The Impact of Ethical Leadership and the Internal Audit Function on Financial Reporting Decisions

Barbara Arel
Accounting Faculty
School of Business Administration
University of Vermont
Burlington, VT 05405
Phone: 802.656.5478
Fax: 802.656.8279
E-mail: Barbara.Arel@uvm.edu

Cathy A. Beaudoin
Accounting Faculty
School of Business Administration
University of Vermont
Burlington, VT 05405
Phone: 802.656.0313
Fax: 802.656.8279
E-mail: Cathy.Beaudoin@uvm.edu

Anna M. Cianci*
Schools of Business
Wake Forest University
Winston Salem, NC 27109
Phone: 336.758.4297
Fax: 336.758.6133
E-mail: cianciam@wfu.edu

*Corresponding Author

The Impact of Ethical Leadership and the Internal Audit Function
on Financial Reporting Decisions

ABSTRACT

Two elements of corporate governance—the strength of ethical executive leadership and the internal audit function (IAF hereafter)—provide guidance to accounting managers making decisions involving uncertainty. We examine the joint effect of these two factors, manipulated at two levels (strong, weak), in an experiment in which accounting professionals decide whether to book a questionable journal entry (i.e., a journal entry for which a reasonable business case can be made but there is no supporting documentation). We find that ethical leadership and the IAF interact to determine the likelihood that accountants book the entry. Specifically, accountants are less likely to book a questionable journal entry when there is a weak ethical leader and a strong IAF compared to all other conditions. These results suggest that the IAF has a different impact on financial reporting decisions depending on the ethicalness of executive leadership and that a strong IAF may have certain unintended consequences (such as increasing the likelihood of booking an undocumented journal entry) when combined with strong ethical leadership. We also find that the interactive effect of ethical leadership and the IAF on an accountant's decision is fully mediated by their perception of the moral intensity of the issue. Thus, accountants, who perceive greater moral intensity associated with booking the entry, are less willing to do so.

KEY WORDS: ethics in accounting, moral intensity, ethical leadership, moral action, internal audit function, financial reporting

Introduction

Many accounting decisions involve uncertainty and tradeoffs between potentially correct alternatives. For example, some managers may be more conservative when estimating GAAP revenue using the percentage of completion method, while others may be less conservative. When presented with such decisions, accounting managers will often seek guidance. At times, guidance may come from organizational factors such as executive management or the internal audit function (IAF hereafter). These two internal organizational factors along with two external organizational factors (i.e., external auditors and the audit committee) comprise the four cornerstones of corporate governance that help ensure effective internal control and reliable financial reporting (IIA 2005). Executive management sets the overall "tone at the top" for the organization and acts as a role model for employees to emulate. For instance, if accountants are presented with a decision to record a questionable journal entry (i.e., an entry for which a reasonable business case can be made for either booking it or not booking it), they may emulate executive management's behavior, especially if such behavior is the social norm and has been rewarded in the past (Mayer et al. 2009). In addition, a high quality IAF can reinforce the tone at the top and provide guidance for decision makers by monitoring internal control and management's actions. For instance, accountants may hesitate to record a questionable journal entry if they know that internal audit is likely to detect inappropriate financial reporting practices (Prawitt et al. 2009).

In this paper, we examine how the strength of executive ethical leadership and the IAF jointly influence accounting managers' decision to book a questionable journal entry (i.e., a journal entry for which a reasonable business case be made that it is needed but for which there is no supporting documentation). For purposes of this study, ethical leadership is defined as the

type of actions an executive takes to encourage or discourage an ethical work environment (i.e., Brown et al. 2005) as opposed to an assessment of the executive's own ethical decision-making process. Experienced accountants participated in an experiment in which the quality of the chief financial officer's ethical leadership and that of the IAF are both manipulated at two levels (strong, weak). Participants assigned to the role of assistant controller indicated the likelihood that they would book a journal entry when requested to do so by their immediate manager (i.e., the controller) and assessed the moral intensity of this decision.

Our results indicate that ethical leadership and the IAF jointly influence accountants' decisions. Specifically, accounting professionals were less willing to book a questionable entry when there was a strong IAF and a weak ethical leader compared to all other conditions (i.e., when there was a strong IAF and a strong ethical leader or when there was a weak IAF and a weak or strong ethical leader). The former case suggests that while a strong IAF function is charged with ensuring both the accuracy of financial reporting and compliance with internal control procedures, the presence of a weak ethical leader in such an environment may cause accountants to question the appropriateness of the journal entry, thereby focusing on compliance with internal control procedures in the financial reporting process. On the other hand, accounting professionals in all other conditions focused more on the accuracy of financial reporting (rather than compliance with internal controls) because (a) with a strong ethical leader, the IAF appears to create a trusting environment whereby accountants are more willing to ignore process and compliance concerns and focus instead on the accuracy of the financial reporting process; and (b) a weak IAF creates an environment in which participants are not concerned about being monitored and are thereby more willing to go along with his/her superior and book a questionable entry, regardless of the ethicalness of executive management.

In addition, we find that the joint influence of ethical leadership and internal audit quality on accountants' willingness to book a questionable accrual entry is fully mediated by participants' perception of the moral intensity of the issue. Specifically, a strong IAF and weak ethical leadership combine to alter accountants' perception of the moral intensity of the issue. As a result, accounting professionals who perceive greater moral intensity associated with the controller's request are less willing to book the questionable journal entry. Apparently, when participants perceive the request by the controller to be more morally questionable, they are less likely to go along with it.

This study contributes to the literature in at least three ways. First, we provide evidence of the joint influence of ethical leadership and internal audit quality on accounting decisions. Prior research has considered the influence of these organizational factors independently (e.g., Merchant and Rockness 1994; Douglas et al. 2001; Prawitt et al. 2009) but no study has examined their joint influence on accounting decisions. Our results suggest that consideration of either factor independent of the other may be potentially misleading. Second, we utilize an ethical dilemma to show that accountants make trade-offs between financial statement accuracy and the need to comply with internal controls. Our findings indicate accountants are willing to sacrifice compliance with internal controls and focus on financial statement accuracy when the control environment is strong and fosters trust but focus on the internal control process when it is not. Third, we extend the ethical decision making model research (Jones 1991) by identifying moral intensity as the underlying factor driving the joint influence of ethical leadership and internal audit quality on financial reporting decisions. While prior research has examined the role of moral intensity on the ethical decision-making process in accounting (e.g., Wright et al. 1997; Leitsch 2004; Taylor and Curtis 2010), it has not identified mediators of this influence. Our

results suggest that ethical leadership and internal audit quality significantly influence the participants' perceptions of moral intensity, thereby affecting their accounting decisions. The rest of the paper is organized as follows. The next section reviews relevant literature and presents our hypotheses. In the subsequent sections, we describe our research method and present our results. We conclude by discussing the implications and limitations of our research and offering suggestions for future research.

