

# AUDITOR'S ETHICAL JUDGEMENTS: ASSESSING THE EFFECT OF ETHICAL SENSITIVITY AND ETHICAL CLIMATE

Aida Hazlin Ismail<sup>1</sup>, Takiah Mohd Iskandar<sup>2</sup>,  
Zuraidah Mohd Sanusi<sup>2</sup> and Zaleha Abdul Shukor<sup>3</sup>

<sup>1</sup>Faculty of Accountancy,

Universiti Teknologi MARA, Malaysia

<sup>2</sup>Accounting Research Institute,

Universiti Teknologi MARA, Malaysia

<sup>3</sup>Faculty of Economics and Management,

The National University of Malaysia, Malaysia

## ABSTRACT

*This study examined effects of ethical sensitivity and ethical climate on auditors' ethical judgements. The study employed a 'between subjects' experimental design to assess auditors' judgements on ethical dilemmas relating to issues of independence and confidentiality. Participants consist of 146 auditors from Big 4 and Non Big 4 firms. Results showed ethical sensitivity had a significant positive effect on auditors' ethical judgements. However, the effect of ethical sensitivity on auditors' ethical judgements was moderated by the ethical climate of the firm. The positive effect of ethical sensitivity is stronger in higher ethical climate.*

**Keywords:** *ethical judgements, International Standards of Quality Control (ISQC) 1, ethical climate, ethical sensitivity, independence and confidentiality*

## INTRODUCTION

This study aimed at examining the importance of ethical sensitivity and ethical climate on auditors' ethical judgements. Ethical judgement is a psychological construct that differentiates the process of determining whether one course of action in a particular situation is morally 'right' or 'wrong' (Vitell & Ho, 1997). When conducting an audit work, auditors

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have to deal with different types of ethical dilemmas at all levels of audit tasks. In dealing with these ethical dilemmas, auditors are expected to make professional ethical judgements in compliance with the requirements specified in the Professional Code of Ethical Conduct. Auditors are expected to conduct ethically when dealing with ambiguous issues of ethics, particularly with regard to the question of reliability and integrity of the audit report (Loviscky, Treviño & Jacobs, 2007).

In performing an audit, auditors may get involved with an unethical action if they fail to recognize themselves as moral agents whose decisions may affect others (i.e. ethical sensitivity). The Transmile Group Berhad in Malaysia case provides a good example of dishonest audit practices concerning a lack of sensitivity to acknowledge the existence of misstatements in financial statements. Having a high ethical sensitivity towards certain issues is expected to influence the auditor's ethical judgements. The process of ethical judgements starts with the identification of ethical issues (Rest, 1986). An individual must perceive the presence of an ethical issue before the process of ethical decision making begins (Sparks & Hunt, 1998). However, ethical judgements vary between auditors, depending on their individual characteristics such as experience, knowledge and cognitive moral development (Libby & Frederick, 1990; Ashkanasy, Windsor & Treviño 2006; Zakaria, Haron & Ismail, 2010a). Prior empirical studies showed that individual characteristics affect auditors' ethical judgements (Hunt & Vitell, 1986; Leo, Ferrell & Mansfield, 2000; Jones, Massey & Thorne, 2003). Differences in auditors' characteristics is expected to influence the way the individual auditor recognises the ethical issue which in turn explains the variance in auditors' ethical judgements.

Hunt and Vitell (1986) suggested that recognising the potential ethical content is a function of individual's ethical sensitivity. Ethical sensitivity is a personal characteristic that may explain the variation in ethical judgements (Hunt & Vitell, 1986). It is significant in determining the individual's perception on the existence of ethical problems. The process of making ethical judgments occurs only if ethical problems are perceived to exist (Sparks & Hunt, 1998). The sensitivity towards ethical issues varies with each person. If no ethical problem is perceived, the process for making ethical judgements does not occur. Only ethical dilemmas which are perceived important would trigger the process of ethical judgements.

Hence, the auditors' perception of ethical dilemmas is expected to affect their ethical judgements.

