

HOW IS THE ETHICAL BEHAVIOUR OF AUDITORS QUANTIFIED?

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ABSTRACT

“Government is going about reform the wrong way” is frequently encountered in the specialized literature which characterizes the synthesis of the present audit period. Although there exists an Ethical Code in the economic word, the practical controversy over the features of the accounting regulation to adjust the economic environment seems to be endless. The purpose of this paper is to analyse the ethical behaviour of auditors and its influence on the degree of audits’ independence, in view of the historical changes and the actual circumstances of the audit market. For this, the biggest financial frauds that have occurred in Europe and US between 1925 and 2020 together with the role of reforms in the audit world are investigated. The results indicate a solution which seems to be in the consciousness of human beings, in the moral law of people written in the Ethical Code and checked by supervisory bodies.

Keywords: *Audit, Ethical Code, Economic frauds, Ethical behaviour, Independence*

1. INTRODUCTION

Over the past decade, the quality of audit services has been debated due to the high number of economic frauds. Consequently, a significant number of countries have agreed to set up an independent oversight authority to supervise the national audit profession. Despite the fact that a large number of countries have implemented this type of authority, there are criticisms of this reform (DeFond, 2010; Beasley, Buckless & Prawitt, 2002) which call into question the expertise and fundamental knowledge of independent inspectors in the Supervisory Board.

At the level of US supervisory authority, Fung, Tong and Chen (2017) and Shroff (2017) examined the impact of PCAOB (Public Company Accounting Oversight Board) inspections in terms of the quality of audit services. They pointed out that Carcello, Hermanson and Ye (2011) together with Gunny and Zhang (2013) argue that the independence and objectivity of the services provided by POB supervisors increase over the time.

At the same time, supervisors were criticised for the lack of human resources expertise, the level of information transparency (Beasley et al., 2002) and the risk associated with the portfolio of inspected companies which underlies national inspections (Church & Shefchik, 2012; Peecher, Solomon & Trotman, 2013).

The objective of this paper is not a systematic account of audit ethics, but a stimulation of critical thinking and an openness to existing empirical evidence by highlighting the moral and institutional complexities of the audit function through the ethical behaviour of auditors. Specifically, all the sections raise important arguments regarding the ethical issues faced by professional auditors, their clients, regulators and the public, whose interests should be paramount in developing and implementing acceptable auditing standards and practices.

Griffiths (1979) makes a clear distinction between the direct effects that occur when the human beings to whom the legislation is addressed comply with the letter of the rules (*ad-literam*) and the indirect effects of the legislation that represent the consequences of compliance with the rules. The volume “Banking and Currency: Hearings Before the Committee on Banking and Currency, United States Senate, Sixty-Third Congress, First Session” (United States Congress Senate Committ, 1913: 58) gives the main argument of this paper which starts with the next dialogue:

Sen. Barkley: Is there any relationship between your organisation with 2,000 members and the organisation of controllers, represented here yesterday with 2,000 members?

Col. Carter: None at all. We audit the controllers.

Sen. Barkley: You audit the controllers?

Mr. Carter: Yes; the public accountant audits the controller's account.

Sen. Barkley: Who audits you?

Mr. Carter: Our conscience.

The auditor's awareness must be the basis of all activities, and this will lead to a considerable increase of level of reports' objectivity over time. If the independence of the audit services is considered only based on the professional obligation, it becomes more vulnerable to threats of all potential types. The result of mechanical work may lead to possible deviations from ethical and moral principles.

This paper analyses the biggest financial frauds in Europe and US, in the period 1925-2020, together with the audit reforms which affected the audit evolution. A classification of auditors into Big 4 and non-Big 4 categories is made, in order to observe the impact of the biggest audit firm in audit market. In this context, the findings argue that the majority of big frauds were audited by Big 4.

Starting with the fraud McKesson and Robbins (1938) audited by PricewaterhouseCoopers (PwC) in US, the audit committee appeared as a solution for the lack of trust in auditors (Baxter, 1999). The scandal of audit firm Arthur Anderson with Enron raised up the SOX Act (2002) which represented the starting point of EU audit reform. Moreover, the American body of supervision PCAOB has changed the perspective of the audit world, being a model of oversight for Europe and other regions.

Through the national inspections, the level of independence has increased in time and the ethical behaviour started to be checked by controllers. Even in these favourable circumstances, the list of frauds continues in time. The results of the analysis presented in this paper appears consistent with the lack of ethical behaviour of auditors. The findings of the analysis indicate a solution which seems to be in the consciousness of human beings, in the moral law of people and written in the Ethical Code and checked by supervisory bodies (Public Interest Oversight Bodies).

Section 1 analyses the historical evolution of ethics taking into consideration the moral and social responsibility of auditors, having a common accountability. Section 2 presents a critical analysis of the biggest scandals over the period 1925-2020, whereas in Section 3 an overview of the audit reforms and the independence of auditors is presented. Section 4 gathers the consequences of the ethical behaviour on audit services. Conclusions are drawn in Section 5.

2. THE HISTORICAL EVOLUTION OF ETHICS

The history of ethics has the beginning in the Ancient Greek Era, the sophists being the first researchers (Guthrie, 1971) in this area. The Greek word σοφός means a wise man. The first generation of sophists includes the Greek thinker, Protogoras of Abdera (480 B.C.) who marked the positive side of ethics with the quotation “Man is the measure of all the things” (Guthrie, 1971) and Gorgias of Leontini (483 B.C.) who marked the negative side of ethics with the motto “The good of another cannot be an end of action to me” (Sprague, 1972).

Later, the philosophers have continued the path of ethics, as the following: Socrates as the founder of the Science of Ethics was against Sophists; Plato, as a student of Socrates, defined the relationship between social and individual good (Rosen, 1983); Aristotle emphasized that the social good is above the individual good; Epicurus encouraged people to understand that “the pleasure is the absence of suffering” (Barnes, 1986).

Taking into consideration the metaphysical point of view, the substantial nature of the people overpasses the social well-being, which represents a general association of human beings. Furthermore, stoicism or zenonism founded by Zeno of Citium (Brennan, 2005) emphasizes that “virtue is only good for human beings” (Irvine, 2008). In the same vein, the stoicism Seneca and Epictetus continued the research of the mentor stating that “virtue is sufficient for happiness” (Roberson, 2018).

The year 0 a.d. represents the beginning of the contemporary ethics under strong influences of Christianity. The Medieval Era comprises two types of concepts as naturalism (Olson, 2017) which is characterised by ethical issues appeared from natural laws and intuitionism (Andow, 2018) represented by ethical obligations observed as intuitive. Pure concepts about ethics are not useful, taking into consideration that every philosopher marked a period of time to the extent that an ethical notion was applicable to a real way of living.