Literature Review and Hypotheses Development

Ethical decisions are not made in isolation and situational factors such as job context, organizational culture, and characteristics of the work itself have been shown to impact the ethical decision making process (Trevino 1986). Two organizational factors—executive management and the IAF—are important components of corporate governance, the purpose of which is to support strong internal control (COSO 1992) and reliable financial reporting (IIA 2005). While prior research has studied the ethical reasoning process in an accounting context,[1] only a small subset of that research considers the influence of either ethical leadership or the IAF and we are not aware of any research that has examined the joint effect of both factors on ethical reasoning. In the subsequent sections, we review the prior research on these issues.

Ethical Leadership

Through actions and policies, executives create a tone at the top that shapes the ethical culture and climate within an organization (e.g., Sweeney et al. 2010; Victor and Cullen 1988; Trevino et al. 1998) and significantly influences financial reporting decisions (D'Aquila 1998). In a review of the financial reporting system, The Treadway Commission (1987, p. 32) found that the "tone set by top management—the corporate environment or culture within which the financial reporting occurs—is the most important factor contributing to the integrity of the

financial reporting process." Research results seem to support the findings of the Treadway Commission. In a survey of CPAs, D'Aquila (1998) concludes that a tone at the top of an organization that fosters ethical decisions has a significant impact on financial reporting decisions. Research on management accountants shows that corporations with top managers who are concerned with ethical values are less likely to pressure employees to materially alter financial results (Lamberton et al. 2005). Merchant and Rockness (1994) survey accounting managers and find that managers from a company with weak ethical leadership (i.e., a major fraud incident had just occurred) rated earnings management scenarios differently than managers from an organization with stronger ethical leadership. The influence at the top can also be found in accounting firms. For example, research shows that the ethical culture of the firm influences the judgments of auditors regarding independence and confidentiality issues (Douglas et al. 2001) and premature sign-offs on the workpapers and time underreporting (Sweeney et al. 2010).

Social learning theory suggests that setting the tone at the top will inspire individuals within the organization to emulate the behavior of attractive role models like ethical leaders (Bandura 1977, 1986). Utilizing social learning theory, research suggests that ethical leadership trickles-down from the top level of management, to immediate supervisors, and ultimately to employees (Mayer et al. 2009). For the financial reporting process, this trickle down impact is important because it means that by setting the tone at the top, ethical leaders can influence the reporting behavior of not only management but also of those employees making the day-to-day decisions and journal entries like assistant controllers or accountants.

Internal Audit Function

The role of IAF is to evaluate and monitor the effectiveness of a company's internal control system (Kaplan and Schultz 2007). Through this monitoring role, the IAF helps a

company achieve its objective of reliable financial reporting by scrutinizing the actions of management and acting as a deterrent to aggressive financial reporting (Prawitt et al. 2009). The IAF also provides assurance on the effectiveness of internal control (i.e., ensuring all transactions are supported by proper documentation) through its periodic evaluation and test of controls and day-to-day oversight of management activities.

There has been limited research on the association between the IAF and decisions made in the financial reporting process. Schneider and Wilner (1990) determine that the presence of an IAF is a deterrent to financial reporting irregularity in the case of an unambiguous potential GAAP violation (i.e. a material write down of inventory to the lower of cost or market value). Asare et al. (2008) found that internal auditors are sensitive to, and adjust their audit plans in response to, changes in management performance incentives which can influence management's reporting intentions. However, Davidson et al. (2005) suggest that the voluntary establishment of an IAF did not lead to a significant reduction in the level of discretionary accruals. Thus, while the findings from Asare et al. (2008) suggest the IAF can influence the financial reporting process in unambiguous situations, Davidson et al. (2005) suggest that internal audit does not necessarily improve performance measured by discretionary accruals. Prawitt et al. (2009) shed light on this apparent contradiction by showing that IAF *quality*, and not just the *presence* of an IAF, is associated with a moderation in the level of earnings management and, therefore, plays an important role in the financial reporting process.

Hypotheses Development

Expanding on the prior research, we investigate how the combination of IAF quality and ethical leadership work together to create a control environment that can influence an accountant faced with a decision to book a questionable journal entry. Since the strength of the IAF and

ethical leadership are integral components of internal control, we are interested in examining how these two factors combine to influence an accounting decision.

Ethical dilemmas are common for lower level employees in a business (Hodge et al. 1998) as those employees are frequently asked to follow the instructions of their superiors. Some of the recent highly publicized corporate failures such as Enron and HealthSouth involved lower-levels employees booking questionable journal entries at the request of their superiors (e.g., McLean and Elkind 2003; Beam and Warner 2009). In the HealthSouth case in particular, a combination of questionable ethical leadership and an ineffective IAF appears to have contributed to employees' reluctance to question management's financial reporting decisions. Specifically, recorded testimony by a HealthSouth employee indicated the "tone at the top" sent a clear message to not question management on financial reporting decisions (Rittenberg et al. 2010), and HealthSouth's IAF was too weak to be effective (Beam and Smith 2010).

Given the importance of lower level employees in business decision making, we focus on the influence of the IAF and ethical leadership on the decision making of a mid-level accountant, an assistant-controller, who is asked by the controller to record a questionable journal entry. The journal entry request is questionable or ethically charged in that a reasonable business case can be made for the entry but there is no supporting documentation for it. Thus, while the assistant-controller may be able to legitimately justify that an entry is needed in order to ensure that the financial statements represent the economic substance of the business activity for the accounting period, s/he may be hesitant to book a journal entry because of the lack of documentation. We refer to the former focus as an "accuracy focus" and defined it as one in which the accountant is primarily concerned about accurately reflecting the potential for unbilled expenses. We term the latter focus as a "process focus" and define it as one in which the accountant's primary concern

is related to compliance with company rules and professional protocol of processing only journal entries that have appropriate documentation.

We propose that the strength, or quality, of the IAF will contribute to a distinctly different control environment depending on the strength of the ethical leadership in an organization. In order to understand why this might happen, we need to think about the dual role of the IAF in an organization as a promoter and supporter of both accuracy and process. The IAF serves as an independent party to help ensure that internal control over financial reporting and the corporate governance process are effective (i.e., process objective) in ultimately producing accurate financial results (i.e., accuracy objective). Whether an accuracy or process focus is primary in the organizational environment depends on the joint effect of the IAF and ethical leadership. Specifically, if an employee is aware that the IAF is strong, then a superior's request to book a questionable journal entry may be interpreted by the subordinate differently, depending on whether executive management's ethicalness is weak or strong. With a strong IAF and weak ethical leadership, lower-level employees may adopt a process focus, feeling the request to book a questionable entry is less ethical and contrary to internal control procedures indicating that booking journal entries requires appropriate supporting documentation. Thus, employees with a process focus may be less likely to follow the instructions of a weak ethical leader, especially when they know that a strong IAF will be monitoring their actions. Alternatively, when there is a strong IAF and strong ethical leadership, lower-level employees may adopt an accuracy focus, feeling that the request to book a questionable entry is acceptable because the leader is trustworthy. With a strong IAF and strong ethical leadership, the request is viewed as contributing to accurate financial reporting. Likewise, an accuracy focus is adopted when the

IAF is weak regardless of the strength of ethical leadership because there is no sense that supporting a process focus is critical to the entity's financial reporting operation.