Besides the individuals' characteristics, the organisational factor is another important determinant in ethical judgements (Hunt & Vitell, 1986). The environment within the organisation is argued to have influence on the employee's ethical judgements. Audit firms may adopt certain measures to inculcate ethical values among employees (Koh & Boo, 2004). The adoption of International Standards of Quality Control (ISQC) 1 by audit firms has nevertheless provided certain guidelines criteria on leadership support, ethical requirements and monitoring to improve the environment within the audit firms. Influential theories of business and marketing ethics are consistent in suggesting that the ethical climate are key situational factors that may affect ethical behaviors (Ferrell & Gresham, 1985; Hunt & Vitell, 1986; Jones, 1991; Treviño, 1986).

Past empirical studies on auditing emphasized the importance of ethical climate in ethical judgements (Shafer, 2009; Rothwell & Baldwin, 2006; Ashkanasy, Windsor & Treviño, 2006; Douglas, Davidson & Schwartz, 2001). Organisational ethics are intended to guide and influence employee behaviour in dealing with ethical climate and making ethical judgements. In performing their audit task, auditors face with diverse types of ethical climate. Hence, in dealing with this situation, the auditors need to make professional ethical judgements before issuing the audit reports. The audit report should be reliable and with high integrity for stakeholders use to make financial decisions. However, past empirical studies found that auditors with different personality tend to make different ethical judgements. In addition, the effect of different levels of organisational ethical climate on auditors' ethical judgements is still questionable.

Pflugrath, Martinov-Bennie and Chen (2007) also suggested that future research on ethical climate within auditing context is highly warranted. Therefore, this study intends to fill the gap by examining the effect of ethical sensitivity and auditors' ethical judgements and the impact of ethical climate. As such, this study addresses the following research questions: Does ethical sensitivity has an impact on auditors' ethical judgements? Does ethical climate lead to better auditors' ethical judgements? Does ethical climate has an interaction with ethical sensitivity and ethical judgements?

This study extends Koh and Boo's (2001) study by introducing ethical sensitivity and investigates the interaction effect of organisational ethics and auditors' ethical judgements. Specifically, it investigates whether top management support for ethical behaviour the ethical climate in the organisation, and the interaction between ethical sensitivity and auditors' ethical judgments. The findings of this study can contribute to the understanding of how organisational ethics may be used as a means to generate auditors' ethical judgements. Apart from providing supports on the applicability of the construct to explain auditors' ethical decision making, the results also indicate effects of the interaction between ethical sensitivity and ethical climate on ethical judgements. Results suggested that ethical sensitivity affects auditors' ethical judgements differently in different ethical climates.

The remainder of the paper is divided into four sections. The first section lays the theoretical and hypotheses development. The research method employed in the study is discussed in the second section. The third section presents the results and findings. Finally, the fourth section concludes the study with discussion on the limitations and suggestions for future research.

## **LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

### **Ethical Judgements**

This study drew on the Hunt and Vitell (1986) general theory of marketing ethics to examine the effect of ethical sensitivity and ethical climate on auditors' ethical judgements. Auditors are expected to make ethical judgements in dealing with ambiguous ethical issues for the purpose of issuing high quality audit report (Lovisky, Treviño & Jacobs, 2007). Auditors encounter ethical dilemmas in making routine decisions ranging from the acceptance of audit engagement until the issuance of audit report. The public relies on the credibility of audit report for decision making. The report relies to a great extent on the level of integrity and accountability of auditors in dealing with ethical judgements. Prior research suggests that auditors' ethical judgements are influenced by their individual characteristics such as gender, nationality, knowledge and experience, moral reasoning and

locus of control (Pflugrath, Martinov-Bennie & Chen, 2007a; Ashkanasy, Windsor & Treviño, 2006; Zakaria, Haron & Ismail, 2010b; Singhapakdi, Vitell & Leelakulthanit, 1994; Cherry, 2006). Knowledge and experience are found to have a significant influence on ethical judgements of the accounting students (Fleming, Romanus & Lightner, 2009).

