

# Examining the Threats to Compliance with the Accounting Ethics Principles

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# Economic and Social Development

73<sup>rd</sup> International Scientific Conference on Economic and Social Development Development –  
"Sustainable Tourism in Post-pandemic World"

## Book of Proceedings

Editors:

Zoltan Baracscai, Dijana Vukovic, Jelena Janjusevic



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Dubrovnik, 21-22 October, 2021

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## EXAMINING THE THREATS TO COMPLIANCE WITH THE ACCOUNTING ETHICS PRINCIPLES

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### **ABSTRACT**

*Accounting ethics became an important issue worldwide due to many recent accounting frauds and financial scandals. Financial reporting quality must be high (containing accounting information that is unbiased, relevant, complete and correct) so that financial statements could be reliable to all stakeholders. Financial reporting quality can be jeopardized if professional accountants act in an unethical manner. Therefore, the ethics of accountants is of public interest since it has wide effect. The various circumstances (professional activities, interests and relationships) in which accountants work might create threats to compliance with the fundamental accounting principles. In order to avoid various ethical dilemmas, professional accountants should consult The International Code of Ethics for Professional Accountants. This code provides a conceptual framework as well as guidelines that should be applied in order to identify, evaluate and address five types of threats (self-interest threat, self-review threat, advocacy threat, familiarity threat and intimidation threat). The purpose of this study is to determine the level of the exposure to the threats to compliance with the fundamental accounting principles. Another aim of the paper is to find out whether the exposure to these threats is related to gender, age and education level of professional accountants. An online questionnaire was used as a research instrument. Empirical research results indicate that some demographic characteristics such as age and gender are not related to the exposure to the threats. On the other hand, the education level can affect the level of exposure of professional accountants to the threats to compliance with the fundamental accounting principles.*

**Keywords:** *Accounting ethics, Financial reporting quality, Professional accountants*

### **1. INTRODUCTION**

Accounting ethics is strongly related to business ethics which has been recently in research focus of many scholars due to different frauds, malfeasance, scandals and ultimately to financial crisis. As Messikomer and Cirka (2010) stated, there is an explosion of unethical behavior in business practice. A gradual deterioration of accounting ethics is the result of the wider social context (Gendron et al., 2006) with severe consequences that could eventually lead to bankruptcy. Unethical behavior of professional accountants can result in unreliable accounting information disclosed in financial statements. Higher quality of financial reporting is beneficial to the investors and other financial statement users (Aljinović Barać, 2021) while low-quality financial reporting is sometimes related to accounting manipulations. Cases of accounting malfeasance are often linked with the issues regarding revenue recognition (such as premature recognition of revenues or the recognition of fraudulent revenues). Aljinović Barać et al. (2017) reported that manipulations in Croatia are “principally oriented towards creditors, tax authorities and suppliers with the intention to hide bad performance, get better terms of crediting and minimize fiscal and political costs”. Thus, the need for integrity-boosting framework is obvious. Establishing ethical guidelines and following the code of ethics could promote professional conduct that is moral, and therefore beneficial to all stakeholders. As Messikomer and Cirka (2010) pointed out, a written code of ethics (although carefully designed and constructed) is not sufficient to prevent unethical behavior. Rogošić and Bakotić (2019) acknowledged that introduction of the code of ethics represents the initial phase of

institutionalization of ethical standards in a company. The well-known framework for the ethics of the accounting profession is the International Code of Ethics for Professional Accountants published by the International Ethics Standard Board for Accountants. This code addresses the issues regarding the threats to compliance with the fundamental accounting principles. The aim of this study is twofold: to determine the level of the exposure to the threats to compliance with the fundamental accounting principles and to explore the exposure to the threats depending on gender, age and education level of professional accountants.