Accordingly, we propose the following hypothesis:

> H1: In an environment with a strong IAF and weak ethical leader, accountants will be less willing to make a questionable journal entry than in all other conditions. Specifically, accountants will be less willing to make a questionable entry when there is a strong IAF and a weak ethical leader than when there is either a weak IAF regardless of the strength of ethical leadership or a strong IAF and a strong ethical leader.

Moral Intensity

Jones (1991) suggests that moral issues vary in their moral intensity. If there is no variation in the moral intensity of an issue, all moral issues are perceived as having the same exact impact (i.e., a $10 misstatement on an expense report is viewed with the same moral intensity as a $1 million misstatement on an audited financial statement). Jones identifies six components of moral intensity: the magnitude of consequences, social consensus, probability of effect, temporal immediacy, proximity, and concentration of effect. Moral intensity has been found to affect the ethical decision-making process in both a general business and accounting context (e.g., Ng et al. 2009; Waldron 2010).

Jones (1991) clearly states that moral intensity focuses on the issue, not the person or the organizational context. However, it is our contention that organizational context can influence employees' perception of the moral intensity level of any given issue. For example, in considering the magnitude of consequences (one of the components of moral intensity), Jones suggests that many moral issues are trivial in terms of their consequences. However, it is also likely that what is trivial in one organizational context may not be trivial in a different organizational context. For instance, when there is a strong IAF or strong ethical leadership, an issue may be perceived as non-trivial but when there is a weak IAF or weak ethical leadership,

the same issue may be perceived as trivial. In considering social consensus (another component of moral intensity), Jones (1991) argues that it is difficult for people to know what good ethics are in a given situation without looking to others to understand what is considered acceptable ethical behavior. Again, it seems logical that two differing organizational environments (such as one with strong IAF versus a weak IAF) will produce two differing social consensus assessments of the same ethical issue.

In considering the probability of effect (the third component of moral intensity), Jones states that the expected consequences are a product of the magnitude of the consequences, the probability of harm taking place, and the probability the action will cause the harm predicted. Since we believe that organizational context can influence the magnitude of consequences, by definition, it must also influence the probability of effect. As for temporal immediacy (the fourth component of moral intensity), Jones argues that people discount the impact of events that occur in the future. The longer people perceive the time between the act and the consequences, the greater the discount for the impact of the action. We contend that different work environments may create differing perceptions of temporal immediacy. For example, if there is a weak ethical leader, employees may perceive the consequences of their actions to be more distant than when there is a strong ethical leader.

Give the rationale described above that organizational context may influence the various components of moral intensity, we contend that the joint impact of ethical leadership and the IAF operates through the perceived moral intensity of the decision. We reason that the combination of weak ethical leadership and a strong IAF signals a heightened state of ethical concern when management requests an employee to engage in a questionable action. For example, we expect that with a strong IAF, weak ethical leadership increases employees' concern for and their

sensitivity to the magnitude of consequences and social consensus associated with questionable activities like booking an undocumented journal entry. Thus, it is possible that when there is a weak ethical leadership, a strong IAF can heighten one's sensitivity to the effects that one's actions has on others. The combined influence of ethical leadership and internal audit quality on the accountant's decision to book the entry may operate through their impact on the accountant's evaluation of the moral intensity of the ethical dilemma. Accordingly, we expect that managers' perception of the moral intensity of the issue itself will mediate the effect of ethical leadership and internal audit quality on the accountant's decision to book the entry (see Figure 1). The above discussion leads to the following hypothesis:

> H2: Assessments of moral intensity will mediate the interactive effect of ethical leadership and the IAF on the decision to book a questionable journal entry.

[Insert Figure 1 here]

Methodology

Participants

Participants were 78 experienced accountants (12 financial executives, 54 financial managers, and 12 financial staff) with an average of 21.65 years of professional work experience.[2] As our experiment asks participants to assume the role of an assistant controller at a company, it was important that we selected experienced accountants who are familiar how financial reporting decisions are made at these companies. Participant demographic data is presented in Table 1.

[Insert Table 1 here]

Design and Independent Variables

To test our hypotheses, we conduct an experiment requiring participants to make a decision regarding whether or not they will book an accrual as requested by their controller in which the two variables of interest—ethical leadership and IAF strength—are both manipulated at two levels, strong and weak. In our scenario, the controller indicates that the entry will be for expenses which may have been incurred but not yet reported to the accounting department. The assistant-controller is also told that analytical procedures reveal that consulting expenses were properly accrued for at the prior year-end but under-accrued for each of the prior three quarters. Thus, the assistant-controller is faced with the following ethical dilemma: book the entry without adequate documentation because the accuracy of the financial statements is at risk (i.e., accuracy focus), or not book the journal entry because compliance with documentation requirements is the more appropriate action to take (i.e., process or compliance focus).

Our first manipulated independent variable is ethical leadership. Brown et al. (2005) propose, and validate, an ethical leadership construct that includes the components of demonstrated integrity and high ethical standards, considerate and fair treatment of employees, and holding employees accountable for ethical conduct. We use these components to describe our ethical leader, the chief financial officer (CFO). In the *strong ethical leadership* condition, employees trust the CFO as someone who treats people fairly, the CFO is vocal about the importance of making ethical decisions, demonstrates ethical values with actions, and, when confronted with difficult accounting decisions, asks: Is this "the right thing to do?" In the *weak ethical leadership* condition, employees do not trust the CFO as someone who treats people fairly, the CFO is seldom vocal about the importance of making ethical decisions, does not

demonstrate ethical values with actions, and, when confronted with making difficult accounting decisions, asks: Is this "getting us the financial results we want?"

Our second manipulated independent variable is the strength or quality of the IAF. We manipulate this variable at two levels—strong, weak—by altering the reporting relationship of the IAF, the primary role (i.e., assurance or consulting) of the IAF, and the quality of the IAF's work (i.e., its history of finding internal control deficiencies). Prior research suggests that the external auditing standards (i.e., SAS No. 65 and PCAOB Auditing Standard 5) can be used to evaluate quality in terms of internal audit competence, objectivity, and quality of work performance (AICPA 1997; PCAOB 2007). Competence is often measured in terms of experience, training, and certification of the internal auditors (Gramling and Myers 1997). Objectivity is often assessed using the reporting relationship of the IAF within the company (Messier and Schneider 1988) and the primary role of the IAF within the company (i.e. assurance or consulting) (DeZoort et al. 2001). An IAF that is more independent of management (i.e., reports to the audit committee instead of the chief financial officer) is thought to be more objective (Kaplan and Schultz 2007). Similarly, an IAF that primarily performs assurance activities is perceived to be more objective than one that primarily performs consulting activities (DeZoort et al. 2001). Along with objectivity and competence, the external auditing standards require external auditors to assess the quality of work performed by the IAF. Output measures such as indicators of internal audit work performance quality (i.e., history of finding internal control deficiencies) are helpful in assessing internal audit quality (Gramling and Hermanson 2009). Finally, an IAF that reports to the audit committee and primarily performs oversight and monitoring activities and has a history of finding deficiencies in internal control is expected to be of higher quality as they are more likely to discover and report areas of accounting manipulation.

