The Impact of Professional Ethics on Financial Reporting Quality

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Abstract: This research aims to study the impact of professional ethics on promoting quality of financial reporting. The statistical population in this study includes 440 listed companies in Tehran Stock Exchange (TSE) in 2010. Using Krejcie and Morgan's table for determining sample size, 205 companies were selected as the statistical sample and a 24-item questionnaire was designed to study professional ethics and qualitative characteristics of financial reporting based on code of ethics of International Federation of Accountants (IFAC) and qualitative characteristics of financial reporting of International Accounting Standards Board (IASB), then the questionnaires were distributed among the financial managers of companies. For testing the hypothesis, relevant statistical tests such as the Spearman's correlation coefficient and other required tests were used. The data collected was analyzed using the SPSS statistical package. The results pointed to statistically significant relationship between professional ethics and quality of financial reporting.

Key words: Ethics, Professional Ethics, Financial Reporting Quality, Tehran Stock Exchange (TSE).

INTRODUCTION

Accountants have obligations to shareholders, creditors, employees, suppliers, the government, the accounting profession and the public at large. In other words, their obligations go beyond their immediate client. Decisions made on information provided by accountants can materially affect the lives of any or all of these stakeholders. Therefore Behaving ethically is an essential and expected trait (Carroll, 2005). As a result, an accountant is responsible for the consequences of his moral choices not only for his own life but also on the lives of other people. An accountant who commits fraud not only ruins his own moral being but also harms the interests of the other members of society who depend on him (Catacutan, 2006). Professional ethics is important to accountants and those who rely on information provided by accountants because ethical behavior entails taking the moral point of view. This can be seen as a formal method of declaring to all that the occupation can be trusted (Carroll, 2005). Internalizing and developing professional ethics in accounting profession lead to promoting the quality of financial reporting (Mahdavikhou, 2010). This paper examines the relationship between professional ethics and qualitative characteristics of financial reporting. The structure of the research is as follows: section 2 presents the literature review, section 3 discusses the research hypotheses, section 4 describes the research method, section 5 discusses the data analysis, section 6 presents discussion and section 7 concludes the discussion.

Literature Review:

Ethics in Accounting:

“Ethics” is a term subject to numerous, sometimes conflicting, interpretations (Luoma, 1989). Ethical problems are a very relevant issue present in many aspects of real life. These situations can be examined through several branches and under several grids of analysis, modern or classic (Filipe et al., 2011). A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest (IFAC, 2005). Key qualities which appear in the codes of ethics of professional bodies include independence, integrity, objectivity, competence and judgment. For example, the ICAEW's introduction to its ‘Guide to Professional Ethics’ (ICAEW, 1997:178) includes a list of five fundamental principles which either expressly mentions or clearly implies all of these qualities, along with other related qualities such as honesty, fair-dealing, truthfulness, courtesy, skill and diligence (Govrthorpe, 2005).

Because of the importance of the issue, many researchers in developed countries have conducted studies on accounting ethics education. They have indicated that ethics education must be given in business schools for the development of future generations (Calicyurt, 2007). Ethics education helps students identify the link between ethical decision-making and real-life behavior (Helps, 1994). Abu Bakar et al., (2008) explore the ethical attitudes of the final year accounting students. The study indicates that the majority of respondents would prefer not to indulge in unethical behavior. Professional ethics has a significant position in the organization of the Thai Federation of Accounting Professions (FAP) and In Australia, ethics are at present the responsibility of an Accounting Professional and Ethical Standards Board limited (Gaffikin, 2009).
Gammie in a study predicated on the Kantian approach to ethical decision making which is located in the domain of deontological ethic theories, suggests that ethics is based on a set of unbreakable ethical rules and is concerned with the simple notion of right and wrong (Gammie and Gammie, 2009). Another study has investigated the influence of knowledge of ethics (KOE) on auditors’ perceived ethical problems (PEP). The results indicated that statistically significant relationships exist between knowledge of ethics (KOE) on auditors’ perceived ethical problems (PEP) (Zakaria et al., 2010). Jabbarzadeh Kangarluei and Bayazidi investigated the relationship between ethical values and agency cost in accounting system. Findings showed that executing of ethical affairs from managers and other employees in Iranian companies increase agency costs, but causes the existence of weak relation between ethical criteria and agency costs, these findings should considerate cautiously (Jabbarzadeh Kangarluei and Bayazidi, 2010).