The moral foundations of modern economics have been explained by Thomas Hobbes (Gert, 1967) Adam Smith (Simnett & Smith, 2005), David Ricardo (Cremaschi, 2004), and in the past decade by John Stuart Mill (Mill, 1961) through moral philosophy. In terms of modern Ethics, Hobbes defines his own doctrine as exclusive egoism (Gert, 1967) or based on the quotation “Man is wolf to man” (Bardach, 1999).

Immanuel Kant represents the modern philosopher who stressed on categorical principals stating that “A person should act on that principles, and when everybody act like that principles become a universal law” (Kant, 1993:421). It must be remembered that Adam Smith wrote a book (Smith, 1937) on the foundations of morality and the economic role of moral values.

The book “Wealth of Nations, Research on Nature and Its Causes” argues that wealth is made up of satisfaction rather than money, and that failure to remedy a breach of contract is inefficient and immoral. Ethical behaviour theory begins with an analysis of ethical theories, such as utilitarianism and deontology.

In this context, Hill (1995: 585) makes the following statement: “As Socrates pointed out long ago, ethics is not a theoretical science, which can be taught and learned in the same way as mathematics. Therefore, it engages the teacher and the student in a completely different way”.

Thompson (1998) made a clear distinction between fundamental ethical principles and cultural values. Fundamental ethical principles represent the universal ethical basis shared in all cultures. Cultural values are represented by the specific qualities and conditions that are necessary for a community to flourish. Ethical principles are the starting point from which social responsibilities are derived based on cultural values that promote the well-being of an organisation or a nation.

The importance of ethics provides some incentives on the means in which ethical behaviour can be incorporated into individual and professional culture, being one of the essential elements for restoring public trust. Over time, it has been concluded that the trust in capital market depends on the accountability and the transparency of the financial reporting and regulatory process.

In turn, the trust in financial reporting hangs on the integrity of the audit firm and its integrity overlies on the ethical behaviours behaviour of auditors based on their own beliefs. Ethical behaviour does not simply comply with legal and professional rules, being a state of mind, following unwritten principles, referring to the culture of “doing the right thing”.

Moreover, auditors also face moral issues when setting audit tasks (Libby & Thorne, 2004). Morality emphasises taking other people into account, not calculating one's own gains and losses. The more robust approach to such moral dilemmas is a deontological feature, which confirms that morality is related to moral duty and this duty is related to not wronging other people (Fried, 1978; Walker, 1991).

A moral person knows what is right, simply because it is right (Kant, 1953). The standard view is that deontology or the moral rule directly conflicts with consequentialism or utilitarianism, the theory that an act is right or wrong depending on its consequences for all those affected by the action, including the agent in question (Mill, 1961).

The defining feature of morality emphasises individual autonomy (Kant, 1953) which attests that all legal persons must decide on what is morally right and wrong, and this includes respecting or disregarding authoritarian social and institutional moral norms. Individual

interpretation of ethical behaviour is influenced by a variety of factors, including industry and company orientations, social and economic pressures, laws and regulations, and surrounding values and beliefs, which create an ethical dilemma.

Under these conditions, it is understandable that specialized studies on ethics in the world of accountants and auditors focus on discovering how to maximise compliance with generally accepted principles of professional conduct (Duska & Shay, 2003). In classifying ethical issues in the field of audit, three areas of activity are distinguished: (1) the practice of auditors, (2) the management and culture of audit firms and (3) the establishment of audit standards and laws.

The practice of auditors is verified through Ethical Code which requests to auditors a “professional behaviour”. The management and the culture of audit firms have to conduct the audit services based on ethics and any conflict of interest should be signalled in every moment of the audit mission. The audit standards and laws should be established globally, on European level, taking into consideration the globalisation and the necessity of harmonization. At the same, the audit standards should be respected uniformly, without any exception of the rules.

Ethical behaviour promotes the excellence of performance in the audit profession, by promoting the good of a community or a nation. In the field of financial audit, Aristotle's discussion of “virtues” is consistent relevant because these virtues promote excellence in audit practice (Brown & Howieson, 1998).

The two types of virtues are closely correlated with the notions of “professionalism” and “professional behaviour”, which combine technical skills with moral skills. Moreover, intellectual virtues consist in the correct application of technical knowledge (ISA, IFRS) and moral virtues are represented by temperance and courage for self-discipline and justice.

From a little reflection on what is outlined in this section, it may be deduce that the existence of a combination of intellectual and moral virtues is absolutely fundamental in the context of audit, so an audit is valid only if the auditor is both technically competent (intellectual virtue) and independent in attitude (moral virtue). Ethics training is about ethical awareness, by improving auditors' behaviours (Howieson, 2005).

In the past, accountants and auditors have been criticised for reporting financial information and regulations, and the purpose of the Code of Ethics is to provide more transparency to internal and external auditors. The application of IESBA (International Ethics

Standards Board for Accountants) principles begins with the independence of the auditor and continues with the behaviour of professional accountants in business (incentives) that leads to the harmonisation of the world.

The Code includes the five fundamental principles of the IESBA Code of Ethics (IESBA, 2010), namely: integrity, objectivity, professional competence and proper care, the privacy of audit mission is one of the most important principle of the Code of Ethics and it should not cover compliance and professional behaviour.

In an interview with IFAC, IESBA President Dr. Stravos Thomadakis (2016) said that: “accountants can be trusted if they meet ethical standards”, whereas lawyer Macphee notes that: “the code of ethics is fundamental to the way accountants work”. In the same field, an IESBA expert points out that: “if there is no ethics, there is a lack of trust”. It is important for us to encourage the right ethical behaviours for professional accountants and other parties involved in the financial system” (Paik, Lee & Pak, 2019).

Regarding the Greek word “scepticism”, the IESBA president uses the equivalent of “the doubt of criticism” according to ancient philosophers: “the age has a piece of wisdom”. Constructive scepticism means that there is a healthy amount of doubt, criticism and challenge, but within a certain limit. The president of IESBA emphasises that the professional scepticism of accountants needs the following elements, such as: “a questioning mind, being alert to a possible error or fraud and critical evaluation of evidence” and “Scepticism is the primary quality of an auditor and is supposed to be the guardian of the integrity of financial statements and all accountants must certify the validity of the evidence” (Thomadakis, 2016).

