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Author

O'Leary, Conor, Stewart, Jenny

Published

2007

Journal Title

Managerial Auditing Journal

Version

Accepted Manuscript (AM)

DOI

[10.1108/02686900710819643](https://doi.org/10.1108/02686900710819643)

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# Governance Factors Affecting Internal Auditors' Ethical Decision

## Making: An Exploratory Study

by *Conor O'Leary\** and *Jenny Stewart\*\**

\* Dr. Conor O'Leary, Senior Lecturer, School of Accountancy, Queensland University of Technology, Brisbane, Australia. Postal: GPO Box 2434, Brisbane Qld 4001. Phone 3138-1019. Fax. 3138-1812. Email: [c.oleary@qut.edu.au](mailto:c.oleary@qut.edu.au)

\*\* Professor Jenny Stewart, Department of Accounting, Finance and Economics, Griffith Business School, Griffith University, PMB 50, Gold Coast MC QLD 9726. Email: [j.stewart@griffith.edu.au](mailto:j.stewart@griffith.edu.au) (Corresponding author)

**Acknowledgements:** The authors wish to thank the Accounting and Finance Association of Australia and New Zealand (AFAANZ) for a research grant which made this project viable. They also wish to express their gratitude to the Institute of Internal Auditors (IIA) Australia, for their assistance and support for the research instrument which was distributed to delegates at an IIA conference. Finally, the helpful comments of two anonymous reviewers and the participants at the *Fifth One Day Symposium on Accountability, Governance & Performance: Achieving Excellence*, February 2006, Brisbane, Australia, are gratefully acknowledged.

**Governance Factors Affecting Internal Auditors' Ethical Decision Making:  
An Exploratory Study**

**Abstract:**

**Purpose**

This paper explores the ethical decision making of internal auditors and the impact of corporate governance mechanisms thereon. It also explores whether ethical decision making is influenced by years of experience in internal auditing.

**Design/methodology/approach**

Sixty-six internal auditors were presented with five ethical dilemmas. For each scenario, a key element of corporate governance was manipulated to assess its impact on ethical decision making. These were audit committee support; management integrity regarding accounting policies; management integrity regarding pressure on internal audit; external auditor characteristics; and organisational code of conduct.

**Findings**

Participants were generally sensitive to ethical dilemmas but were not always confident that their peers would act ethically. A higher quality external audit function was positively associated with internal auditors' ethical decision making. However, the strength of other governance mechanisms did not appear to influence ethical decision making. Finally, more experienced internal auditors adopted a more ethical stance in some cases.

**Research limitations/implications**

Our sample was self-selected and may not be representative of internal auditors in general. Our lack of significant results may be due to insufficient variability in our manipulations and/or an oversimplification of reality in our scenarios.

**Practical implications**

The study has implications for the internal audit profession with respect to training and the provision of support mechanisms to strengthen the ability of internal auditors to withstand pressure when dealing with ethical dilemmas.

**Originality/value**

This paper is the first to study whether the strength of other governance mechanisms influence internal auditors' ethical decision making.

**Key Words:** internal audit; ethics; corporate governance; external audit; years of experience.

# **Governance Factors Affecting Internal Auditors' Ethical Decision Making: An Exploratory Study**

## **Introduction**

The ethical standing of any profession is critical to its acceptance in society (Mintz, 1995). Armstrong (1993, p.38) considers ethical conduct to lie “at the core of each profession’s reason for existence”. This is particularly so for the auditing profession where ethical failings can have far-reaching economic impacts and cause widespread financial distress.<sup>1</sup> Procedures such as the issuing of the *Code of Ethics for Professional Accountants* (Accounting Professional and Ethical Standards Board (APESB, 2006), the setting up of disciplinary committees (Institute of Chartered Accountants in Australia (ICAA) and CPA Australia, (ICAA, 2004), and the imposition of professional sanctions are steps the profession takes to encourage members to act, and be seen to act, in the public interest.

A branch of the auditing profession that has strived for professional status in its own right is internal audit (Ridley, 2004). Like other branches of the profession, The Institute of Internal Auditors (IIA) has a code of ethics which is designed to promote an ethical culture within internal auditing (IIA, 2000). The code sets out the principles governing integrity, objectivity, confidentiality and competency, together with rules of conduct with respect to these principles.

Ethical principles are particularly important for internal auditors for two reasons. First, internal auditors are frequently faced with ethical dilemmas which can challenge their standards (Larkin, 2000; Goodwin and Yeo, 2001; Thompson, 2003). They may face

situations which require them to speak out (Barrier, 2003) and this is not always easy, particularly when pressure is being exerted by senior management to “go with the flow” and not to “make waves” (Thompson, 2003, p.72). Second, with the current emphasis on corporate governance, it is becoming increasingly recognised that internal auditors can play a key role in strengthening business ethics and corporate integrity (Brown et al., 2003; Jennings, 2003; Moeller, 2004). As one of the cornerstones of corporate governance, internal auditors are expected to work with audit committees, boards and senior management to help set the right “tone at the top” and to help ensure that ethical behaviour flows down through the ranks to lower level employees (IIA, 2003; Brown et al., 2003; Bailey et al., 2003).

