Comment

Discussion of “economic analysis of accountants’ ethical standards: the case of audit opinion shopping”

Charles J. Coate *

*Tel.: +1-716-245-5316; fax: +1-716-245-5467.
E-mail address: coate@geneseo.edu (C.J. Coate)

Department of Accounting, Jones School of Business, Geneseo (SUNY), Geneseo, NY 14454-1401, USA

Abstract

In his paper, Cushing (Cushing, B.E., (1999). Economics analysis of accountants’ ethical standards: The case of audit opinion shopping. Journal of Accounting and Public Policy 18 (4/5)) argues for an increasing role of “laissez-faire” approaches to professional accounting ethics. To formally present his argument, Cushing (1999) employs a classic auditor–client dispute over a financial reporting issue; the dispute’s resolution is framed within a prisoner’s dilemma game. Three increasingly sophisticated models are used to examine both strict (explicit rules and monitoring) and laissez-faire (moral training and leadership) approaches to induce ethical auditor play within the prisoner’s dilemma game.

My comments are an effort to consider if Cushing’s (1999) arguments for a laissez-faire approach are practicable. To do this I first relate Cushing’s (1999) arguments to the theoretical attributes of a profession. Second, I extend his arguments to include ethical disposition. Two bases of ethical disposition are discussed, moral reasoning theory and the persona of individuals. I conclude that a movement toward a laissez-faire approach to ethics is a strategy the profession should not ignore. © 1999 Elsevier Science Inc. All rights reserved.
1. Introduction

Cushing’s (1999) paper addresses concerns relating to the lack of independ-
dence issue from an ethical standards perspective. As in all auditor indepen-
dence papers, exceptions are examined and not the norms. That is, in general
both clients and independent auditors behave ethically and it is the exceptions
that are interesting and, therefore, studied. In his paper client opinion shopping
influences wealth-based independent auditor payoffs and may give rise to un-
ethical behavior of independent auditors. Situations, referred to as ethical
climate, modify incentives to entice unethical behavior and may induce an
otherwise ethical auditor to behave less ethically. At the same time, the truly
ethical independent auditor remains so regardless of the situation.

Cushing (1999) employs a classic client–auditor disagreement. Clients re-
quest independent auditors to sign-off on questionable financial reporting is-
issues. Responses to these requests are examined within a game theory
framework, specifically the prisoner’s dilemma game. Rather than a game where
independent auditor plays against client, his paper pits one independent au-
ditor versus another. The game has two independent auditors and each has a
client proposing a questionable financial reporting method. It is assumed that
both independent auditors would agree that the proposed method is dubious
and not within the spirit of Generally Accepted Accounting Principles (GAAP).
Independent auditors may either “consent to or deny” the client
request, with denial of the request resulting in opinion shopping and possible
auditor change (Cushing, 1999, p. x). The ethical play is deny, deny; that is,
both independent auditors deny the clients’ requests and no independent au-
ditor changes occur. Cushing’s paper examines both strict (“explicit rules plus
monitoring” – an enforcement process) and “laissez-faire” (“moral training
and leadership” – a socialization process) approaches to induce the (deny, deny)
play on the part of the independent auditors. This examination leads to ar-
guments for increasing the role of a laissez-faire approach to professional ac-
counting ethics.

Admittedly the prisoner’s dilemma game is relatively simple and can not
practically reflect the complexity of the independent audit market. For ex-
ample, Observation 3 presents the “tit-for-tat” type strategy as “collectively
stable” (Axelrod, 1984 p. 56). Cushing (1999) then discusses a number of
practical difficulties with this solution. A practical difficulty not discussed in his
paper is that applying a tit-for-tat type solution in the independent audit
market requires an ethical independent auditor to penalize an unethical inde-
pendent auditor via consent play. That is, an ethical independent auditor
would knowingly consent to “Accounting methods” they believe to be “du-
bious” (Cushing, 1999, p. xxx). While economically rational, such behavior in a
professional environment appears somewhat unsettling. Nonetheless, modeling
the audit market as a prisoner’s dilemma game does capture interesting and
relevant aspects of the audit market and professionalism. Pressures of competition intrinsic to the prisoner’s dilemma game may lead to lost auditor independence or client turnover. Consequently, Cushing’s paper (1999) is a valuable analysis. Further, recognizing the role of professionalism in a *laissez-faire* approach to inducing ethical behavior is thought provoking and motivates most of my commentary.

