

Does Organizational Ethical Climate Influence Auditors in Perceiving Ethical Problems and Forming Ethical Judgments?

Maheran Zakaria^{1,3}, Hasnah Haron² and Ishak Ismail²

*¹Faculty of Accountancy, Universiti Teknologi MARA
Machang Campus, Bukit Ilmu, 18500 Machang, Kelantan, Malaysia*

*²School of Management, Universiti Sains Malaysia
11800 Pulau Pinang, Malaysia*

³Email: maher835@kelantan.uitm.edu.my

ABSTRACT

The increasing cases of unethical behavior among auditors have led the public to distrust the credibility of this profession. The public accused that most of auditors with unethical behaviors are due to their motivation by revenue generation. Ironically, in the pursuits of generating revenue, some of auditors are willing to go beyond acceptable ethical standards, resulting to increase the probability of unethical judgments. As such, this triggers expectation that audit firms to strictly govern their members' behavior within the ethical manner. Hence, this paper attempts to examine the influence of organizational ethical climate on auditors' perceived ethical problems and ethical judgments. A total of 940 questionnaires were sent to auditors throughout Malaysia. However, an approximate of 250 questionnaires was returned but only 224 were usable. By using path analysis, of AMOS 16.0, the study found that organizational ethical climate influences auditors in perceiving ethical problems, while perceived ethical problems does influence ethical judgments. Finally, perceived ethical problems were found to mediate the relationship between organizational ethical climate and ethical judgments. Hence, these findings will be useful to those in auditing industry in their effort to improve auditors' ethical perceptions and ethical judgments.

Keywords: *organizational ethical climate, auditors, perceived ethical problems, ethical judgments*

Introduction

In recent years, there has been a series of financial scandals in some of the well-established corporations throughout the world. Many people are responsible for these scandals and amongst them are the directors, senior management team as well as the auditors (Accountants Today, July 2007). Evidences have shown that there are involvements of these people in the scandals, specifically the auditors.

Enron was one of the biggest auditing scam involving Andersen and perhaps the best known. The auditor of Enron for a couple of years was Andersen and its revenue in the year 2000 was heavily contributed by Enron. The revenues consisted of US\$25 million from auditing services and another US\$27 million from lucrative consulting services. The over reliance on revenue from Enron had created a strong relationship between them and thus leading Andersen to compromise its professional ethical judgments (Accountants Today, July 2007). Even worst, Andersen was complicit in perpetrating one of the biggest frauds in corporate history. Meanwhile, in a recent scandal involving an Indian outsourcing company namely Satyam; its auditor Price Waterhouse was accused for negligence in performing his or her duties. In this particular case, the auditor signed off the balance sheets, when in fact the company had reported fictitious assets amounting to US\$1 billion. Malaysia has not been spared either, many financial scandals involving big corporations also happened here. Some of the corporations were Transmile Group Berhad, Megan Media Holdings, Southern Bank, Technology Resources Industries Berhad and Cold Storage Malaysia Berhad.

This succession of financial scandals has eroded the image of auditing profession in Malaysia. According to Lee, Azham and Kandasamy, (2008), these scandals have caused a lot of accusation and criticism by outsiders that auditors are not performing their duties ethically. As a result, the public has become cynical about the integrity and ethicality of auditors leading to a crisis of confidence over the profession, as the public perceives these unethical judgments are due to the auditors' motivation for revenue generation (Brook & Dunn, 2008). Auditors exist to serve the public, therefore to be relevant they must put the interest of the public ahead (IFAC, 2001). However, those scandals are an indication that they are doing otherwise, ignoring moral and ethical issues by forming judgments which are not in accordance with professional ethical requirements. This has spurred the need for studies to examine the factors that influence auditors in the formation of ethical judgments.

These studies may help the profession's future planning and development and ultimately restoring the public confidence and corporate reputation. The organization or audit firms are presumed to be the main body to monitor their members' ethical behavior. In return, being employees or members of the organizations, auditors are bounded to the rules and regulations imposed. Hence, to a certain extent, the ethical environment at work place will mould and influence its members in perceiving ethical problems and forming ethical judgments. Prior studies have documented that organizational ethical climate do influence perceived ethical problems (Marta, 1999; Patterson, 1994) and ethical judgments (Aw, 2006; Forte, 2004; Ampofo, 2004; Douglas, Davidson & Schwartz, 2001; Marta, 1999).

Moreover, prior studies have indicated that a person has to perceive ethical problems before he or she forms ethical judgments (Malone, 2006; Marta, Singhapakdi, Attia & Vitell, 2004; Kantor & Weisberg, 2002; Shafer, Morris & Ketchand, 2001; Marta, 1999; Patterson, 1994). However, very few studies have been conducted to investigate the impact of perceived ethical problems in mediating the relationship of organizational ethical climate to ethical judgments (Marta, 1999; Patterson, 1994). Furthermore, these studies were conducted in the United States, which was different from our local context, specifically in terms of organization ethical climate. Therefore, the results may not be similar. As such, this study attempts to fill this gap by examining the relationship between organizational ethical climate and perceived ethical problems.

Furthermore, it will also examine the relationship between perceived ethical problems and ethical judgments among auditors in our Malaysian setting. Finally, it will investigate whether perceived ethical problems mediate the relationship between organizational ethical climate and ethical judgments. This paper will commence with a discussion on an organizational ethical climate, perceived ethical problems and the relationship between these variables. The subsequent section will present the methodology, followed by the research findings, discussion and ended with conclusion.

Literature Review and Hypotheses

The literature is reviewed in three separate sections. The first section emphasizes on the theory or model of ethical judgment. Meanwhile, the second section focuses on the relevant variables to this study and the third section highlights on the previous studies pertaining to the correlations among these variables.