## **2. THE IESBA CODE OF ETHICS**

Developed by the International Accounting Standards Board (IFAC) in collaboration with International Ethics Standard Board for Accountants (IESBA), the International Code of Ethics for Professional Accountants is intended to promote awareness and application of fundamental accounting ethics principles. These principles are integrity, objectivity, professional competence and due care, confidentiality and professional behavior. The latest revised IESBA Code is issued in 2020. It contains four parts. The fundamental ethical principles are explained in the first part along with the conceptual framework. The second part is dedicated to the professional accountants in business (who are employed or otherwise engaged in private, public, and non-profit sector, education and regulatory or professional bodies). The third part includes guidelines for the professional accountants in public practice. The fourth part consists of guidelines for achieving independence for audit review engagements as well as independence for assurance engagements (other than audit and review). Professional accountants should read this Code when they face ethical dilemmas because it provides guidance and enables conflict resolution. The Code (IESBA, 2020) prescribes that a professional accountant must be careful and avoid the association with financial statements and other reports (or any kind of communications) where the s/he believes that the information: “contains a materially false or misleading statement; contains statements or information provided recklessly; or omits or obscures required information where such omission or obscurity would be misleading”. Since low-quality financial reporting can be the result of various accounting misrepresentation, application of the Code guidelines can contribute to better financial reporting quality. The International Code of Ethics for Professional Accountants is highly recommended by many scholars (Clements et al., 2009; Spalding and Oddo, 2011; Nerandzic et al., 2012; Espinosa-Pike and Barrainkua-Aroztegi, 2014; Rogošić and Bakotić, 2019; Žager et al., 2019). The American Institute of Certified Public Accountants’ (AICPA) Code of Professional Conduct (CPC) for accountants practicing in the U.S. is also highly promoted (Spalding and Lawrie, 2019; Jenkins et al., 2020). Clements et al. (2009) noted that as a requirement for membership in the IFAC, a national accounting organization must either adopt the IESBA Code or adopt a code of conduct that is not “less stringent” than the IESBA Code. Smith et al. (2009) compared the accounting ethics codes in three countries (Canada, Egypt and Japan) and concluded that they are alike since they all promote the same ethical principles. Therefore, the objective of the IESBA to harmonize accounting ethics standards worldwide is on its path of fulfillment. According to the IESBA Code, the purpose of its conceptual framework is to “identify threats to compliance with the fundamental principles; evaluate the threats identified; and address the threats by eliminating or reducing them to an acceptable level” (IESBA, 2020).

## **3. THE THREATS TO COMPLIANCE WITH THE FUNDAMENTAL PRINCIPLES**

The literature is abundant of the evidence regarding the importance of accounting ethics education. Cameron and O’Leary (2015) pointed out that ethics education should promote the development of students’ moral sensibility and avoid focusing only on academic knowledge of ethics. Although accounting ethics education may not affect moral reasoning, it could help to recognize the threats to compliance with the fundamental accounting ethics principles.



The IESBA Code provides a conceptual framework that professional accountants should apply in order to identify, evaluate and address those threats. Professional accountants should reflect about conditions, and beware of policies and procedures since these might be relevant factors in their evaluation of whether a threat is at an acceptable level. If those threats are not at an tolerable level, the accountants should address those threats by applying safeguards. According to IESBA Code (2020), the threats to compliance with the fundamental principles are classified as self-interest threat, self-review threat, advocacy threat, familiarity threat and intimidation threat. The board range of circumstances that are threatening accountants' independence fall into one or more of the mentioned categories. Self-interest threat can be described as a threat when a financial or other interest might inappropriately influence a professional accountant's judgment or behavior (like receiving a loan from employing organization, having access to corporate assets for personal use, being offered a gift from a supplier etc.). Self-review threat occurs when a professional accountant does not properly evaluate the results of a previous judgment made or activity performed (by the accountant or by the associate within the accountant's company or employing organization), on which the accountant might rely when forming a judgment that reflects on their current activity. If a professional accountant has an opportunity to manipulate information in a prospectus in order to obtain favorable financing, there is an advocacy threat. Therefore, advocacy threat is the threat that the accountant might uphold a client's or employing organization's position compromising his/her objectivity. Familiarity threat can be recognized when a professional accountant has a close or long (especially if a family member is involved) association with individuals influencing business decision. Long term or close relationship with a client or employing organization can make a professional accountant overly bias and sympathetic to their interests or too accepting of their work. If a professional accountant or his/her family member face the threat of dismissal or replacement due to the application of accounting principles or the way of financial information reporting, an intimidation threat occurs. Intimidation threat also happens when an accountant is discouraged from acting objectively because of actual or perceived pressures, including attempts to exercise unjustified influence over the professional accountant. According to Ishaque (2020) the root causes to these threats are, mostly, "the misaligned incentives with roots in temptation for gain and/or in fear of loss and the workplace pressures with roots in fear of loss". When professional accountants in practice are concerned, intimidation emerges as the most frequent threat (Fearnley et al., 2005). This kind of threat has two clear dimensions. One aspect of intimidation threat is conjoined by the underlying threat from management of removal of the auditor. This results with the self-interest threat where the professional accountant in public practice may perceive damage to himself personally through loss of income and status. The other dimension is bullying, when superiors (directors) may attempt to overcome the auditor's objections by employing aggressive or other unappropriated behavior without any underlying threat of removal from office. Fearnley et al. (2005) explained that intimidation with self-interest could also arise from within a company where other partners make pressure. Erasmus and Matsimela (2020) concluded that real problem is unawareness of the self-review threat that arises due to the conflict between oversight and advisory services provided. Islam et al. (2019) pointed out that professional accountants faced various self-interest and self-review threats to their fair reporting. Thus, they found it difficult to act according to the code of accounting ethics. Familiarity threat was investigated on auditors in United Kingdom (Hussey, 1999). This study revealed that the present directors of both private and public companies have a significant influence on the appointment of the auditor and view their own personal relationship with the auditor as the most desirable characteristic in the selection process. Fearnley et al. (2005) noted that direct financial interest in a client (self-interest threat); a close friend or relative being involved in the management of a client (familiarity threat); and, involvement in the management of a client (self-review threat) undermine accountant's

