

ETHICS AND AUDITING: SETTING THE BAR TOO LOW

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Abstract

Purpose - from a philosophical and empirical perspective this paper seeks to show how the big audit firms have managed to set the bar low so that they offer only opinions on whether financial statements meet accounting standards. It is argued that while the concepts of virtue ethics have now largely disappeared, ethical legitimacy has moved beyond consequential ethics to a form of social Darwinism. It is a Social Darwinism that is legalistic and technical as evidenced by the audit firms' widespread use of the Bannerman clause attached to their opinions. Design - to illustrate the shift of ethical positions, the paper is informed illustrations of a failure to discharge a duty of care to the public. Findings – the shift in underlying social values contributes to what the Economist Journal describes as a steady decline in professional ethics. This arguable conclusion is supported by various illustrations and cites the shift in combinations of cognitive, moral and pragmatic legitimacy as drivers employed by accounting firms. Research Limitations – the paper uses secondary and documentary data and is informed by conceptual analysis which necessarily in the realm of ethics may be contentious. Originality – the paper seeks to link the changing social values with changes in legitimisation and to show shifts in accounting practices like the recent practice of issuing disclaimers.

Keywords: Ethics, Disclaimers, Kant, Unilateralism, Social Darwinism, Values

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1 Introduction

The paper is concerned with ethical trends in the accounting profession. There have been an increasing number of accounting scandals in recent years (The Economist 2009). The trend is also revealed in the very recent global financial crisis, which – while possibly involving some unethical business practices in the banking and finance industry – may also reflect serious ethical issues in the accounting profession, as banks enjoyed the benefits of unqualified opinions from their auditors prior to the collapse (Sikka, 2008). In contrast to the global trend of increasing accounting scandals, the volume of content of the New Zealand professional Code of Ethics (COE) has grown from six pages to more than 120 pages. However, the longer COE does not seem to have had a positive impact on accounting ethics. Most ethical codes are built on the moral traditions of their respective societies. In this way, Accounting ethics reflect and adapt to societal values. The New Zealand code, it can be argued, broadly reflects the moral inheritance of Europe, which has been refined by philosophers like Kant, Bentham and Mill, and Spencer (Stackhouse, 2004). Different ethical positions are always contentious but can be useful to focus thinking on the role of ethics in Accounting. This paper attempts to reveal ethical trends in the accounting profession in New Zealand through an analysis of the changes in underlying ethical philosophies as reflected in the profession's COE:

arguably derived from Kantian principles of virtue ethics, to a more legalistic and technical rhetoric reflective of Utilitarianism and Social Darwinism.

The accounting profession has over one hundred years of history and has been growing in importance to business communities and society (Backof & Martin, 1991). The New Zealand Society of Accountants was founded in 1908 and is now called the New Zealand Institute of Chartered Accountants (NZICA). The accounting professions in commonwealth countries are self-regulating, with members' behaviours being guided by their profession's ethics, regulations, or COE. In New Zealand, professional ethics regulations were first issued by the Society of Accountants in 1927. The most recent version of the COE became effective in 2003 and was subsequently amended in 2006. This paper argues with Abbott (1998) that the changes from 1927 to 2006 in the COE reflect a shift from the personal qualities of accountants to legitimacy of technique. The 2003 COE adopts a more teleological approach with emphasis on legitimising the accounting profession. Preston et al (1995) observe that originally accounting like medicine and law was to be regarded as an occupation more heavily influenced by the service motive than entirely by the profit motive. As suggested by Higgins & Olson (1972), accounting involves judgement and the acceptance of responsibility to others. Putting, originally, a focus on character means as Preston et al (1995) observe that the profession's foundations rest

on moral schema and code of ethics rather than standardisation and regulation. The paper attempts to show how the NZ COE has shifted from a focus on character to a more functionalist model which protects clients by delivering expert services. While such a question cannot be resolved by discussion or by empirical surveys, explanations can be offered for discussion that may illuminate how ethics codes could be derived and developed.

The plan of the paper is first to consider the concept of legitimacy and its link with moral and pragmatic philosophies in respect of COE. Following the discussion of legitimacy, the paper considers some of the elements of Kantian ethics and consequentialist thinking (Utilitarianism, and Social Darwinism) that have relevance to the paper. The object is to briefly outline the differences between these philosophical approaches to ethical problems as is necessary to explain moral and pragmatic legitimacy. With these differences in mind, the paper next compares the COE of 1927 and 2003, being respectively the first and latest COE promulgated by the accounting profession in New Zealand. The discussion which follows draws out concepts embodied in these COE with the overall purpose of showing how the focus has moved from the character of the accountant to the character of accounting. The process is informed by a shift from a more deontological position to a more consequentialist position. We illustrate this latter consequentialist position with a case study which has had considerable media attention in New Zealand – that of Hanover Finance. Like the Graham case (Baskerville-Morley, 2004), the Hanover Finance case illustrates the shift in ethics as reflected in practice. The accounts, reports and audit of Hanover Finance were in a minimalist sense just within the existing legal boundaries but there was widespread loss when the finance company suddenly collapsed – a not uncommon story. Anecdotal evidence has it that from the beginning of the company's short history that the audit engagement was not much sought after because of the risk involved. Before the conclusion, a discussion is advanced to draw together three themes: values philosophy, COE, and how the shift in values reflected in the two COE can be shown in a recent company collapse.

2 Legitimacy

The paper sets out, first, to outline the concept of legitimacy which, it is argued, underpins many professional codes of ethics. As Aldrich & Fiol (1994) observe such a concept may be driven by (1) a concept of legitimacy to meet pragmatic assessments of stakeholder relations (2) a more normative response to what is considered morally appropriate or (3) legitimacy grounded on cognitive appropriateness. So what is legitimacy? Suchman (1995) defines it as, “a generalised perception or assumption that the actions of an entity are desirable, proper and appropriate

within some socially constructed system of norms, values, beliefs and definitions” (p. 574). The appeal for legitimacy is to a social group as a whole notwithstanding individual reservations. It is argued in this paper that COE are the means to establish social legitimacy and the underlying philosophical positions they reflect are designed to be congruent with current social values and beliefs.