Theory of Ethical Judgment

Theory of ethics as was introduced by Hunt and Vitell (1993; 1986) predicts that one of the factors that influences perceived ethical problems is the organizational and professional ethical climate. The theory then further indicates that perceived ethical problems trigger the formation of ethical judgments. The theory is supported by several models of ethical judgment which indicate perceived ethical problems has led to ethical judgments, for example, the Issue Contingent Model, (Jones, 1991); Person-situation interactionist model (Trevino, 1986); Contingency Model (Ferrel & Gresham, 1985); Synthesis Integrated Model (Ferrel, Gresham & Fraedrick, 1989) and 4 component models (Rest, 1986).

Organizational Ethical Climate (OEC)

Victor and Cullen (1988) have conceptualized an organizational ethical climate as the employees' perceptions to the extent that the organization's commitments are concerned with the ethical issues involving its employees and management. Marta (1999) asserts that it is the climate created within the organization through the management practices of ethical policies, enforcement and action. Thus, this climate in turn has creates the shared perceptions among employees pertaining to ethical conditions of their organization. However, the realities of an organization are only understood in accordance to what are being perceived by their members (Forte, 2004). Furthermore, Marta affirms that the members within an organization should predict the consequences or actions taken against the misbehavers. According to Fang (2006), the organizational ethical climate creates and inculcates ethical beliefs among its members of what is being perceived by members of their organization. It is expected that this will influence their ability to perceive ethical problems. Generally, members' perceptions include the organization's functions, events, practices, procedures, punishments, rewards, supported and expected behaviors, consideration of peers, supervision and the way the management handles ethical problems. Thus, an organization that seeks to foster ethical environment will not only adhere its own code of ethics but also the willingness and commitment to enforce it in the form of authority and enforcement (Doughlas *et al.*, 2001; Jones, 1991; Finn, Chonko & Hunt, 1988; Trevino's 1986).

However, if employees perceive that the organization that they are working for are lacking of commitment to support the ethical values,

there will be a higher tendency for moral deficiencies and unethical behavior to occur (Ward, Ward & Deck, 1993; Postner & Schmidt, 1984). Ironically, this situation could be increasingly happening within organizations which support unethical activities, particularly the organizations that make most of its profit from unethical or illegal activities. As a result, it could distract the members of organization from perceiving ethical problems as a serious offence and causing them to be less likely to perform duties ethically. Therefore, ethical climate practiced in the organization greatly affects on the personal values, attitudes and behaviors through the instructions given at the work place (Hofstede, 1998; Hansen, 1992). It appears that, being apart from the organizational 'community' has somehow shaped the employees' behavior according to the organizational ethical climate. Subsequently, this orientation would influence their perceptions of ethical problems. In addition, the management is responsible to create a sound ethical climate within an organization (Mendonca, 2001). Hence, the role of reinforcing the organizational ethical climate and its members' ethical behavior lies both on the management and employees. As such, a sound organizational ethical climate perceived by members will spur them to perceive ethical problems and the likelihood of forming an ethical judgment.

Perceived Ethical Problems (PEP)

The perception on ethical problems or sensitivity on ethical issues refers to an individual's recognition concerned with credibility and realization of him or herself as a responsible agent (Jones, 1991). Marta (1999) conceptualizes the perceived ethical problems as the ability of an individual to discern and recognize the existence of ethical problems or unethical elements within an ethical dilemma. Moreover, Karande, Rao and Singhapakdi (2000) identify that they perceive ethical problems as an involvement into illegal act, yet the perceptions are varied across individuals' actions and situations. Schlater (1990) supports that systematic differences exist on ethical judgments may be caused by the differences of their perceiving ethical problems. In other words, different people may perceive ethics differently seeing that different employees would undergo different circumstances and require different reactions (Karcher, 1992).

The Relationship between Organizational Ethical Climate and Perceived Ethical Problems

A few relevant models on ethical judgments are predicted to have a significant correlation with perceived ethical problems. For example, the person-situation interactionist model proposes the organizational factors to have an interaction effect with regard to the ethical evaluation (Trevino, 1986). In addition, the issue-contingent model postulates that organizational variables influence people in recognizing ethical issues which in turn influence their ethical judgments (Jones, 1991). Hunt and Vitell's affirm that the theory of ethics (1993, 1986) also posits that particular organizational environments influence people in perceiving ethical problems. Similarly, previous studies have indicated that the more ethical employees acknowledged the climate in their organization; the higher ability they have to perceive ethical problems (Marta, 1999; Patterson, 1994). Hence, there is a lesser tendency for unethical judgments to occur.

Marta (1999) has further identified that an empirical study on the contributing factors in perceiving ethical problems, ethical judgments, and intentions. This study was analyzed by using the Lisrel program with sequential equation modeling (SEM). Hypothetically, the correlation and path analysis have indicated that marketers who work in organizations with higher ethical climates were more perceptive with problematic ethical content. Thus, they were more likely to form ethical judgments. The research model addresses the relative importance of organizational ethical climate in determining perceived ethical problems. Likewise, the study is analyzed with SEM using the Lisrel program. The results have supported the model in the context that the organizational ethical climate influenced the respondents' perceived ethical problems. Based on the nature of duties, an audit firm is known as one of the organizations that strictly imposes a high ethical climate derived from various procedures and policies. Furthermore, the influence of peers' and superiors' unethical behavior, ethical environment, rules, and punishments in the firm would also be important matters in influencing auditors in perceiving ethical problems (Patterson, 1994).

Despite the proliferation of research on organizational ethical climate, little knowledge has been revealed about the effects of ethical climate of audit firms on perceived ethical problems. In the context of a profession, this study intends to examine the relationship between ethical climates of audit firms with the perceived ethical problems. Based on Hunt and Vitell's theory of ethics (1993, 1986) and prior studies (Marta, 1999; Patterson,

1994), it is expected that the higher the auditors perceive that their firms have given commitment in promoting ethical climate, the more likely they will perceive ethical problems. As such, this study develops the following hypothesis.

H₁: There is a positive relationship between organizational ethical climate and perceived ethical problems.