The new restructured Code of Ethics also includes non-compliance with parts of the law and regulations (NOCLAR) that help professional accountants act responsibly in the public interest. The non-compliance awareness process (NOCLAR) of the IESBA Code of Ethics (2010) includes:

- Notification of the management about the non-conformity;
- Determining the need for additional actions;
- Option to disclose to the relevant public authority;
- The option of resignation with the revelation of the successor;

In these terms, the standard is proportionally balanced and provides support to the ethical accountant and the auditor who directly faces this type of dilemma. NOCLAR is an articulation of an approach that helps professional accountants analyse harmful non-compliance the president of IESBA stating: “Establish accountants who allow the disclosure of NOCLAR to a public authority” (Thomadakis, 2016).

NOCLAR covers laws and regulations against fraud, corruption, bribery, money laundering and also terrorist financing. This standard provides guidance for the accountant's trial or how to respond to cases of non-compliance, such as informing management and disclosing issue to public authorities.

The world is changing as a direct result of changes in the business sector, taking into account the impact of technology and public expectations, Dr. Thomadakis (2015) stated that: “Ethics will become even more important because technology can blind you to ethical dilemmas”. Consequently, the accounting profession will automatically change in the correct way if there is an applicable code of ethics that supports the correctness and transparency of the financial statements.

Moreover, Dr. Stavros emphasises the global picture of the comic world: “Let's be clear-corruption and bribery are a global problem that affects both developed and developing economies. This is an area where the Code of Ethics for Professional Accountants can have a significant impact on the public interest. By virtue of their obligation to comply with the Code, PAIBs can play an important role in tackling corruption and bribery”.

The International Code of Ethics for Professional Accountants (including International Standards of Independence) is developed by the International Accounting Ethics Standards Board (IESBA) to establish standards of ethics not only for professional accountants but also for the independence of auditors. As the regulatory authority, IESBA facilitates cross-border support, with global applicability. IESBA is supported by the IESBA Advisory Group (CAG) and the Public Interest Oversight Committee (PIOB).

The latter organisation, formulated by the Standards Board, must oversee the work of IESBA, enhancing integrity in the audit profession and improving the quality of international financial reporting. In part, the PIOB is budgeted by IFAC, the European Commission, the International Securities Commission and the Financial Reporting Council (PIOB, 2020).

3. CRITICAL ANALYSIS OF THE BIGGEST FINANCIAL SCANDALS BETWEEN 1925-2020

Corruption is favoured by conflict of interests that occurs when a person's interest conflicts with his or her fiduciary duties or when one person has two subsidiary roles and one's responsibilities compete with the other's (Davis, 1998). Moreover, it must be emphasised that immorality is distinguished from corruption. Typical cases of corruption and fraud and its subspecies involve a breach of a pre-established social, professional or institutional relationship of trust between corrupt agents and their victims.

The condition of a fiduciary duty is the traditional definitions of the term corruption: “the transformation from a sound into an unhealthy impure state” or “the perversion of anything from an original state of purity”. An ethical and governance policy is given by the elimination of conflicts of interest, which eliminates a potential risk of corruption.

For example, in the case of financial reporting, conflicts of interest can be avoided by strictly dividing the audit and financial advisory functions within an accounting firm. In this regard, audit experts need to analyse financial reporting and from a moral point of view, so that morality is captured by the deontological model (Beckett & Campbell, 2015), in order to improve the quality of audit services.

This Section analyses the biggest financial frauds in Europe and US (Table 1), in the period 1925-2020 and the consequences of the audit reforms. In order to understand the impact of the fraudulent financial reporting, a sample of 68 of frauds, from Europe and US, in the period 1925-2020 is analysed.

Table 1: Biggest financial frauds, in EU & US, in the period 1925-2020

Company	Year	Audit firm	Country	Cause of frauds	Source
Fred Stern & Company	1925	Touche, Niven & Co.	United States	Overstated accounts receivable	www.lawteacher.net/cases/ultramares-corporation-v-touche.php
Hatry Group	1929	Price, Waterhouse & Co.	United Kingdom	Borrowing \$1 million on worthless paper	https://moneyweek.com/508563/great-frauds-in-history-clarence-hatry
Royal Mail Steam Packet Company	1931	Kulsant and John Moreland	United Kingdom	Falsifying both the trading prospectus and company records and accounts	https://moneyweek.com/518105/great-frauds-in-history-lord-kylsant-and-rmspc

Interstate Hosiery Mills	19 37	Homes and Davis	United States	Fraudulent stock manipulation	https://www.nytimes.com/1938/07/06/archives/falsified-records-explored-by-sec-interstate-hosiery-mills-official.html
McKesson & Robbins, Inc.	19 38	Price, Waterhouse & Co.	United States	Bogus sales documentation and to pay commissions to a shell distribution company under their control	http://www.mcleodgovernance.com/mckesson-fraud/
Yale Express System	19 65	Peat, Marwick, Mitchell & Co.	United States	The using of false financial statements	https://www.nytimes.com/1964/05/15/archives/yale-express.html
Continental Vending Machine Corp.	19 69	Lybrand, Ross Brothers, & Montgomery	United States	CPA partners convicted and fined	https://www.nytimes.com/2002/03/01/business/an-old-case-is-returning-to-haunt-auditors.html
Four Seasons Nursing Centers of America	19 70	Arthur Andersen	United States	Overstatement of earnings	https://www.nytimes.com/1972/12/21/archives/us-indicts-eight-in-sale-of-stock-in-nursing-homes-200million-fraud.html
National Student Marketing Corporation	19 70	Peat, Marwick, Mitchell & Co.	United States	Overstatement of earnings	https://www.washingtonpost.com/gdpr-consent/?next_url=https%3a%2f%2fwww.washingtonpost.com%2farchive%2fpolitics%2f1977%2f02%2f20%2fex-whiz-kid-tied-to-bankrupt-firm%2f9f9a417b-f983-4a57-a0acf25d21f91154%2f
Equity Funding	19 73	Wolfson Weiner; Ratoff & Lapin	United States	Created fictitious insurance policies	https://www.nytimes.com/1973/04/04/archives/insurance-fraud-charged-by-sec-to-equity-funding-difficulties-were.html
Lockheed Corporation	19 76	Ernst & Young	United States	Bribery scandals	https://www.washingtonpost.com/gdpr-consent/?next_url=https%3a%2f%2fwww.washingtonpost.com%2farchive%2fbusiness%2f1977%2f05%2f27%2flockheed-paid-38-million-in-bribes-abroad%2f800c355c-ddc2-4145-b430-0ae24afd6648%2f
O.P.M. Leasing Services	19 81	Fox & Company	United States	Created fictitious leases	https://www.nytimes.com/1983/05/01/business/a-close-up-look-at-the-fraud-that-ruined-opm.html
ESM Government Securities	19 86	Alexander Grant & Company	United States	Bribery of CPA partner	https://www.nytimes.com/1985/03/08/business/esm-collapse-a-lesson-in-safety.html
ZZZZ Best	19 86	Ernst & Young	United States	Ponzi scheme	https://www.nytimes.com/1990/02/25/books/nothing-but-zzzz-best.html