Despite the critical importance of ethics to the internal audit function, little has been published in this area. Hence, the objectives of the present study are to explore internal auditors’ sensitivity to ethical dilemmas and to examine whether corporate governance mechanisms can in fact impact their ethical decision making. We also examine whether the level of experience of internal auditors affects their ethical decisions. Only a few studies have focused on the ethical decision making of internal auditors (Dittenhoffer and Klemm, 1983; Arnold and Ponemon, 1991; Dittenhoffer and Sennetti, 1994; Larkin, 2000) and none of these examines the issues in the context of the new role of internal audit as a key corporate governance mechanism.

We achieve the objectives of our study by presenting practising internal auditors with five ethical scenarios. For each scenario, we manipulate the strength of a key element of corporate governance in a between-subjects design. The manipulations include audit committee strength, two aspects of management integrity, commitment to a code of

conduct, and external audit characteristics. (Refer to Table I for a summary of these manipulations). Participants are asked to indicate (i) the *likelihood* that internal auditors would behave in a certain manner and (ii) their *attitude* as to how ethical or otherwise that behaviour would be. These responses enable us to gauge whether the corporate governance mechanisms influence ethical decision making and whether the participants' level of experience impacts these decisions. Our findings suggest that only one corporate governance factor, namely the characteristics of the external audit function impact internal auditors' ethical decision making. We do not obtain significant results for the other four corporate governance variables. We also find that years of experience has some influence on internal auditors' ethical decisions.

Due to the sensitive nature of the study's contents, and the possibility of self-selection bias resulting from the research method utilised (a survey instrument distributed at a conference), the results of the study cannot be described as definitive. However they provide preliminary evidence as to the impact - or lack thereof - of certain corporate governance factors on the ethical decisions of internal auditors, thereby demonstrating the need for further research into this important area for the internal audit profession.

The present study makes two significant contributions. First, it explores internal auditors' assessments of the *likelihood* of an internal auditor raising a contentious issue and also their *attitude* towards the action/inaction of their peers in such a situation. Second, the range of contextual factors utilised in this study are specifically associated with the new role of internal audit as part of a broader governance framework. As previously mentioned, as the internal audit function is now viewed as a key component of corporate

governance (studies such as Moeller, 2004) it is critical to evaluate internal audit ethical decision making in the context of modern corporate governance mechanisms.

The remainder of the paper is structured as follows. The next section discusses prior literature and provides the background to the study. The third section outlines the research method while the fourth section reports the results of the study. The final section concludes by discussing the implications of the research findings, highlighting potential limitations and considering future areas for research.

## **Background and Research Questions**

### ***Prior Research on Accountants' Ethical Decision Making***

A substantial body of literature has explored the ethical reasoning of accountants and external auditors, focusing on the impact of both individual and contextual factors (Jones et al., 2003). Individual factors examined include the level of ethical development<sup>2</sup> (Ponemon and Gabhart, 1993; Bernardi, 1994; Thorne, 2000), political orientation (Eynon et al., 1997), work experience (Bernardi, 1994; Thorne et al. 2003), organisational commitment (Patterson, 2001; Lord and DeZoort, 2001) and gender (Ponemon and Gabhart, 1993, Thorne and Magnan, 2000). Contextual factors include national culture (Cohen et al., 1995; Tsui, 1996; Goodwin et al. 2000), regulatory environment (Patterson, 2001; Thorne et al., 2003) and ethical intensity of a dilemma (Shafer et al., 2001). Studies have also examined the ethical reasoning of accountancy students (Haswell and Jubb, 1995; Goodwin and Goodwin, 1999; O'Leary and Cotter, 2000) and also compared students with practitioners (Lampe and Finn, 1992; Shaub,

1994). To a varying extent, these studies support the notion that both individual and contextual factors influence accountants' and accounting students' ethical judgments.

In contrast, research into the ethical decision making of internal auditors is sparse. Dittenhoffer and Klemm (1983) evaluated internal auditors' attitudes to twenty ethical issues, with the study being replicated ten years later by Dittenhoffer and Sennetti (1994). These researchers generally found an improvement in attitudes towards ethical issues over the ten year time period. Arnold and Ponemon (1991) examined internal auditors' perceptions of whistle-blowing, using Rest's (1979, 1994) DIT. They found that internal auditors with lower levels of moral reasoning were less likely to select whistle-blowing as a means of disclosing wrongdoing and this was particularly so when the whistle-blower was likely to lose their job. Larkin (2000) examined the effect of gender, age, years of employment and peer group influence on the ethical judgments of internal auditors working in a large financial services organisation. He provided participants with six vignettes, three of which portrayed unethical behaviour and three portraying ethical behaviour. The results of the study were mixed. There was no gender effect in four of the six vignettes. However, in one ethical scenario and one unethical scenario, there was evidence that females identified the appropriate behaviour better than their male counterparts. More experienced respondents identified unethical behaviour more clearly in two of the scenarios and believed that other internal auditors would make a similar assessment in all three scenarios describing unethical behaviour. However, there was no experience effect relating to the three vignettes describing ethical behaviour.

### *Corporate Governance*

The contextual factors included in the study relate to other key corporate governance mechanisms. We manipulate the strength of the audit committee, the “tone at the top” set by senior management (as measured by (i) their attitude to accounting policy changes and (ii) pressurising internal audit), commitment to a code of conduct and the characteristics of the external audit firm. The rationale for examining the impact of these factors on internal auditors’ ethical decision making lies in recent suggestions that corporate governance is comprised of four cornerstones: the audit committee, management, external audit and internal audit (IIA, 2003; Gramling et al., 2004; Adamec et al., 2005). Hence, we explore whether aspects of the other cornerstones of governance assist internal auditors to act ethically.