2. The models

To illustrate and discuss applications of a prisoner’s dilemma game, Cushing (1999) presents three models in Section 2: the Basic Opinion-Shopping (OS) Model, an Effects of Risk (ER) Model – Section 2.1, and an Ethical Preferences (EP) Model – Section 2.2. These models progressively capture some richness of the independent audit market. The OS Model is the simplest form in which payoffs are strictly wealth-based utilities. Independent auditors are collectively better off when *deny, deny* is played and worse off when *consent, consent* is played. Hence, there is a payoff associated with auditing a client, but a cost to a *consent* play that induces the client to change independent auditors. However, a *deny, consent* play offers a greater payoff to the consenting independent auditor. A payoff, for each client audited, is received by the consenting independent auditor, but the cost to consent is shared evenly by the independent auditors. This sharing rule reflects a loss of credibility and/or status shared equally across the profession as a result of a *consent* play by any independent auditor.

Differentiating the ER Model from the OS Model is the amount of and the sharing rule for the *consent* play’s cost. A risk exposure cost is included in the ER Model; this cost is borne solely by the consenting independent auditor and is not shared across the public accounting profession. Risk exposure cost is specific to a single independent auditor such as litigation costs and/or sanctions from professional bodies. Both the OS and the ER Models capture benefits of cooperation (*deny, deny* play) within the public accounting profession and the overall consequences of non-cooperation (*consent* play).

The EP Model captures the characteristics of the OS and ER Models, but is differentiated from them by the addition of an ethical action (or moral cost) term to the independent auditor’s utility function. In the EP Model, the independent auditor’s utility function is $H(x, a) = U(x) - M(a)$. The $U(x)$ term represents a wealth-based component in the utility function and the $M(a)$ term represents ethically based disutility to unethical but wealth-creating actions. Thus, independent auditors are allowed to act to their monetary detriment by having an economic benefit provided by ethical actions. If $M(a)$ is always zero, then only monetary incentives or disincentives exist and the EP Model reduces to the either the Basic or Risk Model depending on the cost of consent assumptions (shared or not).
Further, the EP Model allows for the interaction between situation and independent auditor. Knowledge of the $M(a)$ function for a competing independent auditor (situation) influences the first independent auditor's play. Cushing (1999) specifically finds “ethical behavior begets more ethical behavior” (Proposition 2). This, of course, raises the concern that unethical behavior begets more unethical behavior. That is, does competing with a less ethical independent auditor make the first independent auditor behave less ethically as well? In contrast with the EP Model, the OS and ER Models' independent auditor decisions or behaviors are decided by wealth-based payoffs alone. Thus, the EP Model offers a richer analysis of ethical behavior and the impacts of strict and laissez-faire approaches to motivating ethical behavior within the public accounting profession.

3. A professional perspective for the models

To gain further insight into the models and into the laissez-faire and the strict approaches to promoting ethical behavior, a view of the models from a professional perspective is helpful. First, attributes of a profession and their fit into the models are considered. Roles of society and the profession in inducing deny, deny play are then considered.

Greenwood (1957, p. 45) lists the following attributes of a profession: (1) systematic theory, (2) authority, (3) community sanction, (4) ethical code, and (5) culture. The first and second attributes are more directly related to the professional competence dimension of audit quality. The third through the fifth attributes are relevant to Cushing’s (1999) models.