Bankers Trust	1988	Arthur Young & Co	United States	Hiding an \$80 million mis-pricing of derivatives contributing to profits by cutting bonuses	https://www.theguardian.com/business/1999/jul/21/bankersinvestmenttrustbusiness
Barlow Clowes	1988	Deloitte	United Kingdom	Gilts management service	https://www.nytimes.com/1988/06/27/business/international-report-financial-scandal-is-talk-of-britain.html
Crazy Eddie	1989	Penn and Horowitz	United States	Inflated sales and money laundering	https://www.nytimes.com/1993/07/21/business/crazy-eddie-founder-guilty-of-fraud.html
MiniScribe	1989	Coopers & Lybrand	United States	Failing to write off bad debts and chanel stuffing	https://www.nytimes.com/1989/09/13/business/fraud-is-cited-at-miniscribe.html
Polly Peck	1990	Erdal&Co	United Kingdom	False accounting	https://www.theguardian.com/business/2010/aug/26/polly-peck-business-asil-nadir
Bank of Credit and Commerce International	1991	PricewaterhouseCoopers	United Kingdom	Money laundering	https://www.nytimes.com/1991/08/12/business/world-class-fraud-bcci-pulled-it-off-special-report-end-twisted-trail-piggy-bank.html
Phar-Mor	1992	Coopers & Lybrand	United States	Embezzlement	https://www.nytimes.com/1995/05/26/business/ousted-phar-mor-president-found-guilty-in-1-billion-fraud.html
Informix Corporation	1996	Ernst & Young	United States	Filing a false registration statement with the SEC, mail fraud, wire fraud and bank fraud	https://www.nytimes.com/2000/10/06/business/fraud-charges-in-informix-case.html
Sybase	1997	Ernst & Young	United States	Overly aggressive sales tactics	https://www.nytimes.com/1998/01/22/business/sybase-loss-to-grow-as-sales-are-disputed.html
Cendant	1998	Ernst & Young	United States	Manufactured fake revenue	https://www.nytimes.com/2001/02/28/business/former-cendant-executives-charged-with-fraud.html
Waste Management, Inc.	1999	Arthur Andersen	United States	Financial misstatements	https://enr.com/waste-management-inc-1998-fraud-scandal/
Unify Corporation	2000	Deloitte & Touche	United States	Fraudulent activity by recognising revenue in barter and contingency transactions	https://www.sec.gov/news/press/2002-71.htm
Computer Associates	2000	KPMG	United States	Massive accounting fraud on accounting methods and	https://www.forbes.com/2005/06/30/ca-accounting-scandal-cx_fr_0630ca.html?sh=489a015c3cb2

				executive compensation	
Lernout & Hauspie	2000	KPMG	Belgium	Fictitious transactions in Korea and improper accounting methodologies elsewhere	https://www.wsj.com/articles/SB10001424052748703989304575503500899087566
Xerox	2000	KPMG	United States	Falsifying financial results	https://www.nytimes.com/2002/04/02/business/xerox-to-restate-results-and-pay-big-fine.html
MicroStrategy	2000	PricewaterhouseCoopers	United States	Civil accounting fraud charges related to a restatement of the software vendor's financial results	https://www.nytimes.com/2000/12/15/business/microstrategy-chairman-accused-of-fraud-by-sec.html
Enron	2001	Arthur Andersen	United States	Accounting loopholes and poor financial reporting	https://www.journalofaccountancy.com/issues/2002/apr/theriseandfallofenron.html
Qwest Communications	2002	Arthur Andersen	United States	Inflated revenues	https://www.justice.gov/opa/pr/justice-department-returns-44-million-victims-qwest-communications-fraud
CMS Energy	2002	Arthur Andersen	United States	Round trip trades	https://www.wsj.com/articles/SB107955679871158233
Vivendi Universal	2002	Arthur Andersen	France	Financial reshuffling	https://www.nytimes.com/2004/06/28/business/media-in-shadow-of-vivendi-scandal-ex-chief-works-to-clear-name.html
Dynegy	2002	Arthur Andersen	United States	Round trip trades	https://www.nytimes.com/2003/06/13/business/former-employees-of-dynegy-face-charges-of-fraud.html
Halliburton	2002	Arthur Andersen	United States	Improper booking of cost overruns	https://www.reuters.com/article/us-halliburton-bribery-idUSTRE50P5ZE20090126
Nicor	2002	Arthur Andersen	United States	Overstated assets and understated liabilities	https://www.wsj.com/articles/SB107109218144756300
Peregrine Systems	2002	Arthur Andersen	United States	Overstated sales	https://archives.fbi.gov/archives/news/pressrel/press-releases/executives-and-auditor-of-peregrine-systems-inc.-indicted-on-securities-fraud-charges
Sunbeam	2002	Arthur Andersen	United States	Overstated sales and revenues	https://www.nytimes.com/2001/05/16/business/sec-accuses-former-sunbeam-official-of-fraud.html
WorldCom	2002	Arthur Andersen	United States	Fraudulent expense capitalization	https://knowledge.wharton.upenn.edu/article/what-went-wrong-at-worldcom/
Adelphia	2002	Deloitte & Touche	United States	Illegitimately purchase personal luxuries	https://www.sec.gov/news/press/2002-110.htm