The board of directors has been recognised as the key player in corporate governance by regulators and governance committees around the world (Cadbury Committee, 1992; United States (US) Congress, 2002; Australian Stock Exchange Corporate Governance Council, 2003). As a sub-committee of the board, the audit committee, in particular, plays an important role in enhancing the quality of financial reporting (McMullen and Raghunandan, 1996; Davidson et al., 2005). An effective audit committee should also strengthen the position of the internal audit function by providing an independent and supportive environment where the chief internal auditor (CIA) can raise matters affecting management (Braiotta, 1999; Goodwin and Yeo, 2001; Goodwin, 2004).

Executive management plays a vital role in corporate governance by ensuring that the appropriate systems of internal control and risk management are in place (COSO, 1992; Adamec et al., 2005). However, according to Cynthia Cooper (the former vice-president

of Internal Audit at WorldCom Inc.), “it is the behavior of corporate leaders that has the greatest impact on an organization” (Barrier, 2003, p.54). This is particularly so with respect to establishing a strong ethical environment. While internal audit can assist management to instil a strong ethical tone throughout the organisation, a poor attitude by management can make it very difficult for the internal auditor to uphold ethical behaviour. This is evidenced by the problems associated with whistle-blowing, particularly when the internal auditor’s job security or progress is threatened (Arnold and Ponemon, 1994).

Both directors and management can further strengthen the ethical environment within the organisation by developing and enforcing a robust code of ethical conduct (Barrier, 2003; Brown et al., 2003; Adamec et al., 2005). Research evidence suggests that corporate codes of ethics, accompanied by training and monitoring programs, have an impact on employee behaviour (Pickard, 1995). The Working Group on Corporate Practices and Conduct (1993) in Australia argues that a code of ethical conduct should help to maintain high standards of behaviour throughout the organisation. To be effective, however, the code must be communicated throughout the organisation and enforced by management (Brooks, 1992; McNamee, 1992; Goodwin and Seow, 2000).

External audit is also regarded as an important cornerstone of corporate governance, particularly with respect to the prevention and detection of fraud and errors in financial statements (Adamec et al., 2005; Davidson et al., 2005). External auditors play a valuable monitoring role in improving the credibility of financial reporting (Schelluch et al., 2004). The performance of a quality audit, however, is dependent on both the independence of the external auditor and on the nature and extent of the work undertaken

(DeAngelo, 1981). The external auditor can rely on the work of internal audit provided certain conditions are met concerning the status, competency and scope of work of the internal audit function (IFAC 2004). In working together, the relationship between internal and external auditors should be one of mutual support and cooperation in order to strengthen overall audit quality (Green, 2003; Gramling and Myers, 2003).

### ***Years of Experience***

As noted, a number of prior studies have found that experience impacts on the ethical decision making of accountants and auditors. However, the direction of the relationship is ambiguous. In an experiment on working paper review, Bernardi (1994) found that managers outperformed seniors with respect to identifying ethical cues. Bernardi and Arnold (1997) found a positive association between years of work experience and moral development (measured by DIT scores), but only for female accountants. In contrast, Shaub (1994) reported a negative association between DIT scores and years of work experience. Ponemon and Gabhart (1993) obtained conflicting results between Canadian and US accountants. Years of experience were negatively related to DIT scores for US accountants but positively related with DIT scores for Canadian accountants. The findings of this study contrast with those of Thorne et al. (2003) who found a significant negative association between years of experience and DIT scores for both US and Canadian accountants.

As previously discussed, the only study to examine the effect of experience on internal auditors' ethical decision making found some evidence that more experienced internal auditors identify unethical behaviour more clearly than their less experienced counterparts (Larkin, 2000). However, Larkin's results relate to internal auditors from a single financial institution in the United States, with two thirds of respondents having no

more than five years experience. Hence, a further examination of the effect of experience on internal auditors' ethical decision making is justified to assess whether Larkin's findings are generalisable to a broader group of internal auditors.

### ***Research Questions***

The above discussions lead to the following research questions (RQ):

RQ1: To what extent do other corporate governance mechanisms affect internal auditors' ethical judgments?

RQ2: To what extent does experience in internal auditing affect internal auditors' ethical judgments?

### **Research Method**

#### ***Sample and Procedures***

The study was conducted as a field experiment. In March 2005, approximately 400 experienced internal auditors attended the SOPAC conference, the annual conference of the Institute of Internal Auditors (IIA) Australia, in Brisbane, Australia. They came from approximately six countries, predominantly Australia. With the support of the IIA, a survey instrument (discussed below) was distributed to approximately 250 of the delegates at the conference. Delegates were to return completed copies to the reception desk at the end of the conference or they could take the survey instrument away with them and complete it later. They were provided with a reply paid envelope to return the completed survey instruments to the researchers. A letter indicating the support of the IIA accompanied all copies of the survey instrument. A total of 66 completed surveys were returned to the researchers, representing a response rate of 26%.<sup>3</sup>

### ***Research Instrument***

The research instrument comprised an introductory letter indicating the support of the IIA, a brief summary of the research together with instructions, five ethical dilemmas each followed by two questions (see Appendix 1 for an example of one of the dilemmas and questions thereon), and a section concerning the background of the respondent. Background questions related to experience, gender, sector worked and nationality.

