

RESEARCH ON PROFESSIONAL
RESPONSIBILITY AND ETHICS
IN ACCOUNTING

RESEARCH ON PROFESSIONAL RESPONSIBILITY AND ETHICS IN ACCOUNTING

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RESEARCH ON PROFESSIONAL RESPONSIBILITY
AND ETHICS IN ACCOUNTING VOLUME 26

**RESEARCH ON
PROFESSIONAL
RESPONSIBILITY AND
ETHICS IN ACCOUNTING**

EDITED BY

TARA J. SHAWVER

King's College, USA



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DESCRIPTION

Research on Professional Responsibility and Ethics in Accounting is devoted to publishing research and cases that focus on the professional responsibilities of accountants and how they deal with the ethical issues they face. The series features chapters on a broad range of important and timely topics, including professionalism, social responsibility, corporate responsibility, ethical judgments, and accountability. The professional responsibilities of accountants are broad-based; they must serve clients and user groups whose needs, incentives, and goals may be in conflict. Furthermore, accountants must interpret and apply codes of conduct, accounting and auditing principles, and securities regulations. Compliance with professional guidelines is judgment-based, and characteristics of the individual, the culture, and the situation affect how these guidelines are interpreted and applied, as well as when they might be violated. Interactions between accountants, regulators, standard setters, and industries also have ethical components. Research into the nature of these interactions, resulting dilemmas, and how and why accountants resolve them is the focus of this book.

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ABOUT THE EDITOR

Tara J. Shawver, CMA, is the Department Chair and Professor of Accounting at King's College in Wilkes-Barre, PA, and is an active member of the American Accounting Association (AAA) and Institute of Management Accountants (IMA). She has received numerous awards and honors for her work including the 2022 Excellence in Accounting Ethics Education Award from the AAA for the development, implementation, and dissemination of new pedagogy for teaching ethics to accounting students; the 2022 IMA Champion Award for her exceptional volunteerism and leadership; and the 2022 Rev. Donald J. Grimes, C.S.C. Annual Award for service-learning teaching excellence. In 2020, she also received an Outstanding Author Contribution Emerald Literati Award.

She has authored or co-authored over 45 articles and chapters that have appeared in *Journal of Accounting Education*, *Journal of Business Ethics*, *Research on Professional Responsibility and Ethics in Accounting*, *Journal of Forensic Accounting*, *Journal of Forensic and Investigative Accounting*, *Journal of Business Disciplines*, *Management Accounting Quarterly*, *Advances in Management*, *Journal of Forensic Studies in Accounting and Business*, *Global Perspectives on Accounting Education*, and *Journal of Emerging Technologies in Accounting*. She has co-authored a book titled *Giving Voice to Values in Accounting*. Her research interests include financial reporting, ethics, whistleblowing, fraud, and ethics education.

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LIST OF CONTRIBUTORS

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CHAPTER 1

CHANGING INTERNAL AUDITING FROM A COMPLIANCE-BASED TO A CONDUCT-FOCUSED APPROACH

Woon Gan Soh^{a,b}, Elena P. Antonacopoulou^c,
Clare Rigg^d, Lourdes F. White^e and Regina F. Bento^e

^aManagement School, University of Liverpool, Liverpool L69 7HZ, UK

^bAsian Pastoral Institute, Singapore 389805, Singapore

^cUniversity of Nicosia, Cyprus

^dLancaster University Management School, Lancaster LA1 4YW, UK

^eMerrick School of Business, University of Baltimore, Baltimore, MD 21201, USA

ABSTRACT

Amid public acknowledgment of recurring ethical violations in the volatile financial service industry, internal auditing (IA) professionals do not seem to have done enough to perform their professional responsibility as a line of defense for their employing organizations. This chapter explores whether changes in an IA approach can effectively enable IA as a practice to fulfill its governance role in managing “conduct risk,” i.e., any behavior in a firm that could cause problems to consumer protection, market integrity or competition. We examine the ethical implications of the existing compliance-based IA approach and explain its ineffectiveness in auditing conduct risk within a turbulent environment. Using action research, we explain the germane changes necessary to define a new conduct-focused IA approach capable of predicting and preventing ethical wrongdoing. A conduct-focused approach launches auditors into unfamiliar but strategically critical areas to not only identify material

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risks but also add value to their organizations. The authors further examine how a change in the auditor's mindset and other factors promote the effectiveness of the new IA approach in a sustainable way. This chapter contributes to the literature by investigating how internal auditors can better fulfill their professional responsibility when adopting a conduct-focused approach.

