Economic analysis of accountants’ ethical standards: The case of audit opinion shopping

Barry E. Cushing 1

David Eccles School of Business, School of Accounting, The University of Utah, Salt Lake City, UT 84112, USA

Abstract

The public accounting profession presently employs a strict system of ethical standards that relies upon explicit rules plus monitoring and enforcement procedures that penalize violations of the rules. An alternative approach to ethical standards that the public accounting profession may wish to consider is a laissez faire approach. Instead of rules and penalties to enforce desired behaviors, the laissez faire approach utilizes moral training and leadership to motivate professional accountants to act in the public interest, for the sake of the profession as a whole. The theoretical basis for the laissez faire approach is a growing body of evidence in economics and related disciplines that people often take actions to further the collective welfare of a group despite a detrimental effect on their own selfish interests. This paper offers a framework for examining the relative economic merits of the strict and laissez faire approaches to ethical standards within the accounting profession. The framework is based on game theory, and the setting employed in the paper involves opinion shopping by audit clients. The paper finds that the effectiveness of a laissez faire approach to ethical standards, at least in the opinion-shopping scenario, is related to (a) the ethical climate, which refers to the likelihood a given independent auditor will choose the ethical action, (b) the frequency of independent auditor rotation, which reduces the economic advantage of being the incumbent auditor, (c) the explicitness of Generally Accepted Accounting Principles (GAAP), which reduces uncertainty over whether or not a particular act is ethical, (d) the availability of opportunities to discuss ethical choices with rival auditors, and (e) disclosure requirements associated with auditor–client disputes over material accounting issues. © 1999 Elsevier Science Inc. All rights reserved.

1 Tel.: +1 801 585 3577, fax: +1 801 581 7214.
1. Introduction

According to a recent Special Report of the Public Oversight Board (POB) of the American Institute of Certified Public Accountants (AICPA)’s SEC Practice Section, “The accounting profession has suffered a serious erosion of public confidence: confidence in its standards, in the relevance of its work and in the financial reporting process” (Advisory Panel on Auditor Independence, 1994, p. 31). To address this problem, the POB report made numerous recommendations for changes in financial reporting, SEC disclosure requirements, auditing practices, corporate governance by public companies, and accounting self-regulation, including changes in the AICPA’s Code of Professional Conduct. Some of these recommendations have been implemented, while others are still under review.

The effort spawned by the POB report raises some fundamental questions for the public accounting profession, as follows. What is the most effective way to achieve public confidence in the public accounting profession? What is the most efficient way? Is there a way that might be more effective or efficient than the public accounting profession’s present approach, which incorporates CPA education and licensing requirements, generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), and the ethical standards promulgated in the AICPA’s Code of Professional Conduct (American Institute of Certified Public Accountants, 1988)?

My paper uses economic analysis to examine these questions, especially as they pertain to the ethical standards of the accounting profession. The paper takes a utilitarian view of ethics; this is the view that a person’s action is right or moral if its consequences result in the greatest good for everyone concerned (Thiroux, 1990, p. 44). This view is consistent with Article II of the Principles of the AICPA’s Code of Professional Conduct, which states that “[m]embers should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism” (American Institute of Certified Public Accountants, 1994, p. 5). For purposes of this paper the words ethical and moral are regarded as equivalent and are used interchangeably.

The primary objective of this paper is to enhance our understanding of the economic basis for the current system of ethical standards in the US public accounting profession. A secondary objective is to raise (though not necessarily to answer) the question of whether some other system of ethical standards might be more efficient. These objectives are accomplished by examining a model of auditor ² behavior in a setting that has ethical implications.

² This and subsequent references to auditor should be interpreted to mean independent auditor.
The setting employed in the paper involves opinion shopping by clients. This is taken to be a representative ethical dilemma in the following sense. The auditor who does the right thing, which is to deny the client’s request to approve a dubious accounting method, suffers the loss of an audit fee if the client switches to another, less scrupulous, auditor. Meanwhile, the auditor who does the wrong thing, which is to consent to the client’s request, will avoid losing the audit fee, but will cause the accounting profession to incur a loss of credibility or status, which is presumed to have an adverse pecuniary effect on all auditors. Hence, the auditor’s personal pecuniary incentive conflicts with what is both right in an ethical sense and best for all auditors in general.

While this setting admittedly does not encompass all possible ethical issues, it does incorporate elements of such crucial ethical principles as integrity, objectivity and independence. In addition, the issue of auditor support for dubious accounting methods used by clients is among the POB’s primary concerns. For example, while serving as Chief Accountant of the SEC in 1994, Walter Schuetze gave “a speech in which he called into question the independence of accounting firms in situations where they condoned ‘incredible’ accounting principles in financial statements, or advocated such principles before the staff of the SEC” and mentioned “four specific cases argued before the Chief Accountant are examples of the national offices of major firms advocating accounting contrary to the spirit, if not the letter, of GAAP” (Advisory Panel on Auditor Independence, 1994, p. 35). In response, less than one year after publishing its Special Report containing three recommendations to strengthen auditor independence and professionalism, the POB appointed an advisory panel to determine whether further steps should be taken “to better assure the independence of auditors and the integrity and objectivity of their judgments on the appropriate application of generally accepted accounting principles to financial statements”. (Advisory Panel on Auditor Independence, 1994, p. 1.)

The remainder of my paper is organized as follows. The following section develops a simple opinion-shopping model in a laissez faire setting that involves no formal ethical standards, and examines the equilibrium solutions to this model under various assumptions about the auditors’ ethical preferences and exposure to risk. Section 3 uses a cost-benefit perspective to examine the effects of introducing ethical standards and related regulatory mechanisms into this setting. Section 4 offers concluding remarks.

2. The basic opinion-shopping model

The basic model presumes a laissez faire approach to ethical standards, under which there is no formal code of professional conduct and no enforcement mechanism for ethical violations. However, the model does presume the
existence of generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), and public accounting education and licensing requirements. The essence of the laissez faire approach is the expectation that every auditor should always choose the action that best serves the public interest because, as professionals, they should place the public interest ahead of their personal interests. ³ This would be emphasized in the preparatory and continuing education of public accountants. In addition, adherence to GAAP and GAAS would be viewed as part of the public accountant’s responsibility to the public interest.

In the basic model, there are two auditors and two client firms. ⁴ Each auditor is engaged by one of the client firms, and earns an audit fee, net of costs, of $3. However, each client firm requests its auditor’s approval of an accounting method that both auditors view as dubious. That is, while the proposed method is not explicitly prohibited by GAAP, it is at best marginally acceptable, and both auditors would refuse to approve it if doing so had no pecuniary effects. However, both clients have threatened to dismiss their auditor if the proposed accounting method is not approved. If both auditors deny their own client’s requests, then it is presumed that each would also deny the request from the other auditor’s client. This would force each audit client to remain with its original auditor and forego use of the dubious accounting method.