What is legitimacy overlaps with what is legitimacy for in that legitimacy cements congruence between an organisation and its cultural environment. The emphasis being not so much what is desirable as is recognisable and understandable such that would explain and justify an organisation's existence (Meyer & Scott, 1983) (Meyer & Scott, 1983). Suchman (1995) points out that the concept of legitimacy seems to divide academic studies into two distinct groups: strategic or institutional. The strategic studies emphasise a management perspective which manipulates and use effective symbols to gain societal support (Ashforth & Gibbs, 1990; Dowling & Pfeffer, 1975). By contrast, the institutional studies emphasise cultural pressures which transcend any organisation's control (DiMaggio & Powell, 1983; Meyer & Rowan, 1991).

While the divisions between strategic and institutional legitimacy are an important consideration, it is the concept of legitimacy being driven by pragmatic, moral or cognitive considerations that arguably helps to explain why COE may be expected to change to meet changing social values.

Pragmatic legitimacy rests on the self-interested calculations of an organisation's most immediate audiences according to Suchman (1995). Aldrich & Fiol (1994) point out that for pragmatic reasons organisations may emphasis image and support such an image by advertising. Moreover, image advertising may foster generalised attributions of good disposition. Whether such calculations are driven strategically or institutionally as a result of cultural expectations is not resolved but what is motivating is a desire to build and maintain a reputation for competence and reliability. When pragmatic strategies of legitimacy are preferred it follows that COE will be designed to include consequentialist values and beliefs.

By contrast, moral legitimacy is harder to achieve. Ashforth & Gibbs (1990) conclude that for organisations their best hope is to accumulate a record of technical success. They observe that within the contemporary rationalist order, technical performance not only establishes consequential legitimacy but it also exerts spill-over effects on moral dynamics to provide a lasting validation for procedures, and structures (Suchman & Eyre, 1992). Moral legitimisation comes with a warning from Selznich (1949) that it carries with a substantial likelihood of unanticipated goal displacement and possibly public cynicism.

Suchmann (1995) argues that to further cognitive legitimacy, gatekeepers may be employed to grant certification to label institutions and grant preferred definitions such as employed by the professions to privilege members and provide them with certified recognition. Finally, while pragmatic and moral legitimacy can be arrived at by cost-benefit appraisals or ethical judgements by way of public discussion cognitive legitimacy implies unspoken assumptions as to professional legitimacy. Some defensive endeavours taken by professional organisations may have the wrong effect and imperil taken for granted assumptions. On the other hand, pragmatic legitimacy relies on audience self-interest that it the right organisation for the job, whereas moral and cognitive legitimacy do not.

These observations from the literature explain from the point of view of legitimacy, why professions need a COE and why such a COE may combine element of pragmatic and moral philosophies. This is not to say that any one kind of legitimacy is dominant in COE but rather that all three – pragmatic, moral and cognitive - are combined. However, what is argued is that there has been a shift within this combination. A shift to reflect changing values not necessarily from a strategic design but from institutional reflexes to cultural change. The paper seeks now to briefly outline features of ethical philosophies, which are sources of legitimacy drawn on by professional monopolies to underpin their COE.

3 From Kant to Social Darwinism

The principles reflected in the COE have an ethical inheritance, which generally reflects the moral values and ethical philosophies of the society in which they are embedded. This section provides an overview of principles of ethical philosophies that are reflected in the COE, namely Kantian and Mintz's virtue ethics, Utilitarianism and Social Darwinism. To explain such a reflection, the paper attempts to link elements of these philosophies with the COE. The position reflected in the paper is that ethics is about choices of principles that may right or wrong, while morality is about good or bad, though the latter is not under discussion.

Ethics is necessary because people's actions may conflict and most people are more interested in their own welfare than in that of others. Such egoistic actions are frequently involved in social conflicts. Ethics has a twofold purpose: first, to find criteria by which to distinguish right and wrong actions; second, by means of praise and blame, to promote right actions and discourage wrong ones (Russell, 1947, p. 807). To ameliorate social conflicts, the moral inheritance generally shared by Europeans, which is also shared in New Zealand, has been developed by philosophers like Kant or modified by philosophers like Bentham into utilitarianism. For the purpose of this paper, the deontological arguments employed are

drawn primarily from Immanuel Kant. It is acknowledged that there are other major deontological contributors, but this paper is necessarily limited in its content.

Immanuel Kant (1724-1804) argues that a fundamental principle of morality is a rational will and such rationality of will must be regarded as independent and self-governing. He calls these moral principles 'Categorical Imperatives' (CI) (*Kant's Moral Philosophy*, 2008). He believes that "The highest good was the good will" (Frederick, 1999, p. 3). Because humans have free will and are rational, they are capable of reasoning what constitutes right actions. CI are formulated so that rational beings should abide by the maxim, "Act only on that maxim through which you can [...] will that it should become a universal law [for all rational beings] (Kant, 1993, p. 30)". In other words, according to Russell, Kant maintains an ethical position of "Do as you would be done by" (as cited in Russell, 1947, p. 737). The second formulation of CI is to "Act in such a way that you treat humanity, whether in your own person or in the person of any other, never merely as a means to an end, but always at the same time as an end" (Kant, 1993, p. 36). Kant argues that certain actions or behaviour cannot be justified as moral based on the outcomes from such actions. For example, a businessman is honest because he knows that it will attract more customers and increase profits. He is not genuinely moral because his intention to be honest is to increase profits under Kantian ethics. Kant's ethics are non-consequentialist. It is a deontological approach, which focuses on duties rather than consequences. The third formulation of CI is that, "So act as if you were a member of an ideal kingdom of ends in which you were both subject and sovereign at the same time" (Frederick, 1999, p. 4). This means that people should abide by the maxim all of the time, without exception. The maxim is thus a law which applies to everyone. No one should exempt himself from the maxim but expect others to abide by it. In other words, Kant's deontological approach emphasised a sense of duty.