Community sanction (Greenwood, 1957, pp. 48–49), the third attribute, stems from a community belief that collectively the profession will act in the best interest of the community irrespective of the personal (wealth measured) cost to the members of the profession. Any decrease in community sanction (any government or legal involvement) reduces the prestige of the profession and imposes a cost on all members of the profession. The ethical code (Greenwood, 1957, pp. 49–51) attribute defines ethical expectations and the controls and monitors required from within the profession to realize those expectations. These controls are mechanisms of the strict approach to ethical standards currently used by the profession. The importance of the culture attribute (Greenwood, 1957, pp. 51–54) is reflected in the central role of socialization processes to the laissez-faire approach to ethics.

To see the roles of both society and the public accounting profession to induce deny, deny play, we consider the EP Model from a professional perspective. Recall, the EP Model's independent auditor utility function has a wealth based term, $U(x)$, and an ethics based term, $M(a)$. Community sanction of the public accounting profession indicates society's belief that the $M(a)$
term has a dominant role in determining independent auditor’s ethical behavior. The (wealth) cost to independent auditors from a consent play includes a loss of some level of community sanction and is reflected in the game’s payoff matrix; society imposes a loss of credibility and/or status as a means to induce a deny, deny play. A second cost society imposes on a consenting independent auditor is risk exposure (or legal cost). Practically (but not explicitly modeled), from the professional perspective, the use of litigation costs to influence independent auditor behavior reflects an additional reduction in the level of community sanction. These community sanction costs associated with failed independent audits are a community response reflecting a lack of society’s confidence in the role of the $M(a)$ term to influence independent auditors’ ethical decisions.

Cushing’s (1999) paper discusses two profession based options to induce a deny, deny play: a strict enforcement of the code of ethics and a laissez-faire approach to ethics. While strict enforcement concentrates on the $U(x)$ term in the utility function, the laissez-faire approach concentrates on the $M(a)$ term. Either approach to inducing deny, deny play by the public accounting profession avoids societal actions or sanctions. However, enforcement which focuses on $U(x)$, the wealth term, parallels the actions available to society. The laissez-faire approach, in contrast, increases the independent auditor’s disutility from unethical actions, which the above paragraph suggests is linked with community sanction. The laissez-faire approach, then, has the advantages of being more professional in addition to being, as the paper suggests, less costly. A question of practicality that remains for the laissez-faire approach. In his paper, Cushing (1999) suggests one strategy for achieving the laissez-faire approach is the employment of a socialization process. A socialization process would be cultural in nature and accomplished through both educational and professional means.

In regard to socialization and education, the question arises as to specific benefits which can be derived from formal ethics education. Certainly the study of ethics is beneficial to students; for example, students can be made aware of approaches to address ethical dilemmas. Related to the EP Model, a question arises – does the use of case studies relating to ethics in class provide students an appreciation for the $U(x)$ and the $M(a)$ components of the utility function? The answer is likely to be no. In cases studies students are outsiders; that is, they may not see themselves in the ethical dilemma. Rather, students may view such cases as classroom exercises, that is, exercises in which students are to supply the professor with the textbook or ethical response. Since there are no wealth-based payoffs, there is no wealth-based disutility to an ethical response.