Ethical Judgments (EJ)

Hunt and Vitell (1986) define ethical judgments as judgments by which one identifies ethical problems and considers alternatives that best solve the problem to attain the most beneficial outcome. In addition, it concerns with one's judgment about what is "right" or "wrong" in the context of socially acceptable standards. On the other hand, an unethical judgment refers to an assessment that would benefit the decision makers yet could bring harm to others (Greenberg, 2001). Fang (2006) has further identified that ethical judgments are the ruling that one could freely formed based on the evaluation of the interests of all parties when facing the ethical dilemmas. Therefore, ethical judgments are important as they would reflect onto the ethical behavior as the practitioners are in dilemma (Bommer, Gratto, Gravender & Tuttle, 1987; Blasi, 1980). Therefore, it is understandable that the ethical judgments are the decisions ones has formed after identified ethical problems and has evaluated either an action is morally "right" or "wrong" according to the professional ethics and standard code of conduct.

The Relationship between Perceived Ethical Problems and Ethical Judgments

Numerous empirical studies were conducted with an attempt to discover the relationship between the perceived ethical problems and ethical judgments (Maheran *et al.*, 2009; Marta, *et al.*, 2004; Zeigenfuss & Martinson, 2002; Shafer, *et al.*, 2001; Marta, 1999; Patterson, 1994). Maheran *et al.* (2009) have carried out a study purposely to investigate the relationship between the perceived ethical problems and ethical judgments with 524 marketers and the results indicate a strong correlation exists between these variables. Marta *et al.* (2004) have further analyzed on the ethical judgments of Middle Eastern marketers and the results revealed that the perceived ethical problems were a contributing factor towards ethical judgments. Likewise, the results were consistent with a

study carried out by Zeigenfuss and Martinson (2002) that investigated the relationship between perceived ethical problems and ethical judgments. The findings revealed a positive relationship between these two variables.

Shafer *et al.* (2001) have investigated the effects of perceived ethical problems on auditors' ethical judgments. Hypothetically, the study has signified that the greater the perceived ethical problems the greater the likelihood of the formation of ethical judgments. A study by Marta (1999) has examined the impact of perceived ethical problems on ethical judgments conducted among American Marketing Association (AMA) practitioners. The findings have confirmed the hypothesis that the respondents who were more perceptive to the existence of ethical problems were more likely to form ethical judgments. Finally, Patterson (1994) has conducted a study to determine the relationship between perceived ethical problems and ethical judgments among 174 auditors from Big-Six firms in two major northeastern cities in the US. Also, the results reflected that the greater the perceived ethical problems, the greater were the likelihood of the formation of ethical judgments.

The perception of ethical problems is the beginning stage that triggers ethical judgments as one can make ethical judgments only after recognizing the existence of ethical problems [Ethics Education Framework, IFAC (2006); Hunt and Vitell theory of ethics (1993; 1986); issue contingent model (Jones, 1991); synthesis integrated model (Ferrel *et al.*, 1989); 4 component-model (Rest, 1986)]. Additionally, these models indicate that if one does not perceive the existence of ethical problems, then ethical judgments could not exist. Many studies have indicated the positive relationship between ethical problems and ethical judgments (Malone, 2006; Marta *et al.*, 2004; Kantor & Weisberg, 2002; Zeigenfuss & Martinson, 2002; Shafer *et al.*, 2001; Marta, 1999; Patterson, 1994; Lampe & Fin, 1991; Schlender, 1990). As such, it appears that the perception of ethical problems is an important factor contributes to ethical judgments.

As such, based on the Hunt and Vitell theory of ethics (1993, 1986), ethical judgment models [issue contingent model (Jones, 1991); synthesis integrated model (Ferrel *et al.*, 1989); 4 component model (Rest 1986)], previous ethics studies (Malone, 2006; Marta *et al.*, 2004; Kantor and Weisberg, 2002; Zeigenfuss & Martinson, 2002; Shafer *et al.*, 2001; Marta, 1999; Patterson, 1994; Lampe & Fin, 1991; Schlender, 1990) and Ethics Education Framework (2006) issued by IFAC, it is proposed that the greater the auditors perceive ethical problems, the more likely they will form ethical judgments. Hence, the study proposes the following hypothesis.

H₂: There is a positive relationship between perceived ethical problems and ethical judgments.

Perceived Ethical Problems as a Mediator

Previous studies have indicated that perceived ethical problems are a mediator to influence the organizational ethical climate towards forming the ethical judgments Marta (1999); Patterson (1994). Marta (1999) adopts the Hunt and Vitell theory of ethics (1993; 1986) which perceived ethical problems as a mediating variable between organizational ethical climate and ethical judgments. Patterson (1994) has also adopted Hunt and Vitell theory of ethics (1993; 1994) examining the factors of ethical judgments among auditors. The study revealed that perceived ethical problems as a mediating variable in the relationship between the organizational ethical climate and ethical judgments. Hence, based on the Hunt and Vitell theory of ethics (1993, 1986), previous ethics studies (Marta, 1999; Patterson, 1994), it is predicted that perceived ethical problems will mediate the relationship between organizational ethical climate and ethical judgments. Therefore, it is hypothesized that:

H₃: Perceived ethical problems mediate the relationship between organizational ethical climate and ethical judgments.

The theoretical framework is illustrated in Figure 1.

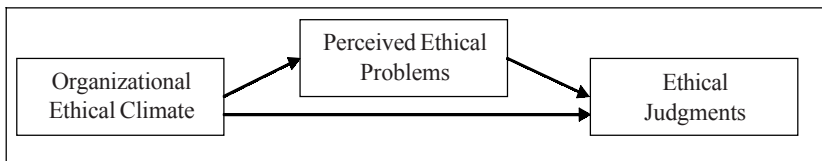


Figure 1: Theoretical Framework

Methodology

Population

The population of this study consisted of audit practitioners who are working for public audit firms and members of MIA. The list of audit firms' addresses from which this study drew the sample was taken from MIA's 2007 directory. However, this list only includes the names and

addresses of audit firms and not the names of the respondents. Hence, the questionnaires were sent to audit firms to be distributed to their audit staff who are MIA's members. There were 1374 audit firms in Malaysia as of 30 June 2007.

