

The Effect of Ethics on Auditor's Judgment in Ethical Dilemma Conditions: Evidence from Iranian Auditors

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ABSTRACT: In spite of the strengthening regulation of ethical conduct and numerous studies in relation with auditors, some factors can affect them in ethical dilemma situation. This study attempted to find the most important terms in dealing with auditor's judgment. The researches on the past studies documented that the most scandals on auditing irregularities was happened because of auditors' unethical behaviors. In addition, previous studies are showed that the understanding of ethical code of conduct and also audit standards is related to make decision by auditors. Consequently, ethics was founded as one important significant factor in process of auditor's judgment on financial statements. The main objective of this research is to investigate the effects of ethics and the code of conduct on auditor's judgments on material misstatements into financial statements. Data are collected from 321 managers, partners and authoritative auditors among Iranian audit firms. The results of SEM indicate amazing ranking of ethics and code of conduct among Iranian auditors and they significantly affect judgment of these respondents.

KEYWORDS: Ethics, Ethical Behavior, Auditor's Judgment, Auditor's opinion

1 INTRODUCTION

Accounting and auditing are complex and technical processes while ethical issues can be considered relatively simple. It can be argued that the difficult part of ethics is not aware of duties, but its enticing action and others right. We know that the features of truthfulness, honesty, accuracy and fidelity, but we do not know how and under what conditions these features can be achieved. If the really problem is that and we want to promote ethics in auditing, we must inevitably attract qualified people to the profession as well as to educate them and do not make them vulnerable to the temptation over their resistant. In addition, we need the sum of the minimum standards of professional conduct and ethical standards that establish procedures for complaints and disciplinary action against any behavior that characterize conservative error such as professional bodies of Australia CPA and the Institute of Chartered Accountants to be followed. These two institutions jointly have published regulations for the members.

According to [1, p.31], "Ethics are the fundamental logical inferences regarding the correctness or incorrectness of certain conduct and behavior". The ability to make ethical judgments is defined by Saat [2, p. 19] as "a process where a person is able to reason out why a particular action is taken". [3] in their review on the historical development of ethical codes stated that for in professions such as accounting and medicine, respecting a code of ethics has a long history.[4, 5, 6] suggested that all members of a profession should attempt to improve ethical conduct and education that would support ethical judgments. According to [7], integrated business and the existence of international investors, auditors rely on international roles to present their opinion on a company. Therefore, The International Federation of Accountants (IFAC) is a body that works on international guidelines for professional conduct and ethics. Auditors from different countries refer to their Code of Ethics for Professional Accountants to express their independent judgments based on the ethics, honesty and ethical conduct.

With this introduction this paper aims is to check the role of ethics, professional code of conduct on Iranian auditors' opinion when they are faced with ethical dilemma conditions.

2 BACKGROUND OF STUDY

Valentine and [8] examined the link between ethical values and the patience of professionals towards social multiplicity. They took a sample of 143 professionals, from business and law and used an ANCOVA tool to analyze the relationship. The results exhibited that auditors who have affiliation with companies with ethical values, were more tolerant of social multiplicity. Firms that wish to develop awareness regarding professional ethics to give them a competitive advantage over other forms should develop ethical values and standards for their employees.

In a similar area and using similar instruments, [9] examined the impact of Guanxi on ethical decision-making processes among Chinese CPAs in Hong Kong. In contrast with previous studies, they found a negative relationship between CMD and ethical judgment in conflict situations. They also revealed that there was a negative relationship between an auditor's ethical judgment and the existence of Guanxi; and the ethical reasoning determines the impact of Guanxi on an auditor's judgment.

The AICPA Code of Professional Conduct and the Ethical Exemplification is investigated by [10]. This study applies the theory of exemplification of impression management in a study of accounting by recognizing and calculating differences in both public and auditor perceptions of ideal behaviors. The auditors were parted into two groups, one of which accounted their perceptions of a usual auditor (A-O) while the other group accounted self-perceptions (A-S). There were two distinct groups of public, which presented their perceptions of a typical auditor and were parted on the basis of their accounting sophistication levels. Public group that is more sophisticated was consisted of bank loan officers (LO) whereas the public group that is less sophisticated comprised of investment club members (IC).