Accordingly, in the *strong internal audit function* condition, participants are told the IAF reports directly to the audit committee. They are also told the chief executive officer establishes the internal audit budget and makes hiring and firing decisions for the unit and that the IAF has historically spent approximately 90% of its time on oversight and monitoring activities and 10% on management consulting activities. Finally, participants in this condition are told the IAF has a history of finding deficiencies in internal control over financial reporting. In the *weak internal audit function* condition, participants are told the IAF reports directly to the chief financial officer. They are also told the CFO establishes the internal audit budget and makes hiring and firing decisions for the unit and that the IAF has historically spent approximately 30% of its time on oversight and monitoring activities and 70% on management consulting activities. Finally, participants in this condition are told the IAF has a history of missing deficiencies in internal control over financial reporting.

Dependent Variables

Two dependent variables are used in this study, one to test Hypothesis 1 and the other to test Hypothesis 2. The dependent variable for Hypothesis 1 is the participants' likelihood that they would book a questionable entry as requested by the controller. Participants indicated this likelihood on a six-point scale (1 = "very unlikely" and 6 = "very likely"). The dependent variable for Hypothesis 2 is a measure of moral intensity. Please recall that moral intensity consists of six components: magnitude of consequences, social consensus, probability of effect, temporal immediacy, proximity, and concentration of effect (Jones 1991). To measure the moral intensity of the issue in this case, we utilize portions of the perceived moral intensity measures and scale adopted by McMahon and Harvey (2006) (see Appendix A).

Procedures

We provided participants with a research instrument containing two sections: a decision task associated with recording an accrual at the request of the controller and a post-experimental and demographic questionnaire. In the context of the study, participants are asked to assume the role of an assistant-controller (i.e., lower level employee) in a hypothetical company and are told they are satisfied working for that company. They are also informed that the company is financially strong, stable, and strategically well-positioned and has steadily increased profits and met or exceeded analysts' expectations. Given this scenario, participants are then informed that the controller would like them to book a $3 million year-end expense accrual entry. They are also provided financial information that indicates the latest operating income projection ($205 million), the revised operating income projection if the entry is made ($202 million), and the analysts' forecast for operating income ($201 million).

Participants are also told that the controller has no invoices or other paperwork to support the accrual request and that the controller's response to further inquiry regarding the nature of the accrual is that "we will eventually find out someone has expenses they haven't told us about; it happens all the time." Participants are told they have a good working relationship with the controller. Finally, participants are advised further analytical procedures reveal that consulting expenses had been properly accrued at the prior year-end but the consulting expenses were under-accrued for each of the prior three quarters. After considering the case information, participants recorded the likelihood that they would book the entry as requested by the controller and responded to several post-experimental and demographic questions.

Results

Manipulation Checks and Potential Covariates

After completing the case, participants answered two manipulation check questions. The first question asked whether the CFO was ethical or unethical, and the second question asked participants about the quality of the IAF. Eighteen out of 109 participants were dropped for not properly identifying whether the CFO in their case was an ethical or unethical leader, not properly identifying whether the IAF in their case was strong or weak, or not properly identifying both.

To determine whether any background measures should be included as covariates in the hypothesis testing, these measures were correlated with the two independent variables and with participants' indication of how likely they were to book the questionable entry. Untabulated results show four background measures, number of years working for a public company, number of years of external audit experience, number of years of internal audit experience, and familiarity with accruals were all significantly correlated with our dependent variable. After conducting tests to see which of these four variables retained significance when entered into our main model, two variables, number of years of internal audit experience and familiarity with accruals, retain significance and are thus added as covariates to our models. However, not all participants who indicated they had internal audit experience provided a measure for the number of years of experience. Thus, 13 additional participants were dropped from the sample, resulting in a total sample size of 78 experienced accountants.

Tests of Hypotheses

Hypothesis 1 is tested using contrast coding that compares the dependent variables (i.e., the likelihood of booking an entry as requested by the controller) in the weak ethical leadership

and strong IAF condition to the other three conditions. For the specific pattern we expect, a weight of +1 was assigned to each of the cells with a weak IAF and the cell with a strong ethical leader and strong IAF; a weight of -3 was assigned to the cell with a weak ethical leader and a strong IAF.

[Insert Table 2 here]

Hypothesis 1 predicts accountants will be less willing to make a questionable entry when there is a strong IAF and a weak ethical leader than when there is either a weak IAF regardless of the strength of ethical leadership or a strong IAF and a strong ethical leader. Participants recorded their decision regarding how likely they were to book a questionable entry on a six-point scale (1 = "very unlikely" and 6 = "very likely"). A separate, untabulated ANOVA revealed that the interactive effect of IAF and ethical leadership was significant (p-value < 0.05). As reported in Table 2, the contrast is also significant, thus supporting Hypothesis 1. As shown in Table 2, Panel A, experienced accountants are least likely to book a questionable journal entry when there is a weak ethical leader and a strong IAF compared to all other conditions (i.e., when there is either weak IAF or a strong ethical leader and a strong IAF). These results suggest that when the IAF is strong, its influence on employees' accounting decisions depends on the strength of the ethical leadership, but when the IAF is weak, the strength of the ethical leadership does not matter.

The results of Hypothesis 1 show a significant contrast between weak ethical leadership and a strong IAF compared to all other conditions (i.e., strong ethical leadership and a strong IAF or weak IAF regardless of the strength of ethical leadership). In Hypothesis 2, we contend that perceived moral intensity of the issue will determine the interactive effect of ethical leadership and the IAF on a financial reporting decision. Recall that we utilize the perceived

moral intensity measures and scale adopted by McMahon and Harvey (2006). Because of the nature of the scale used for these questions, a lower moral intensity score reflects a greater recognition of the issue as involving ethical dilemma. As reported in Table 3, Panel A, participants viewed the moral intensity of the issue different based on the combination of ethical leadership (strong/weak) and strength of the IAF (strong/weak). A separate, untabulated ANOVA revealed that the interactive effect of IAF and ethical leadership on moral intensity was significant (p-value < 0.04). Finally, contrasts tests show that those participants with weak ethical leadership and strong IAF are the most sensitive to viewing this issue as an ethical dilemma (mean = 33.00) compared to participants in the other three conditions (p-value = 0.02).

According to Baron and Kinney (1986), four conditions are necessary to establish mediation (a) the independent and dependent variables must be significantly related; (b) the independent and mediating variables must be significantly related; (c) the mediator and dependent variable must be significantly related; and (d) the relationship between the independent variable and dependent variable should be insignificant (i.e., full mediation) or weaker (i.e., partial mediation) when the mediator is added. We first perform the appropriate contrast test comparing those in the weak ethical leadership and strong IAF condition to those in all other conditions (i.e., the weak IAF conditions and the strong ethical leadership and strong IAF condition). As in the test of Hypothesis 1, participants' experience as an internal auditor and their familiarity with accruals are added as covariates in the model. As shown in Table 3 Panel B, the model contrast is significant with participants' composite score for moral intensity (the mediator) as the dependent variable ($p < 0.05$, one-tailed), thus satisfying the second condition of the mediation test. Correlation tests show that the dependent variable is significantly correlated with the potential mediating variable, thus satisfying the third condition. And finally, when the

mediating variable, participants' composite moral intensity score, is added to the initial contrast test as a covariate, the results (presented in Table 3 Panel C) show that the covariate for composite moral intensity score is significant ($p < 0.001$, one-tailed) and the contrast itself is no longer significant.