However, this focus on duty is not the same as a focus on character, except that, as Aristotle observes, "We are what we repeatedly do" (Gough, 1998). In this vein, according to virtue ethics theory, virtues characterise the decision maker: "Possession and exercise of virtues tend to increase the decision maker's propensity to exercise sound ethical judgements" (Armstrong, Ketz, & Owsen, 2003, p. 3). This combines Kant's view of rational cognitive acts, recognising moral issues and thinking them through, with an intention to act morally, and the ethical character to bring that intention to fruition (Armstrong et al, 2003). From Kant comes the element of reason necessary to understand issues, think, and arrive at an ethical judgement, while virtues add ethical motivation, allowing individuals to place the interest of others before themselves. For Pincoff (1986),

virtues are those attributes of character that describe an individual's direct concern for others, which contrasts with Adam Smith's view that people act in their own self-interest, egoism, and that they are rational but greedy. Mintz (1995) believes that virtues in accounting are linked to the requirements of accounting professional codes: trustworthiness, benevolence, altruism, honesty, integrity, impartiality, open-mindedness, reliability, dependability and faithfulness. Thus, what are for Kant elements of an over-riding concept of "duty", become virtues in practice and characteristics of accountants.

In contrast to Kant's deontological perspective, Jeremy Bentham (1748 – 1832) developed utilitarianism. In essence, his teleological approach advocates identifying the aggregate of pleasure and pain that would best advance "the greatest happiness" of all of those whose interest is in question. Bentham holds not only that the good is happiness in general but also that each individual always pursues what he believes to be in his own happiness. He rejects Kant's subjectivism of what ought to be for everyone else as merely an expression of Kant's moral feelings.

"If each man in fact and inevitably pursues his own pleasure, there is no point saying he ought to do something else. Kant urged that "you ought" implies "you can"; conversely if you cannot, it is futile to say you ought" (Russell, 1947, p. 806).

Bentham seeks a more scientific approach in terms of utility and consequences and by such terms arrives at a deterministic account of mental occurrences (Pope, 2004). Utilitarianism introduces the idea that whether an action is ethical is based on the outcomes resulting from that action. Using the same example as above, the businessman is honest because he knows that is the way to increase profits. Because the consequence is to increase profits and acting honestly is a way to achieve this consequence, the businessman is considered to be morally right. In contrast to Kantian ethics, the intention of being honest is irrelevant as long as it achieves the ends.

Mill (1861) declares: "Utility, or the Greatest Happiness Principle holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness" (p. 257). If the outcomes of action or behaviour lead to greatest happiness, which is calculated as the sum of the happiness of all affected people in a given situation, that action or behaviour is ethical. This rejects Kant's ethics where the ethical values of people are absolute and autonomous. Under utilitarianism, consequences can justify the means. For example, according to utilitarian ethics, stealing can be justified if more people benefit from this action than suffer losses. So where a person steals from his wealthy neighbour's household of four people and gives the proceeds to an orphanage with fifteen orphans, the stealing is an ethically permissible action because the happiness of the fifteen orphans is greater than the happiness of the neighbour's household.

One of the drawbacks of utilitarianism is the difficulty of quantifying happiness and a calculation of happiness (Preuss, 1998). Other flaws also exist. The concept of utilitarianism relies on legislators, who prescribe sanctions, knowing what is in the community's interests while ignoring their own interests or desire for pleasure. If, however, as Adam Smith argues, every man always pursues his own pleasure, how are we to ensure that the legislator will pursue the pleasure of mankind in general? (Russell, 1947) Thus, the ideal that all pain and happiness can be brought into calculation is, for some, flawed. For example, those framing accounting standards must ignore the interests of lobby groups or their own paymasters to pursue a community's interest, which presupposes that they know what such interests are and they know which side of a social conflict they support (Tinker, 1991).

Herbert Spencer (1820-1903), a liberal utilitarian, first enunciated the concepts of Social Darwinism, drawn from the theory of natural selection known as Lamarckism, in which acquired characteristics are inherited. In nature, living things can modify new traits gradually in response to needs created by their environments and pass them on to their offspring (Stent, Sydney, & Jeffrey, 2001). Spencer applies this argument, with irresistible evolutionary logic, that it is natural and proper for the strong to survive at the expense of the weak (Spencer, 1897):

...every type that is best adapted to its conditions, which on the average means every higher type, has a rate of multiplication that insures a tendency to predominate. Survival of the fittest, acting alone, is ever replacing inferior species by superior species. (Spencer, 1882, 2:478 cited in Weikart, 2009, p. 24)

This paper adopts Mike Hawkins definition of Social Darwinism as "the attempt to justify or promote human competition for scarce resources as a necessary, natural phenomenon fostering biological progress" (Weikart, 2009, p. 21). It has two central assumptions. First, it suggests that there are underlying and irresistible forces acting in societies, which are like natural forces that operate in the animal and plant kingdoms. Second, these social forces are of a kind to produce evolutionary progress through natural conflict between social groups. The best adapted and most successful groups survive these conflicts (Abercrombie, Hill, & Turner, 1994). Indeed, to support those unfit to survive can be argued to be morally incorrect, but that does not mean that the opportunity for self-improvement should be denied (Hawkins, 1997). For example, the American capitalist, Andrew Carnegie, was an overt Social Darwinist, using his vast fortune to establish libraries and other educational institutions so that the so-called weak might have the opportunity for self-improvement (Hawkins, 1997). Social Darwinism introduces a laissez-faire approach to business

(Weikart, 2009). “The business of business is business” is a quote attributed to Milton Friedman, an advocate of laissez-faire economics. Taking this observation as the hallmark of Social Darwinism, the relevance of this philosophy to the latest COE is found in the espoused qualities of competence and technical efficiency. More broadly, Social Darwinism mainly holds that it is good to be successful and that eliminating weaker competition facilitates evolutionary progress. It justifies ruthless competition and argues that it is both natural and proper to exploit the weak (Bergman, 2001). Echoes of Social Darwinism arguably resound whenever the concept of “the business of business is business” is used to reject suggestions of business social responsibility and may be applied to audit firms who justify disclaimers to third parties on the grounds that they owe only a duty of care to those who pay them.