On the basis of 30 behaviors enclosed in the AICPA Code of Professional Conduct comparisons were crafted, which supplied as the foundation for the research tool. Profile analysis, an unusual form of MANOVA technique, was utilized to evaluate the results. A-S perceptions proved to be the highest of the four levels of treatment and were considerably higher (i.e., more correct) in comparison to the perceptions of both LO and A-O groups. The user group (LO) that is more sophisticated offered the lowest perceptions of the four levels of treatment. Intended for as a minimum of four of the six measures, in comparison to both the A-O and IC treatments, the LO treatment group observed the typical auditor to be less perfect. No differences were found in perceptions between the IC and A-O group. It is revealed by further analysis that auditors overestimated the extent to which the public is depended on financial statements. Nevertheless, a convincingly high reliance level on financial statements is reported by both public groups when making decisions.

[11] explored ethical decision-making processes in the United States and Egypt. In this study, they investigated the relationship between ethical decision-making and national culture in a business context. They examined individualism versus collectivism and power distances as defined by Hofstede, to look at how a national culture is concerned with ethical behavior. They concluded that U.S participants were individualists and low in strength and distance when it came to ethical decision-making. The ethical behaviors of both Egyptians and Americans relied on utilitarianism, justice and relativism and when the behavioral intentions of peers were examined, American substituted egoism for justice. The background of study on ethics presented that a theory may support the idea of authors on the effect of ethics on auditor's judgment. This theory is Cognitive Moral Development Theory which it is explained in following part.

3 COGNITIVE MORAL DEVELOPMENT THEORY

The theoretical foundation of this study (in moral and ethics part) is partially based on moral development theory suggested by [12]. Most of past studies on moral and ethics among auditors have applied this theory as a supporting theory.

4 HYPOTHESES ON ETHICS

Similar to other professions, auditors have a Professional Code of Conduct which was arranged by AICPA. Ethical conduct is a part of auditor's work, auditors should make their ethical decisions upon these rules, for example, in their interviews with audit partners, [13], suggested that "Auditors have to balance professional ethics with the economic practicalities of operating a viable business". Thus

H₁: There is a significant effect of **Ethics** on auditor's judgment in ethical dilemma conditions.

H_{1a}: There is significant effect of **Honesty** on auditor's judgment in ethical dilemma conditions

H_{2a}: There is significant effect of **Realism** on auditor's judgment in ethical dilemma conditions.

H_{3a}: There is significant effect of **Competent and Caring Professionals** on auditor's judgment in ethical dilemma conditions.

H_{4a}: There is significant effect of **Privacy** on auditor's judgment in ethical dilemma conditions.

H_{5a}: There is significant effect of **Manners and Professionalism** on auditor's judgment in ethical dilemma conditions.

5 DATA COLLECTION

The current research applied quantitative approach and data were collected through the questionnaire among 321 Iranian audit firm managers, partners and authoritative auditors. The questionnaire comprised three parts. The questionnaire in this study in order to examine the opinion of auditors; the main point was ethical dilemma which is applied in this research.

5.1 QUESTIONNAIRE

[14, 15, [16] recommended the use of an audit conflict concerning an accounting transaction revelation that would have a material upshot on financial statements of the client. Thus, this study adopted a case-study form this situation to test the independence of auditor under pressure of power of client management. The conflict is presented in the questionnaire about materiality of certain unrecorded liabilities determined by the auditors of the firm. These liabilities comprised mainly of expenditures incurred in the preceding year which were neither recorded nor paid until the following year. Respondents were asked to imagine that they were the hypothetical firm's auditors where client management differed with the auditor that the amount was said to be material and fundamental, with 12.5% materiality.

As one of the important aims in this study was to examine the effect of ethics on auditor's judgment, the second part of questionnaire was CPA's Characteristic Questionnaire. [10] stated that the AICPA Code of Professional Conduct attempted to improve the reliability of auditor. Brown believed that these codes constructed exemplary conduct standards for professional accountants. Thus, they developed the CPA's Characteristic Questionnaire (CPACQ) based on this code of professional conduct. The CPACQ included 29 questions for measuring perception regarding each of the six characteristics explained in the Principles of the AICPA Code of Professional Conduct. The instructions stress that this instrument pertains to the auditors' performance of their professional duties.