The process of making ethical judgements starts with the identification of ethical dilemmas (Rest, 1986). Before making judgements, an individual needs to perceive if there is any ethical problems before ethical decision judgements could be made. The Hunt and Vitell (1986) theory of marketing ethics suggests that in this process, the perception and identification of ethical dilemmas vary depending on a number of factors. The factors are divided into four categories which include individual characteristics, industry environment, organisational environment and cultural environment. Both the individual characteristics and environment vary simultaneously to influence the ethical decision making. Hence, this study argues that auditors' individual characteristics and the audit firms' organisational ethical environment which is established within the firms would help to encourage audit staff to make highly ethical judgements.

This argument is in line with allegations in many established theories that culture and climate provide situational variables which influence ethical decisions (Hunt & Vitell, 1986; Trevino, 1986). However, published studies on the influence of ethical climate on ethical judgements in auditing research are lacking. Many past studies investigate the effect of individual characteristics rather than the impact of organisational ethical environment on auditors' ethical judgments (Zakaria, Haron & Ismail, 2010a; Chan & Leung, 2006; Karacaer, Gohar, Aygün & Sayin, 2009) only 224 questionnaires were usable. Data were analyzed using SPSS 16.0 and structural equation modeling (SEM). Therefore, this study wishes to investigate the influence of organisational ethical environment of audit firms in Malaysia subsequent to the adoptions of International Standard of Quality Control 1 (ISQC 1). ISQC 1 is expected to provide guidelines to audit firms in establishing quality control characteristics which are conducive to regulating ethical environment.

## Ethical Sensitivity

The literature has shown that ethical sensitivity is among the important individual characteristics that affect ethical judgements. Ethical sensitivity relates to the concept of ethical reasoning and judgements within Kohlberg's (1969) theory of cognitive moral development (Pedersen, 2009). Research has demonstrated that ethical judgements are the function of individuals' ethical perceptions or sensitivity (Shaub, Finn & Munter, 1993). The perception of an individual on ethical issues is an important step in decision making. This is the starting point for the cognitive processing in ethical decision making (Sparks & Hunt, 1998).

Studies on ethical sensitivity show that auditors with high ethical sensitivity are more likely to form ethical judgements (Shafer, Morris & Ketchand, 2001). This is because auditors are sensitive to the ethical information when assessing the risk of fraud in financial reporting (Abdolmohammadi & Owghoso, 2000). This notion is supported by Haines, Street, and Haines (2008) who argue that auditors' ethical sensitivity is an important predictor for ethical judgements. Among accounting students, ethical sensitivity is significantly related to unethical judgements (Malone, 2006). The role of ethical sensitivity in the individual is fundamental for ethical problem solving and ethical behaviour (Pedersen, 2009). The ethical sensitivity provides ethical reasoning in making ethical judgements (Chan & Leung, 2006). Therefore, based on the ethical judgement model (Hunt & Vitell, 1986) theory of ethics, four components model (Rest, 1986) and past literature, the following hypothesis is formulated:

**H<sub>1</sub>:** The higher the ethical sensitivity of the auditors, the more likely that auditors form ethical judgements.

## Ethical Climate

Models of ethical decision-making recognise that individual ethical decision-making in organisations cannot be understood without considering the context within which decision processes occur. Thus, the models generally include not only individual influences on ethical decision-making but also organisational factors, such as reward systems, norms, codes of conduct, and organisational climate (Barnett & Vaicys, 2000). However, the

majority of ethical auditing studies focus on the effect of individual ethical characteristics rather than the organisational factors of ethical judgements (Jones, Massey & Thorne, 2003). Victor and Cullen (1988) ethical climate theory suggests that organisational ethical climate determines what constitute ethical behaviour at work. The organisational ethical climate may improve auditors' judgements by helping individuals determine the ethical issues and criteria to resolve the ethical dilemmas (Bennie & Pflugrath, 2009). Stronger ethical climate imposes additional guidelines for the auditors in making ethical judgements (Libby & Luft, 1993).

