

**The Rational Auditor and Moral Norms:  
The Code of Ethics for Professional Accountants – Lip Service or Self-binding  
Agreement?**

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**Abstract**

Since the public has vehemently debated financial scandals like Enron or WorldCom numerous articles asked for ethical responsibility from auditors. The financial scandals were also seen as *ethical scandals*. A Code of Ethics with moral content could be a potential remedy but the crucial question is: Why should a rational and egoistic auditor obey *moral norms* contained in a Code of Ethics? The paper discusses if moral norms and the Code of Ethics can be justified under the assumption that a Rational Egoist, i.e. a purely selfish-oriented individual, has to be convinced. Furthermore, evidence is presented which shows that human behaviour is driven by a mixture of selfish *and* altruistic motives. For example altruistic sanctions can effectively discipline free-riders in public good experiments. The moral reputation of the auditing profession can be interpreted as an impure public good which has to be protected against free-riders within the profession.

Exactly because the empirical evidence shows that the human nature is neither truly altruistic nor truly egoistic there is a need for moral norms in general or a “Code of Ethics for Professional Accountants” in particular, otherwise they would be superfluous. In this sense the Code of Ethics is neither a pure lip-service nor a strict self-binding agreement: The truth lies between these two extreme positions.

**Key Words:** Code of Ethics, moral norms, rational auditor, public goods, moral reputation

## **1 Introduction: On Professional Ethics and Self-Interest**

Since the public has vehemently debated the so-called financial scandals like Enron or WorldCom numerous articles asked for ethical responsibility from auditors and accounting executives as well. The financial scandals were not only seen as legal or criminal scandals but also as *ethical scandals*. Technical incompetence has been rarely cited as the main problem by the critics. Instead, the *moral base* of the profession has been fundamentally questioned. In addition to technical competence an auditor has to behave with integrity and objectivity. *Integrity* means that a professional accountant should be straightforward and honest in all professional and business relationships (IFAC Code of Ethics 100.4 (a) and Section 110). *Objectivity* means that a professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements (IFAC Code of Ethics 100.4 (b) and Section 120). Integrity and objectivity can be understood as *general ethical principles* applied to an auditing or accounting context. In case of an ethical conflict a professional accountant has the obligation to consider among other factors *ethical issues* involved (IFFAC Code of Ethics 100.17 (b)). With respect to *assurance engagements* “independence of mind and in appearance is necessary to enable the professional accountant in public practice to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest or undue influence of others” (IFAC CoE 280.2). *Independence of mind* is defined as the “state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism” (CoE 290.8). In other words, an individual that adheres to the moral norm “Be honest and tell the truth!” is independent in mind. *Independence in appearance* means the “avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information ... would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional scepticism had been compromised” (CoE 290.8). Independence in appearance may be compromised even if the individual, perhaps an individual with a strong commitment to moral norms, is independent in fact. However, a reasonable and informed party would expect that in a specific situation the temptations to break moral norms are so high that the “average moral individual” could not resist. This concept is based on an implicit ‘common-sense’ theory of normal behaviour. Since independence of mind as a inner mental state is difficult to observe, independence of appearance is easier to verify by third parties.

In the wake of the financial accounting scandals many authors criticized the loss of a strong ethical foundation in the accounting profession. Duska (2005) argues that auditors (and audit firms) have become merely “accumulators of wealth for its own sake” and have forgotten their primary ethical responsibility with respect to the public interest. Wyatt (2004) – a former FASB member – argued that greed became a driving force within the audit firms just as it did within many corporations. He wrote, “the cultures of the firm – changed from a central emphasis on delivering professional services in a professional manner to an emphasis on growing revenues and profits” (Wyatt 2004: 49). After a lengthy discussion of legal and professional rules for auditors, Ballwieser/Clemm (1999) bring forward the argument that primarily a strong ethical attitude is needed whose endorsement by legal and professional rules is valuable, but only secondary. Without ethics “auditing is inoperable and irresponsible” (Ballwieser/Clemm 1999: 414). Other articles argue in the same direction and demand in a normative way more ethical behaviour from auditors as sole practitioners and within audit firms (Satava et al. 2006; Waddock 2005).

However, if ethical mental attitudes have primacy, then it has to be answered how these attitudes are compatible with the rational self-interest of an auditor or how to deal with ethical conflict of interests (Boyd 2004). The above mentioned articles are silent with respect to this question. Some argue in favour of an *ethical education* in accounting and auditing in business schools and audit firms (Melé 2005; Bean/Bernardi 2007). The IFAC Education Standards Board (IAESB) promotes this demand. International Education Standard (IES) for Professional Accountants No. 4 is titled “*Professional Values, Ethics and Attitudes*” and calls for a teaching of professional values, ethics and attitudes for students in the pre-qualification phase and also for a life-long workplace learning and training for accountants in the post-qualification phase. Professional values, ethics and attitudes are understood as the professional behaviour and characteristics that identify professional accountants as members of a profession. They include the principles of conduct (i.e. ethical principles) generally associated with, and considered essential in defining the distinctive characteristic of, professional behaviour (IFAC Education Committee 2003: 23). In October 2007 the International Accounting Education Standards Board (IAESB) has issued an International Education Practise Statement “*Approaches to Developing and Maintaining Professional Values, Ethics and Attitudes*” which aims to guide member bodies in transferring IES 4 into practice. The practice statement is based on an extensive research study about this subject (IAESB 2006). This endeavours show the *relevance of ethics* for accounting. The aim is to

develop ethical competence in a four-stage process with ongoing review and revise loops (the so-called IFAC Ethics Education Continuum):

- Stage 1: Enhancing Ethics Knowledge
- Stage 2: Developing Ethical Sensitivity
- Stage 3: Improving Ethical Judgement
- Stage 4: Maintaining an Ongoing Commitment to Ethical Behaviour

Legislators have reacted and try to impose ethical behaviour by new laws like the Sarbanes-Oxley Act of 2002 in the USA or the Law of Financial Security of 2003 in France. Some authors doubt if these attempts are really successful. Instead, they see a strong corporate culture with imbedded ethical values as central drivers of behaviour in organizations (Rockness/Rockness 2005: 48; Kaplan et al. 2007: 370).

