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Level of Ethics, Ethical Frustration and Accountant Discretionary Practices

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Abstract

In this paper it is shown with the help of a small sample that accounting is ethically loaded; that there exists ethical frustration caused by situational factors related to accounting; and that most probably the situational pressures may also change the level of ethics in the Kohlbergian sense; and that in studying accounting-related ethical problems empirically, the paper-and pencil tests and interviewing may give biased results.

The accountant's model of the world is supplemented with many discretionary practices. The general structure of this model is determined by the duality of double-entry bookkeeping, the system of stock accounts and flow accounts, principles of valuation, allocation, and control. Financial accounting is strongly controlled by legislation concerning who is obliged to do accounting, what is to be accounted for, how allocations should be made, how valuations should be carried out, and what should be presented in public. But even in these procedures there are many discretionary practices, the use of which is guided by conventions and general ideals like, for example, by a 'true and fair view' or a 'good accounting practice'.

In the realm of managerial accounting, the scope of discretion is even greater. To some extent it is, of course, constrained by the demonstration effect of practices present in financial accounting [Johnson et al., 1987], but in principle the hands of the accountant are relatively free.

In this paper we present the results of our small-sample

investigation into how the ethical dimension was handled in the daily work of some chief executives and heads of accounting departments. We will start by presenting a few theoretical concepts, which explain the way in which the study was conducted, and proceed by illustrating what our interviewees told us about their ethical problems relating to discretionary practices in accounting. Finally, an attempt will be made to draw some generalizations from our observations.

1. Personal ethics

Kohlberg's well-known investigations of the development of ethical thinking as a dimension of individual personal growth provide a few important concepts. Ethical development can be presented as a series of phases so that the phases are distinct and sequentially ordered: each subsequent phase is only possible to reach after the preceding one. In each phase ethical problems are solved on the basis of a different kind of reasoning compared to the other phases. Following Arbuthnot and Faust [1981] we present the three main phases as follows.

At the pre-conventional level, one believes that right and wrong are determined by following relatively simple rules given by a few powerful figures, for instance, people or organizations, who are able to punish. The central strategy is to avoid punishment, conform to rules, strive for one's own benefit, and bargain for benefits. - This phase lasts approximately to the age of 13, but about 15% of the adult population remain at this level.

At the conventional level, right and wrong are determined by what the society seems to expect: family, friends, relatives, neighbours, people of the same kind. One's personal benefit is submitted to the expectations of the society. Rules cannot be broken, because if everyone did so, the system would collapse. - Approximately 50% of the adult population reach this level but do not proceed further.

At the principled level, right and wrong are determined by universal principles. These principles concern human rights and duties, justice, and benefits of the mankind. One's personal endeavours should be subjected to these ethical principles. - Approximately 35% of the adult population seem to reach the principled level.

It is important to note that knowing one's ethical phase does not predict actual behaviour in a specific situation. Only the general

nature of the arguments employed in trying to solve ethical problems can be predicted.

At accounting departments some ethical principles might be of particular concern. For example, the right to a due process seems to be directly related to the question of measuring and informing about the performance of people or business units. The principles of justice are relevant in considerations of how performance should be measured. The right to political participation is relevant if we accept that an organization is also a political arena. Accounting information is not equally shared, which may hinder political activity or at least affect its success.

2. The Research Questions, Design, Data, and Related Previous Research

In this piece of work we consider the following questions:

1. Is accounting seen as ethically loaded by the producers and users of accounting information?
2. If it is, then, is the Kohlbergian phase model relevant for this kind of study?
3. If it is not, what kinds of concepts and methods are needed?

We used a qualitative research method in this research, analysing the way in which our respondents experience reality and how they react to it. The study was carried out by interviews in which the interviewer led the interviewee to remember his/her experiences of ethical frustrations. The interviewer used the same list of questions for all the interviewees.

Every interview was recorded on tape and later on transcribed almost word by word. Because of the delicateness of our research topic, it was quite obvious that the interviewees would not tell everything as their own experiences, acts or opinions. For this reason we also asked whether they knew of ethical problems they had heard someone else to have met with.

Each interviewee was told in advance what the subject of the discussion and the problem of our research was.

We tried to be very open-minded and objective in recording any kinds of problematic experiences. Therefore, we did not state any specific hypotheses but chose a small sample of different

kinds of firms, including

- two nation-wide consolidated companies,
- two firms which had suffered a serious financial crisis or bankruptcy,
- two medium-sized entrepreneur-owned companies, and
- two auditing firms.