Past empirical research found that there are significant impact of organisational ethical climate on auditors' ethical judgements (Ashkanasy, Windsor & Treviño, 2006; Barnett & Vaicys, 2000; Douglas, Davidson & Schwartz, 2001; Shafer, 2009). Most studies indicated that strong ethical climate within the audit firm has significant positive impact on ethical judgements (Pflugrath, Martinov-Bennie & Chen, 2007; Mumford, Murphy, Connelly, Hill, Antes, Brown & Devenport, 2007; Fritzsche 2000). In high ethical climate, high cognitive moral development managers became more ethical as compared to in low ethical climate (Ashkanasy, Windsor & Treviño, 2006). This notion is supported by Douglas, Davidson and Schwartz (2001) who argued that personal values and ethical climate has a significant effect on ethical judgements.

In addition, there is a positive relationship between ethical climate and ethical behaviour (Koh & Boo, 2001). In strong ethical environment, managers' decision tend to reduce significantly in failing the projects (Booth & Schulz, 2004). Therefore, an organisation can create an ethical climate that becomes contagious and ultimately leads to more ethical judgements (Trevino, Butterfield & McCabe, 1998). Thus, creating a strong ethical environment may be highly desirable control option for the auditors to form more ethical decisions.

However, there are past studies which have negative effect between high ethical climate and ethical judgements. In high ethical climate, professional accountants make positive ethical judgments but not on judgement made by the accounting students (Pflugrath, Martinov-Bennie, & Chen, 2007). In addition, low cognitive moral development audit managers make less ethical judgements in high ethical climate environment (Ashkanasy, Windsor & Treviño, 2006).

The inconclusive findings from past studies on the effect of ethical climate and ethical judgements require further examination. Therefore, based on Hunt and Vitell's (1986) theory of ethics, Victor and Cullen (1988) theory of work ethical climate and past studies (Mumford, Murphy, Connelly, Hill, Antes, Brown & Devenport, 2007; Rothwell & Baldwin, 2006; Pflugrath, Martinov-Bennie, & Chen, 2007b), it is hypothesise that;

**H<sub>2</sub>:** The higher the ethical climate, the more likely that auditors form ethical judgements.

### **Interaction between Ethical Sensitivity and Ethical Climate**

This study anticipates an interaction between auditors' ethical sensitivity and ethical climate to affect auditors' ethical judgements on ethical issues. Auditors with high ethical sensitivity will form more ethical judgements both in low or high ethical environment. However, it is believed that if auditors with low sensitivity auditors are surrounded with low ethical environment, they would form less ethical judgement. In high ethical environment, auditors with low or high ethical sensitivity would be likely to form more ethical judgements. This argument is based on Trevino's (1986) Person Situational Model which suggests that ethical environment is one of the important moderating organisational variables for ethical judgments. Trevino (1986) argues that ethical judgments in practical situations are not a product of fixed individual characteristics, but results from an interaction between the individual and the ethical environment of the organisations. When the climate within the audit firm is highly ethical the individual auditors, with either low or high ethical sensitivity, would be driven to make high ethical judgements. However, when the ethical climate within the firm is low, it is very likely that only individual auditors with high ethical sensitivity would make ethical judgements. In this later environment, auditors with low ethical sensitivity are expected to make low ethical judgement. Therefore, individual's ethical judgements are the result of the effects of the interaction between individual characteristics and the ethical climate within the organisations (Barnett & Vaicys, 2000; Fournier, Tanner, Chonko, & Manolis, 2010; Windsor & Warming-Rasmussen, 2009; Windsor & Ashkanasy, 1995). For this reason, hypothesis below will be investigated.

**H<sub>3</sub>:** In high (low) ethical climate, auditors with high (low) ethical sensitivity form more (less) ethical judgements.