From an economic viewpoint the decisive question is “Why should a rational auditor obey the *moral norms* of a Code of Ethics? I do not discuss professional rules for which transgressions will lead to juridical sanctions. Instead I’m interested in the *moral content* of a Code of Ethics. This question should also be addressed in the above mentioned stages 1 to 3 of the development of ethical competencies as well (see Colle/Werhane 2007 in general about moral motivation and their integration in ethical programmes).

The paper is organized as follows: *Section 2* gives a philosophical explication of the term “moral norm” and shows how the IFAC Code of Ethics relates to the more general concept of moral norms. *Section 3* analyzes how moral norms in general and the Code of Ethics in particular can be justified under the assumption that a Rational Sceptic, i.e. a purely selfish-oriented individual, has to be convinced that adherence to moral norms is in it’s best interest. *Section 4* shows some evidence mainly from experimental economics that human behaviour is driven by a mixture of selfish *and* altruistic motives. The function of emotional feelings in this context is also clarified. Thereafter, in *Section 5* the implications in an accounting and auditing context are discussed. *Section 6* concludes and summarizes the results.

## **2 The Term “Moral Norms” and the “Code of Ethics for Professional Accountants”**

*Norms* are normative statements which demand or proscribe specific acts from the norm addressees. They are intended to restrict the set of permissible acts of the norm addressee. Moral norms are a subset of social norms (Hausmann/McPherson 1996: 53 et seq.). There is an apparent need for uniform behaviour in a society and therefore norm-deviant behaviour will be sanctioned with social pressure. *Moral norms* as a subset of social norms relate to

interactions of fundamental importance for the functioning of society.<sup>1</sup> Moral norms (Stemmer 2000; Hoerster 2003; Bayertz 2004; Ott 2006):

- relate to interactions of major importance for the functioning of societies, they define “a good cooperative being” (Tugendhat 1993: 58);
- serve to protect of the interests of other human beings, i.e. concern (also) non-egoistic (altruistic) motives (unselfishness);
- relate to – in a narrower sense – the survival and physical integrity of others;
- in the case of deviant behaviour, regularly cause internal senses of shame and guilt by the norm offender and external senses of anger and outrage by other members of the moral community (see Hausman/McPherson 1996: 53; Stemmer 2000: 121-161; Tugendhat 1993: 57 et seq.);
- have an obligatory character; and
- are sufficiently generalizable; ideally they are *universally* accepted and enforced (see Hoerster 2003: 61); therefore, moral norms are *categorical* statements.

The required behaviour can conflict with the self-interests of the norm addressee. Some philosophers see moral behaviour essentially as *unselfish (benevolent) behaviour* which is of use for other beings (Bayertz 2004: 40), e.g. an adult man who does without a life-jacket and gives it to a child or woman on a sinking ship. If somebody acts according to moral norms, her or his behaviour is guided by a *sense of duty*. He or she is doing a certain act “X” due to a sense or *feeling of duty* even if this behaviour contradicts the person’s immediate self-interest. “*Duties*” are obligating and suppress (short-sighted) self-interest. The crucial function of “*feelings*” is to cause senses of guilt and shame by the offender and anger by members of the moral community. Therefore, they place specific internal and external sanctions on the offender. The obligation to obey moral norms is therefore “*a must contingent upon legitimate sanctions*” (Stemmer 2001: 833; 2003). A “morally justified must” can be differentiated from an “extortionate must” due to the fact that sanctions by the former are contractually legitimate. For example, “I’m participating in an extortionate robbery for good reasons because I fear for my life, but I’m *not obliged* to do so”. We should be able to distinguish

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<sup>1</sup> Empirical studies show that humans make a difference between moral norms and pure conventions like „Do not eat your food with fingers!”, see Nichols 2002; Hauser 2006: 196-200, 289-296. Transgressing moral norms lead to feeling of guilt whereas the violation of conventions like a dress code leads to feelings of embarrassment. Conventions can be justified by recourse to authorities whereas for moral norm this is not sufficient. Already children recognize this difference. See also Tugendhat (1993: 46 et seq.) to differences between conventions and moral norms.

between an extortionate regime and a legitimate system (Stemmer 2003: 68). The term “duty” refers only to the latter.

The *fundamental principles* (integrity, objectivity, professional competence, confidentiality and professional behaviour) contained in the *conceptual framework* (Part A) of the Code of Ethics for Professional Accountants are fundamental ethical principles. See for example the principle of *integrity*: “The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness” (IFAC CoE Section 110). An auditor is obliged to obey the moral norms “honesty, truthfulness and fairness”. For example this means that he should render an opinion about financial statements which is consistent with his inner mental beliefs. Part B illustrates the *application* of the fundamental principles for professional accountants in public practice in detail, especially in assurance engagements.

