

32.13: Ethics in Accounting

Learning Objectives

- Discuss the consequences of unethical practices in the accounting profession
- Discuss the impact of the Sarbanes-Oxley Act on accounting practices

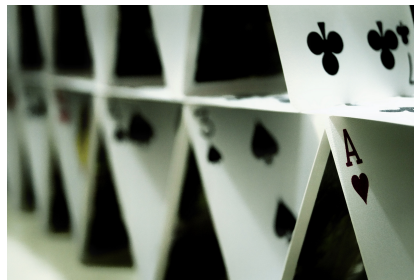
Due to a series of recent corporate collapses, attention has been drawn to ethical standards within the accounting profession. These collapses have caused a widespread disregard for the reputation of the accounting profession. To combat the criticism and prevent unethical and fraudulent accounting practices, various accounting organizations and governments have developed regulations and guidelines aimed at improved ethics within the accounting profession.

The following video is just one example of the type of activities that have brought the accounting profession under fire for what can best be described as questionable business practices.



You can [view the transcript for “Tax Shelters” \(opens in new window\)](#) or the [text alternative for “Tax Shelters” \(opens in new window\)](#).

Why Should an Accountant Be Ethical?



Throughout this module you have read about the wide range of people and institutions that rely on accurate accounting information to make important decisions. Despite the best efforts of FASB and GAAP, accountants and accounting firms have become increasingly “creative” in reporting the financial position of businesses and in some cases have committed outright fraud. The consequences of unethical practices in financial reporting have cost taxpayers billions of dollars, employees their jobs, and the accounting profession its untarnished reputation.

The AICPA (American Institute of Certified Public Accountants) has its own **Code of Professional Conduct** that prescribes the ethical conduct members should strive to achieve. Similarly, the Institute of Management Accountants (IMA)—the primary

national organization of accountants working in industry and government—has its own code of ethics, as does the Institute of Internal Auditors—the national organization of accountants providing internal auditing services.

The AICPA issued guidance to help CPAs solve ethical dilemmas not explicitly addressed in the code. Even though this guidance is for CPAs, it makes sense for anyone facing an ethical dilemma:

- Recognize and consider all relevant facts and circumstances, including applicable rules, laws or regulations,
- Consider the ethical issues involved,
- Consider established internal procedures, and then
- Formulate alternative courses of action.
- After weighing the consequences of each course of action, you select the best course of action based on your own judgment.

It is important to note that these codes of ethics only apply to members of their respective organizations. Thus, despite efforts by professional organizations like the AICPA and legislation by the U.S. Federal Government, there is still a subset of the accounting profession that places profit before ethics.

? Practice Question

<https://assessments.lumenlearning.co...essments/14547>

The Sarbanes-Oxley Act

Senator Paul Sarbanes and Representative Michael G. Oxley, the co-sponsors of the Sarbanes–Oxley Act



Figure 32.13.1: Senator Paul Sarbanes and Representative Michael G. Oxley, the co-sponsors of the Sarbanes–Oxley Act

Over the past 15 years, a number of accounting reforms have been put in place to set better standards for accounting, auditing, and financial reporting. Investors, now aware of the possibility of various accounting shenanigans, are avoiding companies that use complicated financial structures and off-the-books financing.

In 2002, the **Sarbanes-Oxley Act** (commonly referred to as SOX) went into effect. This law, one of the most extensive pieces of business legislation passed by Congress, was designed to address the investing public's lack of trust in corporate America. It redefines the public corporation–auditor relationship and restricts the types of services auditors can provide to clients. The Act clarifies auditor-independence issues, places increased accountability on a company's senior executives and management, strengthens disclosure of insider transactions (an employee selling stock based on information not known by the public), and prohibits loans to executives.

An independent five-member Public Company Accounting Oversight Board (PCAOB) was given the authority to set and amend auditing, quality control, ethics, independence, and other standards for audit reports. The Act specifies that all PCAOB members be financially literate. Two members must have their CPA designation, and the other three cannot be or have been CPAs. Appointed and overseen by the Securities and Exchange Commission (SEC), the PCAOB can also inspect accounting firms; investigate breaches of securities law, standards, competency, and conduct; and take disciplinary action. The corporate Board registers public accounting firms, as the Act now requires. Altering or destroying key audit documents now carries felony charges and increased penalties.

Other key provisions of the Act cover the following areas:

- **Auditing standards:** The Board must include in its standards several requirements, such as maintaining audit work papers and other documentation for audit reports for seven years, the review and approval of audit reports by a second partner, and audit standards for quality control and review of internal control procedures.

- **Financial disclosure:** Companies must clearly disclose all transactions that may have a material current or future effect on their financial condition, including those that are off the books or with unconsolidated entities (related companies whose results the company is not required to combine with its own financial statements under current accounting rules). Management and major stockholders must disclose transactions such as sales of company stock within two days of the transaction. The company must disclose its code of ethics for senior financial executives. Any significant changes in a company's operations or financial condition must be disclosed "on a rapid and current basis."

Financial statement certification: Chief executive officers and chief financial officers must certify company financial statements, with severe criminal and civil penalties for false certification. If securities fraud results in restatement of financial reports, these executives will lose any stock-related profits and bonuses they received prior to the restatement.

- **Internal controls:** Each company must have appropriate internal control procedures in place for financial reporting, and its annual report must include a report on implementation of those controls to assure the integrity of financial reports.
- **Consulting work:** The Act restricts the non-auditing work auditors may perform for a client. In the past, the large accounting firms had expanded their role to include a wide range of advisory services that went beyond their traditional task of validating a company's financial information. Conflicts of interest arose when the same firm earned lucrative fees for both audit and consulting work for the same client.^[1]

Other regulatory organizations also took steps to prevent future abuses. In September 2002, the AICPA Auditing Standards Board (ASB) issued expanded guidelines to help auditors uncover fraud while conducting audits. The New York Stock Exchange stiffened its listing requirements so that the majority of directors at listed companies must be independent and not employees of the corporation. Nor can auditors serve on clients' boards for five years. Companies listed in the Nasdaq marketplace cannot hire former auditors at any level for three years.

In response to the passage of Sarbanes-Oxley and other regulations, companies implemented new control measures and improved existing ones. The burdens in both cost and time have been considerable. Many companies had to redesign and restructure financial systems to improve efficiency. Some finance executives believe that their investment in increased controls has improved shareholder perceptions of their company's ethics. Others, however, reported that costs depressed earnings and negatively affected stock prices. Despite the changes and costs associated with SOX compliance, 15 years after the law's implementation, many business executives believe that the process has helped them fine-tune financial activities and reporting while addressing dynamic changes in the market and other economic challenges.^[2]

? Practice Question

<https://assessments.lumenlearning.com/assessments/14548>

As in any area of business, ethical practices are "good business," but when individuals place their personal interests or wealth above those of the stakeholders, the consequences can be far reaching. It is only through the adherence to ethical reporting and GAAP that the accounting profession can regain the respect and prestige the profession once had and deserves.

1. "A Guide to the Sarbanes-Oxley Act," <http://www.soxlaw.com>, accessed August 11, 2017; Ken Tysiac, "Companies Spending More Time on SOX Compliance," *Journal of Accountancy*, <http://www.journalofaccountancy.com>, June 12, 2017. ↵
2. "Fine-Tuning the SOX Compliance Process," <https://www.protiviti.com>, accessed August 11, 2017. ↵

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