## RESEARCH METHOD

### Research Design

The study adopts a 2x2 between-subject factorial field experimental design of two levels of ethical sensitivity and two levels of ethical climate as independent variables. Auditors' ethical judgements served as the dependent variable. The following paragraphs discuss the measurement of ethical judgements as the dependent variable and ethical sensitivity and ethical climate as the independent variables. The scenario relates to the issue of auditors' independence. Independence is one of the important ethical requirements of the ISQC 1 (MIA 2007) that must be adhered to by auditors. The issue was selected because the element of independence is a specialised concept for the auditors. The independence scenarios were adopted from previous research (Jeffrey, Dilla & Weatherholt, 2004) attitudes toward rule-directed behavior, and the perceived importance of codes of conduct and professional standards on auditor judgments about ethical dilemmas. Taiwanese audit professionals were asked to respond to two ethical dilemmas. The first dilemma concerns a situation in which the auditor is asked to acquiesce to a controller's request to conceal an irregularity. The probability that the auditor's acquiescence is discovered (i.e., the threat of a sanction; Gill, Cosserat, Leung & Coram, 1999) and modified according to the Malaysian auditing context. The independence scenarios relate to self-interest threats.

### Measurement for Ethical Judgments

Auditors' ethical judgments are captured by asking participating auditors to perform an ethical judgement task. The task requires respondents to indicate their agreement or disagreement on a seven-point Likert scale with regards to an audit scenario. The scenario relates to a close relationship between the client and the senior partner in-charge of the audit engagement. Respondents were asked to indicate their degree of agreement or disagreement regarding a statement, "The partner in-charge should resign from being the auditor of M Berhad" on a seven-point Likert-type scale (1=strongly disagree; 7=strongly agree). A high score indicates a respondent

was more likely to form ethical judgement (i.e., respondents perceived the action in the scenario as unethical). A low score indicates that the respondent is more likely to form unethical judgement (i.e., respondents perceived the action in the scenario as ethical).

## Measurement of Independent Variables

### Ethical Sensitivity

Ethical sensitivity is measured by the participants' assessment on the sensitivity of the ethical issue they are requested to identify in the experimental audit task presented to them. The ethical sensitivity assessment is made on a seven-point scale ranging between 1 (strongly disagree) to 7 (strongly agree) on the question "Does this situation involve ethical issues?" This method of measurement is consistent with prior studies for ethical sensitivity (Singhapakdi, 1996; Vitell & Singhapakdi, 1993; Singhapakdi & Vitell, 1990; Singhapakdi, 1999; Karande, Shankarmahesh, Rao & Rashid, 2000). The median value of scores is determined to classify participants' response into high or low. Scores which are above the median are classified as high ethical sensitivity. Scores which are below the median are classified as low ethical sensitivity.

### Ethical Climate

Ethical climate is measured using a 4-items instrument adapted from previous research (Koh & Boo, 2001; 2004). The four items for ethical climate the measurement was developed by Cullen, Victor and Bronson (1993). Ethical climate is examined from the perspective of principled ethical climate<sup>1</sup>. Participants are requested to give their perceptions on a seven-point Likert scale ranging from 1 = strongly disagree to 7 = strongly agree about the ethical environment of audit firms in which they are working. High scores indicate that participants agree that the audit firm has high ethical climate. Low scores on the other hand indicate that participants agree that the audit firm has low ethical climate. This argument is consistent with Victor and Cullen (1988) who believe that the compliance with the requirements of code of ethics, standards and specified rules and procedures by audit firms provides a reliable measure of ethical climate. The ethical climate four-item measurement is presented below in Table 1.

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1 The ethical climate has three categories which are the egoistic, benevolent and principled. Victor and Cullen (1988) suggest that for the public accounting firm, the ethical climate is the principled because of the reliability on the code of ethics or other standards and procedures used in the organizations.

**Table 1: Ethical Climate Four-Item Measurement**

- Compliance with organisational rules and procedures is very important in my firm.
- Employees in my firm are not expected to stick to firm policies strictly.
- People who do not follow firm's rules and procedures are not viewed favourable in my firms.
- My firm does not emphasise the importance of its rules, procedures and ethics.

The median value of the total scores is determined to classify participants' responses into high or low. Scores which are above the median are classified as high ethical climate. Scores which are below the median are classified as low ethical climate. High ethical climate is coded '1'. Low ethical climate is coded '0'. Higher scores indicate that the ethical climate in the scenario is perceived to be of high ethical environment. The computed median value for ethical climate and leadership support were used as the basis to divide the data into 'high' and 'low' groups of ethical climate and leadership support. The groups were coded 1 for 'low level' and 2 for 'high level'.