We should differentiate between the *norm addressee* and the *norm representative*. The latter is a person who has adopted the norm as his/her own because this person prefers the required behaviour of the norm addressee (Hoerster 2003: 46). A norm is *efficient* because external sanctions prevent norm-offending and/or because the norm has been *internalized* by the norm addressee (Hoerster 2003: 48). Efficiency of a moral norm can be reached through *formal or informal sanctions*.<sup>2</sup> Formal sanctions are specified *external legal sanctions* in case of norm breaches. Informal sanctions can be divided in two classes, *external and internal informal sanctions*. External informal sanctions stemming from other members of the moral community are for example social pressure, disrespect, exclusion from the community. Internal informal sanctions like guilt and shame are created by emotions and/or the conscience of the concerned person who faces a moral problem and has internalized certain moral norms. Because the IFAC is not in a legislative position, the Code of Ethics contains no formal sanctions. However, if the Code of Ethics is transformed in national law or professional rules, sanctions like fines or reprimands are normally added. Here I consider only informal sanctions.

To sum up, the IFAC Code of Ethics is a set of generally accepted fundamental ethical principles which are concretised for specific situation, e.g. assurance engagements, for a well-defined profession, e.g. professional accountants. The expectation of the professional bodies and of the public is that professional accountants should not only obey the code because otherwise they are disciplined via formal sanctions but that accountants should *internalize* the code (Brown et al. 2006).

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<sup>2</sup> The same differentiation could be made with respect to rewards.

In the next Section I discuss if moral norms in general and the Code of Ethics in particular can be justified by means of a hypothetical agreement between rational auditors. If this would be the case, there is a greater probability that formal sanctions are not the only determinants of the effectiveness of the code because norm following lies in the rational self-interest of the individuals.

### **3 Justification of moral norms and a Code of Ethics by means of rational agreements**

We can generally differentiate between *objective* and *subjective* justifications of moral norms. The first program (cognitivism) tries to justify moral norms in an objectively valid way independent of individual self-interests, e.g. the Kantian tradition. The second program (non-cognitivism) argues that moral norms can be argued for and accepted by individuals if it can be demonstrated that compliance with certain moral norms is in the best self-interest of the individual (Pauer-Studer 2003: 164-167; Morscher 2006, with respect to cognitivism and non-cognitivism). Only the latter point of view is compatible with basic assumptions of (traditional) economic theories, e.g. the famous opportunistic and (mainly) materially-minded *Homo Oeconomicus* (Güth/Kliemt 2003). In short, as Suchanek (2001: 141; see also Lütge 2005) writes, “the economic ethics answers the question why one should be moral: because it is advantageous for oneself.” Clearly, under an economic viewpoint an auditor is a rational economic agent and, therefore, he or she will only comply with a Code of Ethics if otherwise this would be harmful to his or her self-interest. The decision to comply or not comply is the result of an economic trade-off of the benefits and costs of this decision. The costs of non-compliance may be reputational damage or legal sanctions. If the probability of detection and/or the sanctions are low in relations to the gains, an auditor will not comply with the Code of Ethics. Ethical or moral reasoning for its own sake does not have any influence on the decision. The professional accountant acts like a “moral free” subject; the former “*Professional Man*” has been transformed into pure “*Economic Man*” (Reiter/Williams 2004). The fundamental problem therefore is “Why should a professional accountant act in a moral way, if this behaviour is harmful to his self-interest?” The best world for an opportunistic auditor would be a world in which all other members except for the moral opportunist obey moral norms, so he or she can act as a free-rider taking the opportunities presented by cheating and lying without paying the costs, e.g. being cheated by others. Let us assume a rational moral opportunist could choose between the following alternatives:

1. All except me should obey moral norms;
2. All should obey moral norms;

3. No-one should obey moral norms;
4. No-one except me should obey moral norms;

Faced with this decision, he or she would have the following preferences:  $1 > 2 > 3 > 4$  (Ponemon 1993: 196; Ott 2006: 479; Bayertz 2004: 141-155). The resulting free rider problem immediately causes an *enforcement problem* in a population comprised of rational self-interested individuals. In such a world, the enforcement problem is only solved if the “*Rational Sceptic*” (Stemmer 2003) or the “*Amoralist*” (Bayertz 2004) has to be convinced that it is in his self-interest to obey moral norms. For a (traditional) economist for whom the HOM-model is a cornerstone of economic theory, it seems quite natural to agree to this position. HOM stands for: H = Homo, i.e. the theories are based on a position of methodological individualism; O = opportunistic, i.e. man acts opportunistically, for example to gain an advantage by cheating or lying even at the expense of others; and M = individuals are (mainly) material or monetary orientated (Güth/Kliemt 2003: 316). The moral opportunist can be roughly equated with the well-known Homo Oeconomicus, i.e. a rational and egoistic auditor.

With respect to a Code of Ethics<sup>3</sup> for Professional Accountants it has to be shown that rational auditors accept and comply with such a code without coercion. In the following I do not talk about situations in which legal rules and the related sanctions are so tough and strict that a rational auditor will comply with the norms. We assume a situation leaving enough room for unethical decisions, e.g. not to qualify the audit report in a situation with vague accounting standards where management has chosen a questionable accounting treatment which in the real opinion of the auditor is misleading; or delivering non-audit services which compromise the independence of the auditor despite the fact that there is no clear rule forbidding the services.