Keywords: Internal auditing; conduct risk; compliance; action research; reflexivity

1. INTRODUCTION

Financial institutions have invested extensively to manage conduct risk (hereafter CR). CR represents a special form of financial crime risk that includes three key types of risk (Gittfried et al., 2022, pp. 52–53): market CR (“the risk of the market’s integrity and transparency being harmed by unfair or abusive behaviour towards fellow market participants”), client CR (“the risk of harm to clients by resolving conflicts of interest to their disadvantage, causing them financial loss or other detriment”), and employee CR (“the risk of harm to the organization by employees falling prey to conflicts of interests or violations of the code of conduct”).

According to the “three lines” framework (Institute of Internal Auditors, 2020), financial institutions rely on three lines of defense to manage CR and identify its source: two managerial, at business unit and corporate levels (with the first line of defense owning and managing risks in the business activities and the second line of defense ensuring proper corporate monitoring of these risks); and a third line, internal audit (hereafter IA), operating independently from management.

In spite of increasingly complex regulations, IA has not succeeded in performing its professional responsibility for providing financial service firms with adequate defense against misconduct. There is growing recognition that the compliance-based approach to IA, which is a common practice especially in the first two lines of defense, has contributed to ineffectiveness in auditing CR, by prioritizing a rules-bound, checklist-driven, *detect-and-correct* mindset to past and current CR issues. In contrast, a conduct-focused IA approach may usher in a *predict-and-prevent* mindset, more reflexive, customer-centric, and nimble enough to anticipate and address potential CR issues before they become unmanageable (Coffey et al., 2020; Daly & O’Sullivan, 2020; Gittfried et al., 2022; Miles, 2017; Mitchell, 2016; Packin & Nippani, 2022; Roussy & Rodrigue, 2018; Scott & Reader, 2021).

This study explores a conduct-focused IA approach for managing CR by addressing the following **research question**: “How does a conduct-focused approach to Internal Auditing help organizations avert misconduct and enhance conduct risk management?” Our research question opens the possibility that both traditional and innovative IA approaches might be used in complementary ways across the three lines of defense through an audit mindset that combines the core of traditional, long-standing assumptions with a self-questioning focus on problem-solving.

This chapter contributes empirical findings from an action research (thereafter AR) inquiry that was conducted in the IA function of a financial institution. We describe how the new conduct-focused IA approach was developed and how its robustness was tested through two audit assignments in the organization's trading and sales activities. The contribution of this analysis is the practical demonstration that it is possible to improve IA's capacity to detect and deter misconduct and alert management when there is a lack of CR consciousness and invalid assumptions on compliance with policies and procedures.

Another innovation in the reconfiguration of the IA practice in this study was the introduction of non-career auditors. These business professionals with expertise in financial markets, credit analyses, and information technology worked alongside career auditors to help question assumptions and identify areas with highest CR exposure that career auditors are unlikely to investigate.

The AR inquiry presented here views auditing as a social practice and responds to the need for applied research that directly engages with actors and the ethical issues that may arise in their relationships with different stakeholders, building on the literature that explores how professionals influence each other (Griffith et al., 2020).

2. LITERATURE REVIEW

Rules and regulations have traditionally played an “unusually prominent role” within the accounting profession (Ravenscroft & Williams, 2009). Regulations such as the Sarbanes–Oxley (SOX) Act in the United States have emphasized a compliance-based IA approach resulting in a disproportionate increase in auditor resources devoted to checking for compliance with the plethora of SOX legal requirements (Foster et al., 2007). The compliance-based IA approach seeks to ascertain whether employees have applied institutional policies and procedures in their daily duties. This approach focuses on deviations from policies and procedures, as well as considerations for further action. However, there is typically no examination of potentially unethical behaviors with a focus on risks regarding “the behaviour in governance, the behaviour of management and the board, the skills, the abilities, the capabilities of the board and the non-executives” to ensure the effective identification and mitigation of risks, especially CR (Chambers & Odar, 2015, p. 39).