**Qualitative Characteristics of Financial Reporting:**

Qualitative characteristics are the attributes that make the information provided in financial reports useful to users. As figure 1 shows, the four principal qualitative characteristics are understandability, relevance, reliability and comparability (IASB, 2006).

According to the theoretical concepts of Iran’s financial reporting, the aim of financial reports is to provide brief as well as classified data about the financial status, financial functions, and flexibility of the commercial unit so that they can be useful to the users of such reports in making economic decisions (Talebnia et al., 2011). The qualitative characteristics are complementary concepts in achieving decision-useful financial reporting information; their application, in contrast, should maximize the usefulness of financial reports. Each qualitative characteristic discussed in this chapter makes its own distinct contribution to the decision usefulness of financial reporting information. The objective of financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment and similar resource allocation decisions (IASB, 2006).

**Professional Ethics and Qualitative Characteristics of Financial Reporting:**

The quality of financial reporting indicates a limit in which the financial reports of a company, its economic status, and functions, which are measured over period of time, are presented honestly (Talebnia et al., 2011). Truthfulness of and trust in the financial reporting system depend on far more than the actions and decisions of individuals or sophisticated “mechanisms” for the whole system (Enderle, 2006). Companies in the energy, accounting, and banking industries and the professional associations of the certified public accountants and the investment managers and researchers have, in varying degrees, affected the quality of and confidence in the financial reporting systems. Therefore, truthfulness of and trust in the financial reporting system cannot be a matter of either personal or institutional ethics alone (Brenkert, 2004).

In 1980 the President of AICPA William Gregory warned members over the fact that “accountants have subordinated courtesy, mutual respect, self-restraint and fairness for a quest for firm growth and a preoccupation with the bottom line”. Representatives of the big firms however denied ethical responsibility for the corporate scandals that occurred. According to them what happened between Enron and Andersen was not so much a consequence of the lack of ethics on the part of the auditors, but was due to the failure in the current financial reporting system that advocated for “backward-looking” financial statements (Catacutan, 2006). Behaving ethically in accounting is more important than auditing because accounting system prepares financial statements for auditing (Mahdavikhos, 2010).
Research Hypotheses:

1. **Main Hypothesis:**
   There is a significant relationship between professional ethics and qualitative characteristics of financial reporting information of listed companies in Tehran Stock Exchange.

2. **Sub Hypothesis:**
   **Sub. H1:**
   There is a significant relationship between professional ethics and presenting the financial information of listed companies in Tehran Stock Exchange.
   **Sub. H2:**
   There is a significant relationship between professional ethics and financial information content of listed companies in Tehran Stock Exchange.

**MATERIALS AND METHODS**

The study reported here is a survey study which examines the correlation between professional ethics and qualitative characteristics of financial reporting information. Financial managers were asked to rate each item on Likert scale of 5 in which 1 strongly disagreement and 5 indicated strongly agreement. The application of Five-point Likert scale is supported by Sclove (2001).

**Sample and Statistical Population:**

The statistical population in this study includes the 440 listed companies in Tehran Stock Exchange in 2010. Using Krejcie and Morgan's (1970) table for determining sample size, 205 companies were selected as the statistical sample.

**Data Collecting Tools and Data Analysis Method:**

In order to collect the required data for analysis, a 24-item questionnaire was designed to study professional ethics and qualitative characteristics of financial reporting based on code of ethics of International Federation of Accountants (IFAC) and qualitative characteristics of financial reporting of International Accounting Standards Board (IASB) and was distributed among the financial managers of companies. The reliability of the questionnaire was established through a pilot study including 32 financial managers. As a result, Cronbach's alpha was equal to 0.7303 (≈ 0.73) and therefore the reliability of the questionnaire was confirmed. For testing the hypotheses, relevant statistical tests such as the Spearman's correlation coefficient and other required tests were used and for testing the normality of data Kolmogorov-Smirnov's test was used. Table 2 shows the Sig. value of the K-S Test. As the table shows probability level for a 2-tailed distribution is less than 0.05, which means that variables are not normally distributed. So the Spearman's correlation coefficient was used. The data collected were analyzed using the statistical software package Statistical Product and Service Solutions (SPSS).

