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Another Ingredient Contributing to Recent Audit Failures: A Study Providing Insights on Management Integrity

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ABSTRACT

Integrity is evidenced through behavior. It is evidenced by actions an individual's consistent observance of a code of conduct based upon a coherent set of moral (ethical) or artistic values. It suggests such a high level of trustworthiness that it is difficult to conceive of a person being false to a trust.

In an audit, beginning with evaluating of the reliability of a client's accounting control systems, the auditor relies heavily on the perceived integrity of management. Thus, management integrity has the potential to significantly influence the nature and scope of the independent audit.

Decision-making is influenced by personal beliefs and attitudes, which in turn are controlled by the more basic, more enduring structure of the personal values. The influence of personal values extends to management decision-making. This paper is based on a research instrument developed by England to measure the structure of the personal value systems (PVS) of corporate managers. Results indicate which of 66 pre-tested personal values influence corporate decision-making, the twenty-nine "Operative Values," and which values do not. *Trust* and *Honor*, the personal values of interest, are *not* among the behavior influencing Operative Values. They are classified among the few "Primarily Ethical Values."

Substantial differences in the role of *Trust* and *Honor* in relation to two PVS dimensions, Importance and Success, may significantly influence the integrity of management behavior. Understanding this may assist in understanding and addressing changing audits.

Key words

Trust, Honor, Personal Values, Corporate Integrity

1 BACKGROUND

England developed and utilized (1967, 1974, 1975, and 1978) a questionnaire to identify the personal values that corporate managers bring to bear on their corporate decision-making. The better the understanding of personal values underlying management decision-making processes the better auditors will be able to work with management in producing the best possible audit outcomes.

The underlying mission of the AICPA Code of Professional Conduct (1990) is to define and enhance the quality of the professional services of the accounting profession. The Code details the Principles and Rules designed to accomplish that mission. An aggressive pursuit of this mission is essential to strengthening society's acceptance of the importance and the integrity of the CPA's audit. An integral part of the integrity of the audit is a reliance on representations of management, written and verbal. Thus, at the outset it is important to ask, "What are the personal values of management that accompany and don't accompany those representations that auditors rely upon?"

There are a number of well-accepted avenues for the auditor's assessment of management integrity, such as examining the predecessor auditor's work, interviews with senior management, insights from other professionals, such as lawyers, knowledgeable members of the news media, and the client's Audit Committee. With evidence often difficult to authenticate, the assessment involves personal auditor judgments and relies on numerous management assertions, the importance of reliance on management integrity looms large in designing and conducting the audit.

Under SAS No. 31 (AU § 326) the assertions of management, implied or expressed, are divided into five general categories. In each of these categories, the CPA's trust in the integrity of management impacts the extent and interpretation of the audit field work required. Another area where integrity is vital is in communication with the predecessor auditor.

2 STUDY METHODOLOGY

England's Personal Values Questionnaire contains 66 pre-tested personal values, divided into five groups (Table 1). Each is rated on four dimensions; a primary dimension of Importance (High, Average, and Low) and its relationship to secondary dimensions, Successful, Right, or Pleasant. These secondary dimensions indicate how a particular value concept is rated High, Average, or Low on the Importance scale. The highest response rate determines each value's location in the resulting 3x3 matrix (Table 2). Those personal values in the first cell (High Importance and Successful) constitute England's Operative Values. These values have the most influence on management's decision making. Those in the four cells represented by Average and Low Importance, coupled with the Right and Pleasant secondary dimensions are the values with Low Behavioral Relevance. These values have little or no influence on decisions.¹

¹ Support for the methodology is in, "Personal Value Systems of American Managers," Academy of Management Journal, March 1967, pp. 53-68.

In the current study,² a stratified sample of 941 top-level corporate executives was selected from Standard and Poors Directory of Corporations, Executives, and Directors. This sample size was determined using a difference in population mean test with a projected 30% response rate and a significance level of .01. There are 217 responses, for an actual 23% response rate.

3 RESULTS

General.

The demographics indicate respondents are "top" managers as 74% have less than two levels of management above them. These are the individuals that CPAs must work with on the most critical audit decisions, including the scope of the audit, and the resolution of discrepancies and differences of interpretation.

There are 29 Operative Values, those of High Importance because of their relationship to being Successful, and 6 Primarily Ethical. The observed Operative Values are dominated by values from two of England's five groups of values: Goals of Business Organizations (6 of 8) and Groups of People (12 of 16). On the other hand, those values of Low Behavioral Relevance are not clustered but are well disbursed among the five groups. Over time the Equality, Dignity, and Rational values are not consistently Primarily Ethical Values and are not very clearly related to integrity, so they are not considered here. For Loyalty, it is impossible to discern to whom that loyalty is owed. The corporation? The shareholders? Peers? Others? So, it also is not considered as it is not well linked directly to management integrity.

The remaining 31 concepts locate in other cells in Table 2 and are not of present interest.

Differences in Rankings of Values.