A compliance-based IA approach assumes that the organization's ethical objectives are well embedded in its published policies and procedures for employees to handle ethical dilemmas (Tenbrunsel & Smith-Crowe, 2008). Still, employees can seek loopholes to satisfy the policies and procedures and behave in the very ways that they intend to prevent (Arjoon, 2006). The modus operandi of misconduct and sources of CR thus tend to mutate as the environment evolves (Soh & Martinov-Bennie, 2011). Ethical misconduct occurs *not* because employees are unaware that they need to comply with policies (Tenbrunsel & Smith-Crowe, 2008) but because they may ignore the ethical aspects of such policies when implementing them.

Hence, management's reliance on the adoption of policies and procedures and auditors' checking for compliance cannot assure employees' ethical conduct or detection of misconduct in their activities. Wells Fargo's fake account scandal during 2007–2017 is a clear example of the limitations of the compliance approach to IA in the financial service industry (Antonacopoulou et al., 2019). In the Community Bank division, about 5,300 employees created over three million fraudulent accounts (without consulting clients) to meet aggressive sales goals. The internal auditors, utilizing a compliance approach, consistently rated the division's internal controls as satisfactory and ignored the perverse incentives, while the fraud escalated, increasing employee CR, client CR, and management CR.

The compliance-based IA approach can cultivate in auditors a ritualistic conformance mindset and loss of agility to notice conduct changes in financial markets and customer interests (Arjoon, 2006; Miles, 2017; Soh & Martinov-Bennie, 2011). This mindset renders IA less likely to challenge assumptions (Griffith et al., 2020) and more likely to overlook the complexities of interorganizational-level communications (Ma'ayan & Carmeli, 2016), compensation incentives (Larkin & Pierce, 2016), and employees' influence on each other's thinking and behaviors in social networks (Palmer & Moore, 2016). As long as policies and procedures are followed, organization participants opt to remain silent (Milliken & Morrison, 2003) and neglect other areas in the operating environment where CR exposure may be escalating. There have been several calls in the practitioner literature for IA to increase its emphasis on CRs (Lamoreaux, 2011; Rosthorn, 2000; Stanton, 2018), but actual implementations have been hampered, in part, by a lack of agreement on how to define the scope of CR.

The recent regulatory focus on culture and CR has led some firms around the world to develop multiple and evolving definitions of CR, as revealed in annual surveys (Hammond, 2022). For example, the CR concept adopted in our study (Gittfried et al., 2022) contains elements shared in other well-accepted definitions: "Conduct risk is defined as any action of a financial institution or individual that leads to consumer detriment or has an adverse effect on market stability or effective competition" (Packin & Nippani, 2022, p. 17); "Conduct risk mainly relates to the risks posed by how individuals within a financial institution may behave and how this behaviour impacts on the wider organization" (Daly & O'Sullivan, 2020, p. 4). In spite of the lack of standard CR definitions in financial services, Mitchell (2016) notes that there are common threads "running through the various definitions used by regulatory bodies, which are all underpinned by the expectation that firms will balance their objective to maximize shareholder return with a full understanding and appreciation of their customers' needs and experience."

For the past two decades, IA has become actively involved in enterprise risk management, and its scope has "progressively changed from a control-based approach towards a risk-based approach" (Betti & Sarens, 2021, p. 199). Some IA functions have adopted a risk-based audit plan, believing that it can significantly enhance governance over CR (Sarens et al., 2012). Yet, auditors may still revert to using predefined compliance-checking processes in conducting assignments after drawing up an annual audit plan.

Auditors must apply strategic risk knowledge to incorporate the requirements of CR management into auditing processes (Castanheira et al., 2010). Accordingly, CR challenges auditors to use critical reflection to identify ethical issues and to question boldly one another's assumptions to unveil blind spots. Previous research on auditors' willingness to speak up, however, casts doubt on the likelihood of this bold challenging of assumptions (Griffith et al., 2020).

