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Review of “Accounting Ethics and the Near Collapse of the World’s Financial System”, by Michel Pakaluk and Mark Cheffers (Allen David Press, Sutton Massachusetts, 2011)

Charles Richard Baker

Abstract

The book is a revision of prior version that was intended as a text for teaching accounting students about ethics, as well as a book about ethics for professional accountants. As such, the current book serves a useful purpose. Educating accounting students and practicing professionals is an important activity which should be encouraged. This organization outline is similar to the previous edition of the book, and much of the material is the same or similar, with the primary emphasis of the authors being directed towards instilling “virtue” ethics, as espoused by Alasdair MacIntyre, and based in turn on Platonic and Aristolian notions of ethics.

The primary short-coming with the current edition of the book appears to involve the title, in which it is implied that accounting ethics had something to do with the “near collapse of the world’s financial system”. There is effectively no evidence that a failure of accounting ethics contributed to the financial crisis of 2008-2009. Alleging a connection between accounting ethics and the worldwide financial crisis is misleading at best and it tends to confuse students. While it is certainly important to encourage high standards of ethical conduct among accounting students and practicing accounting professionals, to make unfounded assertions about linkages between failures of accounting ethics and financial crises is tenuous at best.

KEYWORDS: accounting, business ethics, financial crisis, financial scandals

JEL Classification Codes: M42, M41, K40

Book review of Michel Pakaluk and Mark Cheffers, *Accounting Ethics...And the Near Collapse of the World’s Financial System*, Allen David Press, Sutton Massachusetts, 2011.

This book is a revision of a previous book written by Michael Pakluk and Mark Cheffers, which was entitled *Understanding Accounting Ethics* (Second Edition), Allen David Press, Sutton, Massachusetts, USA (2007). The prior version of the book was intended as a textbook for teaching accounting students about ethics, and also a book about ethics for professional accountants. As such, the current book serves a useful purpose. Educating accounting students and practicing professionals is an important activity which should be encouraged.

The current book is organized as follows:

- Part I: Why Accounting Ethics Matters
- Part II: Ethics for Accountants
- Part III: The Meaning of Accounting Professionalism
- Part IV: High Profile Cases
- Part V: Accounting Ethics in Practice

This organizational outline is similar to the previous edition of the book, and much of the material is the same or similar, with the primary emphasis of the authors being directed towards instilling “virtue” ethics, as espoused by Alasdair MacIntyre, and based in turn on Platonic and Aristotelian notions of ethics.

One possible comment that might be made with respect to the current edition of this book is that the title implies that failures of accounting ethics were connected with the “near collapse of the world’s financial system”. While this has been an assertion made by a number of public commentators, most researchers have found little no evidence that a lack of accounting ethics contributed in a significant manner to the financial crisis of 2008-2009. Thus, while it is certainly important to encourage high standards of ethical conduct among accounting students and practicing professionals, the argument there were direct linkages between failures of accounting ethics and the financial crises of 2008-2009 may not be fully supportable.

This is not the first example of a book which argues that there was a connection between a lack of accounting ethics and the financial crisis of 2008-2009. In a book entitled, *Accountant’s Truth: Knowledge and Ethics in the Financial World*, Mathew Gill (Oxford University Press, 2009), made a somewhat similar argument. Like the book by Gill, the assertions made by Pakaluk and Cheffers, suggest that the solution for the avoidance of future financial crises involves an increased reliance on virtue based ethics by

accountants. In my opinion, this would not be an easy task to achieve in a practical sense for a number of reasons. Accounting practice requires a significant reliance on matters of judgment. The types of judgment required in accounting are not necessarily a matter of ethics, at least in the virtue ethics sense. While matters of judgment are central to what accountants and auditors do, accounting judgment is usually based on pragmatic experience, not virtue ethics. That is, what the right answer is a particular set of circumstances, may not be the right answer in all circumstances.

In more specific terms, with respect to matters of judgment, and in particular with regard to risky situations, it has been noted that there are some things that we know that we know; there are some things that we know that we do not know; and there are some things that we do not know that we do not know. It is with regard to this latter group of decisions that most misjudgments occur; in other words, misjudgments take place primarily with respect to things that we do not know that we do not know. Great uncertainty often arises with respect to such decisions, and absent a highly conservative decision making model, the results can lead to spectacular failures, as was the case in the financial crisis of 2008-2009.

In his 1990 book, *The Consequences of Modernity*, Anthony Giddens usefully reminded us that when we faced with the need to make judgments involving risk and uncertainty we often place our trust in institutions; a practice which allows us to take part in what is considered to be “normal” everyday life. Without a certain level of trust in institutions, people would scarcely be able to use elevators, fly in airplanes, or keep money in banks. Trust is needed because it would be impossible, or at least overly costly, to obtain a sufficient level of information in order to allow us to say that we “have checked it all by ourselves”.

In the case of financial markets, trust in institutions has led to audited financial statements. The sociologist, Donald MacKenzie has observed that: “Trust in numbers works only if those who produce the numbers can be trusted”; perhaps implying that those who produce the numbers can no longer be trusted.

The problem is that in the current state of the world, it is not necessarily professional accountants’ who produce the numbers. In fact, professional accountants may no longer even set the rules regarding how the numbers ought to be produced. The primary role for professional accountants is to produce an opinion as to whether the numbers have been prepared in accordance with the rules and standards primarily established by others, who are increasingly not professional accountants.

Pakaluk and Cheffers refer to the Enron scandal as case in point to support their argument that a failure of accounting ethics led to the financial crisis of 2008-2009. What is lacking in this reference to Enron is the fact that the Chief Financial Officer of Enron, Andrew Fastow, was not a professional accountant,

but rather a finance major with an MBA from the Kellogg School at Northwestern University. Finance students in American MBA programs infrequently study accounting, and they often display a lack of understanding of accounting practices and procedures, let alone accounting ethics. They are not required to abide by the ethical standards of the accounting profession.

Thus, it might be argued that it is not accounting ethics that is to blame for financial failures, but rather a lack of understanding of accounting ethics by finance professionals. It can also be observed that the misuse of accounting that occurred in the Enron case would not have taken place if the US government, in the form of the SEC, had not permitted the use of Special Purpose Entities having low equity to debt ratios. Consequently, while it is useful and important to encourage high standards of ethical conduct among accounting students and professionals, in my opinion it is not necessarily correct to blame accounting ethics for the failure of rules set by governmental authorities; rules which may be misunderstood or even misused by finance professionals. Accounting has now become a collective practice involving multiple participants who have not been trained as professional accountants, and who have not been exposed to the type of information that is included in the textbook by Pakluk and Cheffers. Thus, in my opinion it would be important to develop a greater exposure to ethics to business students and practitioners, not merely accounting students and practitioners.

Rejoinder to Williams

I think that Professor Williams comments on my review are well written and are supported by a logic which takes a negative view regarding the fundamental changes that have taken place in accounting in recent years away from accountability to fair value and financial performance. I agree that this fundamental change is in many ways deplorable and that it has led to income disparities and other problems. However, it is my opinion that this fundamental change has been largely imposed upon the accounting profession by financial markets and not necessarily is a change which accountants encouraged or accepted. I believe that this distinction is the central basis for any disagreement between Williams and myself.

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