Duke Energy	2002	Deloitte & Touche	United States	Round trip trades	https://www.nytimes.com/2004/04/22/business/3-at-duke-energy-charged-with-fraud.html
El Paso Corporation	2002	Deloitte & Touche	United States	Round trip trades	https://www.sec.gov/litigation/litreleases/2008/lr20642.htm
Merrill Lynch	2002	Deloitte & Touche	United States	Conflict of interest	https://www.reuters.com/article/us-bank-of-america-broker-fraud/ex-merrill-lynch-broker-to-plead-guilty-to-securities-fraud-idUSKBN1D020A
Reliant Energy	2002	Deloitte & Touche	United States	Round trip trades	https://archives.fbi.gov/archives/news/pressrel/press-releases/reliant-energy-services-inc.-and-four-of-its-officers-charged-with-criminal-manipulation-of-california-electricity-market
AOL	2002	Ernst & Young	United States	Inflated sales	https://www.washingtonpost.com/gdpr-consent/?next_url=https%3a%2f%2fwww.washingtonpost.com%2farchive%2fbusiness%2f2005%2f03%2f22%2ftime-warner-secure-settle-aol-fraud-charges%2f38516f5f-3f51-44d6-bfec-5481809b3dd6%2f
ImClone Systems	2002	KPMG	United States	Executives sold their stock before the announcement of the decision after the close of trading	https://www.thestreet.com/investing/stocks/imclone-scandal-a-timeline-10680995
Mirant	2002	KPMG	United States	Overstated assets and liabilities	https://www.wsj.com/articles/SB1036709070598170748
Bristol-Myers Squibb	2002	PricewaterhouseCoopers	United States	Inflated revenues	https://www.sec.gov/news/press/2005-118.htm
Freddie Mac	2002	PricewaterhouseCoopers	United States	Understated earnings	https://www.sec.gov/news/press/2007/2007-205.htm
Homestore.com	2002	PricewaterhouseCoopers	United States	Improper booking of sales	https://archives.fbi.gov/archives/losangeles/press-releases/2010/la041910.htm
Kmart	2002	PricewaterhouseCoopers	United States	Misleading accounting practices	https://www.sec.gov/news/press/2005-119.htm
Merck & Co.	2002	PricewaterhouseCoopers	United States	Recorded co-payments that were not collected	https://www.reuters.com/article/us-pharmaceuticals-remeron/merck-unit-to-pay-31-million-to-settle-fraud-claims-by-us-states-idUSKCN0I42IO20141015?edition-redirect=uk
Symbol Technologies	2002	Deloitte & Touche	United States	Overstated sales and revenues	https://www.sec.gov/litigation/litreleases/lr18734.htm
Royal Ahold	2003	Deloitte & Touche	United States	Inflating promotional allowances	https://www.sec.gov/news/press/2004-144.htm

HealthSouth Corporation	2003	Ernst & Young	United States	Money laundering, extortion, obstruction of justice, racketeering and bribery	https://www.nytimes.com/2004/01/21/business/healthsouth-audit-finds-as-much-as-4.6-billion-in-fraud.html
Parmalat	2003	Grant Thornton SpA	Italy	Falsified accounting documents	https://www.theguardian.com/business/2004/oct/06/corporatefraud.businessqandas
Chiquita Brands International	2004	Ernst & Young	United States	Illegal payments	https://www.business-humanrights.org/en/latest-news/chiquita-lawsuits-re-colombia/
AIG	2004	PricewaterhouseCoopers	United States	Accounting of structured financial deals	https://www.sec.gov/news/press/2004-163.htm
Bernard L. Madoff Investment Securities LLC	2008	Friehling & Horowitz	United States	Schema Ponzi	https://www.justice.gov/usao-sdny/programs/victim-witness-services/united-states-v-bernard-l-madoff-and-related-cases
Monsanto	2009	Deloitte	United States	Misstated earnings by failing to accurately count rebate costs	https://www.nytimes.com/2016/09/11/business/for-monsanto-whistle-blower-a-22-million-award-that-fell-short.html
Taylor, Bean & Whitaker	2009	PricewaterhouseCoopers	United States	Fraudulent spending	https://www.justice.gov/opa/pr/former-chairman-taylor-bean-whitaker-convicted-29-billion-fraud-scheme-contributed-failure
Lehman Brothers	2010	Ernst & Young	United States	Repo 150	https://www.nytimes.com/2010/03/12/business/12lehman.html
Autonomy Corporation	2012	Deloitte & Touche	United States	Sketchy accounting	https://www.theguardian.com/business/2019/may/13/ex-autonomy-cfo-sushovan-hussain-five-years-hewlett-packard
Pescanova	2013	BDO Spain	Spain	Revenue recognition	https://www.reuters.com/article/uk-pescanova/accounting-scandal-deepens-at-spains-pescanova-idUKBRE93F15N20130416
Tesco	2014	PricewaterhouseCoopers	United Kingdom	Overstated profit	https://www.accaglobal.com/gb/en/student/sa/features/tesco-scandal.html
Wells Fargo	2017	KPMG	United States	False accounting and unauthorized deposit accounts	https://www.nytimes.com/2020/02/21/business/wells-fargo-settlement.html
Wirecard AG	2020	Ernst & Young	Germany	Accounting fraudulent activities to inflate its profit	https://www.ft.com/content/6a660a5f-4e8c-41d5-b129-ad5bf9782256

As it is pointed out by Chatfield (1996), the financial scandal of the company Fred Stern & Company, audited by Touche Niven & Co. (1925), in US, constituted the beginning of the audit failure. Concerning audit reforms and taking as a reference time the company McKesson & Robbins, Inc. (1938), the fraud marked the beginning of the audit reform through the establishment of the audit committee.

In this context, the audit firms were split into Big 4 and non-Big 4 companies, in order to observe the impact of the biggest audit firm in audit world. Figure 1 shows that, from the total sample of 68 companies, only 13 companies (19%) are audited by non-Big 4 as: Homes and Davis, Peat, Marwick, Mitchell & Co., Lybrand, Ross Brothers, & Montgomery, Wolfson Weiner; Ratoff & Lapin, Fox & Company, Alexander Grant & Company, Grant Thornton SpA, Friehling & Horowitz, Crazy Eddie, Kulsant and John Moreland and BDO (Table 1).

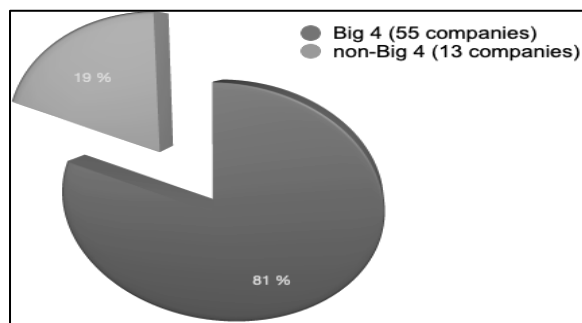


Figure 1: EU & US companies audited by Big 4/ non-Big 4, 1925-2020

An example of a general fraud for three companies from U.S. as Halliburton (2002), Homestore.com (2002) and Monsanto (2009), which was not detected by Big 4 (Arthur Andersen, PricewaterhouseCoopers and Deloitte, respectively), is represented by the improper accounting (Patsuris, 2002) as improper booking of costs (Palmer, 2012) or sales. In Europe a financial reshuffling (Palmeri, 2011) was registered by the company Vivendi Universal (2002) audited by Arthur Andersen. The findings of this quantitative research argue that the majority of big frauds were audited by Big 4 firms (81%), as seen in Figure 1.