A key contributing factor for a CR approach is the assignment of non-career auditors to the IA team. Non-career auditors are not trained in audit technicalities but may be intimately familiar with the industry and certain organizational practices. In the context of the traditional compliance mindset in IA, the use of non-career auditors is not a common practice, because of a misguided belief that it is harder to train a non-career auditor to acquire auditing skills than to familiarize a career auditor with company policies and procedures that they would use to check for compliance. In the context of the CR approach, career auditors need to collaborate with professionals familiar with the business environment and organization's processes, systems, and culture in order to assess CR effectively. Professionals such as traders or treasurers contribute significant operational experience and can pry beyond policies and procedures to assess if unethical practices are skirting around the rules that supposedly prevent such practices. Recently, research on the use of professionals with extensive non-public accounting experience in audit teams has shown that these professionals' participation increases both audit quality and efficiency (Lisic et al., 2022). While the importance of non-career auditors has been recognized as a new positive trend in IA teams (*CPA Journal*, 2019; Soh et al., 2023), in the financial service sector, some multinational institutions such as JP Morgan, DBS Bank, and Standard Chartered Bank have begun regularly recruiting non-career auditors into IA functions.

The "detect-and-correct" risk management mindset prevalent in the banking industry has contributed to perpetuate, rather than eradicate, systemic unethical behaviors that harm stakeholders and erode trust (Scott & Reader, 2021) due to ineffective governance mechanisms for CR (Roussy & Rodrigue, 2018). The emerging awareness of the need for another mindset, "predict and prevent," is aimed at helping financial service institutions address "potential future troubles" (Scott & Reader, 2021). This "predict-and-prevent" mindset characterizes newer conduct-focused IA approaches, which "review and adjust the plan, as necessary, in response to changes in the organization's business, risks, operations, programs, systems and controls" (Marks, 2013, p. 67), because new risks arise from the normalizing of misconduct, and re-drawing of lines for what is right or wrong do not cease at the stage of defining the annual audit plan.

CR consciousness can reduce the organization's exposure to regulatory and financial sanctions as auditors focus on strategic risks (Bowlin, 2011). The outcomes and impact of the conduct-focused IA approach align with the increasing expectations for IA's governance role to improve CR management and promote ethical values in organizations (Institute of Internal Auditors, 2020; Mintz & Morris, 2020). Moreover, the conduct-focused approach has the potential to facilitate a proactive integration of IA into a broader governance, risk, and compliance (GRC) framework, effectively breaking down a pervasive "silo mentality"

(Kenton, 2019). Such integration of IA with governance and risk management (including internal control) is part of the updated three-lines-of-defense model for the IA profession (Institute of Internal Auditors, 2020).

3. RESEARCH METHODS

To explore different IA practices that can equip auditors to identify CR and avert misconduct, an AR inquiry was designed to build on participants' values and multiplicity of value-laden views and understanding (Melrose, 2001) and was found to be an appropriate way for drawing insights about the compliance-based IA approach (Brydon-Miller et al., 2003). The inquiry focused on the IA function where two audit assignments (one concerning trading and the other concerning sales activities) used the new conduct-focused IA approach.

3.1. Action Research

Qualitative methodologies that emphasize interpretation and reflexivity have long been proposed for investigating symbolic aspects of accounting in organizations and society (Covaleski & Dirsmith, 1990). AR was deemed an appropriate qualitative approach for addressing our research question, because it provided the necessary depth of engagement and intervention to form the contextual understanding of the problem of recurring misconduct and auditors' ineffectiveness in identifying conduct issues and strengthening CR management. The essentiality of reflexivity and reflection in AR (Coghlan, 2011) is integral to organizational participants' becoming aware and questioning their own previously unquestioned assumptions, values, and actions – a process of self-reflexivity (Cunliffe, 2003; Hibbert & Cunliffe, 2015). Questioning and critiquing one another's assumptions lead to improved practices as participants learn and change as promoted in Antonacopoulou (2018). AR thus helped auditors identify deficiencies of the compliance-based IA approach and the salient changes required to implement the CR approach.

This study focused on interactions within the IA team of 4 career auditors with 4 non-career auditors and 18 other organization members, who were their auditees in past audit assignments. IA team members were co-researchers who were fully informed of the purpose of the study, and they participated in collecting data in the form of semi-structured interviews, document reviews, and observations. These research-led interactions provided the basis for analyzing the variations in definitions and perspectives of professional misconduct, modus operandi, and root causes of CR issues and how and why professional malpractices were conducted by management and employees, including auditors themselves.