## RESULTS

### Respondents

The study used stratified random sampling to select respondents from registered audit firms directory list obtained from the Malaysian Institute of Accountants (MIA) to ensure representativeness of sample. A total of 500 questionnaires were distributed to the selected auditors from audit firms located within the Lembah Kelang, Kuala Lumpur, in which most audit firms are located. Booklets containing a set of instruments with return envelopes were mailed to the audit firms to be distributed by the person in charge to participating auditors. Participants were subsequently reminded to return the completed questionnaires to the researcher.

Of the 500 questionnaires sent out, 205 completed questionnaires were returned. The data were reviewed to seek out errors in the form of invalid

data including a blank questionnaire or missing values. This procedure was carried out to produce clean data for research analysis (Hair Black, Babin & Anderson, 2010). Upon reviewing, eight of the returned booklets could not be used because of incomplete responses. 197 booklets are useable giving a total response rate of 39.4 percent. The response rate is calculated as the percentage of the number of usable returned questionnaires to the number of questionnaires sent. This response rate was higher than similar research on ethics that involved MIA members (Johari, Sanusi, Rahman, & Omar, 2012 [32 percent] ; Zakaria, Haron & Ismail, 2010 [23 percent]) only 224 questionnaires were usable. Data were analyzed using SPSS 16.0 and structural equation modeling (SEM. Participants are 81 auditors from Big 4 and 116 from non-Big 4 audit firms.

**Table 2: Questionnaire Distribution**

<b>Audit Firms</b>	<b>Number of Firms Selected</b>	<b>Number of Participants</b>	<b>Number of Questionnaires Distributed</b>	<b>Number of Questionnaires Returned</b>
Big 4	4	81	100	60
Non Big 4	72	116	400	145
Total	76	197	500	205

**Hypotheses Testing**

The study used analysis of variance (ANOVA) to test the direct and interaction effects of the independent variables on dependent variables (Pallant, 2007). Preliminary assumption testing was conducted to check for normality, linearity, univariate and multivariate outliers, homogeneity of variance-covariance matrices and multicollinearity. Results indicated no serious violations of the assumptions.

**Effect of Ethical Sensitivity (ES)**

Table 3 presents results of hypotheses testing in this study. The table shows a significant positive effect of ethical sensitivity on auditors’ ethical judgements at  $p = .005$ . The result suggested that auditors with high ethical sensitivity made more ethical judgement than auditors with low ethical

sensitivity. Hypothesis 1 is supported. Findings show that auditors with higher ethical sensitivity have more likelihood to form ethical judgements. The results is consistent with prior studies on the positive significant relationship between ethical sensitivity and ethical judgements (Zakaria & Ismail, 2010; Ponemon & Gabhart 1990; Singhapakdi & Vitell, 1993) only 224 questionnaires were usable. Data were analyzed using SPSS 16.0 and structural equation modeling (SEM. An auditor who has the ability to identify ethical issues and to differentiate what is the ethically right or wrong is able to form more ethical judgements. This finding contradicts with the Chan and Leung (2006) but strengthens the support for significant relationship between ethical sensitivity and ethical judgements.

**Table 3: Tests of Between-Subjects Effects**

Dependent Variable: Ethical Judgement

Source	Type III Sum of Squares	df	Mean Square	F	Sig.	Partial Eta Squared
Corrected Model	75.613 <sup>a</sup>	3	25.204	6.407	.000	.119
Intercept	2277.693	1	2277.693	578.971	.000	.803
Ethical sensitivity (ES)	32.559	1	32.559	8.276	<b>.005</b>	.055
Ethical climate (EC)	6.304	1	6.304	1.602	.208	.011
ES * EC	22.348	1	22.348	5.681	<b>.018</b>	.038
Error	558.634	192	3.934			
Total	3100.000	197				
Corrected Total	634.247	195				
a. R Squared = .119 (Adjusted R Squared = .101) b. Computed using alpha = .05						

