ETHICS IN ACCOUNTING AND FINANCE

Ethics in accounting are concerned with how to make good and moral choices in regard to the preparation, presentation and disclosure of financial information. Currently, a series of financial reporting scandals has brought this issue into the forefront. Knowing some of the issues presented in accounting ethics can help you ensure that you are considering some of the implications for the actions that you take with your own business.

Fraudulent Financial Reporting

Most accounting scandals have centered on fraudulent financial reporting. Fraudulent financial reporting is the misstatement of the financial statements by company management. Usually, this is carried out with the intent of misleading investors and maintaining the company's share price.

While the effects of misleading financial reporting may boost the company's stock price in the short-term, there are almost always ill effects in the long run. This short-term focus on company finances is sometimes known as "myopic management."

Misappropriation of Assets

On an individual employee level, the most common ethical issue in accounting is the misappropriation of assets. Misappropriation of assets is the use of company assets for any other purpose than company interests. Otherwise known as stealing or embezzlement, misappropriation of assets can occur at nearly any level of the company and to nearly any degree.

For example, a senior level executive may charge a family dinner to the company as a business expense. At the same time, a clerk employee may take home office supplies for personal use. In both cases, misappropriation of assets has occurred.

Disclosure Violations

As a subtopic of fraudulent financial reporting, disclosure violations are errors of ethical omission. While intentionally recording transactions in a manner that is not in accordance with generally accepted accounting principles is considered fraudulent financial reporting, the failure to disclose information to investors that could change their decisions about investing in the company could be considered fraudulent financial reporting, as well. Company executives must walk a fine line; it is important for management to protect the company's proprietary information. However, if this information relates to a significant event, it may not be ethical to keep this information from the investors.

Penalties for Violations

Penalties for violations of accounting ethics laws have increased greatly. The law allows for harsh penalties for manipulating financial records, destroying information, interfering with an investigation and provides legal protection for whistle-blowers. In addition, chief executives can be held criminally liable for the misreporting of their company.

N.B.

Financial managers prepare reports, oversee accounting functions, plan investment strategies and direct cash management functions. They also are involved in branch management functions at banks and other financial institutions. They are required to uphold the highest ethical standards because internal and external stakeholders depend on transparent, timely and complete financial documents to make decisions.

Accuracy

A company's financial manager ensures that all financial publications accurately and fairly reflect the financial condition of the company. Accounting errors and financial fraud, such as what was seen in the cases of Enron and WorldCom, damage the interests of shareholders, employees and affect confidence in the financial system. Some organizations document ethics guidelines specifically for financial managers. For example, the ethics code requires senior financial managers to maintain accurate records and books, maintain internal controls and prepare financial documents in accordance with generally accepted accounting principles.

Transparency

Financial documents reflect a company's performance relative to its peers, and its internal strengths and weaknesses. Regulatory agencies require publicly traded companies to submit periodic financial statements and make full disclosures of material information. A change in the senior executive ranks, buyout offers, loss or win of a major contract and new product launches are examples of material information. Transparency also means explaining financial information clearly, especially for those who aren't familiar with the company's operations. Financial managers should not hide, obscure or otherwise render relevant financial information impossible for ordinary shareholders to understand.

Timeliness

Timely financial information is just as important as accurate and transparent information. Management, investors and other stakeholders require timely information to make the right decisions. Many cases exist of a publicly traded company's stock reacting sharply and negatively to negative earnings surprises or unpleasant product-related news. For example, a company should promptly disclose manufacturing problems that could temporarily affect sales. Similarly, the company should not hold back news of a major contract loss in the hope that it can replace the lost revenue with new contracts.

Integrity

Financial managers should strive for unimpeachable integrity. Customers, shareholders and employees should be able to trust a financial manager's words. Managers should not allow prejudice, bias and conflicts of interest to influence their actions. Managers should disclose real or apparent conflicts of interest, such as an investment position in a stock or an ownership interest in one of the bidding companies for a procurement contract. The structure of certain stock-based incentive compensation schemes could also result in ethical issues. For example, managers might be tempted to manipulate stock prices by selectively disclosing or not disclosing relevant financial information.

IMPORTANCE OF ETHICS IN ACCOUNTING AND FINANCIAL DECISION MAKING

The Importance of Ethics in Finance

Whether your company hires an outside financial manager or manages its finances in house, ethical considerations are both necessary and expedient. Finance is the process of managing money and maintaining a set of books that provides insights on how your company earns and spends its cash. Attending to this process with honesty and integrity allows you to present your financial situation accurately, both internally and externally.