The two questions asked after each dilemma were based on prior ethical studies in accounting and auditing. The first question asked the respondent to assess the *likelihood* that the internal auditor in the scenario would act in a certain manner. A nine-point scale (ranging from 1 to 9) was provided with the endpoints marked as ‘highly unlikely’ and ‘highly likely’ respectively. The second question asked respondents to assume that the internal auditor had not taken the action suggested and to indicate their *attitude* as to how unethical or ethical they perceived the lack of action to be. Again, a nine-point scale was used, with the endpoints marked as ‘extremely unethical’ and ‘extremely ethical’ respectively. Following Ponemon and Gabhart (1993) and Arnold and Ponemon (1991), we developed scenarios in the third person rather than asking what the respondent would do. These authors suggest that, because of the sensitive nature of ethical issues, framing the questions in this manner provides a reliable measure of what the respondent actually believes.

Two versions of each dilemma were developed, manipulating the background information of each scenario to capture the impact of other corporate governance mechanisms on internal auditors’ ethical decision making. As noted, these are the strength of the audit committee, management integrity (as evidenced by changes to

accounting policies), management integrity (as evidenced by pressure exerted on the internal auditor), commitment to a code of ethical conduct, and characteristics of the external audit firm. Each factor was manipulated at two levels, stronger or weaker<sup>4</sup>, as shown in Table I. Version One of the research instrument had two of the factors set at a strong level and three at a weak level (Scenarios One and Three were strong and Scenarios Two, Four and Five were weak). Version Two had three strong factors and two weak factors (Scenarios Two, Four and Five were strong, while Scenarios One and Three were weak). Hence, the strengths of the five scenarios were varied within each version of the research instrument. This was to avoid the respondents falling into a “pattern effect” due to reviewing all “good case” or “bad case” scenarios. A pilot study involving four experienced auditors resulted in a satisfactory assessment of both versions of the survey instrument, prior to its distribution for the actual study. In particular, the pilot study confirmed the strength of the manipulations as strong or weak.<sup>5</sup>

*TAKE IN TABLE I*

## **Results**

The 66 responses received were analysed using the *SPSS* software package. As the two versions of the research instrument had been issued randomly, this resulted in 32 useable responses to version 1 and 34 useable responses to version 2.

A summary of the biographical data for the respondents is given in Table II. The table shows that 88% of respondents were male and 85% were from Australia. These distributions mean that we could not meaningfully test for gender or country effects. However, tests indicated that the omission of the females and non-Australians from the sample does not materially impact our results. Table II also shows that 71% of

respondents work in the private sector and 29% in the public sector. We tested for the possibility of sector differences, with the results providing no evidence that the sector in which internal auditors work influences their ethical decision making.<sup>6</sup>

*TAKE IN TABLE II*

It can also be seen from Table II that only 20% of respondents have less than five years experience in internal auditing, while 23% have twenty years or more experience. For the purposes of testing for an experience effect, we collapse this variable into two categories using a ten year cut-off point. This cut-off provides 27 (41%) respondents in the less experienced group and 39 (59%) in the more experienced group.<sup>7</sup>

Tables III to VII report the results of analyses of variance for each of the corporate governance manipulations, together with the experience effect. For each table, Panel A reports descriptive statistics (means, standard deviations and cell sizes), while Panel B reports the analysis of variance results.

*TAKE IN TABLES III TO VII*

Overall, the descriptive statistics reported in these tables suggest a relatively high level of ethical awareness by respondents. Recall that the second question asked the respondent to assume that the internal auditor in the scenario did not raise or report an issue. They were then asked their *attitude* as to how ethical this lack of action would be by marking a point on a 9-point scale, where 1 represents “extremely unethical” and 9 represents “extremely ethical”. These results are reported in the columns headed “Ethical assessment”. Across all the scenarios, the overall means range from a low of 2.42 for

scenario 4 to a high of 3.35 for scenario 1, well below the mid-point of 5 on the scale. Thus, in general, respondents appear to be reasonably sensitive to unethical behaviour.

However, they are less convinced that the internal auditors in the scenarios would actually behave in an ethical manner. Again, recall that the first question asked respondents to indicate the *likelihood* that the internal auditor would raise or report the issue. Using a 9-point scale where 1 represents “highly unlikely” and 9 represents “highly likely”, the mid-point of 5 would suggest a neutral position. Overall means across the five scenarios for this likelihood judgment are relatively close to the mid-point, ranging from a low of 5.06 for scenario 5 to a high of 6.17 for scenario 4.

Scenario 1 involves the chief internal auditor (CIA) raising a material revenue recognition issue with the audit committee when being pressured not to do so by the financial controller. The strength of the audit committee is manipulated (Table 1) as stronger or weaker. Panel A of Table III indicates that the cell means for question 1 (*likelihood* judgment) range from 5.07 to 5.53, implying that respondents are not strongly convinced that the CIA would report to the audit committee. The means for question 2 (*attitude* towards ethical assessment) range from 3.16 to 3.60, suggesting that a failure to report the issue, while unethical, is not considered to be extremely so. Panel B of Table III indicates that neither the audit committee manipulation nor level of experience influences the responses to questions 1 and 2. This suggests that internal auditors, regardless of their level of experience, would not be influenced by the strength of the audit committee when deciding whether to report to the committee.