Neimark (1995) observes that, “What constitutes ethical behaviour at any time is socially constructed; it is a product of time and place” (p. 94). Such behaviour may be constructed from concepts of legitimacy, whether pragmatic, moral or cognitive according to current values. To explain the dominance of Social Darwinism today, Neimark (1995) argues that social, economic and political structures, collectively and inevitably, produce patterns of behaviour that are not ethical even by contemporary Western standards:

“We must consider the relationship between what individuals do and the institutional structures and the ideological underpinnings of capitalism, including its emphasis on Social Darwinism, individualism, competition, and material acquisitiveness” (p. 93).

Some blending of these opposing philosophical positions (Kant, Utilitarianism and Social Darwinism) is the basis and justification for most modern business interpretations of ethics and for various professional COE (Stackhouse, 2004). In the next section, the paper shows how these three philosophical positions are reflected in the accounting professions COE in New Zealand. Through the analysis, the paper demonstrates the inclination and the trend of prevailing philosophies reflected in COE. To achieve this, the paper compares the New Zealand accounting profession’s first COE in NZ, issued in 1927, with the current one, issued in 2003.

4 New Zealand’s Code of Ethics (COE)

This section identifies differences in the content of the 1927 and the 2003 COE. By analysing these changes, this section attempts to demonstrate the shift that has occurred in their underlying ethical philosophies.

The New Zealand Society of Accountants adopted its first Professional Ethics code in 1927. This consists of 17 clauses and is six pages in length (attached as Appendices A). The 17 clauses cover a range of requirements, including: the overall

characteristics of professional accountants (clause 1-2), confidentiality (clause 3), disclosure of conflict of interests (clause 4), relationship with other accountants and the profession (clause 5-9), advertising (clause 10), obligation to stakeholders (clause 11), unbiased judgement (clause 12), no commission dealing (clause 13), obligations to the profession and the Society (clause 14-17). As Preston et al (1995) found in the 1917 American Association of Public Accountants code of ethics there were similar prohibitions against encroachment and advertising. According to Preston et al (1995) the term independence was not used until 1964, rather the emphasis is “replete with exhortations of duty, responsibility and loyalty” (p. 513). They argue such ethics reflect contemporary conceptualisations of morality and societal culture to legitimise the profession within a wider public domain. The insistence is on good character. Preston et al (1995) suggest that the focus was on forming oneself as an ethical subject and being of good character was the basis for legitimising the activities on accountants. This focus on duty, responsibility and loyalty ties in with the concepts virtue ethics.

The first paragraph of the 1927 Professional Ethics, which has disappeared from the current COE, reads:

Every member of the Society in the practice of his profession or in the course of his service to his employer should give such service with absolute fidelity and should be actuated by a spirit of fairness to client and employer, considerate to the fellow practitioners, loyalty to his country, and devotion to high ideals of courtesy and honour (p.1).

The stated virtues of professional members include “absolute fidelity”, “a spirit of fairness”, being “considerate to the fellow practitioners”, “loyalty to his country”, and “high ideals of courtesy and honour”. These virtues are also reflected in subsequent clauses. For example, clause 5 stipulates that practitioners “should not use *unfair means* to win professional advancement or to injure the chances of another Public accountant to secure and hold employment”, reinforcing the concept of fairness in dealing with other people.

Furthermore, clause 10 requires that practitioners should only advertise their services by means of a “card”, the size of which should be small in a newspaper or directory and whose content should include only the name, title and address of the advertiser. Such advertising is very humble, suggesting that, at the time, the Society discouraged advertising of its professional members in order to avoid competition between them. It may reflect also professionals’ consideration and courtesy for their fellow practitioners and a collective distaste for image creation. Competition among practitioners may result in competing fees and it may be regarded as being not honourable to compete with each other for fees. This requirement has disappeared from the 2003

code, which is silent with regard to intra-professional competition. Indeed, for pragmatic reasons of legitimacy as Aldrich & Fiol (1994) observe image advertising may foster generalised attributions of good disposition.

In addition, Clause 11 specifies that practitioners have responsibilities towards “prospective investors, creditors, or others” during the course of preparing or certifying statements. The responsibilities owed to prospective investors or other third parties in 1927 code were explicit. The 2003 code remains silent about duties towards ‘prospective investors’. The requirements prescribed in the 1927 COE focus on personal characteristics or the good will of rational beings. It reflects both a Kantian “duty”-based ethical approach, which believes that rational beings have a duty to act with good will, and a virtue ethics view of the codes as found in Mintz (1995). Values such as fidelity, consideration, loyalty, courtesy and honour are often used to characterise a good person. They assume a sense of self moral regulations governing how accountants should act. The 1927 code focuses on duty and, by repetitive practice, such duties become virtues, which in turn become the characteristics of accountants. Such virtues imply a deontological ethical philosophy underlying the 1927 code, which focus on virtue as forming character (Mintz, 1995).

The current COE comprises two parts, the first part being 63 pages long, and the second part, Independence in Assurance Engagements, being 60 pages long. It reveals a discourse as Previts & Merino (1979) found of increasing use of legalistic and technical rhetoric and a growing concern with public relations. The COE contains five fundamental principles, including Integrity, Objectivity and Independence, Competence, Quality Performance and Professional Behaviour. Each principle is broken down into detailed rules, with applications provided to illustrate how the rules apply in different situations. According to NZICA’s official website, the current COE comprises “fundamental principles and provide guidance on professional conduct needed to sustain public confidence in the profession” (NZICA, n.d.). This implies that accountants need to behave professionally in order to sustain public confidence and that sustained public confidence is an outcome of acting professionally. Therefore, the current COE promotes behavioural rules or regulations that instruct professionals how to behave with the aim of maintaining public confidence. The emphasis is that accountants should behave in such a way as to deliver the desired outcome. Their conduct is justified by the outcomes they lead to, implying an underlying consequentialist ethics philosophy.