If both auditors consent to the client requests, then both retain their clients and their net audit fee of $3. If only one of the auditors consents to the client requests, then it gets both clients and earns a net audit fee of $6, while the other auditor earns no audit fees. In either of these cases, both clients are permitted to adopt the dubious accounting method. In this event, it is assumed that both auditors incur a loss of credibility and/or status, and that the monetary effect of this is a loss of $1 to each auditor.

Certain features of this scenario require further clarification. First, the preference functions of the actors must be specified. Regarding the client firms, it is sufficient to simply assume that they prefer the dubious accounting method. There can be little doubt that some audit clients sometimes have such

³ Several years ago a similar proposal was advanced by Paton (1971, p. 45): “It would be a most beneficial development if the [AICPA] ‘Division’ dealing with ethics, so-called, were scrapped, and the entire existing package of [ethics] rules were abolished. Then there should be substituted a simple statement that the Institute aims to promote competence and integrity in the profession of accounting…”

⁴ Restricting the analysis to two agents of each type should not concern the reader. Unless otherwise indicated, the results obtained from analysis of this limited case also hold for the case of n auditors and n clients.
a preference and are willing to switch auditors to attain it. In any event, the behavior of the client firms is not a central issue in this paper. On the other hand, the preference function of the auditors is crucial here. Initially, it is assumed that the auditors’ objective function in the model is simply to maximize $U(x)$, where $x$ represents wealth and $U$ represents utility, where $U' > 0$. Note that this specification fails to incorporate ethical considerations, as reflected in the objective of “serving the public interest” mentioned above. Accordingly, the auditors’ objective function is modified later in the paper to incorporate such ethical considerations.

Second, allowing a client to use a dubious accounting method is but one example of the ethically questionable acts that an auditor might commit. Other examples include failure to issue a going-concern opinion when circumstances warrant; allowing a client to inappropriately classify a transaction, for example as an extraordinary item rather than an operating item; failure to require a client to accrue a write off of the value of impaired assets; or failure to require a client to accrue a contingent liability when circumstances warrant. Note that all of these examples could be associated with a client threat to shop for another audit opinion. The example of a dubious accounting method is used here because of the attention given to this problem by Schuetze’s remarks in 1994. However, the analysis in this paper could be applied to other forms of dubious auditor behavior such as those listed in this paragraph.

Third, it might be expected that permitting a client to adopt a dubious accounting method (or performing any other ethically questionable act) exposes the auditor to certain risks, such as the risk of litigation. This is certainly true. However, to simplify the presentation of the model, it is initially assumed that there is no risk; that is, all of the payoffs are known with certainty. This assumption is subsequently relaxed to incorporate the effects of risk into the model.

Based on these specifications, the options and monetary payoffs for the basic model are presented in the form of a game matrix in Table 1. The following result is readily apparent.

**Observation 1:** In a single play of this game, (a) a dominant strategy for both auditors is to consent, and (b) the unique equilibrium solution is that both auditors consent.  

---

5 That public corporations sometimes exhibit such preferences has been documented by such critics as Briloff (1972) and is evident from Walter Schuetze’s remarks cited earlier in the paper. The willingness of corporations to switch auditors to satisfy such preferences is manifested by the existence of SAS Nos. 7 (American Institute of Certified Public Accountants, 1975) and 50 (American Institute of Certified Public Accountants, 1986), which provide guidance to auditors in situations where their clients may be engaging in opinion shopping.

6 In this paper, results that are labelled observations are based on well-known extant theory, while results that are labelled propositions are new (to the best of the Author’s knowledge).
Consider auditor A’s decision problem. If B chooses deny then A’s payoff is $3 from choosing the deny strategy, and $5 from choosing the consent strategy. If B chooses consent then A’s payoff is $–1 from choosing the deny strategy, and $2 from choosing the consent strategy. Hence, a dominant strategy for A is to consent; that is, it is A’s best strategy regardless of what B does. But auditor B’s options and payoffs are identical in every sense to A’s, so B’s dominant strategy must also be to consent. Therefore, a dominant strategy equilibrium in a single play of this game is for both auditors to consent to the client requests. It is also a unique Nash equilibrium in that (a) if one auditor chooses to consent, then the other auditor has no incentive to select any strategy other than consent, and (b) all other pure strategy combinations in the game are unstable. In particular, every other pure strategy combination involves selection of the deny strategy by one or both auditors, and this is unstable because either auditor can always do better by switching from the deny strategy to the consent strategy.

Another feature of this result is also apparent.

**Observation 2**: In a single play of this game, the unique equilibrium solution produces a strictly Pareto-inferior outcome.

Relative to the $2 payoff that each auditor receives from the equilibrium solution, both auditors would be better off if the deny, deny strategy combination could be sustained, increasing each of their payoffs to $3. However, based on observation 1, both auditors have an incentive to defect from the deny, deny strategy combination, so it cannot be sustained.

Note that the only difference between the equilibrium result and the Pareto-efficient solution in this game is the somewhat nebulous loss of credibility or status (amounting to $1 per auditor) that is presumed to be incurred when the client firms are allowed to use the dubious accounting method. It is appropriate to ask whether any loss of this kind is likely to be incurred in the real world. In support of this presumption, consider this passage from the recent report of the Advisory Panel on Auditor Independence (1994, p. 8):

### Table 1
Matrix for opinion-shopping game

<table>
<thead>
<tr>
<th>Auditor A</th>
<th>Auditor B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deny</td>
<td>Deny</td>
</tr>
<tr>
<td>$3, $3</td>
<td>–$1, $5</td>
</tr>
</tbody>
</table>

*Note: Cells give payoffs to (A, B).*
In *United States v. Arthur Young & Co.*, the Supreme Court of the United States described the independent audit as a “public watchdog” function and noted that “if investors were to view the auditor as an advocate for the corporate client, the value of the audit might well be lost”.

This is consistent with the view of Watts and Zimmerman (1986, p. 314) that a demand for audit services arises from a belief in the market that auditors are competent and “that they will have some independence from the client”.

In addition, it is appropriate to ask whether the public interest is best served if the auditors achieve the ethical solution. In the context of this model, the entire pecuniary gain from achieving the ethical solution is captured by the auditors. Although not explicitly stated, it is presumed that the ethical solution also has some social value (i.e., outside the context of this game) in addition to the auditors’ incremental payoffs. This social value would arise from more efficient allocation of society’s economic resources, resulting from investors having decision-relevant information that is more complete or more accurate. If this social value exists, then it creates a demand for auditing that meets high ethical standards. A limitation of the analysis in this paper is that this value is merely assumed; it does not arise endogenously.