For summarizing and also creating a general frame from code of ethics, this study has categorized and ranked CPACQ's ethical code of conducts on the based on International Federation of Accountants (IFAC) fundamentals principals Code of Conduct. The principals of professional conduct with reference to authoritative accounting associations contain of honesty, realism, competent and caring professionals, privacy, and manners and professionalism.

6 CODE OF ETHICS PREFERENCES AMONG IRANIAN AUDITORS

Theoretical principles help us to decide in which no explicit rule of law are based on theoretical principles. In this part the Friedman test applied and this test was used when the data were at least ordinal with the order could be arranged into a two-way classification. This test helped to rank the variables in the study [14]. This study also applied the Friedman test to find the most important code of ethics among Iranian auditors. The important fundamental principal codes of conduct are discussed in following paragraph.

Honesty: it means that the professional accountant must be true and righteous in professional relationships and transactions. Openness and fairness are the honesty requirement. Therefore the terms of acts with integrity (X11) intellectually honest (X10) and trustworthy (X2) in CPACQ is categorized to answer honesty. Realism is another fundamentals principal Code of Conduct which is described in next paragraph.

Realism: it means that the professional accountants must considers only the fact in business and their professional judgment, and do not allow prejudice, Siding, conflict of interest or influence of others' words of judgment affect his work. Consequently, three questions in CPACQ are included to examine the respondents' opinion about realism (serves the public interest (X29), delivers competent services(X23) and free from conflict of interest(X19)). In addition of honesty and realism, auditors should care on their professionals and competence as a part of fundamentals principal Code of Conduct.

Competent and caring professionals: According to this principle, the professional accountant should pay for services that it is capable to provide and uses other cooperation or consultation in the necessary cases to perform their work. Professional accounting should develop his knowledge and skills in their new techniques and the rules at which level of the work to ensure the employer to use the efficient professional service. Professional accounting should be serviced based on their professional competence and technical standards relating to professional conduct. Therefore, competent and caring

professionals was examined through some questions like Performs to best of ability (X12), adheres to ethical standards (X13), consistent professional behavior (X14), dedicated to excellence (X16), proficient (Demonstrates Mastery) (X18), objective (X24), always exercise due care (X27), cooperates with other auditors (X28), does not always provide quality Services (X20) and Knowledgeable into CPACQ (X4). The maintaining of privacy is another important fundamentals principal Code of Conduct.

Privacy: is another fundamental principle of professional ethics. i.e., the professional accountant should protect the provided information of the acquired confidential and professional service or their employer to safeguard the confidentiality and does not disclosure of such information without the explicit permission of the employer, just in the case of taking legal or professional right or duty that require disclosing the information. Professional accountant shall not exploit acquired confidential information in the course of personal interests or interests of third parties. Then two questions in CPACQ included adequately supervise services (X5) and maintain client confidentiality (X22) answered the opinion of auditors on significance of privacy. In addition of privacy, auditors' professional behavior in dealing with ethical dilemma is important.

Manners and professionalism: In other words, the professional accountant should respect in dealing with others during his tenure with the courtesy, obeys the rules and procedures and avoid the practice discredit his profession. The nature of services that accountants and auditors has been done, require a high level of moral conduct. Stock holders, investors, creditors, and other users of financial statements rely on the annual financial statements of firms mainly to make a decision. They rely on the auditors that have provided and confirmed the reports to obtain real and fair look from company. The Ethics lessons can help accountants and auditors to overcome the moral contradictions and do the right choice to take action of protecting the public interest. The group of accountants who offer their services to the public must be independent, especially in trusting services, i.e., the services that increases the reliability of the others to financial information. Sometimes independence false interpreted as sense of not employing. But independence in accounting profession means that the person without the affection of others judging, making decision and ordering. The always exhibit proper conduct (X25), genuinely interested in public service (X21), does not always act responsibly (X20), not always impartial (X17), renders prompt service (X9), adheres to code of conduct (X8), independent in thought (X3), and exercises moral judgments (X7) are the items of this components of ethics. The IFAC emphasizes the autonomy and independence of accountants from the employers.