The rational and egoistic auditor has to be convinced that obeying moral norms is in his/her best long-term self-interest. Only if this is the case, are moral norms justified. Stemmer (2003) argues from a *contractual point of view*:<sup>4</sup> moral norms, he argues, are created intentionally by rational individuals by “contractual” agreements. Because such a contract was never signed in reality, it is a *rational reconstruction of a hypothetical contract*. Members of a moral community (here comprised of professional accountants) agree hypothetically ex ante upon certain moral norms including internal and external informal moral sanctions because observing the rules is ex ante mutual beneficial. This creates some kind of self-binding of a

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<sup>3</sup> See also Sacconi (1999) who tries to justify a Corporate Code of Ethics as a social contract between rational stakeholders. A critic can be found in Francés-Gómez (2003).

<sup>4</sup> See for an overview about the ethical contractualism Pauer-Studier (2003: 83-108).

whole profession with respect to the public. Auditing as an institution needs some trust of the public. Otherwise audit reports would lack credibility. So an individual auditor or audit firm depends in some way of the behaviour of the other members of the profession, because audits are trust or credence goods where individual quality is difficult to observe and investors may reduce individual expectations about quality towards the average quality of the whole profession (Kaplan et al. 2007). So there are some incentives for rules and mutual monitoring within a profession. However, there is also a conflict between individual and collective interests which creates a *social dilemma situation* in which it is individually rational to defect. Social dilemmas are characterized by two properties: (a) the social payoff to each auditor for defecting behaviour is higher than the payoff for cooperative behaviour, regardless of what the other members of the professional community do, yet (b) all individuals in the professional community receive a lower payoff if all defect than if all cooperate (Dawes 1980: 170). For an individual auditor it is rational to benefit from the reputation of the profession as a whole while to take an individual advantage by violating the ethical rules of the profession. A social dilemma game can be characterized by two inequalities (Dawes 1980: 178):

$$(1) \quad D(m) > C(m + 1)$$

$D(m)$  is the payoff to the defectors in an  $N$ -person game where  $m$  players cooperate.  $C(m)$  is the payoff to the cooperators when  $m$  players (including themselves) cooperate. (1) expresses that the payoff when  $m$  other people cooperate is always higher for an individual who remains a defector than for one who becomes the  $m$  plus first cooperator ( $m$  goes from 0 to  $N-1$ ).

$$(2) \quad D(0) < C(N)$$

Inequality (2) formulates that universal cooperation among the  $N$  players leads to a greater payoff than does universal defection. Condition (1) shows that defecting is a dominating strategy. This leads to a deficient equilibrium where all players are worse off in comparison to universal cooperation.

A typical example of a social dilemma is the production of a *public or collective good*. A public good is characterized by non-rivalness and non-excludability with respect to the use of the public good. The moral reputation of a profession is not in a strict sense a public good because free riders can be excluded from the profession. However, in fact this is a rare event and the exclusion from the profession is the "*ultima ratio*" and has to be justified with hard legal criteria. Moral criteria alone are not sufficient. Therefore, the moral reputation of a profession can be seen at least as an "*impure public good*". Furthermore, the moral reputation of the profession has to be fostered through individual contributions by the members of the profession, i.e. honest and careful audits, participation in joint professional activities. The

contribution of each individual member is hardly measurable whereas the “output” is equally divided by all members of the profession. In this sense, the production of the moral reputation of the profession can be understood as *team production* (Alchian/Demsetz 1972) which results in a conflict between individual and collective incentives because there is an individual incentive to free ride.

The social dilemma game can be solved by the establishment of an authoritative agency (“Hobbes’ Leviathan”) or by the ex ante mutual agreement to cooperate in conjunction with the above mentioned informal sanctions in case of disobedience.

One of the *problems* of this methodology, e.g. the rational reconstruction of a hypothetical contract, is “why should a Rational Egoist agree ex ante to the establishment of *internal sanctions* (senses of guilt and shame)?” A completely informed and perfectly rational person needs no self-bonding because he always chooses to obey moral norms if this maximizes his or her self-interest. Furthermore, equipped with moral emotions he/she would not be able to expropriate the trust of others in unique situations (“golden opportunities”) with high pay-offs. Let us go back a step to the social dilemma game. This game can be solved by establishing ex ante an informal system of sanctions, too. Therefore, the payoffs of the defectors decrease and defection is therefore no longer advantageous. But why should a Rational Egoist ex ante agree to accept such a system of sanctions? He gives up a potential benefit, i.e. to defect in a situation with high payoffs. Bayertz argues “Why should an Amoralist abandon this option? Why should he strictly and irrevocably abnegate the opportunity offered by prudent misuses of moral norms. From the viewpoint of a solely self-interested person, the decision for a irrevocable self-bonding is not rationally obligatory“ (Bayertz 2004: 175). The problem becomes more complex if we think about individuals with restricted possibilities to exercise sanctions or about members of future generations. “How moral behaviour in such situations can also be “calculated” in the long-term is completely incomprehensible” (Bayertz 2004: 175). Furthermore, it should be mentioned that a system of informal sanctions leads to a *second order social dilemma* because an external informal sanction imposes costs but creates no direct utility for the person who exercises the sanctions. Therefore, why is it rational to exercise a sanction? Punishment of a norm-offender via social disesteem by third parties who are not directly affected by the violation of a moral norm has to be justified. For example, in repeated non-anonymous interactions a person can establish a reputation with respect to sanctions. This can deter potential opportunists who try to exploit a trust game-like situation (Fehr/Fischbacher 2003). The Rational Egoist acts like a free-rider with respect to sanctions with the exception that use of sanctions can be justified by self-

interest reasons, e.g. in repeated interactions. Insofar there are many others who will bear the costs of sanctions, he or she will benefit from the disciplinary effects of sanctions without bearing the costs.