The Appendix lists (a) the Five highest ranked and (b) the five lowest ranked concepts based upon three percentage scores: (1) High Importance and Successful, (2) High Importance alone, and (3) Successful alone. Within the six rankings, no group dominates. In the three Highest ranked Appendix listings only *Trust*, *Honor*, and *Aggressiveness* are not among the 29 Operative Values.

From the auditor's perspective, there is something possibly very important and professionally very disconcerting when examining this result. When coupled with an analysis of an additional aspect of differences in the study's results for the *Trust* and *Honor* personal values a picture emerges helping to understand recent audit failures. During the course of

designing and executing the audit one necessarily places a great deal of faith in understandings with the client's management. In many areas of the audit existing auditing standards set the nature and the amount of field work conducted by the auditor. They are based in part on professional judgments in qualitative areas such as the quality of internal controls, the auditor's working relationship with the management team, and the history of previous audit outcomes. It is routinely expected that all parties will conduct business with regard to all written as well as oral negotiations and agreements.

Management must prepare a representation letter that asserts numerous conditions for the audited annual report, including acknowledgment that management is responsible for all of the enterprise's policies and procedures leading to "fair representations" in the financial statements. This means that to the best of management's knowledge all relevant records have been made available, that there are no known irregularities, no known violations of laws and regulations, and so on. With these responsibilities resting squarely with management, the degree to which the independent auditor can realistically trust management to honor their stated commitments is an important, if not the most essential, ingredient in the design and execution of their audit.

More specifically, for instance, the first factor in assessing the enterprise's control environment is, Integrity and Ethical Values:

3.a. Integrity and Ethical Values

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them...Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. *Italics added*]
[(SAS No. 78, AU§ 319.84, p. 115)

In terms of the personal values in this study the "good faith" of management can best be captured by *Trust* and *Honor*. Why are these of interest beside their inclusion in the greater scheme of measuring personal values?

A macro reason is that the level of integrity influences the economics of business enterprises and, thus, social welfare. One of the factors in determining of transaction costs is integrity. North points out that trust reduces transaction costs.³ Other factors being equal, the lower the level of trust in a society the higher the transaction costs, and vice versa. Thus, *Trust*, and its companion *Honor*, are shown to be essential elements in achieving economic prosperity.

² "Comparing Corporate Managers' Personal Values Over Three Decades 1967-1995," Journal of Business Ethics, June 1999, pp., 163-179.

³ Douglass C. North, Institutions, Institutional Change and Economic Performance, 1990, Cambridge University Press.

Also, the scope of trust influences the scope of business organizations. With a narrow scope of trust, say limited to close family, the transaction costs associated with large business organizations are high, so small, family centered business enterprises are likely more prevalent. This reduces the likelihood of that society significantly benefiting from the economies of scale often present in many larger organizations. With a wide scope of trust, say extending cross-culturally, there are reduced transaction costs and large, multinational enterprises with the ability to capture economies of scale are likely more dominant. This line of reasoning extends to audits. The costs associated with the ongoing efforts to overcome the distrust from recent audit failures are predictably significantly higher.

Both *Trust* and *Honor* are in England's Ideas Associated with People. For respondents, Trust is the personal value of absolute highest Importance (96%) and Honor is fifth highest (84%). Again, see the Appendix. However, these very strong personal values are not (repeat not) revealed as particularly related to one's being a successful manager:

| | Percentage of Responses | | |
|-------|-------------------------|------------|------------------------------|
| | High Importance | Successful | High Importance & Successful |
| Trust | 96 | 19 | 18 |
| Honor | 84 | 17 | 14 |

Virtually every respondent personally values *Trust* (96%), but only one in five (19%) indicate it is related to success. Thus, it is reasonable to ask, "Is *Trust* an operative value in 'corporate integrity'?" From this data, apparently not importantly so. A similar statement applies to *Honor*.

This outcome of the study creates at least the potential for individual managers to be in a conflict of interest position whenever a particularly difficult audit decision must be made. One should ask, "How will a manager actually behave when confronted with a situation where being trustworthy and honorable has the real potential to interfere with the ongoing success of their career/corporation? Will the person follow their two highly important personal values, *Trust* and *Honor*? Or, will they act instead to maximize their opportunities for career success? Will Operative Values, such as High Productivity, Achievement, and Ambition prevail? Given the above information, the answer is not obvious? One would prefer to observe a corporate decision making environment with a very high positive correlation between striving to attain career success and valuing *Trust* and *Honor*. That is, to reveal that integrity is a key to career success. Hence, it is also a key to successful audits.

At a minimum, these results on the *Trust* and *Honor* personal values support the necessity for the social maintenance of a strong monitoring process. At the maximum they suggest that there are quite serious problems with the behaviors of corporate managers. Are they intractable? That is, are these values, and

speculatively the other four Primarily Ethical values, so unrelated to the current state of corporate decision making that fundamental changes in the processes that attract individuals and lead to career success need to be examined and changed? Can the competitive engine fashioned by large, multinational business enterprises continue to receive social and political acceptance?