independence if the safeguards were not adequately applied. Shafer et al. (2004) pointed out that accountants in public practice could change their behavior due to advocacy threat. Hutterski et al. (2020) found that influence of people in charge and pressure exerted by the management represent as well as the attempt to hide previously made mistakes are the most common situations that lead to unethical behavior of accountants. Quick and Warming-Rasmussen (2015) found out that high self-interest and a high-familiarity threat may impair auditor independence in appearance. If all of those threats are not recognized or ignored, they will give rise to the conflict of interests. Consequently, a risk of deviation from compliant behavior is higher (Ishaque, 2020). In order to address the threats to compliance with the accounting ethics principles, adequate safeguards must be applied. Hussey (1999) stated that controls should be introduced to ensure the threat is kept to a minimum.

#### **4. HYPOTHESES**

Moral judgment requires knowledge of concepts, ethical principles, and codes of conduct (Asadiyan Owghani et al., 2020) and enables ethical decision-making. Fraedrich et al. (1994) argued that cognitive moral development theory has been acknowledged as a construct in understanding business ethics. Several models were developed to explain the ethical decision making process in business. Individual factors like cognitive moral development affect ethical decision-making. Ethical decision making in business could additionally be influenced by other factors like demographic characteristics. Findings of Radtke (2000) generally supported the results of prior research that found no differences in the ethical decisions of female and male accounting professionals. Contrary, Roxas and Stoneback (2004) performed cross-country empirical study and concluded that males were significantly less ethical than females but on the country level, results are somewhat different. They found that women in China are less likely to behave ethically while in U.S.A., Australia, the Philippines, Germany and the Ukraine men had higher inclination to unethical behavior. Research conducted on accountants in U.S.A. demonstrated the results that do not support the idea that gender is associated with differences in ethical decision-making (Keller et al., 2007). On the other hand, their findings indicate that there are differences in individual ethical standards based on gender, educational level (graduate versus undergraduate), religiosity, and work experience. Pierce and Sweeney (2010) assumed that there is no relationship between gender (on one side) and ethical judgement, ethical intention, ethical intensity and perceived ethical culture of professional accountants in Ireland. They hypothesized the same between age, degree type, education and all the mentioned aspects of ethical decision-making. The threats to compliance with the fundamental accounting ethics principles can affect accountant's decision-making process and, ultimately, judgment or behavior. The question is if some demographic characteristic are related to the perception of self-interest, self-review, advocacy, familiarity and intimidation threat. Therefore, based on the recent (above mentioned) studies it is reasonable to assume that:

- H<sub>1</sub>: No relationship exists between gender and the threats to compliance with the accounting ethics principles.
- H<sub>2</sub>: No relationship exists between age and the threats to compliance with the accounting ethics principles.
- H<sub>3</sub>: No relationship exists between level of education and the threats to compliance with the accounting ethics principles.