[Insert Table 3 here]

Supplementary Analyses

Our results suggest that when there is a weak ethical leader coupled with a strong IAF, there is evidence that lower-level employees do, in fact, adopt a process focus rather than an accuracy focus. That is, it appears that the accountant is not just willing to "go along" with his/her immediate supervisor since the strong control environment will monitor such actions closely. Thus, process becomes very important. Conversely, the evidence suggests participants adopt an accuracy focus when there is a strong IAF combined with a strong ethical leader. In this case a combination of factors leads participants to trust their supervisor's request to book the journal entry, taking comfort that the control environment will monitor and support procedures. Finally, our evidence suggests an accuracy focus is adopted by those in the weak IAF condition, since participants here are not concerned about adhering to a process focus, given the lax control environment. In such a setting, participants will opt to go along with their supervisor's request.

The notion that a strong IAF has a different influence on the environment depending on the strength of ethical leadership is supported by participants' responses to three specific questions in the experimental questionnaire.[3] Since our main analysis provides support for the form of the interaction between the IAF function and ethical leadership, we focus our discussion on the results of the contrast tests for the responses to those three questions. First, when asked if the entry is appropriate given the current financial projections and the controller's concern for

unbilled expenses, untabulated results show participants in the condition combining the strong IAF with weak ethical leadership report statistically significant lower mean response (mean = 3.42) than those in any of the other three conditions (all means > 4.38) (t = 2.83, p-value < 0.01, two-tailed). This suggests that the process focus is greater in the former condition compared to the other three conditions. Additional evidence supporting the conjecture that participants have a different orientation toward a process versus an accuracy focus is provided by the responses to the second question. Specifically, when participants are asked if the controller's request was unethical (i.e., is it the "right thing to do"), untabulated results show the response for participants in the condition with weak ethical leadership and strong IAF (mean = 5.11) is significantly higher than the response for participants in any of the other three conditions (all means < 3.81) (t = -3.44, p-value < 0.01, two-tailed). Finally, untabulated results show that when asked if it is the assistant-controller's responsibility to make sure only journal entries with appropriate documentation are booked, those in the condition combining the strong IAF with weak ethical leadership report higher mean responses (mean = 6.21) than those in the condition combining strong IAF with strong ethical leadership (mean = 5.46; p-value = 0.02). These results suggest that when there is a strong IAF, process is more important than accuracy when there is a weak ethical leader than when there is a strong ethical leader. Overall, this evidence suggests that when there is a weak ethical leader and a strong IAF, the perception of the request to book a questionable journal entry is viewed differently (i.e., less ethical) than for those in the other conditions.

Discussion and conclusions

This study provides evidence on the joint influence of IAF and ethical leadership on an ethically charged accounting decision. While prior research has examined the effects of the IAF

and, to a lesser extent, ethical leadership on accounting decisions (e.g., Merchant and Rockness 1994; Douglas et al. 2001; Prawitt et al. 2009), research to date has not considered the *joint* effect of these factors on such decisions. In addition, prior accounting research has often focused on the economic incentives for the behavior (e.g., Healy 1985; McVay 2006; Cohen et al. 2007), and has focused relatively less attention on, for instance, organizational factors. Consistent with the findings in organizational research, this paper shows that there is a significant joint influence of organizational attributes—specifically, ethical leadership and the internal audit function—on accountants' decision making. That is, participants are least likely to book a questionable journal entry when there is a weak ethical leader and a strong IAF compared to all other conditions (i.e., when there is either weak IAF or a strong ethical leader and a strong IAF). These results suggest that the IAF has a different impact on financial reporting decisions based on the strength of the ethical leadership in place in an organization and that a strong IAF may have certain unintended consequences (such as increasing the likelihood of booking an undocumented journal entry) when combined with strong ethical leadership.

The current study also provides evidence of the effect of the moral issue itself on accounting decision making. While some accounting research has validated the components of the Jones (1991) model in an accounting context (Merchant and Rockness 1994; Leitsch 2004), prior research has not documented the triggers for this mechanism. Our results suggest that accountants will make financial reporting decisions in response to the IAF and ethical leadership differently depending on the perceived moral intensity of the issue involved. That is, moral intensity mediates the interactive effect of the IAF and ethical leadership.

Many judgments that accountants make in the course of compiling financial reports are often differentially "ethically charged" in that they often are perceived as more or less morally

intense (Elias 2002; Belski et al. 2008), even though they may be somewhat ambiguous in terms of having a right/wrong course of action (Graham et al. 2005). For instance, an accountant would not view the release of fraudulent financial statements by her firm with the same alarm (or lack of alarm) that she viewed a slight over-accrual of expense at the end of the reporting period. In contexts in which the moral intensity of ethical decisions is high, ethical leadership and the role of the IAF may send a completely different signal to an employee depending on the strength of that leadership. The results presented here suggest that an assessment of moral intensity and its relevance in a particular situation is necessary to accurately model the financial reporting decision process. Indeed, consistent with the issue-contingent results presented here, the relative importance and perception of personal factors and situational factors might vary considerably, from issue to issue, thereby affecting the recognition of moral issues and, hence, the decision making process.

Many of the elements of moral intensity (magnitude of consequences, probability of effect, temporal immediacy, and concentration of effect) are related to the perceived importance of moral issues. It may be that people generally behave differently when the moral issue is important than they do when it is unimportant. The results here suggest that accountants' responses to factors surrounding the issue—IAF and ethical leadership—are filtered through the accountants' perception of the moral intensity of the issue. Specifically, the more moral intense the issue is perceived to be, the less willing accountants are to book the entry. Thus, accountants' perception of the moral intensity of the issue fully mediates the interactive effect of the IAF and ethical leadership. Given this significant mediating effect of moral intensity, factors that influence perceptions of moral intensity ought to be considered in subsequent research on ethical decision making.

While prior research has focused on supervisor-direct report relationship to measure the impact of ethical leadership (Brown et al. 2005), our research focuses on an indirect relationship between the decision maker and his/her more distance superior—specifically, the influence of a somewhat distant superior (i.e., CFO) on a mid-level accountant in the organization. Our results indicate that an ethical leader can exert influence on the decision making of lower level employees (such as an assistant controller) even when such leader is not the employee's immediate supervisor, thus providing further evidence of the importance of "tone at the top." In addition, since lower level employee interaction with executive management is often minimal, inferences made about the ethicalness of such leaders are likely to be derived from public or organizational level information (e.g., corporate social responsibility or malfeasance) rather than direct experience (Lord and Maher 1991). If this is the case, perceptions of executive ethical leadership may be managed via broad-based or organizational-level efforts at image management. Future research could examine whether the results presented here are malleable to broad image management techniques such as business press releases or company-wide newsletters, for instance, publicizing company initiatives to increase ethical decision making or depicting organizational leaders as ethical, attractive, credible, and legitimate role models who have altruistic motives and create just work environments. In this way, the ethical salience of a decision can be reinforced, thereby contributing to ethical outcomes.