Scenario 2 concerns the CIA of a government department raising an accounting policy change with the Minister at the annual accounts review. Management's attitude to changing accounting policies is manipulated as a consistent application of policies or frequent changes to policies, reflecting their level of integrity in this regard. Panel A of Table IV shows that the means for the likelihood judgment generally exceed 6.0, suggesting a relatively high expectation that the CIA would raise the issue with the Minister. The means for the ethical assessment are broadly similar to those in the first scenario. Again, Panel B shows that neither of the independent variables significantly influences these judgments.

Scenario 3 relates to the CIA raising a possible environmental liability with the external auditors. Management integrity is manipulated as weaker or stronger by reference to the application of pressure on the CIA by the chief executive officer (CEO) in the weaker case, with no such pressure in the stronger case. Panel A of Table V suggests that respondents are sensitive to the unethical behaviour in this case, with all of the means for the ethical assessment being less than 3.0. The means for the likelihood judgment are lower for less experienced respondents compared to more experienced respondents and Panel B indicates that this difference is statistically significant ( $p = .006$ ). More experienced internal auditors are more convinced that the CIA in the scenario would act ethically than are their less experienced counterparts.

Scenario 4 involves the CIA of a city council reporting management fraud to the council and recommending prosecution. Mitigating circumstances are that the manager involved admits that he stole council assets to fund medical expenses for a sick child and that he has started to make full recompense for his thefts. He has also resigned from the council.

The strength of the council's code of ethical conduct is manipulated so that, on the one hand, a detailed code exists, listing specific ethical issues and appropriate actions while, on the other hand, a very general and vaguer code is in place. Table VI (Panel B) indicates that differences in the code of conduct do not appear to influence responses. However, there are significant experience effects for both the likelihood judgment ( $p = .000$ ) and the ethical assessment ( $p = .015$ ). Panel A shows that more experienced internal auditors expect the CIA to report to Council and to recommend prosecution while less experienced respondents are less convinced that such action would be taken. While both groups assess a lack of action to be unethical, the more experienced respondents' scores are closer to the end-point of "extremely unethical".

Scenario 5 concerns reporting the possibility of management fraud to the financial controller and external auditor. In this case, the internal auditor is standing in for the CIA at a meeting with these parties. External audit characteristics are manipulated to reflect a higher level of independence and commitment to quality on the one hand, and a less independent, lower quality firm on the other. The results are reported in Table VII. Panel B reports a significant external auditor effect for both the likelihood judgment and the ethical assessment ( $p = .023$  and  $p = .027$  respectively). Panel A shows that respondents in the more independent/higher quality auditor treatment believe that the internal auditor is more likely to raise the issue of concern at the meeting compared to those in the less independent/lower quality treatment. The more independent/high quality group also assesses a lack of action to be more unethical than does the less independent/lower quality group. There is also a weakly significant experience effect with respect to the ethical assessment ( $p = .056$ ), with more experienced respondents assessing a lack of action to be more unethical than the less experienced respondents.

Overall, as far as RQ1 is concerned, it appears that four of five corporate governance mechanisms have a minimum effect on the ethical opinions of internal auditors. The exception appears to be external auditor independence and quality. Internal auditors are more likely to raise issues with the financial controller and the external auditor, and consider a failure to do so as more unethical, when the external audit firm is of higher quality and more independent. With regard to RQ2, results indicate that there are some differences in ethical opinions based on years of experience. More experienced internal auditors considered a greater likelihood of adopting a more ethical stance existed in two of five scenarios and they also considered inaction to be more unethical in two of five scenarios. This finding is broadly consistent with that of Larkin (2000).

### **Concluding Comments**

The objectives of this study were to evaluate internal auditors' ethical decision making and to examine the impact of corporate governance mechanisms and the effect of experience thereon. We found that internal auditors as a group demonstrate a reasonably high sensitivity to ethical issues. This was assessed by evaluating their *attitude* towards internal auditors' inactions when faced with ethical dilemmas. However, when assessing the *likelihood* of internal auditors taking appropriate action when faced with ethical dilemmas, evidence exists that they are not always convinced their peers would behave in an ethical manner. One factor influencing this perception is the fact that key corporate governance mechanisms appear to have little impact upon internal auditors' ability to act ethically, when presented with a workplace dilemma. Given five corporate governance support factors, internal auditors only appear to regard the strength of the external audit function as having a positive effect on ethical decision making. The existence of an

effective audit committee, a strong organisational code of conduct and high management integrity do not appear to assist internal auditors to act more ethically when faced with a dilemma.

We also found some significant experience effects in three of the five scenarios. More experienced internal auditors expected the adoption of a more ethical stance than less experienced auditors in some instances. Similarly they also occasionally assessed inaction as more unethical. Given that our more experienced auditors had ten or more years of experience, these findings could indicate a maturity factor, reflecting the views of those in an older age bracket.

The results of our study have implications for the internal audit profession with respect to training and the provision of support mechanisms to strengthen the ability of the internal auditor to withstand pressure when faced with ethical dilemmas. If internal audit is to be considered a critical component of corporate governance, then it is important that practitioners in the area have strong support when making ethical decisions. However, exactly which component(s) of corporate governance provide the most meaningful support appears in need of further evaluation. This study's non-significant results regarding the lack of impact of some corporate governance mechanisms tentatively suggests that they may not be as relevant to internal auditors' ethical decision making as might be expected.