#### **5. METHODOLOGY AND RESULTS**

An online questionnaire was used as a research instrument. The link to this survey created on Google Forms was sent to randomly selected e-mail addresses of the professional accountants in Croatia. After three rounds of e-mails, 370 professional accountants in business filled the questionnaire, containing closed questions (mostly a 5-point Likert scale) and various

demographic questions, although not everyone answered to all the questions. The collected data were analyzed using the MS Excel and IBM – SPSS 23 program. The univariate statistics was used to test the hypotheses. A total of 299 female respondents completed the survey and only 71 male did the same. It is not clear if there is more women employed as accountants in Croatia or they are more eager to participate in this kind of survey. The age of the respondents was grouped in four categories: 1- age between 20 and 29; 2 – age between 30 and 39; 3 – age between 40 and 49; and 4 – age 50 and more. Only 8% of accountants covered with this study are young people of age between 20 and 29. Most of the respondents (36%) are age between 30 and 39 followed by accountants of age between 40 and 49 (34%). The proportion of more experienced accountants (age 50 +) that filled the questionnaire is 22%. The education level was also grouped in four categories: 1 - high school; 2 – undergraduate; 3 - graduate; and 4 – postgraduate degree. High school diploma represents the highest level of education for 19% of respondents. Undergraduate degree is obtained by 18% of professional accountants. Most of the respondents (58%) have graduate degree but only 5% postgraduate degree. The perceived threats to compliance with the fundamental accounting ethics principles were self-assessed using a 5-point Likert scale (where 1 represents “never” and 5 is for “very frequently”) with the offered statement regarding self-interest, self-review, advocacy, familiarity and intimidation threat (Figure 1).

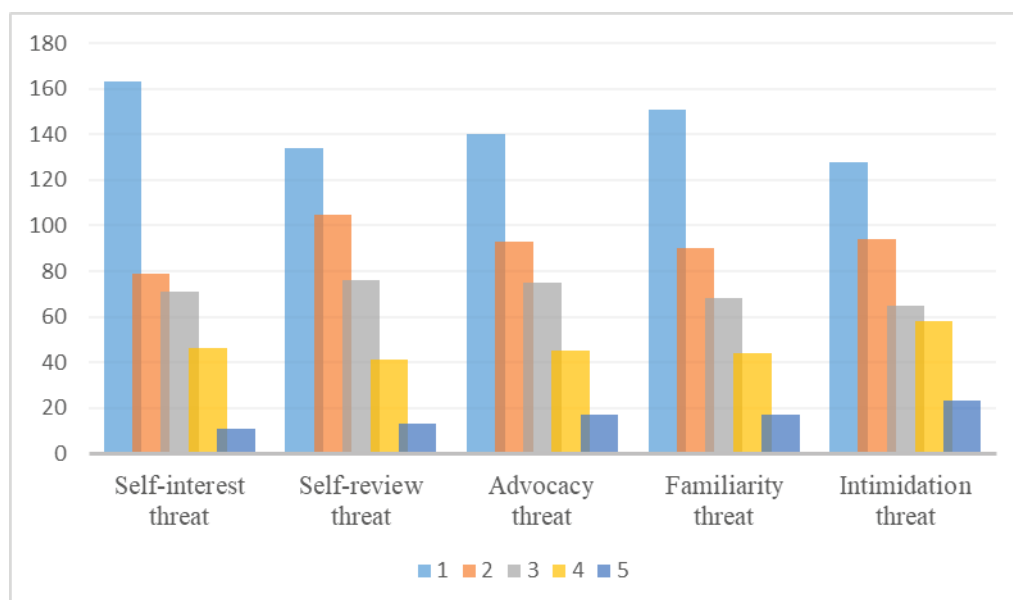


Figure 1: Threats to compliance with accounting ethics principles  
(Source: Author's calculation)

According to these empirical results, most of the professional accountants in business rarely (or never) experienced these threats. The mean value of the perceived exposure to the threats ranges from 2.089 to 2.332 (self-interest threat - 2.089; self-review threat - 2.171; advocacy threat - 2.205; familiarity threat – 2.151; intimidation threat - 2.332). Results indicate that accountants in Croatia face more frequently intimidation threat (comparing to the other kind of threats) that is in line with the findings of Fearnley et al. (2005) and Huterski et al. (2020). The first hypothesis was tested using Mann-Whitney test (Table 1). Independent (grouping) variable was gender. This test was used to determine whether there is difference between men and women regarding their perceived exposure to the threats to compliance to fundamental ethical principles.