The opinion-shopping game presented here is a classic example of a collective action problem. In particular, this game is a special type of collective action problem known as the prisoner’s dilemma game. The prisoner’s dilemma game is often employed to study the ethical dimensions of collective action problems in the fields of economics (Dawes and Thaler, 1988; Hausman and McPherson, 1993, pp. 718–722; Marwell and Ames, 1981; Sen, 1987, pp. 81–88), political science (Axelrod, 1984; Thomas and Feldman, 1988), and psychology (Dawes, 1980). It was first suggested for this purpose in the accounting literature by Noreen (1988, pp. 365–367).

Table 2 presents the opinion-shopping game in the form of a generalized prisoner’s dilemma game matrix. Here, the payoff variables represent the following general parameters:

- \( p \) is prize for mutual cooperation to deny use of the dubious accounting method.
- \( r \) the rogue’s payoff for mutual consent to use of the dubious accounting method.
- \( s \) the sucker’s payoff for denying when the other auditor consents.
- \( t \) the temptation to consent if the other auditor denies.

---

7 Other types of collective action problems include coordination problems and assurance problems (see Hausman and McPherson, 1993, pp. 719 and 720).
Technically, the following relationships among the payoff variables must hold if the game is a true prisoner’s dilemma. First, the preference ranking among the four payoffs must be \(t > p > r > s\). Second, to preclude a repeated-play equilibrium in which the players take turns exploiting each other, it must be true that \(p + p > t + s\).  

The prisoner’s dilemma game may be analyzed under the assumption that it is played repeatedly, rather than just once. In this case, mutual cooperation can emerge as an equilibrium under certain conditions. For example, consider:

**Observation 3**: If the opinion-shopping game is played repeatedly with no definite stopping point, and if the auditors do not discount the future too heavily, then a Nash equilibrium is attained if both auditors adhere to the following strategy: choose deny in every period unless and until the other auditor chooses consent, in which case choose consent in every period thereafter.

To see the logic of this result, suppose that one auditor is considering whether to deviate from this strategy by choosing consent in the next period. This will provide that auditor a payoff of $5 in the next period, followed by payoffs of $2 per period forever after. But continuing to choose deny will provide that auditor a payoff of $3 per period forever after, at least if the other auditor also chooses deny forever. It is easy to ascertain that the $3-forever cash flow stream has the higher present value as long as the discount rate per period is strictly less than 50%. So, as long as both auditors discount future cash flows at a rate less than 50%, neither has an incentive to deviate from this strategy.

---

Table 2
Generalized form of matrix for opinion-shopping game

<table>
<thead>
<tr>
<th>Auditor A</th>
<th>Auditor B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deny</td>
<td>(p, p)</td>
</tr>
<tr>
<td>Consent</td>
<td>(t, s)</td>
</tr>
</tbody>
</table>

*Note: Cells give payoffs to (A, B).*

---

8 See Axelrod (1984, p. 10). In this example, taking turns exploiting each other would mean that A denies and B consents in one period, while B denies and A consents in the next period.

9 Refer to the $3-forever stream of cash flows as stream A, and the payoff of $5 in the next period followed by $2 per period forever after as stream B. The present value of stream A, discounted at 50%, is $3/0.50 = $6. Stream B is equivalent to a $2-forever cash flow stream plus $3 in the next period. Based on this, the present value of stream B, discounted at 50%, is $2/0.50 + $3/1.50 = $4 + $2 = $6. Therefore, the present values of cash flow streams A and B are identical at a 50% discount rate. But at any discount rate less than 50%, the $1-forever advantage of stream A has a higher present value than stream B’s extra $3 in the next period. So, stream A has the higher present value at any discount rate less than 50%.
While this result may appear promising on the surface, it would be difficult to sustain this type of equilibrium in practice for several reasons. First, the rules of the opinion-shopping game presume that both auditors start every game in the same condition; specifically, each with one client. In the real world, however, each client has an incumbent auditor at the beginning of each period, and generally retains that auditor unless there is a compelling reason to do otherwise. Suppose that condition were incorporated into the repeated version of the game. Then it becomes even less likely that an auditor would ever choose to deny the client’s request, because that could mean that the other auditor would become the incumbent for both clients and might retain that position indefinitely. One implication of this analysis is that a requirement of frequent auditor rotation can enhance auditor independence by reducing the value of incumbency and making it more feasible for auditors to deny unreasonable client requests.

Second, another practical difficulty involves the vagueness of GAAP. In the context of the opinion-shopping game, there is no uncertainty about whether the client’s proposed accounting policy is dubious. Accounting issues in the real world are rarely so cut and dried. While one auditor might sincerely believe that a proposed accounting treatment, if allowed, would discredit the entire accounting profession, another might believe just as sincerely that this treatment is fully consistent with GAAP. For example, in response to Walter Schuetze’s critical remarks cited earlier in this paper, the Advisory Panel on Auditor Independence (1994, p. 36) reviewed the facts of the four cases and concluded that “the issues, at least in part, do not appear to be as black and white as Schuetze portrayed them”. To the extent that GAAP are vague, auditors apparently have less resolve to deny client accounting proposals. On the other hand, there are many controversial accounting issues for which reasonable but contradictory positions exist, so it may be impossible to completely remove the vagueness from GAAP.

Third, another practical difficulty involves the number of auditors in the game. If a game is played repeatedly by the same two players, then it is not unreasonable to assume that the players understand each others intentions and likely strategies. Such an assumption is crucial to achieving the equilibrium result described in observation 3. But in the real world, the opinion-shopping game is played by many auditors, and any two auditors are likely to play against each other infrequently and at irregular intervals. Under such conditions it may be unreasonable to assume the kind of mutual understanding that is necessary to achieve the delicate result described in observation 3.

Finally, there is the technical issue of multiple equilibria. The equilibrium strategy given in observation 3 is not unique (Fudenberg and Tirole, 1991, p. 111 and 112). For example, always consent is one of several other possible Nash equilibrium solutions to repeated play of this game. Without adding strong assumptions there is no way to predict which equilibrium will emerge.
But equilibrium strategies other than mutual cooperation are not Pareto-efficient. So it is questionable whether this result provides much hope of a solution to the auditors’ collective action problem.

If we concede that the theoretical ideal of an equilibrium solution cannot be attained, the results provided by Axelrod (1984, pp. 27–69), may offer a promising alternative. Axelrod (1984) used computer simulation to conduct a tournament that involved repeated plays of a prisoner’s dilemma game very similar to the one in Table 1. Professional game theorists were invited to suggest strategies for the tournament. Each “player” was programmed to follow one of the suggested strategies, and was matched once against every other player in a series of games consisting of 200 moves each. The winning strategy was *tit-for-tat*, under which the player chooses the cooperative strategy in the first period, and thereafter does what the other player did in the previous period. While *tit-for-tat* is not a Nash equilibrium strategy in this game (Rasmusen, 1994, p. 124), it is what Axelrod (1984, p. 56), calls “collectively stable” in a multi-player environment. That is, if all other players are using *tit-for-tat*, then no player can employ any other strategy that will produce a higher expected payoff (Axelrod, 1984, p. 56).