### Effects of Ethical Climate

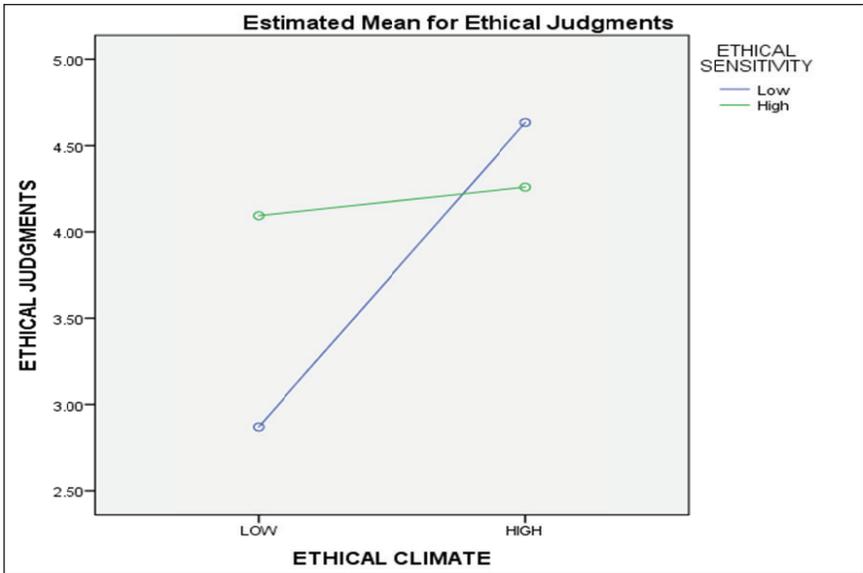
Results in Table 3 show that there is no significant main effects of ethical climate on auditors' ethical judgements with  $p = .208$ . The result indicates that, regardless of the level of ethical climate of audit firm, auditors make similar ethical judgments. The result contradicts with findings of some prior studies such as Mumford, Murphy, Connelly, Hill, Antes, Brown and Devenport (2007), Rothwell and Baldwin (2006), and

Pflugrath, Martinov-Bennie and Chen (2007) which suggest that an ethical climate provides a positive impact on auditors' ethical judgements. The contradictory result of this study indicates that the quality of audit may be due to the implementations of the professional code of ethical conduct and other standards such as ISQC 1 by audit firms as required by the accounting profession in Malaysia. With the introduction and implementation of ISQC 1 by audit firms, the ethical environment is automatically developed within the firms representing an improvement in the control mechanism. Thus, no significant difference in ethical climate may be observed between audit firms to see its effect on audit judgement. Findings of the study provide support that the ethical climate within the audit firms may not necessarily be the driving factor for the auditors in forming ethical judgements.

### **Effects of Interaction between Ethical Sensitivity and Ethical Climate**

Table 3 shows a significant effect of the interaction between ethical sensitivity and ethical climate on auditors' ethical judgements at  $p = .018$ . Results show that ethical sensitivity affects auditors' ethical judgements differently depending on the level of ethical climate. Figure 1 below depicts graphically the effect of interactions between the ethical sensitivity and ethical climate on auditors' ethical judgments. In Figure 1, results indicate that in low ethical climate, auditors with high ethical sensitivity form more ethical judgements as compared to auditors with low ethical sensitivity. The figure shows that ethical climate affects ethical judgements positively when ethical sensitivity of the issue is perceived to be low. However, when ethical sensitivity of the issue is perceived to be high, ethical climate has a negative effect on auditors' ethical judgements. In other words, when ethical climate is low, auditors make higher ethical judgements when they perceive that the ethical issue is highly sensitive than the judgements they make when they perceive that the ethical issue is lowly sensitive.

Results of the analysis indicate that auditors' ethical judgements on issue with different level of ethical sensitivity vary with the level of ethical climate in the audit firms. These findings indicate that interaction effects exist between the auditors' ethical sensitivity and ethical climate on auditors' ethical judgements. Results **support** for Hypotheses 3. Thus, the findings indicate that the ethical climate level interacts with auditors' ethical sensitivity to affect their ethical judgments.