The current study finds that the joint effect of a strong IAF and weak ethical leadership is to reduce discretionary accruals. This is somewhat counterintuitive if one's a priori perspective is that making discretionary accruals is similar to managing earnings and, therefore, an undesirable and unethical behavior. However, like most decisions in the real-world, the accounting decision presented here is ambiguous, its outcome is not clearly determinable as "right" or "wrong," and

professional judgment is required. In such decision settings, the surrounding circumstances—such as standards of practice, ethical guidance from the profession, organization and its leaders—inform one's perception of the appropriate course of action. The results here suggest that the organizational factors of the IAF and ethical leadership (even distant leadership) are jointly effective at altering how ill-defined tasks are perceived and, thereby, influencing task outcomes. Future research could investigate whether these results would generalize to other decision situations including more structured and clearly defined (un) ethical tasks or behaviors (such as, for instance, employee theft).

While the focus of the current study was on the joint *consequences* of ethical leadership and the IAF, questions of how ethical leadership develops (i.e., what are its *antecedents*) are equally important. Future research could examine the temporal nature of the development of ethical leadership. Are ethical leaders born or can an organization develop them? For instance, how do the career tracks available to accountants (i.e., long-term public accounting track or short-term public accounting track coupled with industry experience) impact the development of ethical leadership skills in finance executives? If they are born, can ethical leadership be predicted based upon some dispositional characteristic(s) such as one of the Big Five personality dimensions (e.g., McCrae and John 1992)? Alternatively (and not necessarily mutually exclusively), if ethical leadership can be developed, what training, education and experience are effective in such development? Perhaps working in a highly ethical organization and with highly ethical superiors, subordinates and peers may contribute to development and persistence of ethical leadership.

The results of this study should prove interesting to several parties. Companies and their audit committees should consider the quality of their IAF and be aware that a strong IAF has a

different impact when coupled with other organizational factors such as ethical leadership. Likewise, board of director members should be aware that when the IAF is weak, ethical leadership does not appear to influence decisions made in the financial reporting process. In addition, internal audit standard-setters could consider these findings in their deliberations regarding the potential role of internal auditing in affecting the influence of other organizational factors (like ethical leadership) on financial numbers that are reported externally. The SEC, managements of stock exchanges, and other groups interested in corporate governance processes may also find it helpful to more explicitly consider the dual role of internal auditing on process and outcome/accuracy along with its interactive influence with executive management on financial reporting. For instance, external auditors who have a high reliance on internal auditors because they assess the IAF function as strong should be aware that the strength of ethical leadership can still have a major influence on whether accounting professionals pursue a process or accuracy focus in the financial reporting function. Finally, auditing standard-setters who have focused on internal audit quality in external auditing standards may consider the joint effects of this corporate governance factor in conjunction with ethical leadership.

Limitations of this research should be noted. First, the information provided to participants was limited to limit the time necessary to complete the experimental instrument. Since accounting professionals would have a richer information set in practice when making accounting decisions, this leaves open the question of external validity and the generalizability of our results. However, this limit, while noteworthy, is also applicable to most experimental research. Second, while we find that moral intensity mediates the interactive effect of ethical leadership and the IAF, we are unable to ascertain at what threshold moral sensitivity is triggered or why. Third, highly experienced accountants participate in the current study. While this is

appropriate given the accounting decision task here, we do not know if our results generalize to entry level accountants.

Concerns about ethics and leadership have dominated recent headlines about business and shaken public confidence in many organizations. In response, regulatory agencies have strengthen corporate governance requirements including policies and requirements directed at the IAF and executive management (e.g., SOX 2002). Now, more than ever, rigorous, systematic research on ethical leadership and the IAF is needed. The results presented here suggest that the effects of ethical leadership cannot be determined independent of the control environment including the IAF in which it takes place and vice versa. In addition, the moral intensity of any decision situation must be considered when predicting decision outcomes. More research is needed in both identifying and examining individual and other organizational variables—and how they affect perceived moral intensity—to obtain a more complete understanding of financial reporting decisions.

NOTES

[1] For a review of the ethical reasoning process in an auditing context, see Jones et al. (2003). Examples of research on the ethical reasoning process in a financial reporting context include Carpenter and Reimers (2005), Gillette and Uddin (2005), Graham et al. (2005), and Belski et al. (2008).

[2] We mailed instruments to 1,200 individuals identified by the American Institute of Certified Public Accountants (AICPA) as an executive, managers, or staff accountant employed in business or industry. We received replies from 109 individuals and 13 were returned as undeliverable. The resulting response rate of 10.17 percent (122 responses divided by 1,200 delivered) is consistent with prior studies involving CFO/controller participants (e.g., Graham and Harvey 2001; Gibbons et al. 2007; Sanchez et al. 2007; Agoglia et al. 2010).

[3] The three questions are as follows. First, participants reported their agreement with the statement "most financial managers will view the request by the controller to book a $3 million entry as appropriate given the current financial projections and the controller's concern for unbilled expenses not included in the year-end financial statements" on a seven-point scale (1 = "very strongly disagree" and 7 = "very strongly agree"). Second, participants reported their assessment of whether the controller's request to book a $3 million entry is unethical on a seven-point scale (1 = "very strongly disagree" and 7 = "very strongly agree"). Third, participants reported their assessment of whether, as the assistant-controller of this company, it is their responsibility to make sure only journal entries with appropriate documentation are booked on a seven-point scale (1 = "very strongly disagree" and 7 = "very strongly agree").

APPENDIX A
Measures of Perceived Moral Intensity[a]

- The negative consequences related to booking the entry, if any, will be very serious (MC).
- The overall harm as a result of this decision will be very small (MC).
- People are not likely to agree about whether the decision to book or not to book the entry was right or wrong (SC).
- Most people would agree on what the appropriate decision is in this scenario (SC).
- The decision will not cause harm in the immediate future (TI).
- The negative effects, if any, of the decision will be felt very quickly (TI).
- You, as the assistant-controller, are unlikely to be close to anyone who might be negatively affected by the decision to book the entry (PX).
- The harmful effects, if any, of the decision will affect people that are close to you, the assistant-controller (PX).
- There is a very small likelihood that the decision to book the entry will actually cause harm (PE).

MC = Magnitude of the consequences
SC = Social consensus
TI = Temporal immediacy
PX = Proximity of effect
PE = Probability of effect

(Adapted from McMahon and Harvey 2006)

[a] Participants responded to each statement on a seven-point scale where 1 = "very strongly disagree" and 7 = "very strongly agree."

REFERENCES

Agoglia, C. P., T. S. Doupnik, and G. T. Tsakumis. Forthcoming. Principles-based versus rules-based accounting standards: The influence of standard precision and audit committee strength on financial reporting decisions. *The Accounting Review*.

American Institute of Certified Public Accountants (AICPA). 1997. *The Auditors' Consideration of the Internal Audit Function in an Audit of Financial Statements.* Statement on Auditing Standards No. 65. Available at http://www.aicpa.org/download/members/div/auditstd/AUD-00322.PDF.

Asare, S.K., R.A. Davidson, and A.A. Gramling. 2008. Internal auditors' evaluation of fraud factors in planning an audit: The importance of audit committee quality and management incentives. *International Journal of Auditing* 12 (3): 181-203.