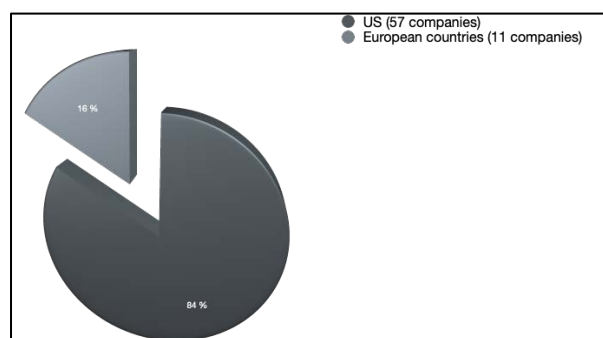


Figure 2: EU & US companies, 1925-2020

Figure 2 presents the biggest accounting scandals by regions. From the total sample of 68 investigated frauds, 57 companies (84%) are part of US region. For the rest of 11 companies (16%), 6 companies (Tesco, Hatry Group, Royal Mail Steam Packet Company, Barlow Clowes, Polly Peck and Bank of Credit and Commerce International) are part of United Kingdom and 4 entities (Parmalat, Vivendi Universal, Wirecard AG and Pescanova) are part of Italy, France, Germany and Spain. From the total sample of 68 companies, the largest number of frauds was register in the year 2002. More precisely, 22 firms were registered in US and only one scandal in 2002 took place in France.

From the total of 22 companies, 9 firms (Qwest Communications, CMS Energy, Vivendi Universal, Dynegy, Halliburton, Nicor, Peregrine Systems, Sunbeam, WorldCom) were audited by Arthur Andersen, 6 firms (Adelphia, Duke Energy, El Paso Corporation, Merrill Lynch and Reliant Energy) by Deloitte & Touche, 1 firm (AOL) by Ernst & Young, 2 firms (ImClone Systems and Mirant) by KPMG and 5 firms (Bristol-Myers Squibb, Freddie Mac, Homestore.com, Kmart and Merck & Co.) by PwC.

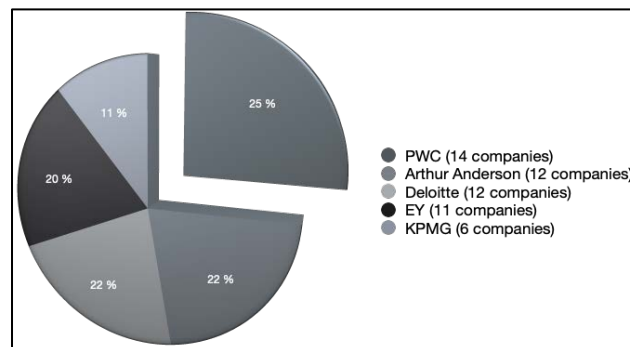


Figure 3: EU & US companies audited by the top of Big 4/ non-Big 4, 1925-2020

Figure 3 presents the top of Big 4 companies which audited the analysed companies, in the period 1925-2020. The top of Big 5 was represented by Arthur Anderson with 25 percent points. More precisely, out of 12 companies, 11 of them were part of US. The collapse of Arthur Andersen determined the change of the term Big 5 into Big 4. In terms of Big, PwC and Deloitte marked the top of errors for 14 companies (25%) and 12 companies (22%), respectively. Further, EY audited 11 companies (20%) and KPMG registered the biggest errors only for 6 companies (11%), recording the lowest ratio of the analysed sample.

It can be registered that all the analysed countries from EU were audited by Big 4 (Belgium by KPMG, France by Arthur Anderson, Germany by Ernst & Young, UK by PwC) with the exception of Italy, which was audited by Grant Thornton, a non-Big 4 audit firm.

Overall, in the history of financial scandals, there was only one scandal costing 100 million\$ (ZZZZ Best, 1986) perpetrated by one person, which was also audited by Big 4 audit firm, Ernst and Young.

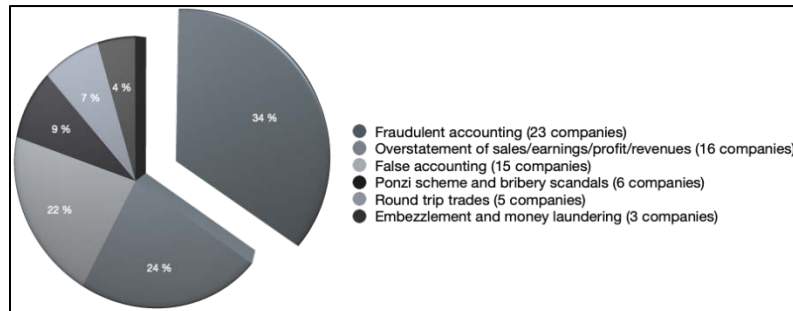


Figure 4: Causes of financial frauds, for EU & US companies, 1925-2020

Figure 4 presents the percentage of the analysed companies taking into consideration the type of financial fraud. The most frequent financial frauds are fraudulent accounting (34%) being preceded by the overstatement of sales/earnings/profit/revenue (24%) and false accounting (22%). Ponzi scheme and bribery scandals (9%), round trip trades (7%), embezzlement and money laundering (4%) are found as causes with the lowest recorded frequency.

The causes of the financial scandals had various consequences and there are some similitudes between all of them. For example, the American cases of the company's Equity Funding (1973) and O.P.M. Leasing Services (1981), fictitious leases (Taylor, 1983), Lernout & Hauspie (2000) created fictitious insurance policies, and fictitious transactions (Wall Street Journal, 2000), respectively. Moreover, an overstatement of earning was registered by National Student Marketing Corporation (1970) and by Four Seasons Nursing Centers of America (1970). Ponzi scheme was recorded by ZZZZ Best (1986).

More companies were custom to gamble round trip trades as CMS Energy, Dynegy, Duke Energy, El Paso Corporation and Reliant Energy (2002) in USA, all the analysed companies were audited by Arthur Anderson and Deloitte & Touche.

More recently, similar causes of frauds were registered, as the following: the falsification of financial results of the firm Xerox (2000), audited by KPMG (Forbes, 2002), the falsification of the accounting documents of the firm Parmalat (2003) audited by Grant Thornton, the registration of false accounting in the firm Wells Fargo (2017), audited by KPMG or the registration of falsified accounts in the firm Pescanova (2013) audited by BDO. The scandal of the company WorldCom (2002) audited by Arthur Anderson registered fraudulent

expense capitalisation and the company Taylor, Bean & Whitaker (2009) audited by PWC registered fraudulent spending (Norris, 2011).