While results of Axelrod (1984) are widely cited in the fields of economics and political science, their application to the opinion-shopping game does not resolve all of the practical difficulties mentioned above. In particular, these results do not address the issues of auditor incumbency and the vagueness of GAAP. As already noted, it might be possible to resolve the issue of auditor incumbency with a policy that requires frequent auditor rotation. However, in the opinion-shopping game the vagueness of GAAP will often make an auditor uncertain about the legitimacy of another auditor’s concession to a client’s request. Such uncertainty about the other player’s previous move makes it impossible to effectively implement the *tit-for-tat* strategy.

To summarize the preceding analysis, it does not appear that an effective solution to the auditors’ collective action problem can be achieved in settings that involve either a single play, or repeated plays, of the opinion-shopping game, at least when the auditors are presumed to be maximizing $U(x)$. Hence, the paper next considers the effect of incorporating ethical factors into the objective functions of the auditors. Before proceeding to this analysis, a brief digression on the effects of risk on auditor decisions is presented.

### 2.1. The effects of risk

If the auditor consents to a client request to adopt a dubious financial reporting policy, then the auditor is exposed to certain risks, the most obvious of which is the risk of a lawsuit. It is reasonable to ask what effect this will have on the model, and especially on the results obtained in the previous section.
The term *risk exposure* is used here to signify the reduction in the auditor’s expected utility associated with the risk of consenting to a dubious client request. This is denoted $e$, and it is assumed that $e$ is the same for both auditors. It is assumed that there is no risk exposure associated with denying a dubious client request. These assumptions change the payoffs in Table 2 in the following way. First, since uncertainty has been introduced into the scenario, we now interpret $t$, $p$, $r$, and $s$ as auditor utility values; as before, it is assumed that these values are identical for each auditor. Second, the auditor who gets both clients by consenting when the other auditor denies earns an expected utility of $t_e = t - 2e$ due to the risk exposure associated with both clients. Third, if both auditors consent, then their expected utilities are $r_e = r - e$. Finally, the expected utilities associated with the deny strategy ($p$ and $s$) are not affected.

The effect of these changes on the results derived earlier is as follows. If $t_e < p$, then *deny, deny* becomes the unique Nash equilibrium solution. In effect, this condition signifies that consenting to the client requests is potentially so costly that both auditors will deny those requests, independent of ethical considerations. This equilibrium solution is also Pareto optimal, and holds in a repeated-play setting. Hence, the case where $t_e < p$ is ethically uninteresting, because the auditors are induced to select the ethically preferable act solely due to its pecuniary advantages, without necessarily giving any regard to its ethical superiority.

On the other hand, if $t_e > p$, then the game retains the structure of a prisoner’s dilemma, with $t_e > p > r_e > s$ and $p + p > t_e + s$. This means that all of the results derived previously continue to hold, even in the presence of risk exposure. Hence, it is assumed in the remainder of the paper that $t_e > p$, so that the presence or absence of risk exposure has no significant effect on the analysis that follows. This has the effect of ignoring the ethically uninteresting cases in order to focus on the “ethically interesting” cases.

### 2.2. Incorporating ethical preferences into the model

Under a traditional approach to economic rationality, it is not generally viewed as rational for an economic agent to sacrifice personal gain in order to achieve some broader social purpose. However, at least with respect to ethics, the traditional view of rationality is being challenged in the economic literature, from both the empirical and theoretical perspectives.

---

10 If $p + p > t + s$, as specified earlier, and $e > 0$, then $p + p > t - 2e + s$ must hold. But showing that $r_e = r - e > s$ requires further analysis. Note that, in the audit opinion shopping version of the game, $r - s$ is equal to the net audit fee. So, if $e$ is strict less than the net audit fee, then $r - e > s$ must hold. But if $e$ were greater than the audit fee, then rational auditors would never accept these audit clients. So, it is reasonable to assume that $r_e > s$ holds.
For example, Dawes and Thaler (1988, p. 188, 189) report that the results of typical single-play public goods experiments offer little support for the strong free rider hypothesis that all subjects will choose the dominant strategy. They (1988, p. 189) indicate that the cooperative action is chosen by a “substantial number”, though not all, of participants. A study by Marwell and Ames (1981, pp. 302–304) finds similar results that hold for both experienced and first-time subjects, for subjects playing in both large and small groups, and over a range of monetary stakes, though the rate of cooperation did decline somewhat in experiments with the highest stakes. Interestingly, Marwell and Ames (1981, p. 306, 307) found substantially lower rates of cooperative behavior among a group of economics graduate students, which suggests that choice behavior that is consistent with strict economic rationality may be partly conditioned. In a subsequent experiment that corroborates this result, Frank et al. (1993, p. 170) report “evidence consistent with the view that differences in cooperativeness are caused in part by training in economics”.

Responding to these results, Dawes and Thaler (1988, p. 196) suggest that “the role of selfish rationality in economic models needs careful scrutiny”. One prominent welfare economist who has often expressed a similar viewpoint is Amartya Sen (1987, p. 79) who noted:

The object [of predictive economics] is to understand, explain and predict human behavior in a way such that economic relationships can be fruitfully studied and used for description, prognosis and policy. The jettisoning of all motivations and valuations other than the extremely narrow one of self-interest is hard to justify on grounds of predictive usefulness, and it also seems to have rather dubious empirical support.

In a recent review of the growing body of literature on ethics and economics, Hausman and McPherson (1993, p. 673) bluntly assert that “The morality of economic agents influences their behavior and hence influences economic outcomes. . . Without honesty, trust, and goodwill, economic life would grind to a halt”.

To summarize this discussion, (a) there is a large body of experimental evidence that people often reject actions that are consistent with pure economic rationality in favor of alternative actions that are consistent with the collective welfare of a group, (b) there is limited evidence that this behavior can be influenced by a person’s education and training, and (c) some prominent economists are suggesting that traditional economic models should be modified in a way that is consistent with this evidence. The first two points offer some hope that a laissez faire approach to accounting ethics, as described above, might be effective even in the absence of monitoring and enforcement mechanisms.
Addressing the more difficult task of incorporating these ideas into models of economic behavior, Sen (1987, p. 86) argues that reciprocity might be viewed as instrumental to achieving a person’s own goals, rather than as intrinsically important. In the context of the prisoner’s dilemma game, this would mean that a player sees action in terms of social strategy, giving consideration to the respective goals of other players, so that a cooperative strategy might be appropriate (Sen, 1987, p. 86). In contrast, Hausman and McPherson (1993, p. 686) suggest a more straightforward approach:

There seems offhand to be no inherent incompatibility between utility theory and the demands of morality. For utility theory places no constraints on the objects of preferences. Preferences can just as well reflect the dictates of conscience as the promptings of the libido.