Your financial reports represent your profit and loss, net worth and cash flow situation. When you use them to understand and improve operations, it is an ethical imperative to present this information in ways that are clear and honest. Whether you are assessing efficiency and profitability or evaluating whether it makes sense to invest in future growth, approaching these documents with a sound moral compass helps you to provide the people who review them with the information they need to make the best possible decisions.

Business partners and stakeholders have a right to know whether your business is earning or losing money and whether they are making investments in an organization with a firm or shaky foundation. Showing a crooked set of books may help you to secure financing that will be convenient and expedient but may be in neither your best interest nor the lender's if your business model is not sound enough for you to repay what you borrow.

Utilitarian Ethics and Accounting

A utilitarian approach to ethical thinking argues that moral behavior yields the greatest good for the greatest number of people. If you present financial statements that inflate your net worth and secure financing for a risky venture, you may further your own short-term interests, but you deceive lenders and investors by not offering them the benefit of an honest evaluation of your loan worthiness.

By borrowing money that you secure via false information, you may not even be acting in your own best interests, especially if you are pledging collateral for a loan. The bank's process of evaluating your financial reports may seem cumbersome and inconvenient, but it is designed with an eye toward the mutual best interests shared by you and the lender. If your business isn't ready to expand or invest in pricey infrastructure, it isn't a good idea to do so.

Even if the money you borrow or land in investments is unsecured, and you lose nothing by losing someone else's money, you can still do broader damage by misrepresenting your situation. If a bank makes too many unsound investments, it will be forced to use stricter criteria going forward. This may lessen the possibility that someone else who is more deserving may not be able to get useful capital. You may further your own interest, but your actions are immoral by utilitarian standards because they ultimately do more big-picture harm than good.

Categorical Imperatives and Accounting

A categorical imperative is a more abstract approach to ethical thinking. Rather than expressing moral principles in terms of their costs and benefits, a categorical imperative weighs the motivation behind an action and judges whether it has merit on principle. The 18th century philosopher Immanuel Kant framed the categorical imperative as a question of whether the maxim behind an action could be used as a universal moral principle.

If you misrepresent your financial situation to borrow undeserved funds or lower your tax liability, you act out of pure self-interest, disregarding the needs of lenders, other taxpayers and other patrons of your lending institution. Self-interest works in the short term for a limited number of people, but if everyone acted purely out of self-interest, the world would be entirely vicious and morally bankrupt.

Most unethical practices in accounting and finance stem from a desire for more money that has not been rightfully earned. If this single-minded pursuit of money at the expense of honesty, integrity and kindness were a universal practice, then ethical principles would be largely irrelevant, and charity and generosity would be obsolete. Although this may seem like a leap from simply fudging some numbers on your financial reports, ethical evaluation based on a categorical imperative requires you to take this perspective.

Understanding Gray Areas

Accounting concerns itself with truth in the form of faithful numerical descriptions of business activities. The ethical principles that drive the profession speak to the importance of providing accurate and unbiased information. This allows business owners to glean the information they need, and auditing agencies can make useful assessments. Ethics in accounting is a matter of both guidelines and principles. Specific standards are set by governing bodies and trade organizations who craft the rules of accounting, but personal values and professional ethics must guide accountants. This extra layer of ethical judgment helps in making decisions in the face of ambiguities and gray areas.

Ethics in Audits

Auditing is one of the most important tasks that accountants perform. It involves verifying information to assess the truth and accuracy of accounting information, whether for internal purposes or external evaluations for tax and lending institutions. To act ethically during an audit, an accountant should evaluate numbers with the primary objective of getting to the truth. There should be no conflicts of interest, such as owning stock in the business and standing to gain if the numbers portray operations in an advantageous light.

When a company hires an outside auditor to review its accounting data, it is the job of that accountant to be thorough and fair and to search for inconsistencies even if these red flags will add additional work or create other problems for the company. An auditing accountant who works for a bank or government agency should not be swayed by personal feelings such as greed or even sympathy but should be concerned only with making sure that the numbers line up and accurately express the company's financial activity.

Code of Ethics in Accounting

The International Ethics Standards Board for Accountants, itself an independent agency, has created a code outlining the principles at play in ethical accounting. These principles cover many facets of ethical behavior for accountants, although unique situations may call for judgment calls that aren't explicitly reflected in these principles.

- **Integrity:** Integrity isn't a set of rules or a course of action, but rather a state of mind oriented towards honesty, straightforwardness and a commitment to acting following principle rather than for the sake of personal gain.
- **Objectivity:** To the extent that it is humanly possible, accountants shouldn't be influenced by the interests or perspectives of the individuals or businesses who hire them. An accountant also shouldn't let personal biases or interests influence either the numbers