The biggest audit failure (Bratton, 2002) was represented by Enron which hid billions in the debt from failed projects. Inflated revenues and sales were registered by some companies as Qwest Communications (2002) audited by Arthur Andersen, Bristol-Myers Squibb (2002) audited by PWC and AOL (2002) audited by EY. In the same field, Royal Ahold (2003) audited by Deloitte was registered inflating promotional allowance.

Further, Mirant (2002), audited by KPMG and Nicor (2002) audited by Arthur Anderson and Kinross Gold (2010) audited by KPMG, overstated the value of the assets. Penn West Exploration (2012) audited by KPMG and Valeant Pharmaceuticals (2015) audited by PWC overstated the profit and the revenue, respectively. The companies Peregrine Systems, Symbol Technologies and Sunbeam (2002) overstated the sales and the revenues of the companies.

The similitudes of the causes and the consequences of the Enron scandal have created the audit reform which is represented by the biggest one (Sarbanes, 2002) and its European version was extended by the Directive 2006/43/EC. The ethical part of the international standards or the part of the moral virtues appears not to be publicly observable for all the analysed companies. In the same vein, it is observable that the Ethical Code beyond ISAs seems to be invisible for the people without compunction.

4. OVERVIEW OF THE AUDIT REFORMS AND THE INDEPENDENCE OF AUDITORS

The Audit Reform is a consequence of a financial crisis. Starting with the investigation of the company McKesson & Robbins (1938), SEC (Security Exchange Commission) advocated the term of audit committee and later (1978) the New York Stock Exchange started to require to all the listed companies to present an audit committee. In 1998 the chairman of SEC, Arthur Levitt emphasised through the speech “The Numbers Game” the low level of accounting practices focusing on earnings management.

Blue Ribbon Committee (BRC), created by NYSE (National Association of Securities Dealers) and NASD (National Association of Securities Dealers), started to amend the level of the committee’s oversight process, and one year later, NYSE and NASDAQ (National Association of Securities Dealers Automated Quotation) were approved by SEC. In 2002, for

the first time, the audit committee was created exclusively by independent members (Nowak & Liang, 2003).

In the United States, since 2002, the American Institute of Chartered Accountants has established that the PCAOB, elected by the SEC, applies auditing standards by reviewing auditors as a trusted leader that promotes high quality auditing. This PCAOB model institution has become a model in setting up similar bodies, with the necessary capacity to inspect any company participating in an audit, whose securities are traded on a regulated market. PCAOB oversees the audit services of public companies registered with the SEC to protect investors and promote the public interest in preparing informative, accurate and independent audit reports. Surveillance activities include setting standards and periodic inspections through anticipatory, responsive and innovative surveillance.

The Sarbanes-Oxley Act (2002) sponsored by Paul Sarbanes and Michael Oxley, started to change the federal securities law. Senator Paul Sarbanes (Lucas, 2004) argues in one interview that: “The Senate Banking Committee undertook a series of hearings on the problems in the markets that had led to a loss of hundreds and hundreds of billions, indeed trillions of dollars in market value. The hearings set out to lay the foundation for legislation.

We scheduled 10 hearings over a six-week period, during which we brought in some of the best people in the country to testify. The hearings produced remarkable consensus on the nature of the problems: inadequate oversight of accountants, lack of auditor independence, weak corporate governance procedures, stock analysts' conflict of interests, inadequate disclosure provisions, and grossly inadequate funding of the Securities and Exchange Commission”.

Independent audit services of financial statements represent the cornerstone of a consistent global financial system. The recent frauds, however, attest that audit services do not provide with assurance to investors about the real performance of the companies. The public oversight body of USA (PCAOB) inspects only a small percentage of the listed companies each year, providing a public inspection report to each company. For PCAOB, the inspection report represents the most important indicator of audit quality (Westermarck et al., 2018)

The perspective of EU reform argues that audit reform has to strengthen confidence in the honesty of the financial reporting and to augment the level of audit quality. Michael Barnier (European Commission, 2011: 2), the Internal Market and Services Commissioner stated that:

“Investor confidence in audit has been shaken by the crisis and I believe changes in this sector are necessary: we need to restore confidence in the financial statements of companies. Today's proposals address the current weaknesses in the EU audit market, by eliminating conflicts of interest, ensuring independence and robust supervision and by facilitating more diversity in what an overly concentrated market is, especially at the top-end”.

"Audit Policy: Lessons from the Crisis" in Green Paper (2010) was the key to the final agreement elected by the European Parliament in April 2014. Furthermore, the EU reform seeks to accomplish a single European audit market through the following elements:

- Directive 2014/56/EU amends Directive 2006/43/EC which applies to all statutory audits. By each Member State, the directive is transposed into national law.
- Regulation No. 537/2014 adds new requirements concerning governing statutory audits of PIEs without the transposition into national law.

In Romania, the Law 162/2017 is the equivalent of the EU audit Reform, more precisely EU Directive 56/2014 and the EU Regulation 537/2014. The European Union's audit reform starts the foundations for a single market for auditing European companies. The main aim is to restore the confidence in the financial statements of European companies (e.g., PIEs) by strengthening governance, audit quality and auditor competence as well as increasing the independence of key stakeholders involved in the audit process.

According to the audit firm Mazars, EU audit reform is an encouraging step towards the creation of a single European audit market (2020). In brief, the principles challenges of the Regulation applied to EU Public Interest Entities (Directive 2014/56/EU) refers to the mandatory rotation of the audit firm, the non-audit services and the extended role of the audit committee. In the same vein, the adoption of Directive 2014/56/EU adds the followings amendments:

- the definition of PIEs has been extended;
- more requirements on objectivity and independence concerning the statutory auditors and audit companies;
- the content of audit report includes additional requirements;
- the augmentation of the competencies of the authorities responsible of PIOB;
- harmonisation of the rules related to sanctions;

- Concerning the Regulation 537/2014, the followings amendments are summarised:
- the content of audit report includes additional requirements as the performance of the audit services;
- mandatory rotation of the audit company;
- adding a blacklist for all the non-audit services which cannot be assured by statutory auditors and limitations on the non-audit fees;
- imposing limitations on the fees which are received from PIEs;
- more requirements to augment to competence of the audit committee (Committee of European Auditing Oversight Bodies);

The other legal sources related to audit activities are compounded by (Westermarck et al., 2018):

- Accounting Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC
- Transparency Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC
- Solvency Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

Westermarck et al., (2018) argues that: “Audit oversight by a supervisory authority is conducted at national level. Therefore, there is no supervisory authority at the EU level” and “it may be mentioned that in accordance with the new Audit Directive, cooperation and coordination is to be carried out at the European level by a new Committee of European Auditing Oversight Bodies (CEAOB), a group that will replace the existing European Group of Auditor Oversight Bodies (EAOB)”.