There are two fundamental principles introduced into the current COE to regulate how accountants should do their job to ensure that they provide quality service. These are competence and quality performance:

Competence - Members must only undertake professional work in which they have the Competence necessary to perform the work to the technical and professional standards expected. (p 3)

Quality Performance - Members must perform their professional work with due care and diligence, ensuring that all professional obligations are completed in a timely manner and are carried out in accordance with the relevant technical and professional standards appropriate to that work. (p 3)

These two principles, not in the original code, mainly deal with technical competence and good quality work. Competence and Quality Performance are required to assure the public that accounting professionals are technically competent to deliver their service. This is similar to a quality control procedure in a manufacturing factory for ensuring the quality of products so that they can be competitive in the marketplace. It can be argued that this similarity suggests that the two principles are not so relevant to ethics, but are more like a quality control procedure. Some authors share this view. Velayutham (2003) analysed both New Zealand and Australian COE and argues that “the main focus of the codes ... is quality rather than ethics” (p. 484). Further, he states that “Compliance with technical standards and professional behaviour could not be considered to be ethical principles since their compliance depends on law like statements and quality standards” (p. 494). In relation to competence, Fogarty (1995) adds, “The central message of quality ... fails to express any coherent moral ideas” (p. 111). On the other hand, it may be argued that quality does have an ethical dimension especially when clients are unaware of what constitutes a quality standard. According to Dellaportas (2005) the social contract concept and clients’ reliance on the knowledge of the professional accountant professional competence should be perceived to be a duty of the professional accountant.

The addition of these two principles to the current COE implies that quality work is at least equally as important as accountants’ character, if not even more so. Velayutham (2003) also comments on the quality focus of the current COE and maintains that it reflects a shift from the ideals of sentient beings to standards of service, where “technique has character as an important value” (p. 501). This may reflect a Social Darwinian approach in that the accounting profession seeks competent people who can deliver quality work. People who are not technically competent enough should not be in the profession. The accounting profession needs such technically-competent people to maintain its public profile, and possibly improve its reputation and image, so that the whole profession becomes stronger and more influential in the business community and society.

Apart from the two new quality focused principles, other principles also reflect their utilitarian origin. For example, the purpose of the Integrity

principle is that “It is members’ adherence to the fundamental principle of Integrity that allows the public to derive their trust in the accountancy profession” (p.7). Although integrity can be seen as a virtue, in here, there is an aim to being honest. Integrity is required to gain trust from the public. Therefore integrity is a means to reach an outcome,

Some authors argue that the primary purpose of a COE is to improve the image of the profession and there is for pragmatic reasons of legitimacy good reason to promote such an image (Backof & Martin, 1991; Fogarty, 1995). According to Kantian ethics, this is not morally right because the purpose of having integrity or providing quality service is not to improve a profession’s image; rather, the motive is on goodness as an absolute moral principle. By contrast, according to utilitarianism, integrity and quality service are needed to earn a good public image for the profession. Accounting professionals’ characteristics are less relevant if they do not result in improving the public’s image of the profession. The focus of competence and quality performance are arguably primarily technical issues aimed at legitimising the profession’s monopoly particularly in assurance engagements (Mitchell, Puxty, Sikka, & Willmott, 1994).

Furthermore, the principles of Independence and Objectivity outlined in Rules 3 &4 in the current COE are to ensure that professional accountants are objective when making professional judgements particularly for assurance engagements. However, Williams (1992) points out that independence in accounting has shifted from being conceived as an integral part of character to being regarded as an economic commodity. The consequence of this shift is that independence is now the focus of much interpretation as a claim to independence is not longer credible to the general public. Claims to independence need today to be supported by rules specifying its nature and scope (Preston, et al., 1995). Such rules of independence are expressed in rules that are seen to be more precise and legally interpretable so that compliance or non-compliance can be determined. The importance of codifying ethics into rules is, as Preston et al (1995) point out; a big part of legitimation. While rules may be a source of legitimation in contemporary society, this increasing emphasis as Preston et al (1995) observe, “raises the question as to whether the code and the discourses surrounding it may be defined as moral” (p. 528). Rules require only conformity and no moral discernment. As Francis (1991) comments that the moral question as to how I, an accountant, should act in a particular situation becomes a legalistic rather than a moral one.

Some writers question the motive of this principle. For example, Mitchell et al. (1994) examine audit failures and alleged unprofessional conduct by accounting firms and their partners in UK. They find that professional accounting bodies failed to take

effective action against offending firms or their partners. Therefore they argue that “The ideals of independence and integrity, [...] are little more than a smokescreen, or fig-leaf, for the pursuit and protection of sectional interests” (p. 48). Allen (1997) also states:

Independence is not a value in and of itself. Independence in this context is an instrumental value. We value it because we think it helps produce something else: efficiency (of the capital markets and thus, efficiency of the economy as a whole)(p. 3).

According to Preuss (1998),utilitarianism offers an advantage to accountants in that it links self-interest with moral behaviour and is by definition self-serving (i.e. he argues that utilitarianism is formulated on a deterministic psychology that every individual seeks his own happiness). It is, he argues, by default the most influential ethical theory in the business context. The calculation of greatest happiness and harm shares similarities with the calculation of profit and loss.

Accountants can be seen as conveying neutral information on which users can base their decisions and, in this sense, the consequences can only be helpful. However, in as much as the COE focus on the consequences of an ethical action, it would seem that the COE conveys legitimacy to both professional monopoly and the wider public.