Hausman and McPherson (1993, p. 686) offer a simple example of this approach with their suggestion that a person might prefer a delicious piece of apple pie that came as a gift over a physically similar piece of pie that was known to be stolen. To reformulate this example in the context of the opinion-shopping game, an auditor might prefer to acquire an important client by offering to provide good service over acquiring that same client, at an identical audit fee net of costs, by consenting to that client’s request to use a dubious accounting method.

Based on the notions suggested by Hausman and McPherson (1993, p. 686), it is proposed here that an auditor’s utility function be defined over wealth and action as follows.

\[
H(x, a) = U(x) - M(a),
\]

where \(H\) represents total utility and \(M\) represents the moral disutility to the auditor of the action choice represented by \(a\). Assume that \(x\) is increasing in \(a\) (e.g., \(\partial x / \partial a \geq 0\)), but that increases in \(a\) represent actions that are increasingly unethical, so that \(M' > 0\). Further, the auditor’s preferences over wealth and action are assumed to be independent, such that the total utility is additively separable in wealth and action.

Eq. (1) implies that auditors face a trade-off between moral considerations and monetary return. However, this does not necessarily imply that “every auditor has his price”. For example, one could assume that any unethical act has a cost, \(M\), that is infinite for every auditor. Eq. (1) may be viewed as a generalization of the standard utility function to admit two possibilities: (a) under certain conditions, some auditors might be willing to sacrifice ethical considerations for monetary gain, and (b) under other conditions, some auditors might be willing to sacrifice monetary gain for ethical considerations. This is consistent with Dawes (1980, p. 191) assertion that, “repugnant as it may be from a normative point of view, moral and monetary (or survival)
utilities combine in a compensatory fashion for most people”. The evidence that cooperation rates in public goods experiments decline somewhat as stakes increase (Marwell and Ames, 1981, p. 303 and 304) suggests that monetary returns sometimes outweigh moral considerations for some people. Evidence is needed on the extent to which this is true for auditors. 11

In auditing settings, however, it must be remembered that the ethical quality of a particular action is often ambiguous. For example, recall the previously cited response of the Advisory Panel on Auditor Independence to Walter Schuetze’s allegations that accounting firms were supporting “incredible” accounting principles. Consistent with this ambiguity, Eq. (1) allows the “moral cost” of a particular action to increase with the auditor’s degree of certainty that the action is unethical. In other words, $M(a)$ may be viewed as the product of the auditor’s assessment of the probability that $a$ is unethical and the disutility of $a$ given that it is unethical. In addition, since the parameters specified in Eq. (1) are auditor-specific, this formulation allows each individual auditor to have a different assessment of the ethical quality and moral cost of a particular action.

Now consider the implications of Eq. (1) for the opinion-shopping game. To simplify this discussion, the following analysis assumes that $U(x)$ is linear in $x$. Suppose that for both auditors the moral cost of choosing the ethical action (deny) is equal to zero, and denote the moral cost of choosing the unethical action (consent) as $M_{ac}$. Next, for any ethical dilemma faced by an auditor, define the ethical threshold as the value of $M_{ac}$ that makes the auditor indifferent between choosing the ethical and unethical actions. The lower the ethical threshold, the less the auditor has to sacrifice in pecuniary terms to select the ethical action in that case, and hence the more likely it is that the auditor will select the ethical action. Note that the ethical threshold is primarily a characteristic of the ethical dilemma, and not a characteristic of the auditor. However, the ethical threshold is affected by the auditor’s assessment of the action that the other auditor is likely to choose.

For example, in the opinion-shopping game represented in Table 1, suppose that auditor A knows that auditor B has no ethical standards, such that $M_{B}(a_c)$ is zero (Dawes and Thaler, 1988, p. 196, call this “selfish rationality”). Therefore, in a single play of the opinion-shopping game, B will certainly choose consent. Then A’s payoff from consent is $2, compared with $-1$ from deny, a difference of $3. This represents the ethical threshold faced by auditor A in this case. That is, A will choose the ethical action (deny) in this case if and

---

11 Preliminary evidence on the ethical dispositions of accounting students suggests that ethical conditioning may have a positive influence on ethical perceptions and judgments; for example, see Fulmer and Cargile (1987, p. 216 and 217) and Hiltebeitel and Jones (1991, p. 272).
only if A’s incremental disutility for the unethical action exceeds a monetary equivalent of $3.

Next, contrast this with the case where auditor A knows that auditor B has very high ethical standards; that is, $M_B(a_e)$ is so high that B will always deny this client’s request to use the dubious accounting method in a single play of the opinion-shopping game. If A is certain that B will choose deny, then A’s payoff from consent is $5, compared to $3 from deny. The difference of $2 represents the ethical threshold faced by auditor A in this case. It is noteworthy that, as A’s assessment of B’s ethical standards rises, the ethical threshold faced by A decreases, which means that the pecuniary sacrifice to A of taking the ethical action also decreases.

It turns out that the result obtained in contrasting these numeric examples can be generalized to all instances of the opinion-shopping game. Before demonstrating this, it is necessary to specify the structure of the game more formally. First, denote the net audit fee for each auditor by $f$, while $k$ represents the monetary effect of the loss of credibility and/or status that both auditors incur if both clients are allowed to adopt the dubious accounting method. Assume that both $f$ and $k$ are positive, and that $f > k$. Based on our initial description of the game, the general payoffs given in Table 2 can be restated in terms of $f$ and $k$ as follows: $p = f$, $r = f - k$, $s = -k$, and $t = 2f - k$. Next, suppose that auditor B may be one of only two possible types, labelled unethical ($M_B(a_e) = 0$) and ethical ($M_B(a_e) > f$). This leads to the following proposition.

**Proposition 1.** In a single play of the opinion-shopping game, if auditor A knows auditor B’s type, then the ethical threshold faced by A is strictly lower if B’s type is ethical.

**Proof.** The ethical threshold faced by both auditors is $t - p = f - k$ if the other auditor chooses deny and $r - s = f$ if the other auditor chooses consent. If auditor B is unethical, then by definition $M_B(a_e) < f - k < f$, and auditor B’s dominant strategy is to choose consent. Given this, the ethical threshold faced by auditor A is $f$. If auditor B is ethical, then by definition $M_B(a_e) > f > f - k$, and auditor B’s dominant strategy is to choose deny. In this event, the ethical threshold faced by auditor A is $f - k$, which (since $k > 0$) is strictly less than $f$. □

The intuition behind this result is straightforward. If auditor B is unethical, then both auditors will incur the cost $k$ regardless of what auditor A does. Hence, the opportunity cost to auditor A of choosing the ethical act is simply $f$. However, if auditor B is ethical, then auditor A’s choice of the ethical act will ensure that $k$ is not incurred. This reduces the opportunity cost to auditor A of choosing the ethical act to $f - k$. 
Proposition 1 is easily generalized to the case where auditor A is uncertain about auditor B’s type. Define $P_e$ as A’s assessment of the probability that B’s type is ethical. Then we have:

**Proposition 2.** In a single play of the opinion-shopping game, the ethical threshold faced by auditor A is strictly decreasing in $P_e$.