There are a number of limitations to our study, all of which provide opportunities for further research. First, our sample was a self-selected sample drawn from internal auditors attending a conference. Given that those attending the conference are likely to be

highly motivated members of their profession, and that those responding to the survey are likely to be those with an interest in ethical issues, the sample may not be representative of internal auditors in general. Second, the sample comprises mainly Australian males and thus we are unable to explore the possibility of both gender and country differences in ethical decision making. Third, our failure to find significant corporate governance effects in four of the five scenarios may be due to insufficient variability in our manipulations, given the between-subjects design. While pilot testing indicated that our manipulations were appropriate, the lack of manipulation checks in our instrument means that we cannot be certain that respondents interpreted the scenarios in the manner intended. For example, those in the weak audit committee treatment group may still have perceived the audit committee to offer some protection to the internal auditor. Similarly, the weaker code of conduct treatment may have been perceived as offering some guidance to the internal auditor. Fourth, as with all studies of this nature, the scenarios we present inevitably oversimplify the reality of an ethical dilemma faced by internal auditors. In particular, each governance mechanism we manipulate is examined in isolation from the other mechanisms that may also have an impact on an internal auditor's ethical decision making. This design was necessary in order to avoid the likelihood of complex interaction effects that would be extremely difficult to interpret. Further, such a design would either require a much greater number of participants or would necessitate a within-subjects study, leading to possible response bias problems.

Despite the acknowledged limitations of this research, both the significant results relating to the external audit function and the non-significant results relating to the other governance mechanisms are considered useful findings and provide many opportunities for further research. Indeed, the non-significant results tend to suggest more research is

urgently needed in this area. Further exploration of the experience effect is also warranted in order to assess the influence of maturity or seniority on ethical decision making.

Given the exploratory nature of our study, there are numerous avenues for future research in addition to those already noted. The impact of other mechanisms such as board independence, CEO/board chair duality, risk management procedures and whistleblowing policies could also be explored. Further, the combined impact of the various governance elements could be explored to assess whether the overall strength of a corporate governance system influences internal auditor ethical decision making. Finally, studies could incorporate other contextual and individual factors such as national culture, organisational culture, level of moral development, organisational commitment and gender.

## Appendix 1 – Example Ethical Scenario and Questions from the Research Instrument

### Scenario 1

Tom is in his first year as chief internal auditor for Refrigerators Ltd. reporting directly to the CEO. Management’s new sales policy of selling refrigerators to clients and extending the normal one year warranty to two, on payment of an extra \$300 at time of purchase, has proved very successful. This has a material effect on the turnover figure. Sales have increased 30%. Tom notes however that the total revenue is being recognised in the first year instead of deferring the \$300 to the second year. Tom wishes to raise the issue for discussion with the **audit committee**, whom he meets with every quarter. The financial controller disagrees and says, “It’s a done deal” and that the CEO wants it to remain that way. Once they sign up, she explains, they’re effectively tied in so we can recognise the total revenue immediately. She is an executive director and stresses to Tom she does not want the matter raised with the audit committee, as it’s frivolous. She also stresses Tom’s first year performance review with the CEO is to be undertaken shortly.

Refrigerators Ltd.’s new **audit committee** meets quarterly. It is comprised of one former auditor, now a non-executive director and two other non-executive directors both of whom have significant accounting experience. The audit committee’s new charter states they are to actively review compliance with significant accounting standards. The audit committee reports to the full board after each meeting.

**What do you think would be the likelihood of Tom raising the issue of revenue recognition with the Audit Committee at his next meeting:**

Highly Unlikely

Highly Likely

---

1    2    3    4    5    6    7    8    9

**Now assume that Tom does not raise the issue with the board at his next meeting. Please indicate the extent to which you believe that Tom's action is ethical or unethical:**

Extremely Unethical

Extremely Ethical

---

1    2    3    4    5    6    7    8    9

## Endnotes

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<sup>1</sup> As evidenced, for example, by the collapse of companies such as *Enron*, *Sunbeam* and *WorldCom* in the United States and *HIH*, *Harris Scarfe* and *One-Tel* in Australia.

<sup>2</sup> Most of these studies use Rest's (1979 and 1994) defining issues test (DIT) to measure accountants' level of moral development.

<sup>3</sup> As the distribution was at various sessions of the conference, participants who took the survey instrument could not be identified for subsequent follow up. Also, given the nature of the distribution a response rate of 26% was considered adequate. Apart from the IIA covering letter there was no other way of encouraging additional responses. There was no reason to suspect that non-respondents would have differed from respondents, as all were random delegates at an internal audit conference. However a possibility of non-response bias, self-selection bias, or bias due to the small sample size must be recognised as possible limitations of the study.

<sup>4</sup> The terms "stronger" and "weaker" only have meaning relative to each other.

<sup>5</sup> We did not include manipulation checks in our instrument in order to avoid the likelihood of response bias resulting from alerting participants to the factor being explored. This means that we cannot be certain that participants interpreted our scenarios in the way we intended and this is noted as a limitation of the study.

<sup>6</sup> ANOVA tests – comparisons of mean responses - for public and private sector auditors were performed and revealed no significant differences.

<sup>7</sup> While nine years experience may appear to be extensive, recall the discussion from the background and research questions section. It was shown there that previous studies regarding years of experience have revealed ambiguous results. Hence, it was decided for this study to be conservative in our estimate of experience and so it was set at a sufficiently long time span. It should be noted that our differentiation is based on "less experienced" compared to "more experienced" and we do not assert that the "less experienced" group is inexperienced.