I would like to come back to social dilemmas in which free-riding is not observable by others. Frank (1988: 258) calls such situations “golden opportunities”, Stemmer (2000: 162-191) talks about “wrongdoing in secret”. Here, only *internal sanctions* may help to resist the temptation to break moral obligations. These *unique situations* (“golden opportunities”) where secret wrongdoing is possible without detection are the ultimate “stress-test” for an ethical justification program solely based on individual rationality (Gauthier 1986: 170; Francés-Gómez 2003: 173). In the end, the Rational Sceptic cannot be convinced with respect to such situations (Steinfath 2003; Schaber 2003; Roughley 2003). By the way, it should be mentioned that legal sanctions by definition can’t solve the problem because norm transgression isn’t observable. Even Stemmer (2000: 190) considers with respect to such situations “if the moral sanctions are powerless, then the rational obligation is also necessarily powerless.”

Furthermore, in a (hypothetical) rational reconstruction approach the empirical development of the system of internal sanctions cannot be explained. Going back to socio-biological, neuro-biological and cultural theories of the development of emotions seems far more promising. It is highly counter-intuitive to think of informal sanctions like guilt and shame as the results of a rational reconstruction of a hypothetical contract.

In Section 5 I will discuss if it is realistic to assume in an auditing context the at least partial efficiency of such informal sanctions. In an accounting and auditing context, especially on anonymous capital markets, it remains questionable if internal sanctions like senses of guilt and shame are an effective enforcement mechanism. Maybe in cases with high publicity, “finger-pointing” or “naming and shaming” by the financial press can induce such an effect. With respect to the auditing profession convincing evidence of punishment via social disesteem is not existent. On the contrary, in the past for example in Germany professional failure of auditors detected by the German Chamber of Public Accountants has been published without the name of the offenders.

To sum up, the justification of a Code of Ethics as a rational reconstruction of a hypothetical contract leads into severe difficulties because a rational egoistic auditor cannot be convinced to abstain from norm transgression if a “golden opportunity” is present. In the next section I will discuss some empirical evidence about the nature of human altruism and egoism. If the

human traits are to a lesser extent egoistic as previously assumed then human beings have fewer difficulties to obey moral norms.

#### 4 Selected Empirical Evidence about the Moral Nature of Man – From Homo Oeconomicus to Homo Moralis?

Recent evidence stemming from experimental economics (Fehr/Falk 2002; Falk 2003; Güth et al. 2003; Güth/Kliemt 2003; Fehr/Renniger 2004; Güth/Kliemt 2007) but also from psychology and (neuro-)biology (Bauer 2006; Hauser 2006) shows that the Homo Oeconomicus is more adequately described as a *Homo Reciprocans*, perhaps partly even as a *Homo Moralis*.<sup>5</sup> It follows that the Rational Egoist is no longer our natural reference subject. Furthermore, the functions of moral-emotional dispositions (senses of guilt and shame) can be clarified with the help of evolutionary biology (Frank 1988; Föhr/Lenz 1992; Frank 2004).

The standard design of public good experiments which tests the willingness to contribute to the production of a public good can be described as follows (Fehr/Fischbacher 2004a: 185).  $N$  members of a group receive  $b$  monetary units (MU). The group members  $i$  ( $i = 1, \dots, N$ ) decide individually about the amount  $c_i$  of their contribution to the public good and  $c_i$  lies in the interval  $[0, b]$ . The experimenter multiplies the whole amount of the group with the number  $m$  ( $1 < m < N$ ) and the resulting total proceeds will be distributed equally to all group members. The individual payoff function  $P_i$  is therefore (Levitt/List 2007: 155; Ostrom 2000: 139)

$$P_i = b - c_i + \frac{m}{N} \cdot \sum_{i=1}^N c_i$$

and the return  $m/N$  of one invested MU in the public good is always smaller than 1 because of  $m < N$ . This follows from  $\partial P_i / \partial c_i = -1 + (m/N) < 0$ . That means a selfish subject should never contribute to the public good in a one-shot experiment and should behave as a free-rider. Otherwise, if all would contribute fully to the public good, each group member would receive  $bNm/N = bm$ . Each group member would be better off in this case because  $m > 1$ . For example, if  $N = 5$ ,  $m = 2$  and  $b = 10$  € and all members invest in the production of the public good ( $b = c = 10$  €) then each member receives  $100$  € /  $5 = 20$  €. However, if one member of the group acts as a free-rider and contributes nothing to the public good then his payoff is  $10$  € +  $16$  € =  $26$  € and all other get  $16$  €. If all members behave as free-riders the public good cannot be produced and each member remains with the initial endowment. The incentive to

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<sup>5</sup> It should be mentioned that in many economic context the homo oeconomicus-assumptions as theoretical idealizations are useful for theoretical purposes.

free-ride rises with increasing  $N$  because the individual return  $m/N$  decreases with increasing  $N$ .