	Self-interest threat	Self-review threat	Advocacy threat	Familiarity threat	Intimidation threat
Mann-Whitney U	10431.500	10434.000	10442.500	8949.500	10498.500
Wilcoxon W	12987.500	54985.000	55292.500	53799.500	54751.500
Z	-.239	-.187	-.221	-2.155	-.058
Asymp. Sig. (2-tailed)	.811	.851	.825	.031	.954

Grouping Variable: Gender

*Table 1: Threats to compliance with the fundamental principles regarding the gender (Source: Author's calculation)*

The results (Table 1) indicate that the relationship between gender and the level of the perceived self-interest, self-review, advocacy and intimidation threat does not exist. The only threat that is gender related is familiarity threat. The males admit to be more exposed to familiarity threat. Thus, men seem to be more influenced with the close and/or lasting relationships with the clients or employers that made them overly bias and sympathetic to their interests. The second hypothesis was validated using the Jonckheere-Terpstra test (Table 2). Independent (grouping) variable was the age of the respondents. This test was used to determine whether there is difference between the age groups regarding accountants' perceived exposure to the threats to compliance with the accounting ethics principles.

	Self-interest threat	Self-review threat	Advocacy threat	Familiarity threat	Intimidation threat
Number of Levels in Age	4	4	4	4	4
N	368	367	368	368	366
Observed J-T Statistic	22807.000	23662.000	23679.500	21464.000	22293.000
Mean J-T Statistic	23675.500	23554.000	23675.500	23675.500	23384.500
Std. Deviation of J-T Statistic	1059.558	1069.130	1073.861	1067.961	1071.472
Std. J-T Statistic	-.820	.101	.004	-2.071	-1.019
Asymp. Sig. (2-tailed)	.412	.920	.997	.038	.308

Grouping Variable: Age

*Table 2: Threats to compliance with the fundamental principles regarding the age (Source: Author's calculation)*

According to the results (Table 2), age is only related to the familiarity threat. Younger accountants are more exposed to the familiarity threat than their more mature colleagues. It can be assumed that more mature accountants are more resilient to the familiarity threats. As people grow old the exposure to the familiarity threat weakens. The Jonckheere-Terpstra test was performed in order to test the third hypothesis. It was assumed that education level, as other demographic characteristics, is not related to the perceived exposure to the threats.

	Self-interest threat	Self-review threat	Advocacy threat	Familiarity threat	Intimidation threat
Number of Levels in Education	4	4	4	4	4
N	369	368	369	369	367
Observed J-T Statistic	22215.000	22161.000	21461.000	22901.500	22674.000
Mean J-T Statistic	20112.000	19988.500	20210.500	20210.500	19983.500
Std. Deviation of J-T Statistic	996.549	1004.347	1011.393	1005.901	1009.372
Std. J-T Statistic	2.110	2.163	1.236	2.675	2.666
Asymp. Sig. (2-tailed)	.035	.031	.216	.007	.008

Grouping Variable: Education

*Table 3: Threats to compliance with the fundamental principles regarding the education level (Source: Author's calculation)*

According to the results (Table 3), the third hypothesis is rejected. The level of education is related to the perceived exposure to self-interest, self-review, familiarity and intimidation threat. Only advocacy threat (promoting a client's or employer's position that can lead to detraction of the accountant's objectivity) is not related to the accountant's education level.

## 6. CONCLUDING REMARKS

This paper examines the level of self-reported exposure to the threats to compliance with the accounting ethics principles. The professional accountants in business generally face low level of self-interest, self-review, advocacy, familiarity and intimidation threat. Among those threats, the intimidation threat is the most frequent and the self-interest threat is the least recurring. Prior studies show conflicting results regarding demographic aspects of ethical behavior in accounting. This study aimed to determine the effect of gender, age and education level of professional accountants on their exposure to the threats. These threats could lead to unethical behavior of accountants so must not be ignored. Furthermore, the compromised accountant's objectivity and, ultimately, judgement can jeopardize financial reporting quality. The research is based on a large sample of professional accountants in business with a good spread across the demographic variables of interest that adds to the reliability of the findings. Research results appear to support the first and the second hypothesis. Therefore, gender and age do not have an effect on the perceived exposure to the threats (except the familiarity threat). On the other hand, the education level is related to the exposure to the threats to compliance with the accounting ethics principles (advocacy threat excluded). Hence, this paper contributes to the accounting ethics literature since it sheds light on the exposure to the threats to compliance with the accounting ethics principles. All of these findings could be the result of a specific cultural environment so the future research should be cross-country with more demographic features. One of the limitations of this study is due to self-reported exposure to the threats since accountants can have some implicit bias.

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