**Figure 1: Effects of the Interaction between Ethical Sensitivity and Ethical Climate on Auditors' Ethical Judgments**

Although results of the analysis show that ethical climate by itself does not make much difference on auditors' ethical judgements, it has a significant influence on auditors when dealing with issues of different ethical sensitivity level. The ethical climate provided by the firms enable them to distinguish the need to make very ethical or less ethical judgements.

## CONCLUSIONS

The Hunt and Vitell (1986) general theory of marketing ethics provides a basis for evaluating effects of individual's ethical sensitivity and ethical climate on auditors' ethical judgements. Consistent with the theory, individual characteristics (ethical sensitivity) has an effect on auditors' ethical judgements. However, situational effects such as the ethical climate play an important role in influencing ethical judgements.

Findings from the study show no direct effect of ethical climate on auditors' ethical judgements. This result contradicting prior studies that found ethical climate has an impact on ethical judgements (Barnes, 2013;

Park, Chevalier & Ali, 2012; Cullen, Parboteeah & Victor, 2011). Ethical climate in auditing firm may have different impact on the auditors. In performing their audit work, auditors refer to the Companies Act 1965, MIA By-Law and other relevant regulations that relate to accounting and auditing standards. Hence, auditors may not be easily influenced with the ethical climate of the firm but they are more guided with the relevant standard and regulations. Therefore, auditors follow rules and guidelines in performing their job rather than being influenced by the environment of the firm.

Results also show a significant interaction between ethical climate and ethical sensitivity to affect auditors' ethical judgements. This indicates that the top management of the firms play an important role in setting ethical climate in the firm and enhancing ethical behaviour among the auditors. Top management monitoring and enforcement on the ethical guidelines and standards is expected to create a high ethical environment within the audit firms. Hence, it enhances auditors' sensitivity towards ethical issues which would influence them to form more ethical judgements when faced with ethical dilemmas. Although ethical sensitivity of the issue would influence ethical judgements, audit firms may be able to create an environment to enhance ethical understanding among auditors by making a favourable ethical climate within the firms.

The study has several limitations when interpreting the findings. Firstly, the experimental case materials provide participating auditors with a limited amount of information about the ethical issues to make judgements. In an actual work setting, auditors have access to more information that may influence their perceptions on the issues when making judgements. Secondly, participants are mostly audit juniors with less than three years audit experience. Results may reflect ethical judgements of junior auditors which may be different from judgements of more auditors with more experience. Prior study support that experience has a significant effect on the auditors' judgement (Bennie & Pflugrath, 2009; Pflugrath, Martinov-Bennie & Chen, 2007).

In spite of the above limitations, this study offers a few important opportunities for future research. First, the use of more ethics scenarios allows a more robustness measurement of ethical judgements representing other dimensions of ethics as specified in ISQC 1 which include acceptance

and continuance of client relationships, specific engagements, human resource and engagement performance. Secondly, future research may examine individualities other than ethical sensitivity such as locus of control and experience in order to understand their impacts on ethical judgements. The interaction between these other individual characteristics with ethical environment may be examined in order to obtain a more in-depth of auditors' ethical judgements. Lastly, a comparative study on the impact of ethical environment in countries with different ethical climates and cultures may enhance the understanding on auditors' ethical judgments.

Some practical implications of this study include the appreciation of the enforcement of ISQC 1 on audit firms in Malaysia in enhancing the ethical environment. It is important that audit firms are aware on the expected increase of ethical behaviour among auditors after the adoption of ISQC 1. ISQC 1 provides the monitoring mechanism on the implementation of code of ethics and compliance level among the auditors. Partners of audit firms are responsible to ensure that auditors act in accordance with the code of professional conduct and other relevant standards on ethics in performing their audit tasks. Results of this study corresponds with that (Bennie & Pflugrath, 2009; Pflugrath, Martinov-Bennie & Chen, 2007) on the positive impact of ISQC 1 on the quality of audit judgements.

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