None of the chosen respondents refused. The data were gathered with interviews that took one or two hours. All the respondents, one from each firm, turned out to have university-level education and, with one exception, they had had no formal studies in business ethics. The interviews were semistructured so that only general themes were decided in advance, and in each case time was also allowed for free talk on the general theme. The discussion was started with topics like the general economic situation in the country and future expectations. Then the discussion was directed towards ethical problems associated with accounting. The interviewees had some difficulties in understanding that we were not studying any financial crime that was being discussed in the media at the time.

The ethical thinking of CPA's is well-studied, and seems to be connected to their promotion [Ponemon, 1992]. There are also examples of possible ethical dilemmas in the form of teaching cases of external and internal reporting [Mintz, 1992]. The typical ethical problems of managers are also known. At the CEO level these include price discrimination and unfair pricing; giving of gifts, gratuities, and bribes; cheating; price collusion by competitors; unfairness to employees; contract dishonesty; included are also the role conflicts in the CEO's organization with respect to honesty in communications; gifts and kickbacks; fairness and discrimination; price collusion and pricing practices; firings and layoffs [Vitell and Festerward, in Snoeyenbos, 1992]. At the middle management level, the problems include complying with a superior's requirements even when they conflict with your code of ethics; job demands infringing on home obligations; methods employed in competition for advancement; and avoiding or hedging responsibility [Evans, in Snoeyenbos, 1992]. The relationship of accounting and ethics has not been studied extensively.

3. The ethical problems found in our data

The first finding is that every interviewee admitted that there are ethical problems related to accounting. This means that

accounting is not a value-free exercise in practice.

The following areas with a problematic ethical dimension could be found in the generated and tape-recorded discussions. The problems seemed to fall in two main categories: problems with honesty/the truth and problems with justice.

A. The 'true' income/cost

The first problematic area seemed to be the reporting (or non-reporting) of the 'true' income figures. The respondents obviously believed that such figures exist.

i. The conceptual meaning of depreciation was not clear and there were also difficulties in deciding upon the actual numbers. The Finnish legislation prior to 1993 gave relatively great freedom to decide on the magnitude of depreciation figures (the upper boundary was stated by the law) but also to write off inventories. These discretionary practices were described as 'hiding the profits' and 'distorting the true income'.

ii. Further, the practice of writing off inventories which have a lower predicted market price than the historical cost had serious problems with evidence.

iii. The appreciation (revaluation) of the balance sheet values of fixed assets also posed an ethical problem.

iv. The long-lasting overvaluation of inventories has led banks and other lending institutions astray.

v. The premature writing-off of inventories and/or fixed assets has at a later point offered an opportunity for smoothing the income figures by only minimal write-offs or calling off the previous write-offs.

vi. The practice of writing off the costs of research and development long before the commencement of sales was seen to distort income figures.

vii. One respondent suggested that there should be some compulsory depreciation of cars, for example.

viii. Due to the use of wrong cost drivers the cost figures are distorted, which may lead to wrong pricing.

B. Justice

i. When accounting shows that some employees are no longer needed in the future, how could one decide whom to dismiss?

ii. Employees cannot understand accounting numbers and are therefore in a weaker position. They can be led astray by being presented accounting information that they cannot understand. Balance sheets are no pocketbooks for people. Present recession, in particular, can be used to "clear out" personnel even in firms where the situation is not really bad - it can be done because this is generally done in many firms and accounting information is not understood by the personnel or it is manipulated.

iii. In transfer pricing the prices may or may not include the interest of capital - the numbers can be manipulated by such a simple inclusion/exclusion. Internal prices are arbitrary, sometimes knowingly and intentionally, sometimes not.

iv. The allocations made in managerial accounting and transfer pricing lead to local optimization. For example, if land and buildings are overvalued in the accounts of a business unit, then selling these will lead to a loss in the books of the business unit. The unit will oppose the sale, although in the books of the parent company a profit would emerge.

As this list shows, there is an abundance of ethical problems associated with accounting. Mainly they are what could be expected on the basis of previous literature, the accountant's model of the world, and obvious discretion found in the legislation. Seeing these phenomena as ethical problems indicates that the respondents are able to think at least at the conventional Kohlbergian level. Also, the most part of the data shows that there is little concern about people outside the firm, which is in accordance with the idea of a non-principled level, too. Without a formal measuring instrument it is difficult to say what the respondent's level of ethical thinking is. Arbuthnot and Faust [1981] give, however, useful hints. In our opinion, there were few, if any, signs of thinking at the principled level. One respondent, for example, commented that "Finns are guerilla people in the sense that when one's own skin is safe, who gives a damn about the neighbour". We estimated that the dominant Kohlbergian level in our data was the conventional level. The controllers/accountants seemed to think at a slightly higher level than the CEOs.