**Table 1:** Descriptive Statistics.

<table>
<thead>
<tr>
<th></th>
<th>N</th>
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<th>Std. Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Percentiles</th>
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<td>7.00</td>
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<td>3.03993</td>
<td>6.00</td>
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</table>

**Table 2:** One-Sample Kolmogorov-Smirnov Test.

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<tr>
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<td>8.0000</td>
<td>14.6000</td>
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<tr>
<td>Std. Deviation</td>
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<td>1.88388</td>
<td>3.03993</td>
</tr>
<tr>
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<td>.151</td>
</tr>
<tr>
<td></td>
<td>Positive</td>
<td>.147</td>
<td>.151</td>
</tr>
<tr>
<td></td>
<td>Negative</td>
<td>-.149</td>
<td>-.112</td>
</tr>
<tr>
<td>Kolmogorov-Smirnov Z</td>
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<td>2.162</td>
<td>2.638</td>
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<tr>
<td>Asymp. Sig. (2-tailed)</td>
<td>.000</td>
<td>.000</td>
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**Sub-H1:**

There is a significant relationship between professional ethics and presenting the financial information of listed companies in Tehran Stock Exchange.

Table 3 indicates that the level of Sig. at p≤0.01 is enough to reject null hypothesis and thus, the hypothesis that "There is a significant relationship between professional ethics and presenting the financial information of listed companies in Tehran Stock Exchange" is confirmed.
Table 3: Correlations coefficient between Professional Ethics and Presenting.

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<thead>
<tr>
<th></th>
<th>Presenting</th>
<th>Correlation Coefficient</th>
<th>Sig. (2-tailed)</th>
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<td>Correlation Coefficient</td>
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</table>

*. Correlation is significant at the 0.01 level (2-tailed).

Sub-H2:
There is a significant relationship between professional ethics and financial information content of listed companies in Tehran Stock Exchange.

Table 4 indicates that the level of Sig. at p≤0.01 is enough to reject null hypothesis and thus, the hypothesis that "There is a significant relationship between professional ethics and financial information content of listed companies in Tehran Stock Exchange" is confirmed.

Table 4. Correlations coefficient between Professional Ethics and Content

<table>
<thead>
<tr>
<th></th>
<th>Content</th>
<th>Correlation Coefficient</th>
<th>Sig. (2-tailed)</th>
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<tr>
<td></td>
<td>Correlation Coefficient</td>
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*. Correlation is significant at the 0.01 level (2-tailed).

Main H:
There is a significant relationship between professional ethics and qualitative characteristics of financial reporting information of listed companies in Tehran Stock Exchange.

Table 5 indicates that the level of Sig. at p≤0.01 is enough to reject null hypothesis and thus, the Main hypothesis that "There is a significant relationship between professional ethics and qualitative characteristics of financial reporting information of listed companies in Tehran Stock Exchange" is confirmed.

Table 5: Correlations coefficient between Professional Ethics, Content and Presenting.

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<th>Content</th>
<th>Presenting</th>
<th>Correlation Coefficient</th>
<th>Sig. (2-tailed)</th>
<th>N</th>
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<tbody>
<tr>
<td>Spearman's rho</td>
<td>Professional Ethics</td>
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<tr>
<td></td>
<td>Correlation Coefficient</td>
<td>.515**</td>
<td>.360</td>
<td>205</td>
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<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td>.000</td>
<td>.000</td>
<td>205</td>
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</table>

*. Correlation is significant at the 0.01 level (2-tailed).

Discussions:
Lack of professional ethics accompanied with qualitative characteristics of financial reporting can make an unrealistic picture of financial reporting. Regardless of accounting standards and rules, without professional ethics, accountants can provide manipulated financial reports. The existence of accounting standards and rules per se does not guarantee a sound and appropriate financial reporting. Hence, combination of professional ethics and qualitative characteristics of financial reporting must be used. This idea can be seen in figure 2. Ethics is the heart of economic and social freedom. Unethical behavior is a dagger in the heart. Company policies and internal controls are ineffective without ethical leadership from the top. Likewise, the future of the accounting profession depends on ethical leadership by accounting professionals and accounting educators (Smith, 2003).

Fig. 2: Impact of professional ethics on qualitative characteristics of financial reporting.

Conclusion:
The aim of this study was to investigate the impact of professional ethics on promoting quality of financial reporting in listed companies in Tehran Stock Exchange (TSE) in 2010. Findings of this study showed professional ethics has high effect on promoting quality of qualitative characteristics of financial reporting. It should be noted that the professional ethics and financial information content and professional ethics and presenting the financial information had positive correlation coefficient .515 and .360 respectively. For the future researches, the authors believe that methodology and tools used in this research need to be improved, completed, and developed to encompass other aspects of financial reporting.
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