A number of important questions auditors arise from the above differences in responses for *Honor* and *Trust*:

- What is the CPA's best interpretation of these value differences in terms of the scope of the audit?
- Must audit contracts be altered for auditors to have confidence in their final audit opinions?
- What impacts might this have on the CPA's reliance on statements management makes about the fair representation of the financial statement?
- How might data sampling have to be changed if trust in management is more uncertain previously assumed?
- When the CPA has some question about any aspect of the engagement, how much of an inquiry is sufficient?
- Does this result suggest that the CPA needs to do significantly more independent auditing?

The auditor has always been in the unenviable position of balancing the representations of management with the need for independent verification through the gathering of objective, verifiable evidence and the exercising of professional judgment. This position is coupled with the professional's dual obligations; the contractual obligation with the client and the fiduciary responsibility with the society providing the CPA profession with the rights and privileges accompanying that professional status.

This has never been an easy task. It never will be. Meeting their fiduciary responsibilities and abiding by the Principles and Rules of the AICPA Code of Professional Conduct, while at the same time faithfully meeting the terms of the client's contract, can create an ethical dilemma for CPAs. In order to meet one set of responsibilities there may have to be a compromise or violation of the other. Yet, ethically solving any ethical dilemma is one of the key ingredients in maintaining the professional status society grants the auditor. A "healthy degree of skepticism" is necessary to conduct an effective independent audit. In the final analysis:

Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management representation in the financial statements is such that the audit cannot be conducted. [Italics added]
 | (SAS No. 78, AU§ 319.84, p. 115.)

Regardless of the history of the CPA's dealings with its clients, the profession requires an independent attitude before a quality audit opinion can be determined. The "bottom line" for the CPA firm is that the proffered opinion is its product. This is the root reason society

provides public accounting with its professional status. Without solidly independent audits, society has the right, even the responsibility, to alter or remove that status.

At a minimum, results on *Trust* and *Honor* support the necessity of maintaining a strong auditing profession.

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APPENDIX

Five Highest Ranked and Five Lowest Ranked Concepts In Three Categories

High Importance & Successful:

| | | <u>Lowest</u> | <u>Highest</u> |
|-----|-------------------|---------------|----------------|
| 1. | High Productivity | | 65% |
| 2. | Achievement | | 64 |
| 3. | Ambition | | 63 |
| | Customers | | 63 |
| 5. | My Company | | 62 |
| 63. | Risk | 3% | |
| 64 | Force | 3 | |
| | Labor Unions | 3 | |
| | Leisure | 3 | |
| 65. | Liberalism | 2 | |
| | Prejudice | 2 | |
| 66. | Conformity | 1 | |

High Importance:

| | | <u>Lowest</u> | <u>Highest</u> |
|-----|------------------|---------------|----------------|
| 1. | <i>Trust</i> | | 96% |
| 2. | Customers | | 92 |
| 3. | My Company | | 87 |
| 4. | Job Satisfaction | | 86 |
| 5. | <i>Honor</i> | | 84 |
| 62. | Conflict | 9% | |
| 63. | Liberalism | 6 | |
| | Labor Unions | 6 | |
| 65. | Force | 4 | |
| 66. | Conformity | 2 | |

Successful:

Lowest Highest

| | | |
|-----|-------------------|-----|
| 1. | Ambition | 87% |
| 2. | Skill | 85 |
| 3. | Achievement | 83 |
| 4. | High Productivity | 81 |
| 5. | Aggressiveness | 79 |
| | Success | 79 |
| 62. | Obedience | 13% |
| 63. | Social Welfare | 11 |
| | Religion | 11 |
| 65. | Compassion | 9 |
| 66. | Leisure | 8 |

**Table 1
England's Grouped Manager Values**

| <u>Goals of Business Organizations (8)</u> | <u>Personal Goals of Individuals (13)</u> | <u>Groups of People (17)</u> |
|--|---|------------------------------|
| High Productivity | Leisure | Employees |
| Industrial Leadership | Dignity | Customers |
| Employee Welfare | Achievement | My Co-workers |
| Organizational Stability | Autonomy | Craftsmen |
| Profit Maximization | Money | My Boss |
| Organizational Efficiency | Individuality | Managers |
| Social Welfare | Job Satisfaction | Owners |
| Organizational Growth | Influence | My Subordinates |
| | Security | Laborers |
| | Power | My Company |
| | Creativity | Blue Collar Workers |
| | Success | Government |
| | Prestige | Stockholders |
| | | Technical Employees |
| | | Me |
| | | Laborers |
| | | WhiteCollar |
| | | Employees |

Ideas Associated with People (13)

Ambition
Ability
Obedience
Trust
Aggressiveness
Loyalty
Prejudice
Compassion
Skill
Cooperation
Tolerance
Conformity
Honor

Ideas About General Topics (15)

Authority
Caution
Change
Competition
Compromise
Conflict
Conservatism
Emotions
Equality
Force
Liberalism
Property
Rational
Religion
Risk

Table 2

3x3 Personal Values Matrix

| | <u>High Importance</u> | <u>Average Importance</u> | <u>Low Importance</u> |
|------------|--------------------------|---------------------------|-----------------------|
| Successful | Operative Values | Operative Values | |
| Right | <i>Primarily Ethical</i> | | |
| Pleasant | | | |