Bandura, A. 1977. *Social learning theory*. Englewood Cliffs, NJ: Prentice-Hall.

Bandura, A. 1986. *Social foundations of thought & action*. Englewood Cliffs, NJ: Prentice-Hall.

Baron, R. M. and D. A. Kenny. 1986. The moderator-mediator variable distinction in social psychological research: Conceptual, strategic, and statistical considerations. *Journal of Personality and Social Psychology* 51 (6): 1173-1182.

Beam, A. and C. Warner. 2009. *HealthSouth: The Wagon to Disaster.* Alabama: Wagon Publishing.

Beam, A. and W. Smith, 2010. FASRI Roundtable: Aaron Beam and Weston Smith. Discussion hosted by *Financial Accounting and Research Initiative.* February 10, 2010. Available at http://fasri.net/index.php/2010/02/aaron-beam-weston-smith/

Belski, W.H., J.D. Beams, and J.A. Brozovsky. 2008. Ethical judgments in accounting: An examination on the ethics of managed earnings. *Journal of Global Business Issues* 2: 59-68.

Brown, M.E., L.K. Trevino, and D.A. Harrison. 2005. Ethical leadership: A social learning perspective for construct development and testing. *Organizational Behavior and Human decision Processes* 97: 117-134.

Carpenter, T.D. and J.L. Reimers. 2005. Unethical and fraudulent reporting: Applying the theory of planned behavior. *Journal of Business Ethics* 60: 115-129.

Cohen, D. A., A. Dey, & T. Z. Lys. (2008). Real and accrual-based earnings manipulations in the pre- and post- Sarbanes-Oxley periods. *The Accounting Review,* 83, 757-787.

Committee of the Sponsoring Organizations of the Treadway Commission (COSO). 1992 *Internal Control, Integrated Framework (COSO Report).* New York: AICPA.

D'Aquila, J.M. 1998. Is the control environment related to financial reporting decisions? *Managerial Auditing Journal* 13 (8): 472-478.

Davidson, R., J. Goodwin-Stewart, and P. Kent. 2005. Internal governance structures and earnings management. *Accounting and Finance* 45(2): 241-267,

DeZoort, F.T., R.W. Houston, and M.F. Peters. 2001. The impact of internal auditor compensation and role on external auditors' planning judgments and decisions. *Contemporary Accounting Research* (Summer): 257-281.

Douglas, P.C., R.A. Davidson and B.N. Schwartz. 2001. The effect of organizational culture and ethical orientation on accountants' ethical judgments. *Journal of Business Ethics* 34: 101-121.

Elias, R.Z. 2002. Determinants of earnings management ethics among accountants. *Journal of Business Ethics* 40: 33-45.

Gibbins, M., S.A. McCracken, and S.E. Salterio. 2007. The chief financial officer's perspective On auditor client negotiations. *Contemporary Accounting Research* 24 (2): 387-422.

Gillette, P.R. and N. Uddin. 2005. CFO intentions of fraudulent financial reporting. *Auditing: A Journal of Practice and Theory* 24: 55-75.

Graham, J.R. and C.R. Harvey. 2001. The theory and practice of corporate finance: Evidence from the field. *Journal of Financial Economics* 60: 187-243.

Graham, J.R., C.R. Harvey, and S. Rajgopal. 2005. The economic implications of corporate financial reporting. *Journal of Accounting and Economics* 40: 3-73.

Gramling, A.A., and P.M. Myers. 1997. Practitioners' and users' perceptions of the benefits of certification of internal auditors. *Accounting Horizons* 11(1): 39-53.

Gramling, A.A., and D.R. Hermanson. 2009. Internal audit quality: Would we know it if we saw it? *Internal Auditing* 24(1): 36-39.

Healy, P. M. (1985). The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics*, 7, 85-107.

Hodge, T.G., D.L. Flesher, and J.H. Thompson. 1998. The empirical development of a financial reporting ethics decision model: A factor analysis approach. In: L.A. Ponemon (Ed), *Research on accounting ethics* (pp. 247-266). Stamford, CT: JAI Press.

Institute of Internal Auditors (IIA). 2005. Corporate governance. *The Institute of Internal Auditors Homepage*. Available at: http://www.theiia.org/?doc_id=1041.

Jones, T.M. 1991. Ethical decision making by individuals in organizations: An issue-contingent model. *Academy of Management Review* 2: 366-395.

Jones, J., D.W. Massey, and L. Thorne. 2003. Auditors' ethical reasoning: Insights from past research and implications for the future. *Journal of Accounting Literature* 22: 45-103.

Kaplan, S., and J. Schultz. 2007. Intentions to report questionable acts: An examination of the influence of anonymous reporting channel, internal audit quality, and setting. *Journal of Business Ethics* 71:109-124.

Lamberton, B., P.H. Mihalek, and C.S. Smith. 2005. The tone at the top and ethical conduct connection. *Strategic Finance* 86 (9): 36-40.

Leitsch, D.L. 2004. Differences in the perceptions of moral intensity in the moral decision process: an empirical examination of accounting students. *Journal of Business Ethics* 53: 313-324.

Lord, R. G., & Maher, K. J. 1991. *Leadership and information processing: Linking perception and performance*. Boston: Unwin-Hyman.

Mayer, D.M., M. Kuenzi, R. Greenbaum, M. Bardes, and R. Salvador. 2009. How low does ethical leadership flow? Test of a trickle-down model. *Organizational Behavior and Human Decision Processes* 108: 1-13.

McCrae, R. R., & John, O. P. 1992. An introduction to the five-factor model and its applications. *Journal of Personality* 2: 175–215.

McLean, B. and P. Elkind. 2003. *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron.* London: Penguin Books Ltd.

McMahon, J. M. and R. J. Harvey: 2006, _An analysis of the factor structure of Jones' moral intensity construct. *Journal of Business Ethics* 64:381–404.

McVay, S.E. 2006. Earnings management using classification shifting: An examination of core earnings and special items. *The Accounting Review* 81:501-531.

Merchant, K.A. and J. Rockness. 1994. The ethics of managing earnings: An empirical investigation. *Journal of Accounting and Public Policy* 13: 79-94.

Messier, W.F. Jr., and A. Schneider. 1988. A hierarchical approach to the external auditor's evaluation of the internal auditing function. *Contemporary Accounting Research* 4(2): 337-353.

Ng, J., G.P. White, A. Lee, and A. Moneta. 2009. Design and validation of a novel new instrument for measuring the effect of moral intensity on accountant's propensity to manage earnings. *Journal of Business Ethics* 84: 367-387.

Public Company Accounting Oversight Board (PCAOB). 2007. *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, Auditing Standard No. 5. Washington, DC: PCAOB.

Public Company Accounting Oversight Board (PCAOB). 2007. *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements.* Available at: http://pcaobus.org/Rules/Rulemaking/Docket%20021/2007-06-12_Release_No_2007-005A.pdf.

Prawitt, D. F., J.L. Smith and D.A. Wood. 2009. Internal audit quality and earnings management. *The Accounting Review* 84 (4): 1255-1280.

