accounting' by accounting professionals. Royal Corporation was one of the leading construction giants in Asian continent with headquarter in Mumbai, India. Aman Sharma joined Royal Corporation as accounts executive 10 year ago. Within a short span of less than 10 years, he moved to Financial Controller of the company. The company has shown a promising financial performance for last couple of years. But, Aman was expecting a downfall in net income of the company this year. As a result, he was afraid that top management might recommend cost reductions by laying off accounting staff.

He was under a tremendous pressure as his job was also at stake; being linked to performance benchmark of previous year. He came out with a plan of designing the accounting numbers in the financial statements to please the management. He knew that it was unethical but decided to go ahead with this. He was aware that depreciation is a major expense for the company. The company currently uses the straight line method of deprecation, and he thought of changing to written-down value method.

This would decrease depreciation expense (and increase income). The best part of this adjustment was prospective effect and this would not be highlighted in the current or future years' financial statements. This approach seemed to be more feasible to him for saving his job and the staff.

However, this change would be highlighted in the position statement under retained earnings as a cumulative effect adjustment. The management would have to justify this change to stakeholders that it will give a more accurate picture of the usage of assets in the financial statements.

So, on one hand Aman has an obligation to protect his skin and his staff and on the other hand, opting for sudden change in the method of depreciation could raise a question mark on the company's reporting integrity. This may not go well with the stakeholders and ultimately it might get revealed. Thus, creative accounting falls under unethical accounting domain.

7 The Regulation

Coglianese et al. (2004) states that prior to 1929, there were no official standards for accounting practices and ethics. The accountants were not obligated to disclose profits and losses of companies, and were accountable to their employer corporation. The need for corporate financial accounting initially gained momentum after the stock market crash in 1929 as during that time corporate financial statements were often not audited. Further, accounting conventions were in practice rather than the accounting rules.

That's how the idea of setting official standards for accounting got originated in the light of the 1929 stock market crash and the Great Depression. This resulted in the establishment of the United States Securities and Exchange Commission.

7.1 Code of Ethics for Professional Accountants

International Federation of Accountants (IFAC) had long recognized the need for developing, promoting, and enforcing international recognized standards for providing credible information to the investors and other stakeholders and protecting their interests.

IFAC lays down the structures and processes for supporting the four independent standard-setting boards: the International Auditing and Assurance Standards Board (IAASB), the International Accounting Education Standards Board (IAESB), the International Ethics Standards Board for Accountants (IESBA), and the International Public Sector Accounting Standards Board (IPSASB).

These independent standard-setting boards are responsible for developing and ensuring the high-quality standards in a transparent, efficient, and effective manner. These boards issue the following pronouncements:

- Code of Ethics for Professional Accountants
- International Standards on Auditing, Review, Other Assurance and Related Service
- International Standard on Quality Control
- International Education Standards
- International Public Sector Accounting Standards

According to International Ethics Standards Board for Accountants (2012), the Code of Ethics for Professional Accountants (the Code) issued by the International Ethics Standards Board for Accountants (IESBA) has been effective since January 1, 2011.

7.2 Sarbanes-Oxley Act

The Sarbanes Oxley Act (SOX) of 2002 is another powerful Act that regulates corporate behavior in the United States of America (U.S.A). It came out as a result of several large corporate scandals in the country. This Act was a means to protect the public from unethical accounting practices. Koestenbaum et al. (2005) explains that SOX provided a multifaceted approach to embrace ethics in corporate, focusing on (i) Process compliance and the price of non-conformance, (ii) Behaviors and attitudes throughout the organization, and (iii) The role of leadership. The Securities and Exchange Commission (SEC), in compliance with the Sarbanes-Oxley Act of 2002, requires a company to disclose whether it has adopted a code of ethics.

7.3 Accounting Code of Professional Conduct

The American Institute of CPAs outlines an AICPA Code of Professional Conduct for accounting professionals. The code provides general guidance on professional responsibilities, the public interest, integrity, objectivity and independence, and the nature and scope of their services. There must be a clear understanding between independence and objectivity at the time of providing services to the clients.