With respect to one-shot public good experiments Fehr/Fischbacher (2003: 786) summarize that, „subjects typically contribute between 40 and 60 % of their endowment, although selfish individuals are predicted to contribute nothing.” This is the good news; the bad news is that “cooperation is, however, rarely stable and deteriorates to rather low levels if the game is played repeatedly (and anonymously) for ten rounds“ (Fehr/Fischbacher 2003: 786). Altruistic punishment (Fehr/Fischbacher 2004b) and rewarding plays a decisive role and can sustain cooperation by deterring potential non-cooperators. To test the effectiveness of altruistic punishments and rewards the players or a not directly involved third-party get the opportunity to sanction or reward cooperation or non-cooperation in public good experiments. Such activities are altruistic because in anonymous and one-off interactions the person who punishes or rewards will pay the costs but has not benefit from the educative effects of the measures in following interactions.

Reciprocal behaviour is not only restricted to bilateral situations but also present in social multilateral dilemma games (Falk 2003: 147). An experiment done by Fischbacher et al. (2001) shows that contrary to the Homo Oeconomicus prediction based on rational and selfish players which should choose the defection option most players choose a *strategy of conditioned cooperation*. Their contribution to the public good in a one-shot game depends on the contribution of the other players. If the other players contribute more the individual contribution increases. Roughly 50 % of the subjects showed conditional behaviour such that the own contribution increases in the other group members' average contribution. A third of the subjects can be characterized as free riders (Fischbacher et al. 2001: 398). Fischbacher et al. (2001: 403) expect that contributions in repeated interactions “*spiral downwards*” over time. “Positive and stable contribution to the public good are very unlikely. Put differently, despite a majority of conditional cooperators, free riding will be pervasive under conditions of anonymous interactions” (Fischbacher et al. 2001: 403).

In a recent laboratory experiment, however, Gürer et al. (2006) have shown that the opportunity to punish free-riders disciplines effectively these players, i.e. they contribute to the public good. In this experiment the participants had the opportunity to choose in the first stage between a sanctioning institution (SI, opportunity to reward cooperative behaviour and punish free-riders) and a sanction-free institution (SFI). In the second stage of the game they decide on their contribution to the public good and in the third stage they have the opportunity to punish or reward other participants. At the beginning of the game, which has been played

with 84 participants over 30 rounds, only one third of the players opted for SI; half of these participants contributed with substantial amounts to the public good and three-fourths of the participants sanctioned free-riders despite costly sanctions. In the course of the game nearly all players (93 %) switched from SFI to SI and cooperated fully as well. With respect to the remaining players in SFI the results show that cooperation collapses, i.e. free-riding dominates. The individual maximization of payoffs cannot explain why new members who switch from SFI to SI obey the established norm in SI “Punish free-riders!” because it would be rational to join SI but to abstain from costly sanctions. Altruistic punishment is a *second order public good* which invites again to free-riding (Güerck et al. 2006: 110). Despite this incentive 63 % of the switching players instantly punish free-riders, i.e. the prevailing norm will be accepted immediately. Because a lot of players punish and punishment has a disciplinary effect the result is that, in the end, the participants who contribute with large amounts to the public good and punish as well “„exhibit a payoff disadvantage of less than 2 %; hence, the ‚selection pressure‘ against strong reciprocators becomes quite weak“ (Güerck et al. 2006, 110). Güerck et al (2006, 110) summarize: „The initial establishment of the ‚norm to cooperate and punish free-riders‘ is mainly driven by the steadfastness of the strong reciprocators to punish noncooperative subjects, despite severe individual losses. Although strong reciprocators are a minority, they manage to establish and enforce a cooperative culture that attracts even previously noncooperative individuals and thus resolves the social dilemma.”

With reference to other experiments which give the possibility to reward and to sanction others, Falk (2003: 144) concludes that a majority of human beings reward fair behaviour and punish unfair behaviour even if the latter is associated with costs. It should be mentioned here that the literature distinguishes between reciprocity and “*strong reciprocity*”. “Strong reciprocity is a combination of altruistic rewarding, which is a predisposition to reward others for cooperative, norm-abiding behaviours, and altruistic punishment, which is a propensity to impose sanctions on the others for norm violations. Strong reciprocators bear the cost of rewarding or punishing even if they gain no individual economic benefit whatsoever from their acts” (Fehr/Fischbacher 2003: 785). Strong reciprocators reward and punish even in anonymous one-shot interactions. Therefore, strong reciprocators could play a decisive role in the enforcement of moral norms even in situations characterized by “golden opportunities”.

What are the motives for rewarding and punishing in the above experiments: Retaliation and revenge feelings, anger and resentment? Remember the saying “revenge is sweet”. Such deep-rooted and non-controllable feelings could explain why person X punishes person Y despite