Rittenberg, L.E., K.M. Johnstone, and A.A. Gramling. 2010. *Auditing: A business risk approach* (7th ed.). Mason, Ohio: South-Western Cengage Learning

Sanchez, M. H., C. P. Agoglia, and R. C. Hatfield. 2007. The effect of auditors' use of a reciprocity based strategy on auditor-client negotiations. *The Accounting Review* 82: 241–63.

Schneider, A., and N. Wilner. 1990. A test of audit deterrent to financial reporting irregularities using the randomized response technique. *The Accounting Review* 65 (3): 668-681.

Sarbanes-Oxley Act. 2002. http://sarbanes-oxley.com.

Sweeney, B., D. Arnold and B. Pierce. 2010. The impact of perceived ethical culture of the firm and demographic variables on auditors' ethical evaluation and intention to act decisions. *Journal of Business Ethics* 93: 531-551.

Taylor, E.Z. and M.B. Curtis. 2010. An examination of the layers of workplace influences in ethical Judgments: Whistleblowers likelihood and perseverance in public accounting. *Journal of Business Ethics* 93: 21-87.

Treadway Commission. 1987. *Report of the National Commission on Fraudulent Financial Reporting* (National Commission on Fraudulent Financial Reporting, Washington, DC)

Trevino, L.K. 1986. Ethical decision making in organizations: A person-situation interactionist model. *Academy of Management Review* 11: 601-617.

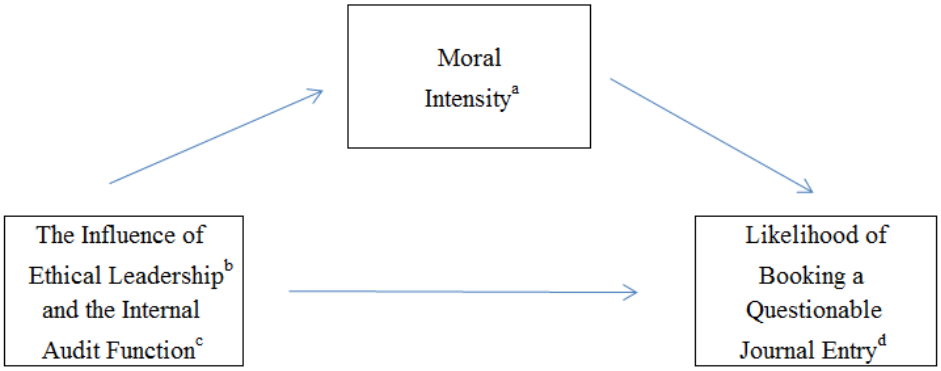
Trevino, L.K., K.B. Butterfield, and D.L. McCabe. 1998. The ethical context in organizations: Influences on employee attitudes and behaviors. *Business Ethics Quarterly* 8: 447-476.

Victor, B. and J.B. Cullen. 1988. The organizational bases of ethical work climates. *Administrative Science Quarterly* 33: 101-125.

Waldron, M. 2010. Issue contingency: A review of moral intensity components. *The Business Review* 14: 9-16.

Wright, G.B., C.P. Cullinan, and D.M. Bline. 1997. The relationship between an individual's values and perceptions of moral intensity: An empirical study. *Behavioral Research in Accounting* 9: 26-40.

FIGURE 1
Mediation Model
Moral Intensity as a Mediator of the Interactive Effect of Ethical Leadership and the Internal Audit Function



[a] Moral intensity is measured utilizing the questions and scales adapted by McMahon and Harvey (2006).
[b] Ethical leadership is manipulated as either strong or weak.
[c] The Internal Audit Function is manipulated as either strong or weak.
[d] Participants recorded their decision regarding how likely they were to book a questionable entry on a six-point scale (1 = "very unlikely" and 6 = "very likely") .

TABLE 1
Demographic Data

	n	Percent
Participants with external audit experience	55	70
Participants with no external audit experience	23	30
Participants with public company experience	54	69
Participants with no public company experience	24	31
Participants with internal audit experience	13	17
Participants with no internal audit experience	65	83

	Mean	(SD)
Professional work experience (in years)	21.65	(9.57)
Public company work experience (in years)	10.27	(8.06)
External audit experience (in years)	4.97	(4.18)
Internal audit experience (in years)	7.19	(6.74)
Familiarity with recording expense accruals[a]	5.65	(1.33)
Experience with meeting analysts forecasts[b]	4.71	(1.70)

[a] Participants reported their familiarity with recording expense accruals on a seven-point scale where 1 = "not at all familiar" and 7 = "very familiar."
[b] Participants reported their experience with meeting analysts forecasts on a seven-point scale where 1 = "not at all experienced" and 7 = "very experienced."

TABLE 2
Descriptive Statistics and Contrast Coding (Hypothesis 1)

PANEL A: Mean (standard deviation) of managers' willingness to book a questionable journal entry[a]

Ethical Leadership		Internal Audit Function: Strong	Internal Audit Function: Weak	Overall
Strong	Mean	3.73	3.40	3.61
	(SD)	(1.51)	(1.59)	(1.53)
	(n)	26	15	41
Weak	Mean	2.74	3.39	3.05
	(SD)	(1.33)	(1.85)	(1.61)
	(n)	19	18	37
Overall	Mean	3.31	3.39	3.36
	(SD)	(1.50)	(1.71)	(1.59)
	(n)	45	33	78

PANEL B: Results of contrast coding using managers' willingness to book the journal entry as the dependent variable

Source of Variance	*SS*	*df*	*F*-statistic	*p*-value[b]
Model contrast	9.67	1	4.25	0.04
Error	163.91	72		

[a] Participants were asked how likely they were to book the journal entry as requested by the controller on a six-point scale where 1 = "very unlikely" and 6 = "very likely."
[b] p-values are based on one-tailed tests since expectations were directional.

TABLE 3
Mediation Analysis (Hypothesis 2)

PANEL A: Descriptive statistics for managers' composite score for moral intensity[a]

Ethical Leadership		Internal Audit Function: Strong	Internal Audit Function: Weak	Overall
Strong	Mean	38.68	37.00	38.11
	(SD)	(9.14)	(6.93)	(8.66)
	(n)	25	13	38
Weak	Mean	33.00	37.78	35.32
	(SD)	(8.89)	(7.91)	(8.25)
	(n)	19	18	37
Overall	Mean	36.23	37.45	36.73
	(SD)	(9.07)	(7.24)	8.52
	(n)	44	31	75

PANEL B: Results of contrast coding using managers' composite score for moral intensity as the dependent variable

Source of Variance	*SS*	*df*	*F*-statistic	*p*-value[b]
Model contrast	368.53	1	5.46	0.02
Error	4,655.22	69		

PANEL C: Results of contrast coding using managers' willingness to book the entry as requested by the controller as the dependent variable and the composite score for moral intensity as the mediating variable

Source of Variance	*SS*	*df*	*F*-statistic	*p*-value[b]
Model contrast	1.23	1	0.851	0.36
Composite Moral Intensity Score	55.43	1	38.41	<0.001
Error	98.13	68		

[a] Lower scores represent higher levels of moral intensity related to this ethical dilemma.
[b] p-values are based on one-tailed tests since expectations were directional.