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**TABLE I**  
**Ethical Dilemma and Manipulation of Corporate Governance Factors**

<b>Dilemma</b>	<b>Factor</b>	<b>Strong/Good</b>	<b>Weak/Poor</b>
<ul style="list-style-type: none"> <li>- CIA of company</li> <li>- Raising material accounting issue with audit committee</li> <li>- Recognising revenue ahead of time</li> <li>- CIA pressured by financial controller (an executive director) not to raise with audit committee</li> </ul>	<b>Audit Committee</b>	<ul style="list-style-type: none"> <li>- Meets quarterly and reports to Board quarterly.</li> <li>- All non-executive directors, all with accounting expertise.</li> <li>- Organisation's charter empowers Audit Committee (AC) to actively 'review and pursue'.</li> </ul>	<ul style="list-style-type: none"> <li>- Meets half-yearly and reports to Board annually.</li> <li>- All non-executive directors but only one with accounting expertise.</li> <li>- Organisation's charter only empowers AC to review overall results and annual report.</li> </ul>
<ul style="list-style-type: none"> <li>- CIA of Government department</li> <li>- Raising material accounting policy change with Minister at annual accounts review</li> <li>- Change in depreciation rate by joint-venture entity</li> <li>- Financial officer refuses to provide supporting evidence</li> </ul>	<b>Management Integrity</b> (evidenced by changes to accounting policies)	<ul style="list-style-type: none"> <li>- Accounting policies applied consistently from period to period.</li> <li>- Few changes, all thoroughly explained with a clear demonstration of profit effect.</li> </ul>	<ul style="list-style-type: none"> <li>- Accounting policies changed on a surprisingly regular basis.</li> <li>- All changes are appropriately disclosed but information and explanations are at a minimum.</li> </ul>
<ul style="list-style-type: none"> <li>- CIA of company</li> <li>- Raising possible contingent liability (environmental liability) with external auditors</li> </ul>	<b>Management Integrity</b> (evidenced by pressurising Internal Audit)	<ul style="list-style-type: none"> <li>- Diversified Board</li> <li>- CEO (executive director) less powerful</li> <li>- CEO does not apply pressure to CIA</li> </ul>	<ul style="list-style-type: none"> <li>- Board dominated by one family</li> <li>- CEO (executive director) more powerful (family member)</li> <li>- CEO applies pressure to CIA</li> </ul>
<ul style="list-style-type: none"> <li>- CIA of city council</li> <li>- Reporting fraud to council, recommending prosecution</li> <li>- Theft of assets by manager to pay for medical expenses of sick child</li> <li>- Manager resigns and starts to make full recompense</li> </ul>	<b>Code of Conduct</b>	<ul style="list-style-type: none"> <li>- Organisation's <i>Accounting and Procedural Arrangements Manual</i>, includes a detailed "Code of Conduct".</li> <li>- Specifically lists several ethical issues and the actions to be taken.</li> </ul>	<ul style="list-style-type: none"> <li>- Organisation's <i>Accounting and Procedural Arrangements Manual</i>, includes a very general "Code of Conduct".</li> <li>- Does not specifically list ethical issues. Vague as regards actions to be taken.</li> </ul>
<ul style="list-style-type: none"> <li>- IA of company</li> <li>- Raising an unusual expense that suggests management fraud with financial controller (FC) and external auditor (EA)</li> <li>- IA has to stand in for CIA at meeting with FC (board member, son of company founder) and EA</li> </ul>	<b>External Auditors</b>	<ul style="list-style-type: none"> <li>- Respected second tier firm.</li> <li>- Second year as auditors and the board respects them.</li> <li>- Threatened to resign last year unless certain matters were disclosed in the final accounts.</li> </ul>	<ul style="list-style-type: none"> <li>- Small suburban firm.</li> <li>- Long association with board, board treats them as a friend.</li> <li>- Once accounts are lodged on time and all appears reasonable, they are satisfied.</li> </ul>

CIA = chief internal auditor; IA = internal auditor; CEO = chief executive officer

<b>TABLE II</b>		
<b>Details of Respondents</b>		
	<b>No.</b>	<b>%</b>
<b>Gender:</b>		
Male	58	88
Female	8	12
<b>Sector working in:</b>		
Public	47	71
Private	19	29
<b>Country</b>		
Australia	56	85
New Zealand	8	12
Other	2	3
<b>Years of internal auditing experience:</b>		
Less than 2 years	5	8
2-5 years	8	12
5-10 years	14	21
10 - 20 years	24	36
20 years or more	15	23

<b>TABLE III</b>						
<b>Scenario 1 – Strength of Audit Committee</b>						
<b>Panel A: Means (standard deviations) and cell sizes</b>						
	Less than 10 years		10 years and more		Overall	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Stronger audit committee	5.50 (1.73) n = 12	3.17 (1.11)	5.30 (2.41) n = 20	3.45 (2.11)	5.38 (2.15) n = 32	3.34 (1.79)
Weaker audit committee	5.07 (2.22) n = 15	3.60 (2.50)	5.53 (2.17) n = 19	3.16 (1.07)	5.32 (2.17) n = 34	3.35 (1.82)
Overall	5.26 (1.99) n = 27	3.41 (1.99)	5.41 (2.27) n = 39	3.31 (1.67)	5.35 (2.14) n = 66	3.35 (1.79)
<b>Panel B: Analysis of Variance</b>						
Source of variation	Mean Square		F		Sig. of F	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Audit committee	.170	.079	.035	.024	.851	.878
Years of experience	.267	.100	.056	.030	.814	.863
Interaction	1.722	2.083	.360	.625	.551	.432