Sample

Samples were then selected based on the number of audit firms located in every state in Malaysia. A proportional sampling was done based on a stratified random sampling. According to Krejcie and Morgan (1970) the proposed sample size for population 1400 is 302 or equivalent to 23.0%. Therefore, in order to obtain this sample size ($1374 \text{ firms} \times 23\% = 304 \text{ firms}$), about 940 questionnaires were distributed to 304 audit firms throughout Malaysia. The selected firms (that were taken from MIA's 2007 directory) were contacted through telephone calls. The purpose was to seek their permission to allow questionnaires being sent to their audit staff. Firms which express an interest to participate were given three copies of the research booklets ($300 \text{ firms} \times 3 \text{ questionnaires} = 900 \text{ questionnaires}$). However, the Big 4 firms were given ten copies each ($10 \text{ questionnaires} \times 4 \text{ firms} = 40 \text{ questionnaires}$) amounting to 940 questionnaires being distributed ($900 \text{ questionnaires} + 40 \text{ questionnaires} = 940 \text{ questionnaires}$). The questionnaires consisted of a cover letter and a research booklet. They were sent via mail to the contact person or audit manager or partner of the selected audit firms. The instruments were then distributed to individual auditors. The firms were also requested to return the completed research instruments in a self-addressed and pre-stamped envelope to the researcher. They were assured of confidentiality and anonymity. After 2 weeks, when the questionnaires were not received, the researcher contacted the officers-in-charge to remind them to collect the questionnaires and to mail them to the researcher. Of the 940 questionnaires sent out, 250 were returned. However, only 224 were usable, representing a 23.82% response rate. The remaining 26 unusable questionnaires were received from respondents who were not MIA members. As the sample of this study only targeted the audit practitioners who are members of MIA, their responses were excluded. This sample size was assumed sufficient as stated by Roscoe's (1975) rules of thumb that any sample sizes of larger than 30 and less than 500 are appropriate for most research.

Variables and Measurements

Use of Scenarios

The study used ethical scenarios to measure perceived ethical problems and ethical judgments. The use of scenarios has been tested in prior researches and has offered several advantages (Malone, 2006; Ampofo, 2004; Marta, 1999; Patterson, 1994). Among them are the ability to access cognitive thinking over a wide variety of respondents and fields. Moreover, it can assess the relevance of issues within a research scope. However, there is a drawback from the usage of scenarios in which the respondents may not be familiar with the selected scenarios. Therefore, careful selection is important for the research design. This is to ensure that the scenarios are common unethical practices faced by the respondents. In this study, the respondents were given three scenarios of auditing ethical dilemmas; confidentiality (non-compliance to MIA By-laws section 12), low balling (underperform audit and low balling) and underperformed audit (Acts discreditable to the profession non-compliance to MIA By-laws section 18) (adopted Cohen, Pant and Sharp, 1992). The respondents were required to analyze and respond to the scenarios in a similar manner to the study of Marta (1999). The difference between this study and Marta's (1999) was that the prior study examined the marketers' ethical judgments based on the three circumstances namely; marketing research, selling defective product and force selling. This study on the other hand, has examined the auditors' ethical judgments; as such it required respondents to analyze three auditing scenarios as mentioned above.

Perceived Ethical Problems

Perceived ethical problems were the focus of many previous studies (Md. Zabid & Saidatul, 2008; Malone, 2006; Marta *et al.*, 2004; Md. Zabid & Ho, 2003; Cherry & Fraedrick, 2002; Kantor & Weisberg, 2002; Karcher, 1992; Wilkins *et al.*, 1990; Shaub, 1989). In addition, the perceived ethical problems were a mediating or endogenous variable to a numbers of previous studies (Nill & Schibrowsky, 2005; Zeigenfuss & Martinson, 2002; Buchan 2004; Marta, 1999; Patterson, 1994). Likewise, perceived ethical problems were one of the endogenous variables in this study because it was assumed to be the first stage in the formation of ethical judgments. Meaning, the ethical judgment should take into place prior to any ethical judgments.

Perceived ethical problems could be measured by a single item from the three ethical scenarios (adopted from Cohen, Pant & Sharp, 1992). The three ethical scenarios employed were confidentiality, low balling and underperforms audit. Here, the perception (perceived ethical problem) was a type of sight, measured by a single test to assess the extent of how clearly one could discern an object. After the respondents have read a scenario, they have to express their degree of agreement whether or not the situation involved is ethical (on a nine-point Likert scale from 1 = strongly disagree to 9 = strongly agree). Next, the score for each of the scenario was analyzed and added. The score of more than 1 indicated that the respondents were able to perceive the existence of an ethical problem in the scenario. The use of a single item measure was similar to prior studies and intuitively satisfying (Marta *et al.*, 2004; Marta, 1999; Singhapakdi & Vitell, 1991).

Ethical Judgments

This study has also measured the ethical judgments (endogenous variable) through single item based on the three auditing scenarios to measure the perceived ethical problems (confidentiality, low balling and underperforms audit). The respondents are required to indicate their degree of agreement with the action as described in the scenarios (Please rate the auditor's action as to how ethical you believe it was), measure on a nine-point Likert-scale (1 = very ethical, 9 = very unethical). Each score from the three scenarios would be added and divided by the total number of scenarios to get the variable's mean value. A high score indicates a respondent was more likely to form ethical judgments (respondents perceived the situation as unethical). Meanwhile, a low score indicates that a respondent was less likely to form ethical judgments (respondent perceives the situation as ethical). However, this measurement was similar to previous studies (Md. Zabid & Saidatul, 2008; Marta, 1999; Singhapakdi *et al.*, 1994; Hunt & Vasquez-Parraga, 1993; Singhapakdi & Vitell, 1993; Mayo & Marks, 1990).