**Proof.** Based on the proof of Proposition 1, the ethical threshold faced by auditor A is $f$ if auditor B is unethical, and $f - k$ if auditor A is ethical. By simple algebra, if $P_e$ is A’s assessment of the probability that B’s type is ethical, then the ethical threshold faced by auditor A is $f - P_e k$. For any plausible utility function, the certainty equivalent of this expected payoff to A must be strictly decreasing in $P_e$ as long as $U' > 0$ and $k > 0$, as assumed. □

The general implication of this analysis is that ethical behavior begets more ethical behavior: the likelihood that an auditor will behave ethically in a particular case increases with his or her degree of belief that other auditors will also behave ethically in that case. Put another way, the incremental expected payoff that accrues to an auditor who selects the unethical act is decreasing in the probability that the other auditor is ethical.

Next, this analysis of ethical thresholds may be extended to the repeated-play version of the opinion-shopping game. First, consider the repeated-play game with no stopping point and assume that each auditor expects the other auditor to select an always consent strategy. This implies that if auditor A chooses deny in the first period, then auditor B will attract both clients in the first period and (through incumbency) retain both clients thereafter. Then the ethical threshold faced by auditor A is $\frac{3}{3}$ divided by the discount rate per period; for example, $\frac{3}{30}$ if the discount rate is 10%. Extrapolating from the single-play case, the ethical threshold faced by auditor A declines with an increase in the expectation that auditor B will choose the ethical strategy, always deny.

Now assume that the game is played $n$ times, such that $1 < n < \infty$, and $n$ is common knowledge. Also assume that an auditor can only lose a client by choosing deny when the other auditor chooses consent. This incumbency advantage effectively means that it is not optimal to employ any strategy (such as tit-for-tat) that involves a mix of deny and consent actions across periods. In other words, always deny and always consent are the only viable strategies.

---

12 Unfortunately, while Propositions 1 and 2 hold for the opinion-shopping game and any other prisoner’s dilemma game whose payoffs are as specified immediately above Proposition 1, they do not hold for all prisoner’s dilemma games in general.
Under these conditions, it is apparent that the ethical threshold faced by auditor A is increasing in the number of periods, \( n \), and that this holds regardless of auditor A’s assessment of auditor B’s ethical standards. In effect, by choosing deny in the first period, auditor A risks loss of the client for all periods, and the cost of this is increasing in the number of periods. This result provides further support for the notion that requirements for auditor rotation tend to reinforce ethical behavior by auditors.

One other factor that has been found to increase cooperation rates in public goods experiments is communication between subjects prior to action choice. Dawes (1980, p. 185 and 186) reviews several experiments that investigated the effects of pre-act communication on cooperation, and concludes that its beneficial effects are pervasive in these studies. Dawes (1980, p. 186) cites evidence that the aspect of communication that leads to more cooperation is discussion of the issue that must be acted upon. Dawes (1980, p. 186) surmised that intragroup commitments to choose the cooperative action might also increase cooperation rates, but the evidence on this issue is inconclusive.

In terms of the auditor utility function expressed in Eq. (1), communication prior to final action choice may be viewed as one aspect of \( a \). For example, define actions \( a' \) and \( a'' \) as follows:

- \( a' \) is consent to the client’s proposed accounting method without discussing the issue with other auditors.
- \( a'' \) is consent to the client’s proposed accounting method after discussing the issue with other auditors.

It seems plausible that the moral cost to an auditor of \( a'' \) might differ from the moral cost of \( a' \). In particular, if discussing the issue with other auditors results in a mutual commitment not to consent to the proposed accounting method, then it seems plausible that \( M(a'') > M(a') \), because \( a'' \) would entail breaking the commitment, while \( a' \) would not. This example also suggests a beneficial side-effect of such communication, which is the likelihood that it will reduce the auditors’ uncertainty over whether the proposed accounting method is acceptable under GAAP.

This analysis suggests the value of an institutional procedure that enables an auditor to discuss a client’s proposed accounting treatment with other auditors. The results cited by Dawes (1980, p.185 and 186), support the view that, in the opinion-shopping setting, such a procedure might facilitate ethical behavior by auditors. It turns out that, in the current accounting environment, such a procedure is provided SAS No. 50 (American Institute of Certified Public Accountants, 1986). This standard provides guidance to an auditor who is approached by a prospective client firm that seeks the auditor’s views about a financial reporting issue. The standard requires the auditor to consult with the prospective client’s existing auditor “to ascertain all the available facts relevant to forming a professional judgment” (American Institute of Certified Public Accountants, 1986, paragraph .07). It is understood in the public accounting
profession that this standard was developed specifically to address the problem of opinion shopping.

In summary, the economics literature offers some hope that a laissez faire approach might be a viable way to achieve a standard of ethical behavior among auditors, at least in the opinion-shopping scenario. The analysis in this section suggests that the effectiveness of a laissez faire approach to ethical standards depends on (a) the ethical climate, which refers to each auditor’s beliefs about the likelihood that other auditors will behave in an ethical manner, (b) the explicitness of GAAP, (c) the frequency of auditor rotation, and (d) the opportunity for auditors to discuss their ethical dilemmas with other auditors. Of these factors, the ethical climate is probably the most important. The development and maintenance of a strong ethical climate requires an educational system that encourages the formation of sound ethical values among persons entering the public accounting profession, and professional leaders who continuously stress the virtues of ethical conduct through their rhetoric and behavior.

The viability of the laissez faire approach may be assessed, at least conceptually, using cost-benefit analysis. This would involve comparing the incremental social cost of ethical lapses under the laissez faire approach to the incremental cost of developing, maintaining and enforcing a formal code of professional conduct. While it is unlikely that precise measures of these costs can be obtained, this analysis may have value as a conceptual exercise. Accordingly, the following section offers a modest framework for this analysis.

3. Comparing alternative systems of ethical standards

According to Thiroux (1990, pp. 44–46) the utilitarian approach to ethics generally takes two main forms, which he calls act utilitarianism and rule utilitarianism. Under act utilitarianism, each individual is expected to assess his or her situation and try to figure out which act would bring about the greatest good for everyone involved (Thiroux, 1990, pp. 44–46). Advocates of this approach do not believe in setting up formal rules, because they believe that each situation is different (Thiroux, 1990, pp. 44–46). In contrast, rule utilitarianism involves establishing a carefully reasoned set of rules that, if followed by all individuals, should bring about the greatest good for the community in general (Thiroux, 1990, pp. 46–48).