The importance of these principles is reflected in the introduction section of the current COE

The Code of Ethics recognises that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement. This Code is designed to provide members with authoritative guidance on minimum acceptable standards of professional conduct. The Code focuses on essential matters of principle and is not to be taken as a definitive statement on all matters.

Perhaps the exposure draft (ED) of the latest COE spells out the importance of fundamental principles more clearly. (An ED was issued by Professional Standard Board in December 2010 and the new COE became effective on the 1 January 2012). According to section 100.1 of the ED

“A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a member’s responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest, a member shall observe and comply with this Code”.

Again, the COE emphasises that to adhere to the principles is to sustain a public interest. Public interest is what sets members of the profession apart as a group of “ethical and competent accountants” compared to accountants who are outside the profession. The paradox is that the professional qualified accountants are trying to limit their responsibility to the public by introducing something

like the Bannerman clause. Such clauses undermine the concept of public interest and, as a consequence, the COE looks more like a screen to legitimate the profession. The self-interest of the Bannerman type clauses imply a social Darwinist influence. As others have observed for some time the profession needs to have a COE to promote their own interests, secure privileges and stay competitive (Johnson, 1972; Larson, 1977; Preston, et al., 1995; Willmott, 1986). Overall, the differences between the 1927 and the current COE and the 1927 codes illustrate a shift in the ethics philosophies underlying them. The 1927 code implies a deontological approach, whereas the 2003 Code reflects a teleological approach. Some of this shift may be explained by the confusion that the “new burst of interest in business ethics in universities” has evoked (Stackhouse, 2004, p. 238). He goes on to write:

Textbooks written for these [ethical] courses seldom treat theological issues, focusing instead on some combination of Kantian principles, utilitarian calculus and various versions of social Darwinism. (p. 238)

An explicit example of a shift in the COE to limit the obligations to stakeholders is evidenced by Baskerville-Morley (2004). She refers to the Graham case which led to statutory reform of the accounting profession in New Zealand. For some time prior to 1991, the Chartered Accountants Society in New Zealand had maintained a Fidelity Fund to recompense clients who had been cheated by their ‘black sheep’ members. It was a characteristic of being a ‘Chartered Accountant’ which, by having the fund, combined a sense of duty and virtue as hallmarks of a profession. That is, the profession, recognising that it must inevitably at some time have “bad” members, set out to protect unknown third parties from the effects of these members’ activities. However, as Baskerville-Morley (2004) points out, following the Graham case, which emptied the Fidelity Fund, the then ‘Big 6’ accounting firms in New Zealand in conjunction with other practitioners no longer wanted to maintain the fund and lobbied successfully for its cessation. Since then, injured third parties have no resort to the profession for recompense. The outcome is consistent with Sikka’s (2000) determination from the UK that power symmetries meant that private profit, not human welfare, was the dominant behavioural driver. The push to abolish the Fidelity Fund concealed a power asymmetry between the influence of the Big 6 firms and that of other members of the profession in small and medium partnerships (Baskerville-Morley, 2004).

The following section draws on another New Zealand case, that of the failure surrounding Hanover Finance, which shares similar features to the Baskerville-Morley’s (2004) Graham case in that it attracted high public attention because the majority, least dominant, stakeholders were marginalised. Like

the Graham case, the Hanover Finance case illustrates how the shift in the COE is reflected in practice.

5 Pragmatic legitimacy: the Hanover Finance case

As described above legitimacy comprises a combination of moral, cognitive and pragmatic elements. Pragmatic legitimacy rests on the self-interested calculations of an organisation’s most immediate audiences according to Suchman (1995). The case illustrated reflects a shift towards pragmatic legitimacy and rather less of moral (what is morally appropriate) or cognitive (what is grounded on cognitive appropriateness) legitimacy. In this case, the audit firm’s most immediate audience was the small group of major shareholders controlling Hanover.

In December 2009, it was announced that 16,000 so-called “Mum and Dad” depositors in the failed finance company, Hanover Finance, had voted to take shares in Allied Finance, another New Zealand finance company, in order to seek future repayment (Eriksen, 2008). The “Mum and Dad” investors had, in reality, lost most of their money as the new shares that they had to accept in place of the deposits with Hanover Finance are of little and diminishing value. It is a story of social conflict, where accounting served the interests of one side of this conflict, that of the controlling shareholders - accounting taking the form of one of the Big 4 firms. The Big 4 firms enjoy considerable market place legitimacy resting on their recognisability (cognitive legitimacy) and good reputation for efficient audits (moral legitimacy). It is the third element in the legitimacy combination, the pragmatic that features as dominant in this story.

The case attracted huge media attention in New Zealand. Television cameras camped outside the homes of the controlling shareholders who, to avoid further interviews, fled the country. The media sensed corruption and fraud but, in fact, as the auditors were probably aware, the company’s financial reports were within the “form” of the law (such as existed) if not its substance. The Hanover Finance story begins in 2006. Thousands of depositors were drawn to Hanover Finance by television advertising fronted by a popular television news reader, Richard Long, who gave authenticity to what would subsequently be shown to be extravagant claims:

The Long advertising strategy was highly successful and at the end of the June 2006 year the company had total assets of more than \$1 billion and was ranked number one in terms of total assets and net profit after tax in the KPMG Property Development and Commercial Finance category. (Gaynor, 2008)

What was not disclosed in the advertising and prospectus was that nearly 20% of the company’s assets were related-party loans with a capitalised

interest facility relating to property bought by the controlling shareholders that was worth much less than their book value. Amazingly, under accrual rules, the interest due but not received from the related-party loans were treated as income and the audits were not qualified. What is of significance is that as the years progressed increasingly more of Hanover Finance's loans became related-party loans and 93% of these loans were on a capitalised interest basis, with only 7% paying interest. Moreover, a capitalised loan is where interest is added to the principal instead of being paid, so that interest is deferred. Nevertheless, "Hanover included this interest as interest received and, as a result, was able to give the impression that its earnings were far stronger than they actually were from a cash income point of view" (Gaynor, 2008). Such an accounting policy, while not strictly illegal, is misleading and says much about the how the auditors viewed these transactions. To accept the form rather than the substance of these transactions implies that drivers of moral and cognitive legitimacy were weakly held. If, as Suchmann (1995) observes, "Pragmatic legitimacy rests on the self-interested calculations", then the driver in this sad story seems to be self-interest.