Organizational Ethical Climate

The exogenous variable of this study is the organizational ethical climate. Organizational ethical climate refers to the employees' perceptions on a set of managers' and employees' ethical values and the formal and informal policies on ethics of the organization (Hunt & Vitell, 1986). It is also

concerned with the perceptions on how the managerial board promotes a sound ethical climate within the organization. This study examines on the impact of organizational ethical climate and the auditors' perceived ethical problems and accordingly adopts a scale which is developed by Hunt and Vitell (1986). Originally, there was only 5 questions been asked to the respondents (question 1, 3, 4, 5 and 7), yet, another 3 questions were added (question 2, 6 and 8) purposely to generate a more reliable research findings. This measurement had been utilized in the previous studies (Aw, 2006; Zeingenfuss and Martinson, 2002; Marta, 1999, Singapakdi *et al.*, 1995; Hunt *et al.*, 1989).

There were 8 questions which would be specifically measured based on the nine-point Likert type scale from 1 (strongly disagree) to 9 (strongly agree). In general, the questions were constructed pertaining to the top management board members and the employees' ethical behavior, the punishment against the misbehavers and ethical orientation practiced within the organization. All scores from questions 1 to 8 would be added as to ascertain the variable mean score. In other words, the higher the score, the higher perception that the employees have towards the ethical values.

Data Analysis and Findings

The research findings and discussions of the findings were analyzed in three sections. The first section presented the demographic profile of respondents, meanwhile, the second section focused on the statistical analysis and descriptive results by using SPSS 16.0 and finally, the third section discussed the hypotheses testing.

Response Rate

An approximate of 940 questionnaires was distributed via mail to the identified audit firms located throughout Malaysia. The firms' addresses were obtained from MIA directory. Of the 940 set of questionnaires distributed, only 250 were returned. However, only 224 were usable, for a total response rate of 23.8 %. The remaining 26 questionnaires were received from non-MIA's members, thus they were excluded from the analysis.

Profile of Respondents

The demographic profile of this study indicated that 67.5 % of respondents were female, while the remaining 33.5 % were male. Meanwhile, the respondents' levels of education were as follows; 67.9 % is the degree holder, followed by professional qualifications (67.9 %), Master (3.1 %) and PhD (3.1 %). In terms of level of position, there were 42.9 % of them are the seniors, 29.0 % managers and the remaining 28.1 % partners. For job tenure with the present firm 37.1 % had been with the firm less than 3 years, 45.5 % within 3 to 6 years, 10.7 % within 7 to 9 years and 6.7 % above 9 years. Almost 22.8 % had membership with MIA for a period of less than 3 years, 54.0 % within 3 to 6 years, 14.7 % within 7 to 9 years and 8.5 % above 9 years. As for the working experience as an auditor, 15.6 % had an experience less than 3 years, 66.1 % within 3 to 6 years, 10.7 % within 7 to 9 years and 7.6 % above 9 years. In addition, about 29.0 % of respondents had encountered unethical situations such as low balling, underperforms audit and confidentiality. This confirmed that unethical situations did occur and were encountered by audit practitioners. Finally, 14.7 % of the respondents were attached to Big Four, and the remaining 85.3 % were employed by Non Big Four. All information is presented in percentages to facilitate interpretation. Table 1 represents the distribution of demographic profile of respondents.

Statistical Analysis

Assessment of the Normality

Firstly, the data were assessed to determine the normality of distribution or to check the existence of outliers. These outliers could be very high or very low scores (extreme values) and could result in non-normality and distorted statistics (Hair *et al.*, 2006). To check any deviation from normality, many methods can be used and one of them is skewness and kurtosis (Hair *et al.*, 2006). The values should not be greater than positive one (1.0) and lower than negative one (-1.0). In other words, values that are not in this range are candidates for modification and elimination. Using SPSS, the results indicated that both values of skewness and kurtosis were within the recommended levels, suggesting univariate normality. All the variables indicate that they did not deviate from normality, therefore it was not necessary to make any adjustments.

Table 1: Demographic Profile of Respondents

	%		%
Gender		Level of education	
Male	33.5	Degree	67.9
Female	67.5	Professional qualification	25.9
		Master	3.1
Years being a member of MIA	22.8	PhD	3.1
Less than 3 years	54.0	Level of position	
3 to 6 years	14.7	Senior	42.9
7 to 9 years	8.5	Manager	29.0
Job tenure with present firm		Partner	28.1
Less than 3 years	37.1	Encountered unethical situation	
3 to 6 years	45.5	Yes	29.0
7 to 9 years	10.7	No	71.0
More than 9 years	6.6		
Years being an auditor		Firm category	
Less than 3 years	15.6	Big Four	14.7
3 to 6 years	66.1	Non-Big Four	85.3
7 to 9 years	10.7		
More than 9 years	7.6		

The measurement model was assessed in two stages. The first stage is to measure the unidimensionality while the second stage is to assess reliability and validity. In the first stage, the measurement model was assessed by determining the relationship between factors and their items. The factor loading between underlying factors should not exceed .85 (which indicates that the factor being highly correlated, showing a lack of discriminant validity). Meanwhile, convergent validity exists when the relationships between all items are statistically significant ($p < .05$) and loadings on their specified factors are above than .50 (by being AE .50 and over). Construct validity exists when the measure is a good representation of the variable. Finally, the assessment of model fitness using goodness-of-fit indices has confirmed construct validity.

In the second stage, further analyses were conducted to evaluate the reliability and validity of each construct in the model. Reliability test or cronbach's alpha, CV and AVE were used to assess internal consistency. The recommended level is .60 for Cronbach's Alpha, .60 for CV and .50 for AVE (Hair *et al.*, 2006). There were three constructs

employed by the study namely perceived ethical problems, ethical judgments and organizational ethical climate.

Perceived Ethical Problems and Ethical Judgments

Based on prior study (Marta, 1999), these two constructs had only one factor. Following the prior study, this study did not perform confirmatory factor analysis on these two constructs.