7.4 Clause 49 of the Listing Agreement

The stock market regulator in India, the Securities and Exchange Board of India (SEBI) implemented Clause 49 of the Listing Agreements in 2003 which finally came into effect in 2005. The Clause 49 is considered as a milestone in the evolution of corporate governance practices in India. Besides other features, it also stressed on 'disclosures by the company.'

Grant Thorton (2014) has stated in their report, "the Securities and Exchange Board of India ("SEBI"), vide its circular dated 17 April 2014, had issued certain amendments to Clause 49 of the Listing Agreement. These amendments followed the overhaul in the corporate governance norms under the Companies Act, 2013 and the related rules notified on 27 March 2014 (together, the "2013 Act")."

7.5 Companies Act, 2013

The new Indian Companies Act, 2013 is a proposition to improve corporate governance system in India on account of corporate scams and failures in the past. Under this Act, significant corporate governance reforms have been recommended primarily *to improve the board process.*

(As mentioned on the MCA 2013), On Auditors' front, the limit of the maximum number of companies in which a person may be appointed as auditor is fixed at 20. Their appointment for 5 years shall be subject to confirmation at every annual general meeting.

8 How to Promote Ethics in Accounting?

Promoting ethics is not a solution but inculcating ethics in the value system is the solution. It's all in culture.

Table 1 2013 World's most ethical companies

Company	Industry	Country
ABB Asea Brown Boveri Ltd	Electrical equipment	Switzerland
Accenture	Business services	Ireland
Baptist Health South Florida	Healthcare services	USA
Capgemini	Business services	France
Colgate-Palmolive Company	Consumer products	USA
Dun & Bradstreet	Business services	USA
Kellogg Company	Food and beverage	USA
Microsoft Corporation	Computer software	USA
Tata Steel Ltd	Metals and mining	India
Wipro Ltd	Computer software	India

Source: Smith (2013)

First, the value system of human beings has to be strengthened. This does not include only accounting professional or corporate executives but the society in all and it has to start right from his childhood.

Second, as discussed earlier the two most important factors for unethical behavior—'greed' and 'threat' should be dealt with strongly. Strong regulatory mechanisms, enforcement of standards are an easy approach to fight with this greed. Equitable distribution of income in the society is the best measure to reduce the gap between haves and haves not for dealing with the threat factor.

The World's most ethical companies as mentioned in Table 1 have been leaders of their respective industries on criteria, such as approach of the top, employee well-being, compliance parameters. This strong quality culture of is also key to their increasing financial performance. Table 1 lists world's leading ethical companies of 2013 in an alphabetical order.

9 Conclusion

The accounting and corporate professionals are responsible to the firm and the public for maintaining a high standard of ethical performance, as set out in their various codes of professional ethics and good corporate governance. The professional ethics are not simply a compliance of a few rules; rather it goes beyond the written code. The ethical behavior has to be in spirit not in letter.

One important lesson from recent cases of corporate scams is that the unethical behavior is not only immoral in business sense but is also disastrous for the economy. 'We cannot have business people lying, stealing, perpetrating frauds, and making up accounting rules as they go without seriously disrupting business' (Hilton 2005). Thus, according to him, ethical behavior by business people in general, and accountants in particular, is not a luxury or a discretionary 'good thing to do'. It is an absolute necessity to the smooth functioning of the economy. *So, ethical accounting is the backbone of any business and the nation.*

Based on the foregoing discussion, the following recommendations will encourage ethical behavior by accounting professionals and motivate ethical accounting:

- Relevant professional bodies should review their codes and regulations at regular intervals in the light of changing global practices.
- Widespread enlightenment about these codes among the members needs to be encouraged and strict penalty for professional misconduct should be levied.
- Accounting professionals need to be fully aware and conscious of the values and goals regarding the nature of their job.
- Strong whistle-blowing and/or ethical concerns procedure must be set up by corporate for discouraging internal unethical practices.
- Ethics training programs should be provided to all the accounting executives as a part of orientation on the job.

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