This interpretation of our data is in congruence with the results presented by Ponemon [1992] from his data on CPA's: He found a negative correlation between DIT (an instrument measuring the level of ethical thinking) and the position level. Furthermore, the dominant level in his data was the conventional level.

We observed a few differences relating to different professional backgrounds and gender. The accountants/controllers seemed to think very locally and in a more detailed way, while the CEO's related accounting also to politics and the society as a whole. Our two CPA's had serious trouble in understanding the whole problem: the law had such a guiding influence on their thinking that it had actually substituted for ethics. Female respondents were more interested in ethics, which was also formally shown, for example, by the longer interviewing times.

4. The Relevance of the Kohlbergian Model

Although the discussion above is possible by the use of the Kohlbergian phase model, our data contained some observations which do not fit well with this model.

In this respect, the interview of one respondent, Hanna, seems to be particularly informative. She works as a controller in a medium-sized entrepreneur-owned company. The firm is heavily indebted, which dictates heavy demands for the profit figures. She stated the following:

"We always have to make profit in one way or another. Often I think about these things from the ethical viewpoint and what can and cannot be done. ... I often come into conflict with the good accounting practice ... so it is a kind of ethics, a measure of how you interpret it. ... Then there is the manager who tries to say that such and such things should be done, so I have experienced being caught in the cross-fire. ... There are, you know, social constraints, but on the other side there is the claim to do something from the firm's point of view ... adjusting these together is quite troublesome. .. For example, more equity is needed ... quite often the value of land and buildings is upgraded so that it will emerge on both sides of the balance sheet and thus create additional equity. We had an outside estimator make a value assessment. He estimated the value to be 'too little' and the manager tried another estimator, giving him straightly those numbers that are needed ... a certain kind of paper was received and the appreciation was done. This simply doesn't fit into my

mind but what can I do?"

Another interviewee, Nina, told the following:

"Let's say [that the problem is] that some managers try to advance their career which is what I observe here. If we were an independent enterprise, there would not be things like that ... so I mean that when we send our budget to the headquarters and change certain things ... we say that, for example, the margin is lower than it will be ..."

Actually, we observed that there seemed to be variables that intervened in the relationship between ethical opinions and their objects. As objects we can generalize concepts like 'false' income or some special unjust conduct in the accounting function. It seems that accountants and managers have an opinion about the ethical desirability of these. This opinion is based on thinking at the (usually) conventional or preconventional ethical level, taking into account known facts, assumed conception of justice and honesty, and estimated values of the causal consequences to oneself and to his/her loyalty group.

However, the resulting act is affected by situational pressure by factors like the accepted view about the financial situation of the firm and the opinions presented in the loyalty group (for example, the term 'climate' was used). These variables create pressures both directly and indirectly. Direct pressure is generated by the possible outcome to the person him/herself (the threat of the weakening social status or even unemployment, complaints from others). Indirect pressure is generated by the possible consequences to other people belonging to the group of mutual loyalty (including only members of the personnel). As a result of pressure, a person adjusts his/her acts, but at the same time feels that they are not, however, exactly what should have been done without the pressure; but, in this situation these were the best actions to take. If the difference between what is seen to be right and what is actually done is great, a feeling of ethical frustration is experienced.

Thus, accounting offers a multitude of discretionary practices. Ideally the result of their use should be something called 'the true income' or 'the just performance measurement/fair play'. The respondents do not at all question the validity of accounting as such. On the contrary, they believe that there exist factors like the true income or just measurements and policies, and in

principle, accounting would be able to tell what they are. The respondents would want to reveal these. But there may also be pressures dictated by the situation so that they seem to feel unable to report what they would want. This pressure leads to experiences of having to distort accounting numbers (lying, leading astray) or being involved in actions that otherwise should not have been taken (participating in unjust conduct of affairs). This results in ethical frustration. The Kohlbergian model cannot handle ethical frustration at all because the model is not related to the behaviour but only to the ways of thinking (which fact is well-known, of course).

There was also a differing view presented in our data. One respondent, Heikki, told us that:

"I have not heard ... in my firm there are no such pressures ... accountants should be honest and strong ... they must say how things are no matter how big a boss the person is ... you need high morals and an independent position ... When I have to say something, it is a question of a misunderstanding on the boss's part, I had to correct him."

Despite of this contradictory observation we will now take it as shown that pressure may be and often is an intervening variable, and has an effect on the relationship between ethics and actions. This leads to ethical frustration. The next step is to study a stronger hypothesis about pressure having an effect upon the very code of ethics, and try to find support for this in our data.