Organizational Ethical Climate

Organizational ethical climate was measured by two factors namely ethical orientation and punishment. The punishment was measured by 4 questionnaire items (labeled as Ec 1, Ec 2, Ec 3, Ec 4) while ethical orientation was also measured by 4 questionnaire items (labeled as Ec 5, Ec 6, Ec 7, Ec 8). The ethical climate items and their descriptions are presented in Table 2.

Table 2: Ethical Climate Items and Their Descriptions

Items	Item Label
Partners' unethical behavior	Ec 1
Employees' unethical behavior	Ec 2
Compromise ethics in order to success	Ec 3
Management will not tolerate unethical behavior	Ec 4
Partners will be reprimand for unethical behavior to fulfill their personal gain.	Ec 5
Employees will be reprimand for unethical behavior to fulfill their personal gain.	Ec 6
Partners will be reprimanded for unethical behavior to fulfill corporate gain	Ec 7
Employees will be reprimanded for unethical behavior to fulfill corporate gain	Ec 8

As shown in Figure 2, the model (organizational ethical climate) was tested with four indicators measuring punishment (Ec 1, Ec 2, Ec 3, Ec 4) and four indicators measuring ethical orientation (Ec 5, Ec 6, Ec 7, Ec 8). The standardized factor loadings for these measures were all higher than the recommended level of .50. The results indicated that standardized parameter estimates were all significant ($p < .05$) and the results of the

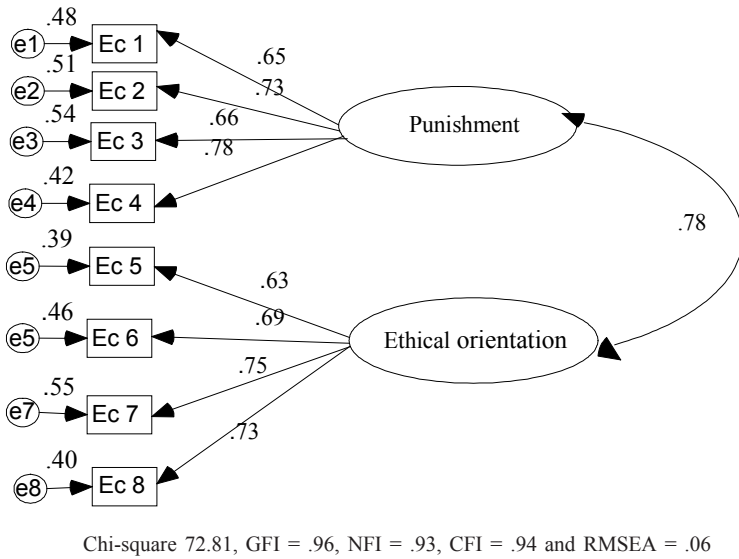


Figure 2: A CFA Measurement Model of Organizational Ethical Climate

CFA indicated that this model fits adequately to the data (the GFI was .96, NFI = .93, CFI = .94, RMSEA = .06). The results showed that the construct had unidimensionality scale for each of the two factors which is indicated by the model fits the data, the correlations between the underlying factors which were less than .85 (see the values on the double-headed arrows in Figure 6.1) and standardized parameter estimates for these measures which were statistically significant ($p < .05$).

Stage Two - Structural Model (The Hypothesized Model)

After all constructs in the measurement model were validated and satisfactory fit was achieved for unidimensionality, a structural model was tested for which it presented a second stage of the analysis. The structural model specifies the relationship between the latent variables and indicates which latent constructs directly and indirectly influence the values of other latent constructs in the model. The analyses of the structural model were conducted by testing the hypothesized model, which specified the three relationships as indicated in Table 4. In this path diagram, the exogenous construct namely organizational ethical climate have a single headed arrows pointing to an endogenous variable (perceived ethical

problems). Straight arrows or single headed arrow indicate causal relationships or paths, whilst absence of arrows linking constructs implies that no causal relationship has been hypothesized. Organizational ethical climate which is measured using two factors (punishment and ethical orientation) is posited to influence perceived ethical problems. Perceived ethical problems were predicted to influence ethical judgments. The values appearing next to the edges of the items are squared multiple correlations between the latent variables.

The values appearing next to the edges of the items are squared multiple correlations between the latent variables. The error terms (e) represent random error due to measurement of the constructs they indicate. Meanwhile, the parameter (z) represents the residual errors in the structural model resulting from random errors. The Structural Model for this study is shown in Figure 3.

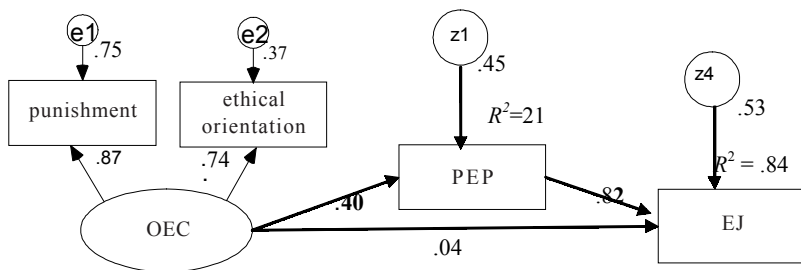


Figure 3: The Structural Model

Model Fitness

A good fit is evident when values for Goodness Fit Index (GFI) are found to be more than .90 (Joreskog & Sorbom, 1984). For Adjusted Goodness of Fit Index (AGFI) a value above .90 are suggestive of good fit (Tanaka & Huba, 1985). Whilst, for Root Mean Square Error Estimate RMSEA (Hair *et al.*, 2006), values should be less than .10 for good fit. The chi-square value should be insignificant, as the observed variables differ considerably (Hair *et al.*, 2006). Finally, for the Normed Fit Index (NFI), a value of 0 was indicates as non-fit, while a value of 1 indicates a perfect fit. The results suggested that the fit indices revealed a very good fit and are exhibited as in Table 3.