The laissez faire approach to ethical standards is consistent with act utilitarianism. In contrast, the system of ethical standards presently employed by the public accounting profession in the United States is consistent with rule utilitarianism, in that the AICPA’s Code of Professional Conduct includes a
large and growing section of rules and rule interpretations. In addition, this system entails sanctions for those CPAs who deviate from the rules. For purposes of this paper, this is labelled a strict approach to ethical standards. In this section, these two systems are compared from a cost-benefit perspective. In addition, an intermediate alternative that incorporates a few carefully chosen rules is also identified and analyzed; this is labelled a limited approach to ethical standards.

3.1. Strict ethical standards

For purposes of analysis, a strict approach to ethical standards may be viewed as a mechanism having the following features. First, it has a non-zero probability of detecting any ethical violation committed by an auditor. Second, it entails the authority to impose a financial penalty on any auditor it identifies as having committed an ethical violation, and to compel payment of that penalty by the auditor. Third, its operation has a cost that is allocated in some equitable way among all auditors, such as through licensing fees. Such a mechanism is referred to here as an ethical monitoring and enforcement mechanism. Based on this definition, it is apparent that, if the upper limit on penalties is sufficiently high and the cost of the mechanism is sufficiently low, then there exists an ethical monitoring and enforcement mechanism that can improve upon the laissez faire equilibrium solution shown in observation 1.

For example, suppose that an auditor who consented to a client request in the opinion-shopping game would incur a certain penalty in excess of $2. Then it becomes optimal for both auditors to deny their client’s request to approve the dubious accounting method, and the deny, deny strategy pair becomes the equilibrium solution. In essence, the threat of sanctions makes it economical for each auditor to choose the ethical action. Furthermore, if the cost of the ethical monitoring and enforcement mechanism is less than $1 for each auditor, then this result improves upon the laissez faire equilibrium solution identified in observation 1. However, due to the cost of the mechanism, this result still falls short of the Pareto-optimal solution under which each auditor earns a net audit fee of $3.

In one sense, this result is instructive about the differences between the strict and laissez faire approaches. In general, ethical standards are characterized as requiring the public practitioner to place the public interest ahead of personal

---

13 Whereas the 1988 version of the AICPA’s Code of Professional Conduct included only five pages of rules (American Institute of Certified Public Accountants, 1988, pp. 8–13), this grew to over nine pages by 1994 (American Institute of Certified Public Accountants, 1994, pp. 8–17). In contrast, both versions of the Code include less than five pages of principles (American Institute of Certified Public Accountants, 1988, pp. 3–8; American Institute of Certified Public Accountants, 1994, pp. 4–8).
gain (Carey and Doherty, 1966, p. 4 and 5). But in the restructured game established by adding the ethical monitoring and enforcement mechanism, the ethical action is also the one that maximizes the auditor’s personal gain. In contrast, under the laissez faire approach, an auditor for whom $M(a)$ is sufficiently high is willing to choose the ethical action, despite the fact that it entails a financial sacrifice, because it is the right thing to do. This suggests that, relative to the strict approach, the laissez faire approach has a certain aesthetic appeal.

A more practical comparison between the strict and laissez faire approaches involves cost-benefit analysis. Both approaches fall short of achieving the Pareto-optimal result, but in different ways. The amount by which the laissez faire approach falls short is equal to the expected social cost of ethical lapses, or failures to prevent the client firms from using the dubious accounting methods. In turn, this depends on the ethical climate and related factors cited earlier. On the other hand, the amount by which the strict approach falls short is equal to the expected cost of the ethical monitoring and enforcement mechanism. This cost could be substantial. For example, consider the system of public accounting ethical standards now employed in the United States. It consists of one or more committees of the AICPA that are involved in promulgating the Code of Professional Conduct. It also requires enforcement procedures designed to monitor the behavior of practitioners, identify deviant behavior, and impose such sanctions as expulsion from the AICPA, revocation of the CPA license by a State Board of Accountancy, or suspension of membership in the SEC Practice Section (Robertson, 1990, pp. 114–116). Taken together, the cost of these activities is not trivial. Part of this cost is borne by auditors through membership dues and licensing fees, and part is borne by the public through federal and state taxation.

Due to the virtual impossibility of measuring the costs identified above, this analysis is not conclusive, nor is it intended to be. Rather, the analysis simply attempts to establish a framework that permits us to identify the key factors in comparing the strict and laissez faire approaches to ethical standards. Another advantage of this framework is that it suggests the possibility of an intermediate approach between these two extremes. This would involve limited regulation of ethical conduct which would allow fewer ethical lapses than the laissez faire approach, but at a fraction of the cost of strict ethical standards. Some possible features of a limited regulatory regime are now considered.

### 3.2. Limited regulation of ethical conduct

Four types of limited regulation are briefly examined in this section. These are (a) broad ethical standards with no formal enforcement mechanism, (b) mandatory auditor rotation, (c) a formal procedure for obtaining rulings on accounting methods proposed by audit clients, and (d) disclosure requirements
associated with auditor–client disputes. A regime of limited regulation could consist of one or more (possibly all) of these. Note that the last three of these are not ethical standards per se, but rather refinements of GAAS or GAAP that could reduce the potential for ethical violations by auditors. In addition, some of these ideas are applicable primarily to the opinion-shopping scenario, so the development of a more complete regime of limited regulation would require further analysis of other ethical dilemmas that auditors face.

The AICPA’s current Code of Professional Conduct consists of principles, which include integrity, objectivity and independence, due care, and the public interest (American Institute of Certified Public Accountants, 1994, pp. 4–8) and rules, which include interpretations and are much more specific than the principles (American Institute of Certified Public Accountants, 1994, pp. 8–17). As envisioned here, a set of broad ethical standards with no formal enforcement mechanism would be something like having only the current principles, but no rules or interpretations.

The economic implications of this type of approach are uncertain. The cost of developing and maintaining broad ethical standards with no formal enforcement mechanism would certainly be much lower than the cost of our current system. With respect to benefits, broad standards would have value only if they enhance the ethical climate in a way that decreases the threshold for ethical conduct faced by all independent auditors. Of course, such standards should be designed to do just that. In addition, broad standards should provide a better basis than no standards for educating entrants to the accounting profession about how the ethical accountant should behave (Thiroux, 1990, p. 45). However, from the traditional economics perspective, broad ethical standards seem to add little more than rhetoric, relative to the laissez faire approach. One might argue that detailed rules encourage auditors to search for loopholes, while broad standards would encourage them to take a more principled view of their responsibilities to the profession and the public. But this is highly speculative. It appears that economic analysis is not very helpful in assessing the incremental value of broad standards. This will have to be left to professional judgment.