7 DATA ANALYSIS

In this study, in order to making comment on the relationship between ethics and its dimensions and auditors' judgments, SPSS and The path analysis method in AMOS was applied to examine the role of ethics' dimensions on auditors' judgments. In order to analyse of data, different alternatives were applied. The KMO was first test to check the suitability of sample size for factor analysis. The result of KMO illustrated in Table 1.

Table 1. The Results of KMO

Dimensions	Items	KMO		
Honesty	Integrity	0.761		
	Intellectually honest			
	Trustworthy			
Realism	Serves the public	0.713		
	Interest			
	Delivers competent			
	Services			
	Free from conflict of interest			
Competent and Caring Professionals	Ability	0.891		
	Adheres to ethical standards			
	Consistent professional behavior			
	Dedicated to excellence			
	Proficient (Demonstrates Mastery),			
	Objective			
	Always exercise due care			
	Cooperates with other auditors			
	Does not always provide quality Services			
	Knowledgeable into CPACQ			
	Privacy		Adequately supervise	0.877
			Services and maintain	
			Client confidentiality	
Manners and Professionalism	Always exhibit proper conduct (x25)	0.738		
	Genuinely interested in public service (x21)			
	Does not always act responsibly(x20),			
	Not always impartial (x17),			
	Renders prompt service (x9)			
	Adheres to code of conduct (x8)			
	Independent in thought(x3)			
	Exercises moral judgments(x7)			

The results revealed that since the estimated significance level Of KMO was more than 0.7, then the sample size and the number of questions were suitable for factor analysis.

