An Investigation of the Impact of Codes of Ethics on the Opportunistic Judgment Tendencies in an Accounting-related Judgment

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Abstract

Critics of U.S. Generally Accepted Accounting Principles (GAAP) have argued that the rigid, highly detailed, rules-based nature of current accounting standards may actually be detrimental in achieving transparent financial reporting. Many of these critics claim that the investing public might be better served by principles-based accounting standards. In fact, Section 108 of the Sarbanes-Oxley Act (SOX) required the Securities and Exchange Commission to investigate the feasibility of adopting a principles-based accounting system similar to that which utilized by the International Accounting Standards Board (IASB) in their promulgation of International Financial Reporting Standards (IFRS).

Proponents of principles-based accounting standards favor their flexibility and emphasis on 'substance over form.' However, detractors point to the additional onus placed on the accountant (and auditor) to use her or his judgment to identify the appropriate financial reporting for the transaction. Of greater concern is the notion that accountants might exercise greater opportunism in exercising their judgment in order to achieve a desired financial reporting objective.

Given these divergent philosophies and given the enhanced priority by both FASB and IASB to work towards the convergence of accounting standards, several interesting questions arise. If the convergence project culminates in one set of global accounting standards, will the standards tend to be principles-based or rules-based? If U.S. GAAP and IFRS continue as distinct forms of guidance, will the convergence project have resulted in a principles-based influence to U.S. accounting standards? More importantly, regardless of the source of future accounting standards, if they tend to be more principles-based in nature, what assurances exist to mitigate the exercise of opportunistic judgment to produce an accounting that, in substance, does not resemble the underlying transaction?

Among management scholars, business ethicists consider ethics codes a valuable tool to institutionalize desirable behavior within the organization. Codes are part of a command-and-control approach to mitigate unethical behavior in the workplace and to provide a system with which to evaluate whether a corporation's mission and vision statements are being upheld. "Their function is to provide guidance and direction for the management of the multiplicity of transactions between the company and its stakeholders" (Clarkson & Deck, 1992: 216).

There are three main types of codes, which must be delineated. A "code of ethics" is a statement of principles and values whose main purpose is to support the purpose of the organization and state the responsibilities the company has to its various stakeholder groups (Clarkson & Deck, 1992). In other words, a code of ethics is a statement of "who we are" as an organization. In contrast, a "code of conduct" is very compliance-based. They state very clear rules and preferred behaviors for all the employees of the firm. In this type of code, it is often commonplace to define the penalties for ethical transgressions. Finally, there is a "code of practice". This type of code is the most vague and obtuse of the three in that they demonstrate company values in terms of what employees are supposed to do in certain situations. For example, rules of thumb such as "seek advice" and "act and disclose" in particular situations would represent a code of practice (Clarkson & Deck, 1992: 217).

An alternative way of looking at different types of codes for professionals, like accountants, is to view them as a tool for ethics management. There are two ends of the spectrum in this approach—one which takes an "integrity-based" view of ethics management, and the other which merely focuses on legal compliance (Paine, 1994). The former "combines a concern for the law with an emphasis on managerial responsibility for ethical behavior" (p. 106). Codes in this type of approach would emphasize principles and values to guide behavior in an organization. The "compliance-based" view of ethics management, by contrast, emphasizes legal clearance and simply making sure that behavior is not perceived by regulators or outside stakeholders as being unlawful. Compliance-based companies tend to overemphasize "the threat of detection and punishment in order to channel behavior in lawful directions" (p. 110). Companies taking this latter approach are likely to overlook the moral consequences of their actions and choices.

Integrity-based (e.g., principles-based) strategies for governing ethical behavior are more robust in that they are based on ethical principles that go beyond the rules established by the law. Principles-based strategies are seen to use values as a beacon to the organization to create a work climate that is more ethically sound. Recently, Herron and Gilbertson (2004) conducted a study among accountants that examined how different types of codes affect independence judgments for their clients. They found that subjects were more likely to reject questionable audit engagements with clients when principles-based reasoners are supplied with a Code of ethics (based on principles). Thus, auditors who are high in moral development respond in a more ethical manner when presented with a principles-based, or integrity-based code of ethics.

Effective codes must be clearly stated to support the organization's mission and culture. Generally, corporate ethics codes are distinct, formal documents that outline ethical constraints on conduct in organizational life (Weaver, 1993). The effectiveness of corporate ethics codes in

preventing unethical behavior has been disputed, as some scholars consider them mere symbolic gestures to comply with Federally-set regulations (Stevens, Steensma, Harrison, & Cochran, 2005). Thus, in the business ethics literature, there is some debate as well as to what kinds of codes are the most effective and useful for mitigating aggressive, unethical behavior in the workplace.

The main purposes of this study are to examine whether: (1) codes of ethics have a mitigating effect on the opportunism exhibited in the accounting-related judgments of novice decision-makers; (2) differences exist between principles-based ethics codes and rules based ethics codes in mitigating opportunistic behavior; and, (3) ethics training curbs aggressive decision-making.

Participants in this study are undergraduate business students (juniors and seniors) who have completed the Financial and Managerial Accounting course requirements of their curriculum. Prior to administering the instrument participants are provided with a verbal description of the accounting-related decision, the importance of earnings in investors' perceptions of the company's performance and the significance of an initial public offering.

Experiment group participants are then provided with one of two codes of ethics that have been formally adopted by the hypothetical company for whom they are employed. One version of the code is *principles-based* while the other version is *rules-based.* Control group participants are provided with a document that is neutral with respect to the hypothetical company and its code of ethics. Next, all participants are provided with a hypothetical case involving a company (their employer) which is about to miss its expected earnings target. However, the undesirable situation can likely be avoided by extending the useful life of a significant asset acquired earlier in the year. While the decision to adopt an extended useful life represents a departure from company policy (within acceptable accounting guidelines) it is likely to situate the company positively for an upcoming initial public offering. Students having completed both of the introductory accounting course requirements should have a solid grasp on the impact that an asset's useful life has on both depreciation expense and corporate earnings and thus be capable of making an informed decision with respect to this issue.

After reading the case participants are asked to provide a recommendation as to the expected useful life for the asset (with the alternatives ranging from a "conservative" response to an "aggressive" response). Participants are reminded that none of the decision alternatives are in violation of generally accepted accounting principles nor are they in violation of any laws. A summary of the decision consequences are also be provided to assist them with the decision. After completing the ARJD instrument, participants are asked to complete the newest version of the Defining Issues Test (DIT2). The final step of the data collection process involves the administration of a post-experiment questionnaire.

Currently, we are in the data collection phase of our study. Data analysis will take place next month and we fully intend to report the results of the study at the conference.