some costs. A norm offender will therefore be penalized. Y anticipates this, especially if X has a respective reputation or if X can credibly signal the disposition to sanction, and cooperates for this reason. With respect to the non-reciprocity of awards feelings of shame and guilt could be rised, whereas otherwise reciprocity could positively lead to feelings of gladness and gratitude. Feelings of shame and guilt can deter a person to break a fairness norm (“Don’t be a free-rider!”).<sup>6</sup> An important function of culture is to strengthen cooperative behaviour. The learning of moral norms is encouraged by emotions which assist and stabilize norm-compliant behaviour (Föhr/Lenz 1992: 153 et seq.). A person may realize that in the long-term it pays off to impose penalties despite some costs. Even in this case the person may be tempted to avoid these costs. A disposition in favour of anger and resentment may help to control this impulse (Föhr/Lenz 1992: 149). Frank (1988, 2004) attributes precisely this function to positive and negative emotions. Human beings with a stable disposition to be fair can successfully survive in the long run if they are able to identify people who are emotionally predisposed to cooperate.<sup>7</sup> Frank (2004: 28-44) gives some evidence that cooperators can find one another. In Frank (1988) it is argued that the resulting equilibrium must entail a mixed population of cooperators and defectors. “In any population consisting of only cooperators, no one would be vigilant, and opportunities would thus abound for defectors. In a mixed population, cooperators can survive only by being sufficiently vigilant and skilled in their efforts to avoid good mimics” (Frank 2004: 11). More recently Fehr/Renniger (2004) and Fehr/Fischbacher (2003) discuss the possible mechanism of the gene-culture coevolution of human altruism and especially the interaction between selfish and strongly reciprocal individuals. They also point out that cultural forces, e.g. learning and socialization, have a significant influence on human altruism (Fehr/Fischbacher 2003: 790).

Are there further motives or reasons for rewarding and punishing in the above example? According to the philosopher Hoerster (2003: 201) a further motive could be a *conscious mental attitude of fairness*, an attitude which a person has deliberately chosen under rational conditions. If the person has been educated accordingly then he or she could later rationally adhere to this attitude. The mental attitude of fairness could be described as follows, “I will not be unfair and I will not exploit the situation of a cooperative undertaking to my additional personal benefit at the cost of others”. According to Hoerster, this ideal of a fair and righteous life could lead to the acceptance of moral norms. I accept moral norms because they help to realize my ideal of a fair life. In this sense the moral norms are based on my interests and are therefore rational justified (Hoerster 2003: 204). Indeed, the above cited evidence from

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<sup>6</sup> This has been shown in an experiment done by Ketelaar/Au (2003).

experimental economics shows that a remarkable portion of individuals can be characterized in this way (Fehr/Falk 2002; Fehr/Fischbacher 2003; Falk/Renniger 2004). There are therefore some good empirical arguments in favour of the rationality of this mental attitude of fairness.

However, with respect to the *justification* of moral norms, the philosopher Bayertz (2004) points out that if there are strong empirical arguments in favour of human altruism or moral feelings then moral norms *as normative statements* would be redundant. We need (additional) moral norms exactly because human beings are not moral by nature (Bayertz 2004: 212). The argument from Bayertz is not convincing. Moral norms are only pointless if all humans are either perfect selfish rationalists or perfect unselfish altruists. It is precisely because the empirical truth lies between these extremes that moral norms can fulfil a specified function. They remind not so perfect, sometimes short-sighted, rationalists who are tempted to break a norm that it may be wise in the long run to obey that norm. Also, they remind not so perfect altruists in a situation of moral temptation which could compromise their personal integrity or the fairness attitude of their (endangered) moral feelings. This could help to trigger the “right” behaviour which is in accordance with their moral feelings.

A more severe argument is that central moral feelings such as sympathy or fairness for others are maybe restricted to friends, relatives or members of the same ethnic group. Insofar as this is the case, the resulting morality is only a particular ethic and not a truly universal one (Bayertz 2004: 212f.). Whereas some experiments (ultimatum, dictator, trust and public good games) show that human altruism can be found even in the absence of kin or group relations, others support the hypothesis that in stable groups with the possibility to sanction the degree of cooperation is remarkably higher than in groups with changing members from round to round without sanctions (Fehr/Fischbacher 2003; Fehr/Renninger 2004). At the moment, it must be said that based on empirical grounds the exact scope of moral feelings is an open question and at “the ultimate level, the evolution and role of altruistic rewarding for cooperation in larger groups remains in the dark” (Fehr/Fischbacher 2003: 790).

With respect to normative codes of conduct Lauer et al. (2008) show in a laboratory standard public good experiment subjects who were shown excerpts from normative code of conduct contribute to a higher extent to the public good and at the same time free-riding behavior is reduced. They conclude that codes of ethics which in economic terms are only “cheap talk” can be an effective mean to increase team production efficiency.

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<sup>7</sup> See for a respective experiment Frank (2004: 28-44).

## 5 Ethical behaviour in an auditing context

What follows from the above comments in Section 3 and 4 with respect to my initial question “Why should a rational auditor obey the *moral norms* contained in a Code of Ethics?”. In Section 3 I tried to show that the reconstruction of a Code of Ethics as rational agreement between professional accountants failed. In Section 4 we abandoned the assumption of a purely self-interested auditor and this opened *in principle* the possibility that a strong minority of auditors with a disposition to “strong reciprocity”, i.e. a disposition to punish other members of the profession who act as free-riders, even then if this is related with substantial costs, enforces norm-compliance within the profession. Furthermore, without sanctions the pure existence of a Code of Ethics may increase cooperation and decrease free-riding (Lauer et al. 2008). The question, however, is if the results of the experiments done by Gürerk et al. (2006) and Lauer et al. (2008) *can be generalized to the auditing profession*. Could such an altruistic punishing behaviour or the pure existence of a Code enforce the compliance with a Code of Ethics? I’m in doubt about that and will discuss these doubts with respect to the German auditing professions.<sup>8</sup>