Table 3: Fit Indices for Measurement Model

Chi-square	AGFI	GFI	NFI	RFI	CFI	RMSEA
26.69	.998	.0967	.944	.994	.987	.000

The structural model was carried out to test the underlying hypotheses as to answer the research questions. First, the structural model had to be evaluated in terms of the goodness of fit indices. This is to ensure that the hypothesized structural model fits the data. Next, the parameter estimates were examined because they are used to generate the estimated population covariance matrix for the model (Hair *et al.*, 2006) together with coefficients' values. These coefficients' values are obtained by dividing the variance estimate with its standard error. When the critical region (C.R) or z-value is greater than 1.96 for a regression weight (standardized estimates), the parameter is statistically significant at the .05 level. In the path diagram shown in Figure 3, the values for the paths connecting constructs with a single headed arrow represent standardized coefficient beta weights. In addition the values appearing on the edge of the boxes are variance estimates or squared multiple correlations for which the amount of variance in observed variable is explained by latent variables.

Hypotheses Testing

At the structural phase, the method of SEM was used to assess the correlation among the latent variables. Hypothesis 1 was formulated to test the following statement; there is a positive relationship between organizational ethical climate and perceived ethical problems. The results of path analysis indicated that organizational ethical climate had a positive relationship with ethical judgments (standardized estimate = .40, $p > .001$, $R^2 = .21$).

Meanwhile, hypothesis 2 was developed to test the following statement; There is a positive relationship between perceived ethical problems and ethical judgments. Again, the results of path analysis indicated that perceived ethical problems had a positive relationship with ethical judgments (standardized coefficient = .82, $p > .001$, $R^2 = .84$).

Finally, hypothesis 3 was formulated to examine the following proposition; Perceived ethical problems mediate the relationship between organizational ethical climate and ethical judgments. According to Baron

and Kenny (1986) a construct is considered a mediator if it carries the influence of the independent variable (organizational ethical climate) on dependent variable (EJ). Basically, mediating effect or indirect effect is present using SEM if the following three conditions are fulfilled:

1. The independent variable (OEC) is significantly associated with the mediator (PEP). (standardized coefficient = .40, $p < .001$).
2. The mediating variable (PEP) is significantly associated with the dependent variable (EJ) (standardized coefficient = .82, $p < .001$)
3. The independent variable (OEC) is not significantly associated with the dependent variable (EJ) (standardized coefficient = .04, $p > .05$).

The results indicated that organizational ethical climate had significantly influenced perceived ethical problems (endogenous variable). In addition the results indicated that perceived ethical problems (exogenous variable) had significantly influenced ethical judgments. However, the results indicated that there was no relationship between organizational ethical climate and ethical judgments¹. All the requirements for mediator to exist were fulfilled, meaning that, perceived ethical problems were mediators that mediated the relationship between organizational ethical climate ethical problems and ethical judgments. Hence, all the hypotheses are supported and illustrated in Table 4 and the structural model as shown in Figure 3.

Table 4: Testing Hypotheses Using Standardized Estimates
(Hypothesized Model)

Hypothesized path	Standardized estimate	z-value	Supported
H1: OEC → PEP	.40	.64***	Yes
H2: PEP → EJ	.82	.83***	Yes
H3: PEP mediate the relationship between OEC and EJ			Yes

Notes: ** $p < .05$

*** $p < .001$ (two-tailed test).

Discussion and Implications

The discussion of the findings will answer the research questions of this study.

The Relationship between Organizational Ethical Climate and Perceived Ethical Problems

The results of path analysis indicated that organizational ethical climate is positively related to perceived ethical problems (standardized coefficient = .40, $p < .001$, $R^2 = .21$). In other words, the more ethical the climate, the higher is the likelihood to form ethical judgments. The results are seen as comparable with the two previous studies (Marta, 1999; Patterson, 1994). For example, Marta (1999) who has conducted a study among 325 marketers and Patterson (1994) carried out a survey among 174 auditors discovered that the organizational ethical climate had significantly influenced perceived ethical problems. Moreover, the study has also supported by the Hunt and Vitell theory of ethics (1993, 1986) who predicted that organizational environment influences perceived ethical problem. Clearly, organizations that adopted, practiced and promoted a high standard of ethical climate would influence their members in perceiving ethical problems.

Although, the results indicate that 84.4 % of auditors have more than 3 years of working experience as auditors, while 62.8 % have been working with the present firms for more than 3 years, many of the auditors or approximately of 71 % of them have not encountered any unethical problems. It is believed that the organizational ethical climate has helped them to perceive ethical problems efficiently.

Though there is no local study has investigated on the correlation between the organizational ethical climate and perceived ethical problems, there were two researches were conducted to examine on the relationship between organizational ethical climates with other variable namely ethical judgments (Aw, 2006; Gupta & Mohamed, 1996). These studies have also recommended that the firms with transparent ethical surroundings, implementing a strict code of conduct, and enforcing effective mechanisms could relatively prevent unethical behaviors among its employees. Thus, these are considered as essential factors in creating an awareness of ethical issues within members and therefore promote ethical judgments. The results are seen to be consistent with the previous studies (Marta, 1999; Patterson, 1994) and in the meantime supported by Hunt and Vitell theory of ethics (1993, 1986). This study has concluded that the organizational ethical climate has a positive relationship with perceived ethical problems.

The Relationship between Perceived Ethical Problems and Ethical Judgments

The results of path analysis of Structural Equation Modeling indicated that there were positive relationships between perceived ethical problems and ethical judgments (standardized coefficient = .82, $p > .001$, $R^2 = .84$). The results were in tandem with the results of previous accounting studies (Malone, 2006; Zeigenfuss & Martinson, 2002; Shafer *et al.*, 2001; Patterson, 1994) and business (Marta *et al.*, 2004; Kantor & Weisberg, 2002; Marta, 1999). It appeared that the results were consistent across the accounting and business studies. Moreover, the results were supported by many ethical judgment models [Hunt & Vitell theory of ethics (1993, 1986); Issue Contingent model, (Jones, 1991); Synthesis Integrated Model, (Ferrel *et al.*, 1989); 4 Ethical Component Model, (Rest, 1986)] that proposed a link between perceived ethical problem and ethical judgment. Furthermore, Ethics Education Framework (2006) issued by IFAC (International Federation of Accountants) also urges the accountants to perceive ethical problems and identify threats in the functional disciplines of accounting in order to assist them in forming ethical judgments.