The accounting misdemeanours were several. In New Zealand directors are supposed to declare dividends only after confirming that the business is a going concern. The six major shareholders of Hanover Finance distributed 5.5 million dividends to themselves after its profits plunged and shortly before interest payments were suspended. As one business commentator observes, this action was hardly justifiable (Gaynor, 2008).

Whether the auditors questioned the solvency declaration is unknown. It may be argued that had the auditors respected the Bannerman judgment of responsibility to unknown third parties then they may have been prompted to ask further questions. But they chose not to this and the Big 4 firms are now adopting a specific "Bannermann" clause to their audits denying responsibility to anyone except the shareholders as a body. Quite what "as a body" means no one knows.

Inter-company loans can obscure the state of a holding company's true financial situation. Without consolidated accounts, investors cannot be assured that so-called "stringing" or "hydraulicking" is not taking place. Stringing or hydraulicking is commercial slang used to describe the way a finance company might use one loan book as equity to raise another. The result is a complex structure that is more highly leveraged than is possible to see from the available information. When asked about the inter-company loans, Mr Hotchin, one of Hanover Finance's controlling shareholders, pointed to each finance company's trust deed as well as the signoff from the Big 4 auditors as reasons why investors should be reassured (Cone, 2004). In other words, the image of

legitimacy created by the Big 4 firms was enough to silence critics.

Since the controlling shareholders of Hanover Finance always acted to just within such laws as exist to control finance company operations, their auditors also were always able to endorse their transactions. As Tinker (1991) observes, accounting inevitably favours one side of a social conflict. In spite of a new COE in 2003, the practices that ruined the New Zealand share market in the late 1980s were repeated: extravagant advertising to draw investors, unwarranted dividend payments from capital, lack of consolidation so as to hide illiquid subsidiaries, and inter-company loans to related parties.

The central point with regard to this case and its relevance to the paper is that the auditors – post-Bannerman – chose to issue unqualified audit reports which served the interests of a small group of Hanover Finance shareholders. The case is now under investigation. Chartered accountants are given a monopoly over audit work because they enjoy legitimacy. Cognitively, they are recognised as the appropriate professional body and their advertising is cultivated to convey an image of responsibility and integrity. Morally and cognitively, they enjoy legitimacy because of their professional image. Yet, the auditors in the Hanover Finance case sought to serve specific interests. This shift from 'means' to 'ends' is a shift exemplified in terms of the driving features of legitimacy.

6 Discussion

Ethical problems in accounting and auditing are global. Sikka (2010) refers to the Lehman insolvency and warns that the public should be sceptical of the audited reports published by large corporations. Sikka (2010) comments:

Ernst & Young, Lehman's auditors, collected \$31mn in fees in 2007, and knew of Lehman's \$ 50 bn Repo 105 accounting gimmick, but did not make or demand public disclosures even though the insolvency examiner argues (page 735) that "the only purpose or motive for the transactions was reduction in balance sheet ... there was no substance to the transactions". Repo 105 had been in existence since 2001. Perhaps, the auditing firm was unwilling to upset its paymasters. (p. 1)

It is this question of accountants and auditors accepting the "form" of transactions rather than enquiring too deeply into their "substance" that is a troubling problem, as illustrated in the Hanover Finance case cited above. Reducing the balance sheet by off-balance sheet techniques may not be uncommon but most auditors would or should be aware of such practices. As Sikka (2010) states,

Some estimates have suggested that banks may have organised as much as \$ 5,000 bn off their balance sheets and window-dressed their leverage. Despite the chicanery, all distressed banks received

clean bills of health from their auditors. If auditors are unwilling to speak up on accounting gimmicks of \$ 50 bn or \$ 5,000 bn, there is no point in continuing with the present arrangements. ("Lehman chicanery is tip of the iceberg" The Guardian, 16 March 2010)

What this paper tries to show is that the practices referred to by Sikka (2010) and illustrated in the Hanover Finance case occur because of the economic practice of what Shearer (2002) refers to as "granting value to a desired object only insofar as the object stands in instrumental relation to the desiring subject (p. 553) Shearer explains further, "In the language of Kant, the other is made a means rather than an end in herself, and by this act is objectified and her own subjectivity denied" (p. 553). The unfortunate Hanover Finance investors were of no consequence to the auditors and as "others" were only a "means" whereby audit fees were collected. In other words, calculation of self interest prevailed and served a legitimising strategy.

The practice of accounting is driven by the assumptions of neo-classical economics: "the subject will do that and only that for which he expects a net gain in well-being" (Arrow, 1979, pp. 111-112). This deep rooting of accounting within neo-classical economic theory has been observed by many (Cooper & Sherer, 1984; Gray, 1992; Hines, 1989; Lukka, 1990; Mouck, 1995; Preston, et al., 1995; Reiter, 1994; Thompson, 1998; Tinker, 1991; Tinker, Lehman, & Neimark, 1991; Tinker, Merino, & Neimark, 1982) . The problem with neo-classical assumptions is that, as Shearer (2002) observes,

If economic theory does not effectively restrict itself to discrete domains of human life, then it is at risk of colonizing the whole of human experience, ensuring that human subject understand themselves and one another as self-interested utility maximizers, even in those domains of human engagement most removed from market transactions. (p. 549)

In other words, neo-classical economic theory practices an imperialism that spreads to the whole of human experience. But where do these assumptions draw their strength? Stigler (1981) comments, "We believe that man is a utility-maximising animal ..., and to date we have not found it informative to carve out a section of his life in which he invokes a different goal of behaviour" (p.176). The result as Shearer (2002) explains is that, "Within economic discourse each individual is properly held accountable only for the pursuit of her or his private good" (p. 556). As utility-maximising animals our origins and motivations can be explained by Social Darwinism. But this was not always the case. Before Spencer, there was Kant where, perhaps, more in theory than practice, society thought honour was paramount and that the means justified the ends. However, as the COE separated by time witness, other ideas prevail: "self-interest (broadly construed) becomes the only motive that appears rational for a sovereign and self-determining subject" (Shearer, 2002, p. 555).