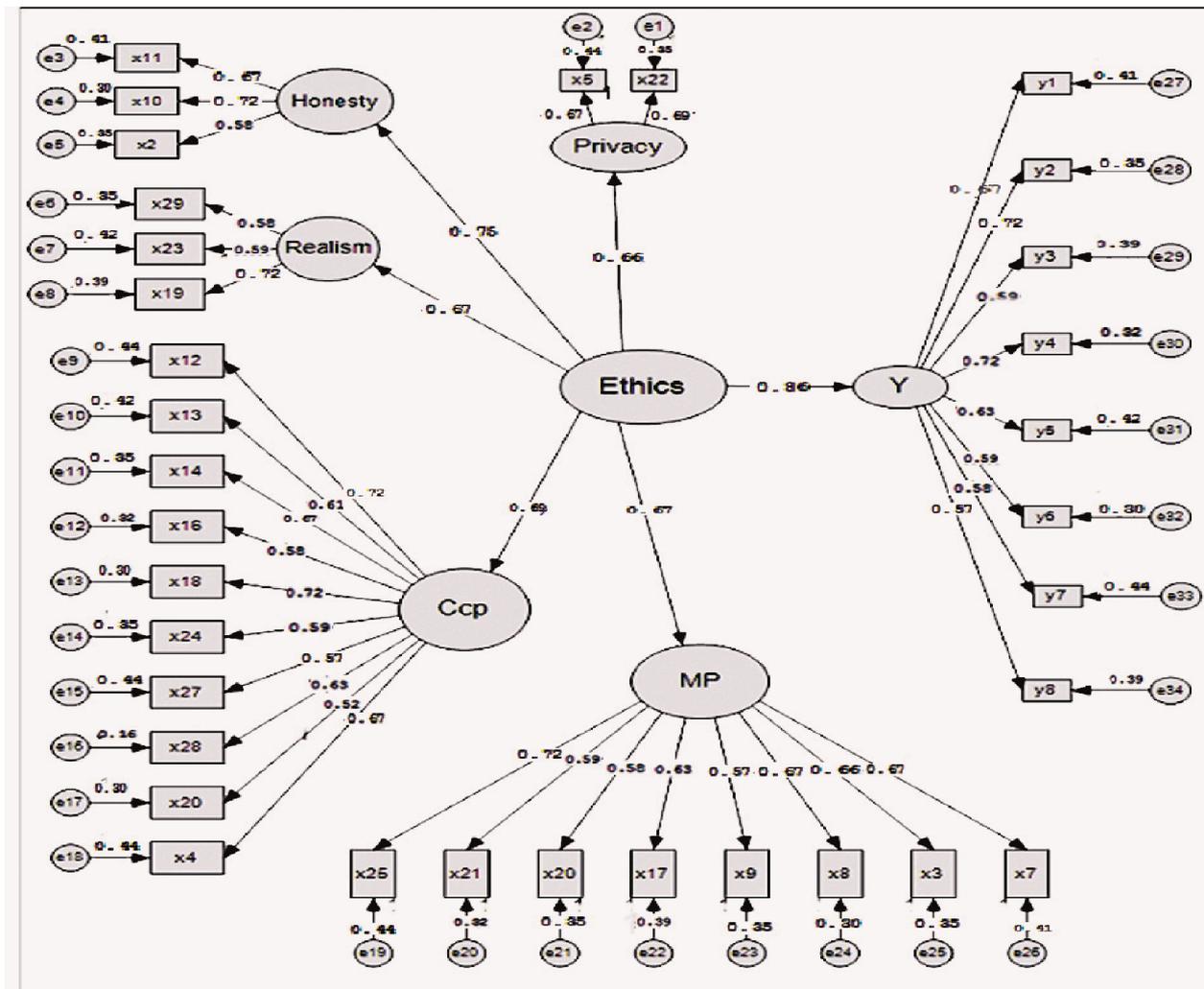
8 THE HYPOTHESES TESTS' RESULTS

The main hypothesis of this study was the effect of ethics on auditor's opinion in ethical dilemma conditions. This hypothesis and also the sub hypotheses has examined and analysed through the SEM in following parts.

To investigate the causal relationships between variables, great efforts have been employed in recent decades. One of the promising methods in the field is structural equation model or multivariate analysis of the observed and latent variables. Regardless to the countless name and content, this term refers to a series of models, including confirmatory factor analysis, Classical Simultaneous Equation Models, Path Analysis (Hoyle, 1995). The sparks of entering this debate began by the issue of multiple criteria.

Structural equation modeling is a comprehensive statistical approach to testing hypotheses of the relationships between variables (Hoyle, 1995). This approach tests the theoretical models reliability in specific communities by using un-experiment data. This study was applied path analysis method in structural equation modeling to examine the role of ethics on the independent auditor's judgments. This phase of the structural equation model is just like standardized regression coefficients (β Standard). The only step in this process of test was the evaluation models and model parameters coefficients.

- H₁: There is a significant effect of **Ethics** on auditor’s judgment in ethical dilemma conditions.
- H_{1a}: There is significant effect of **Honesty** on auditor’s judgment in ethical dilemma conditions
- H_{1b}: There is significant effect of **Realism** on auditor’s judgment in ethical dilemma conditions.
- H_{1c}: There is significant effect of **Competent and Caring Professionals** on auditor’s judgment in ethical dilemma conditions.
- H_{1d}: There is significant effect of **Privacy** on auditor’s judgment in ethical dilemma conditions.
- H_{1e}: There is significant effect of **Manners and professionalism** on auditor’s judgment in ethical dilemma conditions.



The df is freedom index which should be more than zero. Most important parameters are Root Mean Square Error Approximation (RMSEA), Goodness of Fit Index (GFI), Adjusted Goodness of Fit Index (AGFI), and Root Mean Square Residuals (RMSR). The optimum conditions for these tests are as follows:

Table 2: The Result of Structural Model

Index	Result	Index	Result
CFI	1.00	NFI	0.99
χ^2/df	1.11	P-Value	0.23
RMSEA	0.048	Goodness of Fit Index (GFI)	0.99
Adjusted Goodness of Fit Index (AGFI)	0.94		

It can be seen, the χ^2 / df is 1.11 and the Goodness of Fit Index (GFI) is equal to 0.99 and the Adjusted Goodness of Fit Index (AGFI) is 0.94. The results of the model indicated that the ethics can affect auditor's judgments. The chi-square and RMSEA values were low while the GFI and AGFI values were above 90%. The result of standard estimating analysis showed that the Root Mean Square Error of Approximation (RAMSEA) was less than 10% (RMSEA=0.048) and the Goodness of Fit Index was more than 0.9 (GFI=0.94), which indicates the model is good fit (Hoyle,1995).

The results of model showed that the ethics affected auditors' judgments. The findings of analysis presented in table 3.