In reality, numerous evidences have shown that dishonest practices by Transmile Group Berhad, Megan Media Holdings Berhad, Southern Bank Berhad, Technology Resources Industries and Cold Storage Malaysia Berhad are the results of failure to perceive ethical problems and have ultimately led to unethical judgments. For example, in Transmile scandal, if the management had perceived that inflated revenues were unethical, they would have not committed into this behavior. Similarly, if the external auditors of Delloite and Touche in Tranmille scandal, Arthur Andersen in Enron Scandal and PriceWaterhouse in Satyam scandal, had perceived that the practice of inflating revenues was unethical (incompliance of accounting standards) they would have revealed it to the authoritative bodies in order to avoid the misreporting on their actions. The results have been supported by several models that relevant with ethical judgments (Hunt & Vitell theory of ethics, 1993, 1986; Issue Contingent model, Jones, 1991; Synthesis Integrated Model, Ferrel *et al.*, 1989; 4 Ethical Component Model, Rest, 1986), Ethics Education Framework proposed by IFAC and consistent with prior studies (Malone, 2006; Marta *et al.*, 2004; Kantor and Weisberg, 2002; Zeigenfuss and Martinson, 2002; Shafer *et al.*, 2001; Marta, 1999; Patterson, 1994) Thus, it can be concluded that perceived ethical problems have a positive relationship with ethical judgments and by understanding and practicing the ethical

code of conduct, the tendency towards unethical behaviours can be significantly reduced.

The Relationship between Organizational Ethical Climate and Ethical Judgments through Perceived Ethical Problems (Mediating Impact)

The perceived ethical problem is considered as a mediator that influences the variable towards ethical judgments. Commonly, the mediating effect is presented when the independent variable (organizational ethical climate) is significantly related to the mediator (perceived ethical problems) (standardized coefficient; .40, $p < .001$). The mediator is also significantly related to the independent variable (ethical judgments) (standardized coefficient; .82, $p < .001$). In addition the independent variable (organizational ethical climate) is not significantly related to dependent variable (ethical judgments) (standardized coefficient; .04, $p > .05$). The results of this study are also comparable with the Hunt and Vitell theory of ethics (1993; 1986) and also consistent with some of the previous studies (Marta, 1999; Patterson, 1994). For that reason, it can be concluded that the perceived ethical problems serves as a mediator between the organizational ethical climate and ethical judgments.

Implication

This study has in fact contributed several implications; explicitly, the organization which provides a sound environment to its employees is possibly to generate positive judgments with the perceived ethical problems (Marta, *et al.*, 2004; Zeigenfuss & Martinson, 2002; Shafer, *et al.*, 2001; Marta, 1999; Patterson, 1994).

Practically, the outcomes of this study offer numerous recommendations for those who are in accounting industry. Considering the audit firms as the subject of study, the research findings are definitely have become a challenge in promoting a sound ethical climate at the workplace, however, these strategies are achievable if a stricter implementation of standard code of conduct are taking into place. On the other, severe penalties should be imposed for any violations. These mechanisms would shape the desirable ethical behaviors within members of the profession. Also, the firms are recommended to provide its employees with proper trainings and exposure of policies and ethics.

Essentially, these suggestions are to equip the auditors with necessary ethical knowledge and skills in preparing them to handle ethical challenges while performing their duties.

Limitation and Suggestion for Future Research

Though this study is supported with several theoretical works, there are certain limitations that need to be acknowledged. The first identified limitation is a low score of squared multiple regression ($R^2 = .21$) for the relationship between ethical climate and perceived ethical problems. The lower score could be caused by several reasons, yet, one of the acknowledged factors is the limited variables been constructed for the purpose of this study. Thus, to overcome this limitation, future studies are suggested to examine more variables as have been proposed by Hunt and Vitell (HV) theory of ethics (1993; 1986); that potentially affect perceived ethical problems and the formation of ethical judgments. Among the proposed variables are the personal characteristics of employees specifically their religion, belief system, strength of moral character, stability of emotion and cognitive moral development. Accordingly, it is expected that the future research could enhance the validity of theory along with an increased of testable variables.

The second limitation concerns with the inadequate scenarios provided to the respondents and through which they have to construct ethical judgments. The instruction was seem to be unrealistic, as in an actual working environments, the auditors have been managing numerous issues in different context of situations, and do not merely focusing on the three mentioned scenarios (confidentiality, low balling and underperforming audit). Last but not least, the future studies are also suggested to conduct an in-depth interview with the experienced practitioners on purpose to attain more reliable results.

Conclusion

The organizational ethical climate appears to be persuasive on the perceived ethical problems and ultimately in forming ethical judgments. Additionally, the perceived ethical problems serve as a mediator between the organizational ethical climate and ethical judgments. It is believed that the auditors who are working within a high ethical climate of organization tend to be more convenient in performing their duties in an

ethical way, perceiving ethical problems and eventually forming an ethical judgment. This research finding is proven to be consistent with the previous studies (Aw, 2006; Malone, 2006; Forte, 2004; Ampofo, 2004; Doughlas, Davidson & Schwartz, 2001; Marta, 1999; Patterson, 1994). Though this relationship are originally based on the literature of marketing ethics and has extensively tested in the context of United States, the consistency in its finding is unquestionable; perhaps due to common context of Malaysia and United States and the general judgments of respondents. Finally, this study is expected to generate several beneficial outcomes in assisting the professional bodies as well as the audit firms to restore their profession's and organization's reputation in the eyes of public.

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