Each assignment team comprised a career auditor and a non-career auditor, with former trader and sales professionals assigned to the trading and sales teams, respectively. Both the sales and trading audit assignments covered classical products, and each assignment took one month for fieldwork, while the finalization of each assignment and writing up the report took another three weeks.

During the assignments, auditors were guided by the researchers to practice reflexivity through a series of stages (see Fig. 1.1). Data from the AR inquiry were accumulated as notes of informal discussions, interviews, and observations and regularly reviewed by auditors in the two assignments and the wider collaborative inquiry team. Entries from one researcher’s journal recorded her reflexivity at the outset of the AR inquiry:

I recognized the typical role and practices of an auditor cultivate in us the approach to tell auditees what to do and how to do it through the issue of audit recommendations. This mindset has obstructed our openness to receive feedback, especially from auditees. Hence, semi-structured interview questions were drawn up with the intention to elicit inputs from auditees. (Researcher, Diary entry 1.1)

The emerging findings at different phases of the AR inquiry were discussed with the whole collaborative inquiry team in order to extract richer and deeper understanding on conduct issues. This method follows the AR cycle of collecting the data, analyzing it, and presenting the findings to organization participants, who use their intimate organizational knowledge to provide feedback (Adams et al., 2018). The inquiry was thus carried out through the four phases of an AR cycle, namely constructing (i.e., exploring the issue to enhance understanding), planning action, taking action, and evaluating action (Coghlan & Brannick, 2014), as elaborated in Fig. 1.1.

3.2. Constructing Phase

For the constructing phase of the AR intervention, the researchers asked the following questions of IA team members:



Fig. 1.1. Concurrent Application of AR Cycles for Each Phase of the Changed IA Approach. Source: Adapted from Coghlan and Brannick (2014, p. 30).

How do you feel when misconduct recurs despite your performance of auditing reviews on these activities? What changes would you like to see in the IA processes and in yourself in order to be an effective contributor to CR management?

The auditees (disciplinary committee members, salespersons, traders, sales manager, trading manager) were asked:

How have auditors contributed to the identification of misconduct causes and CR management? What, in your view, needs to be done differently to instill professional practices that mitigate CR?

These questions were presented to auditees in order to elicit comprehensive views from those who were facing ethical dilemmas in their daily business dealings and those who had to exercise judgment on the appropriateness of employees' behaviors. The responses were seen as important feedback to inform the auditors' mindset.

Responses from auditors and auditees were triangulated with the organization's conduct-related documents and combined with the researchers' own diary entries, reflections, and other observations, which drew out themes on auditors' and auditees' perceptions of what needed to be changed in the existing IA approach and how to change it. Because misconduct is a sensitive topic, informal discussions were anticipated to be more effective than formal discussions (as was typical in conducting previous audit assignments). Having an informal channel to raise conduct issues could open more channels for dialogue on the topic. This was shared with the collaborative inquiry team, in such a way that the researchers could convey a new conduct-focused approach to performing the IA practice:

We are to work with the business management in a collaborative manner. I don't think we should be seen as police because that would be very counter-productive. We will get far less information than if we are seen as a collaborator to add value. Being too formal like police results in people being defensive even if they have nothing to hide. They will be less willing to share the information they have or you will really have to ask every single thing so that they talk to you which of course is not helpful. (Researcher, Diary Entry 2.5)

In this new IA approach, the researchers role-modeled asking critical questions and challenging assumptions on auditing CR traditionally, querying: "Why do we always need to have a set of pre-defined IA processes to conduct audit assignments?" Within the collaborative inquiry team, each critiqued one another's perspectives, and eventually, auditors arrived at the perspective that predefined auditing processes might not always be useful and sometimes could be an obstacle to see beyond superficialities, as illustrated by this quote from the IA team:

A pre-set of auditing processes will give a good framework of how we conduct audit, but if we want to flush out conduct risk which in my view is one of the most complex risks, and very subjective and you need experience to be able to find them. Pre-defined auditing processes will not be able to help. In fact, they will deter and constrain the type of thinking we need when auditing conduct risk. (Non-career Auditor, A2)

3.3. Planning Action Phase

Following the constructing phase, the auditors began to plan for the reconfigured IA approach. They recognized the need for deeper business knowledge so that