At least in some cases, although not in all, there are, as discussed above, problems with the pressures. This observation leads to a difficult question. Ponemon [1992], for example, concludes that, according to Kohlberg's model, an individual's ethical level should not decrease. He explains his contrary observation by either (a) that there exists a culture gap between higher and lower position levels, or (b) that there operates a socialization process which is beneficial to lower-level ethics. His careful analysis supports the latter.

But our findings give reason to think that there may well also be temporary moves downwards on the Kohlbergian scale. An example of this seems to be what one respondent, Olli, told us. In the first instance he told the following:

"It is terribly wrong that the state and the local authorities sack

people in the name of savings."

Here Olli feels that it is clearly wrong to sack people, but later, when we were talking about savings in the firm and how to achieve them, he said:

"Sacking people on the basis of the rules of the Finnish Law in order to cut costs is so slow... First there is this negotiation obligation, and then that period of notice, which is from two to nine months. So, you cannot cut the costs as quickly as the fall of income would assume."

This paradox can be explained in the following way. Olli owned the company in which he was the CEO. His company had gone bankrupt about twelve months prior to the interview. The first excerpt tells about his general ethical code about sacking people. The latter excerpt tells that he has different thoughts in a situation where his position and property are on line. He has considered sacking people because he had troubles in the business, but decided against this; not because it is wrong but because of the slow legal process. Instead of cutting costs by laying off employees, his firm moved into its old facilities. But, what is important, there are no signs of ethical frustration in the latter case which seems to represent lower ethics than the first case.

Perhaps by testing (for example, by DIT) one is only able to measure a certain type of ethical level, and not the whole information involved in it. In the same way, our data were gathered in a specific way that possibly gives only a partial picture. In fact, we asked our respondents to tell about ethical problems they had experienced or heard somewhere. In this way our data were mainly able to capture memories of frustrations.

We suggest tentatively that pressure may change both ethical thinking and actions. In usual testing situations people are asked to give the grounds for choosing an action in an ethically problematic situation. These exercises are not real life but reading and writing [Straughan, 1986]. It is tempting and easy to present an image of a good person, as the respondent understands it according to his/her predominant level. In other words, in speech people tell their ethics-in-theory, the ethical thinking which they understand will give the best image of themselves. But in actual, real situations, if under pressure, they think and act according to their ethics-in-use, which is then at a lower level in the Kohlbergian sense. If they really change their

ethics in this way, they may not experience severe frustration at all, which would not be reported in the kinds of interviews like the ones we conducted. Neither will it be observed in normal testing situations.

As Straughan [1986] points out:

"The agent accepts that there are good reasons why he ought to do x, yet other reasons are operative upon him in the actual situation which lead him to do y instead. In other words he sees that factors A, B, C constitute reasons which justify or require to the doing of x, yet he fails to do x because factors D, E, F constitute reasons which motivate or incline him to do y - or put more simply, we do not always want to do what we believe we ought to do. Reasons for action of a justifying kind, therefore, do not always provide us with reasons for action of a motivating kind."

If our suggestion is taken as a hypothesis, it is perhaps only testable in field work, not in pencil-and-paper testing or in interviews. In a short period of the interviewing time people are quite able to give a consistent impression. But we have the case of Olli described above, and in addition to this, another interviewee mentioned an assumed lack of solidarity towards the dismissed employees from the part of those who were able to stay, and yet another informant told the following:

"It may be that you are a bit schitzophrenic here ... many times it may happen that you are a bit more uptight than in other times .. it may be possible."

Thus, discretionary practices in accounting are in principle chosen on the basis of the Kohlbergian level of ethics. But moderate pressure can have the effect that another practice is actually chosen. If the pressure is strong, it may also lower the level of ethics, that is, the ethics-in-use will differ from the Kohlbergian ethics-in-theory, and may lead to choosing a practice which is not seen unethical according to the former, although it would be unethical according to the latter.

5. Summary

Eight CEO's or controllers/accountants were interviewed about their own and perceived or reported experiences of unethical behaviour in accounting. Everyone was able to tell examples of these, which clearly shows that accounting is not a value-neutral

exercise in practice. The examples of discretionary practices that were told to us can be classified into two groups: those about distorted income figures and those about injustice.

The predominant level of ethical thinking seemed to be the conventional level. There were, however, slight differences in favour of lower-level positions and of female respondents.

Situational pressure was observed to lead to behaviour that was experienced unethical and had caused ethical frustration. But if the situational pressure was high enough, the level of ethics in the Kohlbergian sense changed temporarily. This observation gives reason to question the validity of both pencil-and-paper testing of ethical thinking and also interviewing in studying ethics in practical situations. In both cases the information gathered may be partial, giving only the ethics-in-theory that an individual is able to reach. More research into real-life behaviour seems appropriate.

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