Table 3 The Findings of First Hypothesis

Path Rate	Significant Level	Results of Analyses
0.86	P<0.0001	The first hypothesis accepted

Cultivating from Table 3, the result revealed that the significant level was less than ($p<0.05$), signifying that the predictor variable can be considered to influence auditors' judgments. Indeed ethics affected auditors' judgments with 0.86. This means that 0.86% of the variability of dependent variable (auditor opinions) was explained and predicted by the model's dependent variables. It is interpreted that attention to ethics among auditors are expected to improve their opinions on financial statements. Therefore, this supports hypothesis H_1 . The findings of sub hypotheses also indicated in following table.

Table 4. The Findings of Sub Hypotheses

Path Rate	Significant Level	Results of Analyses	
0.75	0.86	P<0.0001	H _{1a} accepted
0.67	0.86	P<0.0001	H _{1b} accepted
0.69	0.86	P<0.0001	H _{1c} accepted
0.66	0.86	P<0.0001	H _{1d} accepted
0.67	0.86	P<0.0001	H _{1e} accepted

Considering with above table 4, the results showed that the term of "Honesty"(H1a) with 0.645 was first important code among auditors and other terms like "Competent and Caring Professionals"(H1b)with 0.593and "Realism"(H1c) with 0.576had seconde and thrid rank respectively.Furthermore the fourth and fifth rank was related to the Privacy (H1d)with 0.567 and Manners and professionalism(H1e)with 0.576.All these terms are under competent and caring professionals and it signifies that most important principle among Iranian auditors.

9 DISCUSSION AND FINDINGS

There are some rules in any profession that individuals should abide. Similar to other professions, auditors have a professional code of conduct constructed by AICPA. Iranian auditors also have professional code of conduct which is stated by Audit Organization in accompany with IACPA. One of the main responsibilities of IACPA is to introduce ethical standards for professional accountants. For this purpose, the Iranian Code of Ethics for Professional Accountants was established in 2003. The Code states that the fundamental principles should be observed by professional accountants in order to achieve the objectives of the accounting profession. Ethical conduct is a part of Iranian auditor's work and they should make their decisions based upon these rules.

This study revealed that there is a significant effect of ethics on auditor's judgment. This finding implies that ethics or code of professional conducts has important role in auditor's opinion. Despite the importance of ethics in the field of audit as well as numerous articles on this subject, the inadequate training of auditors and accountants and the lack of morality within the profession cannot be justified [18]. The current approach is to assume that there is a sufficient expertise and common moral sensitivities with proper patterns of pioneers' behaviour that can provide ethical behaviour in this profession.

The results of this study support to the results presented by [19, 8, 7, 20] which indicates that ethics and code of professional conducts are related to auditors' decision-making when they encounter ethical dilemma. [10] in their study also indicated that professional code of conduct is important for professional auditors and they have a reasonably high level of reliance on financial statements when making decisions. The results also showed that the cognitive moral development theory is related to ethics and auditor's judgment in ethical dilemma conditions.

10 CONCLUSIONS

The ethical dilemma pressure is usually caused by mental or actual threat to the future financial relationships between auditors and auditees. This marks a clear conflict of interest in the context of the relationship between the auditor and his auditee, in financial perspective the auditor is related to the auditee [15,21]. Professional auditors must resist to these pressures if they think that the reports they have presented are authentic and fair, but the issue again is that they require a legitimate way to earn their living and maintain audit clients expectations. The robust approach to this moral problem is the duty features, i.e. the view that moral duty and loyalty should not make others underestimate auditors. Moral principles are obligations that must be considered independently from the results of their operations.

Furthermore, finding of the study points out that audit firms must have their own internal disciplinary measures and they must pay attention to the legitimate expectations of the society. It seems that the auditors should have a legal approach or ethical choices related to their professional standards. As a result, when the discipline and rules are set by audit firms, the performance of the auditors will be monitored through their peer-reviews.

11 CONTRIBUTION OF THIS RESEARCH

This research, for instance, introduces ethics as related factor to audit profession, because the attention towards ethics by auditors will help financial statements' users to trust the content of financial reports. As government has responsibilities to make audit standards, the findings of this research are useful for Iranian government to set the rules and policies to enhance the auditing practices in Iranian audit firms.

The findings of this study revealed that professional ethical conduct is very important for auditors to give clear report on the based on audit standards. In other words, code of ethics or code of conduct plays an important role in the daily routine of an auditor. It is hoped that government can understand the importance of ethical rules among auditors.

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