5. THE CONSEQUENCES OF ETHICAL BEHAVIOUR ON AUDIT SERVICES

As a generalisation, Hill (1995: 585) noted that: “the fruits of deep cynicism are now with us, as prominent figures are in court to defend their actions and seem amazed that they are accused of doing something wrong at all”. The answer probably lies in Socrates' exhortation that: “life that is not examined is not worth living” (Fine, 1999: 541).

Lack of moral courage is the foundation behind the Abilene paradox described by Harvey (1988: 66): “Organisations often take actions that contradict what they really want to do, and ultimately the goals of the organisation must be realised”. The Abilene paradox argues that there are certain circumstances in which members of a private organisation individually consider an action to be unethical, but they collectively admit, during public meetings, the action is considered illegal.

Therefore, this paradox has the potential to lead people who have unethical behaviour into unethical actions. The Abilene paradox is based on four factors (Harvey, 1988: 70), namely:

- Action anxiety: Individuals are overwhelmed by a state of anxiety, when they must take the right action, which is in contradiction with what is currently happening in the organisation;
- Negative fantasies: Individuals anticipate and emphasise only negative results if they act with ethical behaviour;
- Real risk: taking the right action can risk being fired unless the current set of circumstances has been allowed to take its course;
- Fear of separation: individuals do not want to risk being ostracised by their co-workers and others;

Audit services require competence and independence. Excluding ethical practice, the audit profession is not able to fulfil its responsibilities in the contract with the company. The audit profession and the accounting profession recognise existing ethical dilemmas that can be minimised through a wide range of strategies. In the same context, threats to independence diminish when independence is recognised as a potential ethical dilemma.

Thus, if a member of the audit firm, partner or employee, recognises a possible threat to independence that may become a real issue to be addressed, then all threats and ethical

dilemmas can be minimised. To achieve this, substantial education would lead to a change in the entire audit profession by increasing the quality of audit services. The recommended model proposes a consistent inspection process that increases the quality and transparency of the independence decision-making process in audit firms and better disclosure of auditors' skills and attributes to increase auditor accountability by publishing annual reports of national audit inspections.

Financial supervision systems are a key institutional factor, which guarantees the quality of financial information and keeps investors' confidence and capital markets stable. Throughout history, there has been public uncertainty about the role that professional auditors and audit firms have played in the biggest corporate scandals (Enron, HIH or Parmalat).

The economic and social damage was incalculable, and the implications were far-reaching for corporate management, audit firms and the government. While the story behind these corporate frauds has been complex, the ethical behaviour of many individuals and legal entities has been completely lacking. At that time, when the biggest economic scandals were being discussed by regulators, the biggest challenge for auditors was to identify how ethical behaviour can be restored, as this was the basis for rebuilding public confidence in the profession and in the practice of auditing.

In this context, attention was focused on the weaknesses in the capital market and on reforms aimed at corporate reporting and the role of audit services, which could address existing problems in the market (Simnett & Smith, 2005).

Since the twentieth century, the number of lawsuits against audit firms has produced an ongoing debate about auditors' liability for economic losses incurred when a company tends to collapse financially. The audit profession expressed concern that there is a gap between the defined legal role of auditors and the expectations of the investing public: "The general public considers that the auditor has a responsibility to detect all fraud, while the audit profession considers that the responsibilities its limited to audit planning, so that there is a reasonable expectation to detect material fraud" (Gay & Pound 1989: 118).

The power of a principles-based regime as a means of control also lies in the uncertainty it generates. Hence the answer that David gave, when asked at the beginning of the new regime how it will work, it seems to emphasize the audit period: "We are like the javelin thrower with

our eyes crossed at the Olympic Games. We may not win, but we will keep the crowd on its seats” (McBarnet & Whelan 1999: 11).

The predominant structure initiated or proposed by different jurisdictions aiming at a reform of the processes for setting audit standards, is represented by the creation of a public oversight committee (POB). This committee mainly includes persons independent of the audit profession, who oversee the activities of the standard-setting board. The reason behind this structure is that the audit has a dimension of public interest.

Thus, one can compare and contrast the different structures that have been instigated or proposed by the main national and international bodies regarding the public oversight of the audit standard setting process. It was also accepted that the solution for restoring investor confidence in the audit profession is given by improving the degree of independence and transparency (Sharav, 2003).

Theoretically, public oversight by an independent body will restore confidence in the audit profession by introducing neutrality and transparency. Public oversight of the audit profession is considered a “major element in maintaining confidence in the audit function” (European Commission 2003b).

International debates about the qualities of a member and how POB members are appointed continue to inspire stakeholders, as they are an important factor in ensuring the independence and transparency of the oversight process. The opposite ideas are argued by both parties, namely, McNamee & Fleming (2007) show that POB members must show adequate expertise and capacity for practical implications and Pesch (2003) states that they are obliged to act independently and not as representatives of any stakeholder group.

Moreover, the appointment of POB members by the state has been described as a controversial and politicised process (McNamee & Fleming, 2007). The European Commission argues that public oversight should include the exercise of investigative and disciplinary powers because public oversight remains without public credibility” (European Commission, 2003a).

6. CONCLUSIONS

In this paper, the ethical behaviour of auditors and its influence is analysed in order to observe the degree of independence related to audit services, taking into consideration the historical changes and the actual circumstances of the audit market. The biggest European and

American financial frauds between 1925 and 2020 are analysed together with the audit reforms which affected the evolution of audit market. The findings show that the majority of the biggest frauds were signed by Big 4 in the US and the lack of ethical behaviour is signalled by a lack of attention related to the Ethical Code.

Most financial frauds are represented by fraudulent accounting (34%) being preceded by the overstatement of sales/earnings/profit/revenue (24%) and false accounting (22%). Ponzi scheme and bribery scandals (9%), round trip trades (7%), embezzlement and money laundering (4%) are found as causes with the lowest recorded frequency.

For the analysed period 1925-2020, the similitudes of the causes and the big consequences of the Enron scandal have created the audit reform which is represented by the biggest one of its kind (SOX, 2002) and its European version was extended by the Directive 2006/43/EC. The ethical part of the international standards or the part of the moral virtues appears not to be publicly observable for all the analysed companies.

In the same vein, it is observable that the Ethical Code beyond ISAs seems to be invisible for the people without compunction. In order to quantify the ethical behaviour, the nation oversight bodies represent the main clue of the external incorporation of moral virtues which appear to be part of the natural human being. For an auditor, working in accordance with the ISA and the Code of Ethics should be a professional reflex and not an obligation. Moreover, the results should be interpretable if professional ethics is respected only as a professional obligation.

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