Likelihood of action: 1 = highly unlikely; 9 = highly likely

Ethical assessment: 1 = extremely unethical; 9 = extremely ethical

<b>TABLE IV</b>						
<b>Scenario 2 – Management Integrity (Consistency of accounting policies)</b>						
<b>Panel A: Means (standard deviations) and cell sizes</b>						
	Less than 10 years		10 years and more		Overall	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Good management attitude to changing accounting policies	6.40 (2.41) n = 15	3.53 (2.47)	6.32 (2.19) n = 19	3.26 (1.88)	6.35 (2.25) n = 34	3.38 (2.13)
Poor management attitude to changing accounting policies	5.75 (1.91) n = 12	2.75 (1.36)	6.00 (2.51) n = 20	3.35 (2.21)	5.91 (2.27) n = 32	3.13 (1.88)
Overall	6.11 (2.19) n = 27	3.19 (2.06)	6.15 (2.33) n = 39	3.31 (2.03)	6.14 (2.26) n = 66	3.26 (2.03)
<b>Panel B: Analysis of Variance</b>						
Source of variation	Mean Square		F		Sig. of F	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Management attitude	3.692	1.920	.698	.454	.407	.503
Years of experience	.109	.431	.021	.102	.886	.751
Interaction	.442	2.997	.084	.709	.773	.403

Likelihood of action: 1 = highly unlikely; 9 = highly likely

Ethical assessment: 1 = extremely unethical; 9 = extremely ethical

<b>TABLE V</b>						
<b>Scenario 3 – Management Integrity (Pressure exerted on Internal Auditor)</b>						
<b>Panel A: Means (standard deviations) and cell sizes</b>						
	Less than 10 years		10 years and more		Overall	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
No pressure exerted	4.73 (2.09) n = 15	2.60 (1.40)	6.21 (1.72) n = 19	2.26 (1.24)	5.56 (2.00) n = 34	2.41 (1.31)
Pressure exerted	5.00 (1.95) n = 12	2.67 (1.30)	6.20 (1.79) n = 20	2.85 (1.81)	5.75 (1.92) n = 32	2.78 (1.62)
Overall	4.85 (1.99) n = 27	2.63 (1.33)	6.21 (1.73) n = 39	2.56 (1.57)	5.65 (1.95) n = 66	2.59 (1.47)
<b>Panel B: Analysis of Variance</b>						
Source of variation	Mean Square		F		Sig. of F	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Pressure	.260	1.691	.074	.768	.786	.384
Years of experience	28.371	.093	8.095	.042	.006	.838
Interaction	.304	1.071	.087	.486	.769	.488

Likelihood of action: 1 = highly unlikely; 9 = highly likely

Ethical assessment: 1 = extremely unethical; 9 = extremely ethical

<b>TABLE VI</b>						
<b>Scenario 4 – Code of Ethical Conduct</b>						
<b>Panel A: Means (standard deviations) and cell sizes</b>						
	Less than 10 years		10 years and more		Overall	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Stronger code of conduct	5.20 (2.43) n = 15	2.87 (1.79)	7.00 (2.13) n = 19	1.79 (0.63)	6.21 (2.10) n = 34	2.26 (1.33)
Weaker code of conduct	4.67 (2.39) n = 12	3.25 (2.45)	7.00 (1.41) n = 20	2.20 (1.79)	6.13 (2.47) n = 32	2.59 (2.09)
Overall	4.96 (2.38) n = 27	3.04 (2.05)	7.00 (1.79) n = 39	2.00 (1.36)	6.17 (2.27) n = 66	2.42 (1.74)
<b>Panel B: Analysis of Variance</b>						
Source of variation	Mean Square		F		Sig. of F	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
Code of conduct	1.126	2.495	.261	.877	.611	.353
Years of experience	67.626	17.911	15.399	6.297	.000	.015
Interaction	1.126	.003	.261	.001	.611	.975

Likelihood of action: 1 = highly unlikely; 9 = highly likely

Ethical assessment: 1 = extremely unethical; 9 = extremely ethical

<b>TABLE VII</b>						
<b>Scenario 5 –External Audit Characteristics</b>						
<b>Panel A: Means (standard deviations) and cell sizes</b>						
	Less than 10 years		10 years and more		Overall	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
More independent external auditor	5.25 (2.30) n = 12	3.08 (2.23)	6.15 (2.60) n = 20	1.75 (0.79)	5.81 (2.49) n = 32	2.25 (1.61)
Less independent external auditor	4.40 (2.41) n = 15	3.47 (2.10)	4.32 (1.80) n = 19	3.21 (1.40)	4.35 (2.06) n = 34	3.32 (1.72)
Overall	4.78 (2.36) n = 27	3.30 (2.13)	5.26 (2.40) n = 39	2.46 (1.33)	5.06 (2.38) n = 66	2.80 (1.74)
<b>Panel B: Analysis of Variance</b>						
Source of variation	Mean Square		F		Sig. of F	
	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment	Likelihood of ethical action	Ethical assessment
External auditor	28.520	13.458	5.416	5.101	.023	.027
Years of experience	2.634	10.000	.500	3.791	.482	.056
Interaction	3.834	4.593	.728	1.741	.397	.192

Likelihood of action: 1 = highly unlikely; 9 = highly likely

Ethical assessment: 1 = extremely unethical; 9 = extremely ethical