The profession in Germany is comprised of approximately 14,000 public auditors, i.e. the marginal return of a single auditor who contributes to the public good “moral reputation of the profession” is negligible small. Unlike experimental conditions a clear monetary valuation of the return is not possible and in addition uncertain. In the above mentioned experiment it was possible to identify free-riders without ambiguity and without uncertainty. They remain anonymous but the other participants receive information about the free-riders and they can allocate rewards and sanctions in monetary form via the experimenter. In the auditing reality the transgression of moral norms cannot be detected *ex post* if we do not consider specific investigative inspections and rely only on mutual monitoring between auditors. Auditors get information about the activities of other professionals only in the case of an auditor change or during audits of consolidated financial statements. However, auditor changes are rare events. The auditing profession commands over an *institutionalized mutual monitoring system*, e.g. the German quality control system (see for details Articles 57a et seq. Law Regulating the German Profession of Auditors (WPO) and Marten et al. 2007: 541 et seq.). All auditors in Germany offering statutory auditing services have to submit to the quality assurance system. “The review serves to control the professional’s compliance with the principles and measures of quality control in accordance with the laws and the by-laws of the

Wirtschaftsprüferkammer (Chamber of Auditors) in general and when performing specific engagements” (Article 57a, para. 2 WPO). If offences against professional norms are detected during a quality control these facts “may not be used in disciplinary proceedings in accordance with Articles 63 et seq. and the fifth part of this Law” (Article 57, para 4 WPO). For this reason a central possibility to sanction will not be used by the profession. Due to confidentiality obligations for the institutions engaged in the quality control system informal sanctioning by “gossip” is not possible.

Also unanswered remains the question to what extent individual moral feelings like shame and guilt in conjunction with norm-deviant behavior play a role in the auditing context, especially if we talk about audits of large public companies engaged on anonymous capital markets. Insofar as I know we have no empirical evidence in favor of punishment via social disesteem and pressure. Only in cases with high publicity, so-called accounting scandals, the public discourse could be interpreted in this sense. It should be mentioned that members of the profession could be interested in the concealment of professional failures because disclosure may damage the reputation of the profession in the public. Otherwise one could argue that a tough sanctioning regime could increase the reputation of the profession as a whole.

To sum up in Germany the possibilities for *mutual monitoring and sanctioning with informal measures* are currently weak. Another opportunity to solve a social dilemma and discipline free-riders is the formation of a (state-run) authoritative agency which is equipped with investigation and sanctioning competencies. In Germany and in other countries as well this seems to be the preferred solution. The new Law about the Reform of the Supervision of the Profession from September 2007 has expanded the competencies of the German Public Chamber of Auditors. The Chamber has the obligation to do inspections in case of concrete indication for professional misconduct of auditors. For auditors who audit firms of public interest (firms engaged on the capital market, banks and insurance companies) the Chamber can do random inspections without concrete evidence for wrongdoing. In case of severe violation of profession norms the Chamber induces a legal court procedure. The solution in Germany can be characterized as a *Hobbes’* solution, i.e. submittal under a state authority. This shows that the rational self-interest as well as moral incentives is seen to be not powerful enough to solve social dilemmas in the profession.

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<sup>8</sup> For a general and critical discussion about the generalizability of experimental results concerning social preferences see Levitt/List (2007).

## 6 Summary and conclusions

I started in *Section 1* with the question “Why should a rational auditor obey the moral norms in a Code of Ethics?”. In *Section 2* it has been shown that the IFAC Code of Ethics contains simple and fundamental ethical principles which were concretized for specific situations of the auditing profession. Professional associations and the public expect that auditors obey the Code of Ethics not only because they fear legal sanctions like reprimands and fines but also because of their inner conviction. *Section 3* analyzed if a Code of Ethics in conjunction with informal internal and external sanctions like social pressure and feelings of guilt and shame could be interpreted as a hypothetical agreement between rational auditors. We failed because the ex ante self-binding of a Rational Egoist who has the opportunity to transgress a moral norm in a one-shot situations without the risk of detection and subsequent sanctions is not rational obligatory. In addition the justification of moral feeling in a rational-contractualistic approach is too far-fetched. Selected empirical results about the human behaviour in social dilemmas in *Section 4* have shown that altruistic behaviour including altruistic rewarding and sanctioning in public good experiments can convincingly be demonstrated. The existence of a strong minority of human beings with a disposition to “strong reciprocity” is of major importance because this minority under certain conditions can induce cooperation. Strong reciprocators sanction free-riders even if the cost of a sanction is greater than the benefit. However, the question is if the results from experiments can be extrapolated to real situation in the auditing profession. In *Section 5* we argue that the moral power of a Code of Ethics in the German profession is weak. The effectiveness of fundamental professional principles is predominantly dependent from legal but not moral sanctions.

If human beings would be perfect egoists or perfect altruists then moral norms in general and a Code of Ethics in particular would be superfluous. Pure rational considerations done by selfish persons lead to decisions which maximize the self-interest and leave no room for moral obligations. Altruists with other-regarding or social preferences need no explicit moral norms because their behaviour follows from a stable genetical-cultural disposition and therefore an explicit normative moral requirement is not necessary.

However, it remains an open question how altruistic cooperation has been developed and works in detail in larger groups or societies and therefore it remains an obvious need to transcend pure empiricism and to enter the philosophical and normative sphere. Exactly because the human nature is neither truly altruistic nor truly egoistic there is a need for moral norms in general or a “Code of Ethics for Professional Accountants” in particular, otherwise

they would be superfluous. In this sense the Code of Ethics is neither a pure lip-service nor a strict self-binding agreement: The truth lies between these two extreme positions.

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