To nail down their pragmatic self-interest further, accounting firms are issuing Bannerman-inspired disclaimers with their audits – a practice that as some firms are realising might have the self-defeating result of undermining the worth of the audit (ACCA, 2008). In this way, economic theory invites the imperialism of self-interest into every aspect of human behaviour as natural and self evident. The result is that, within economic discourse, each individual is properly held accountable only for the pursuit of her or his private good (Shearer, 2002, p.555). Thus, legal judgements (Caparo Industries v Dickman and Touche Ross & Co, 1990, and Royal Bank of Scotland v Bannerman Johnstone Maclay, 2005) based on this discourse have found that third parties (who do not pay directly for the audit service) cannot hold auditors accountable. However, as financial reports are held to be true and fair as a consequence of an unqualified audit, it seems odd that they are deemed only true and fair to those who can pay for them. These judgements represent as a consequence a shift in legitimacy to pragmatic considerations being paramount and give the green light to audit firms who seek to narrow their responsibilities as in the Hanover Finance case. Unfortunately for the auditors and the controlling shareholders, the wider public had not appreciated this shift in legitimising accounting as a more pragmatic calculation. The media attention that the Hanover Finance case engendered was huge, with television cameras camped outside the homes of the controlling shareholders to seek interviews which were not forthcoming as both main shareholders fled the country. One of the controlling shareholders was even pursued by the media to his new home in Hawaii. As has been cited, the only defence offered by one of the directors is that they had a clean audit, so what was the problem? However, the New Zealand media interest in the Hanover Finance case that was aroused can be explained because the public has not understood that audits are tailored to meet the expectations of their fee-paying clients. The image that accounting firms have cultivated is at odds with a legitimacy driven by more self-interested calculations. This was not the kind of legitimacy the New Zealand public expected it was granting to accounting firms. An expectation gap had emerged. The old unwritten social contract gave legitimacy that featured more cognitive and moral drivers though there was always present a pragmatic driver. Now it has emerged that, with or without disclaimers, some auditors are selling a "true and fair view", which may not be a "true and fair view" for other stakeholders. In other words, self interest prevails and those that can pay receive what they pay for, those that do not or cannot pay for the service cannot expect to be catered for. This is how the invisible hand of Adam Smith works: people supply what people are willing to pay for. It is not the invisible hand of God but that of Social Darwinism. It was these principles from another age that the

earliest COE drew on. The current COE has a legitimising and reassuring role for its members and the public, but the source of such legitimisation has assumed more of a pragmatic, consequentialist direction and is part utilitarian and part Social Darwinist and less deontological. However, this analysis is limited by the extent that legitimacy is a motivating element for profession and their COE. Also, the analysis is based on the assumption that COE are derived from certain philosophical ethical theories and such COE may be drawn up without any prior thought as to underlying philosophical positions.

7 Conclusion

A longer, more detailed COE does not appear to have any effect on moral trends in accounting. Globally, there is evidence of a spread in self-interested “egoism” capitalism (The Economist, 2009), which may be a reflection of concepts drawn from social Darwinism. The cause of these shifts in the COE has been shown by Sikka et al (1989, 2000) and Baskerville-Morley (2004) to result from crisis situations and a subsequent asymmetry of stakeholders which allows some dominant stakeholders to become definitive. The effects have been, as argued in this paper, to narrow the sphere of public responsibility and promote self-interest. Although the current COEs aim to sustain public reputation of the profession, in reality the codes appear to legitimate the profession at a pragmatic level. The Hanover Finance case was cited as New Zealand’s contribution to this trend as this typical case explains why there has been widespread failure of most of New Zealand’s finance companies. Audits were performed, but because of insufficient regulation, the same dubious accounting practices were condoned by the auditors who would seem to have interpreted their duty of care narrowly to serve their actual paymasters. Such end results undermine the advertising of the profession to convey an image of disinterested integrity and possibly have a consequence of calling for even more image advertising. By contrast, the original COE was carefully restrictive and reduced advertising to a small card.

The current COE would have us believe accounting can serve the public interest by being utilitarian – meaning objective and without bias, and serving both sides of any social conflict. While, in theory, everyone’s happiness is equally important, in practice, as some commentators have pointed out, such egalitarianism is inevitably denied. A calculation has to be performed by either appointed or unappointed moral legislators as to whose happiness constitutes the greatest happiness. Unhappily, such legislators may prefer their own happiness, or that of their paymasters, and bias the calculation. Arguably, utilitarianism in its ideal sense is the better ethical position for the profession to pursue. However, ethical

preferences are contentious and discussion can serve to illuminate differences in practice. The point being that as “The Rot Spreads” (The Economist, 2009, p. 3) a focus on ethical issues in Accounting are worthwhile. Since the 1927 publication of the first New Zealand COE, the world has changed and other ideas now prevail. This is not to argue that before 1927 some ideal sense of duty and virtue existed. The celebrated Graham case illustrates that before Graham emptied the Fidelity Fund, such a fund existed to reimburse third parties who were the victims of predatory accountants. The Hanover Finance case in New Zealand illustrates how the self-interest driver of legitimacy is predominant. Arguably, such pragmatism is reflective of unconsciously absorbed Social Darwinist thinking which has an effect on institutions and accounting practices globally. For accountants such egoistical thinking, albeit often unconsciously absorbed, is a licence for practices that are directed to legitimising narrowly-served interests that, while possibly passing as legal, externalise an ethical cost to the wider public.

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