The potential value of auditor rotation in enhancing the ethical behavior of auditors is discussed earlier in this paper. According to the report of the Commission on Auditors’ Responsibilities (1978, p. 108), proposals to require companies to rotate auditors every three to five years are frequently made. However, the Commission’s analysis of this proposal suggests that its benefits would be offset by the incremental start-up and learning costs that auditors must incur for new clients. While these costs would certainly exist, it is hard to assess whether they would outweigh the benefits of more frequent auditor rotation.

A formal procedure for obtaining rulings on accounting methods proposed by audit clients would resemble the procedure for obtaining IRS rulings on
difficult tax issues. This would be intended to alleviate the problems that arise from the vagueness of GAAP. However, such a procedure might also be very costly. First, there would have to be a staff group within the FASB or SEC to provide the rulings. Second, since these issues would have to be resolved before the client firm could issue its financial statements, the time frame to respond to these requests would have to be short. Third, it is possible that such requests could become frequent, exacerbating the cost of the process. Fourth, it is likely that there would be a significant peak period for such requests during the time when calendar-year companies are preparing their annual financial statements. Once again, the question of whether the benefits of this procedure would outweigh its costs is difficult to answer.

The last type of limited regulation to be discussed here involves disclosure requirements associated with auditor–client disputes over material accounting issues within public companies. For example, suppose that an auditor believes that a client’s proposed accounting method is not appropriate in the circumstances, even though it is not necessarily in violation of GAAP. Then the auditor might be required to publicly disclose its position on the issue, either in the audit report or in a separate filing with the SEC. In addition, the company would be required to disclose the financial statement effects of the disputed accounting method, in comparison to a more appropriate method.

This proposal combines certain features of recommendations recently made by the POB and the Advisory Panel on Auditor Independence. First, the POB recommended that SEC registrants be required to file, with their annual financial statements, a statement by the audit committee or board of directors indicating whether the committee or board members “believe that the financial statements reflect appropriate accounting principles” (Public Oversight Board, 1993, p. 52). Responding to this recommendation, the Advisory Panel on Auditor Independence (1994, p. 21) suggested that the auditor, rather than the audit committee, should judge the appropriateness of a company’s accounting principles, and also proposed that the auditor communicate this judgment to the audit committee, rather than to the public at large. In addition, the Advisory Panel on Auditor Independence (1994, p. 22) expressed reservations that their proposal could lead to opinion shopping among accounting firms. Of course, the potential for opinion shopping would be even higher if independent auditors (rather than the audit committee) were required to comment publicly on the appropriateness of a company’s accounting principles, as suggested here.

14 The Emerging Issues Task Force (EITF) is a group established by the FASB to provide timely guidance on accounting issues that are new and controversial (Miller and Redding, 1986, p. 131 and 132). It differs from what is suggested here in that the EITF provides timely guidance to all reporting entities in general, rather than to a specific reporting entity upon request.
However, the prospect of opinion shopping is addressed by the following recommendation by the National Commission on Fraudulent Financial Reporting (1987, p. 47).

When a public company changes independent public accountants, it should be required by SEC rule to disclose the nature of any material accounting or auditing issue discussed with both its old and new auditor during the three-year period preceding the change.

Taken together, these recommendations would effectively require those public companies that engage in opinion shopping (or actually switch auditors) to disclose the nature and financial statement effects of any accounting treatment that the auditor feels is not appropriate.

In terms of the opinion-shopping game represented in Table 1, this proposal would mean that decisions to opinion shop could have undesirable consequences for audit clients in the form of increased disclosure. This effectively changes the game by making it necessary to include the audit clients as players. If the audit clients view these undesirable consequences as large enough, then they could decide not to opinion shop. If so, then the Pareto-optimal solution to the game is obtained by default. Hence, the potential benefits of this proposal appear to be substantial. Furthermore, while the costs of the required disclosures might be minimal, this becomes moot if most clients opt not to opinion shop under this requirement. In summary, this appears to be the most promising of the proposals for limited regulation of ethical conduct.

4. Concluding remarks

The expectation that auditors will act in the public interest is an important element of the value of audit services. According to the Public Oversight Board, however, public confidence in the accounting profession may have declined in recent years (Public Oversight Board, 1993, p. 1). As a result, various proposals have been made for modifications in the profession’s ethical standards and other regulatory mechanisms. Many of these proposals are still under consideration.

At present, the AICPA’s Code of Professional Conduct is a focal point of the profession’s efforts to induce auditors to act in the public interest. The ethical standards promulgated in the present Code are interpreted here as strict in that they include detailed rules proscribing certain behaviors, and they are upheld through various monitoring and enforcement mechanisms. A less strict system of ethical standards might include no detailed rules and no monitoring and
enforcement mechanisms, and might or might not include broad ethical standards such as the principles in Section I of the present Code.

This paper offers a framework for thinking about the costs and benefits of these alternative approaches to ethical standards. Since a strict system of ethical standards is likely to be more costly than a less strict system, the public accounting profession’s preference for a strict system must reflect a presumption that it is more effective in some way. But the analysis in my paper suggests that the benefits of stricter enforcement (e.g., reduction in the cost of ethical lapses relative to a less strict approach) do not necessarily outweigh the incremental costs of an ethical monitoring and enforcement mechanism. A less strict system might attain a satisfactory degree of effectiveness by cultivating a strong ethical climate under which entrants to the profession are conditioned to act in an ethical manner. Furthermore, the effectiveness of less strict ethical standards might be enhanced by selected regulatory mechanisms such as mandatory auditor rotation, formal procedures for obtaining rulings on accounting methods proposed by audit clients, and disclosure requirements associated with auditor–client disputes.

The limitations of the analysis in my paper must be acknowledged. First, the model is based on an audit opinion-shopping scenario, so the analysis may not apply to other ethical dilemmas faced by auditors. Second, the social value of ethical behavior does not arise endogenously from the models employed in this paper; it is merely assumed. In response to these caveats, however, the analysis in my paper is based on the prisoner’s dilemma game, which is often used to examine the ethical dimensions of collective action problems in other fields such as economics, political science and psychology.

The proposed auditor utility function incorporating a moral cost is a novel contribution of this paper. This formulation may be a useful tool in developing more refined models of auditor behavior that have higher predictive power. It may also be useful in more general economic settings, such as moral hazard models in which employees may have an incentive to shirk or adverse selection models that involve disclosure of private information. Some economists have recently suggested a need to incorporate moral incentives into economic models. This paper may be viewed as a preliminary attempt to respond to these suggestions.

Acknowledgements

The author thanks workshop participants at the University of Utah and participants at the 1997 conference on Ethics and Economic Behavior in Accounting and Taxation at the University of Oklahoma for helpful comments on an earlier draft.
References

Advisory Panel on Auditor Independence, 1994. Strengthening the professionalism of the independent auditor, Report to the Public Oversight Board of the SEC Practice Section, AICPA. Public Oversight Board, Stamford, CT.


Public Oversight Board, 1993. In the Public Interest: Issues Confronting the Accounting Profession. Public Oversight Board, Stamford, CT.