Other classroom exercises may provide more direct involvement of and appreciation by students for the $U(x)$ and $M(a)$ terms. Such exercises may provide students an understanding of how wealth, ethics, and social processes influence behavior and decisions. For example, Dirsmith and Ketz (1987)
mis-scored exams experiment forced students to realize the trade off between monetary gain, $U(x)$, and ethical actions, $M(a)$. In Dirsmith and Ketz’s (1987, pp. 132, 133) mis-scored examination experiment a group of student examination scores were intentionally mis-added. Some students received 10 points too many, while other students received 10 points too few (Dirsmith and Ketz, 1987, p. 132). Students with too few points returned their examinations; students with too many points did not (Dirsmith and Ketz, 1987, p. 132). When the experiment was revealed to the students, it appears that they understood the cost to the ethical play was 10 points on the examination (see the general discussion in Dirsmith and Ketz, 1987, p. 133). For a number of semesters, as a precursor to an ethics discussion, I have often posed on a hypothetical basis a dilemma somewhat similar to Dirsmith and Ketz’s (1987) dilemma to my upper level accounting undergraduate students. Most students freely admit they would not (or probably would not) return the points; yet, ironically, students also generally agree that returning the points is the right thing to do. To explain this irony students rely on a number of rationalizations. A popular rationalization is for students to note that, in K-12 and college, teachers rarely take back points when offered. Thus, student behavior has been socialized within the educational system – a norm has been established. Interestingly, some students occasionally also remark that if they knew other students returned points, then they too would return points.

In regard to socialization at the professional level it is noteworthy that practically the profit motive and the profession motive may often seem in conflict (certainly in the short run). This, of course, recognizes the EP Model’s trade-off between $U(x)$ and $M(a)$. The professional motive must always be paramount. That is, service to society (or the general public) takes precedence over service to clients, peers, or profits. Further, the professional motive must always be present. Actions, both implicit and explicit, of independent auditors and independent audit firms must always be congruent with this ordering.

4. Ethical disposition

While socialization is one strategy to induce ethical behavior, an alternative or supplemental laissez-faire type approach may be to consider the ethical dispositions of independent auditors. An ethical disposition can be defined as a propensity to behave in a certain manner, in this case, ethically. Also of importance would be the ability to avoid situations where ethical dilemmas are more likely to occur. Recall, situations may induce unethical behavior in an individual. In contrast with socialization, which attempts to change behavior over time, ethical disposition attempts to identify those individuals more likely to behave ethically and/or to avoid situations where ethical dilemmas are more likely to occur. In either case, the role of $M(a)$ in decisions is significant.
Some research to identify those individuals more or less likely to behave ethically or unethically does exist. For example, Schaefer and Welker (1994, p. 113) found CPAs disciplined (by state boards) were most likely to be males who were working in small firms. Those disciplined for committing criminal violations were characterized by non-membership in the state society (Schaefer and Welker, 1994, p. 115). However, without further research and analysis, it might be difficult to ascribe causality to these findings.

A basis of causality, propensity to behave ethically, may be found in Moral Reasoning Theory. Moral Reasoning Theory (Kohlberg, 1969, 1976) and the related Defining Issues Test (Rest, 1979) are often used in the accounting ethics literature, examples include Laflar and Thomas (1997) and Falk et al. (1999). Kohlberg’s three levels of moral reasoning (see Kohlberg, 1976, pp. 32–36) have a loose fit to the strategies for improving chances of a deny, deny play. The avoiding of legal costs to motivate deny, deny play may be seen as a punishment and a “preconventional” (“level 1”) solution (see Kohlberg, 1976, pp. 32–34). Strict enforcement by the public accounting profession or socialization within the public accounting profession, a colleague group, may be seen as a “conventional” (“level 2”) solution (see Kohlberg, 1976, pp. 32–34). Finally, an exclusively laissez-faire approach, no formal code of professional conduct, is movement toward a “postconventional” (“level 3”) solution (see Kohlberg, 1976, pp. 33,35).

Another basis of causality and ethical disposition may be persona or personality. To illustrate, consider the following example (Arens and Loebbecke, 1997, problem 3–28, pp. 101–102). This example chronicles the story of an individual with a large public accounting firm who becomes unprofessionally involved with a client. The individual exhibits unethical and illegal behaviors. Extravagant spending and high profile lifestyle play a role in the questionable behaviors.

So what is the causality of the questionable behaviors of the individual in this story? Certainly circumstances play a role in defining the situation, but what determined the circumstances? An interesting question is the role of persona in these situations. Does persona influence behavior and, hence, ethical disposition? Fundamental psychological theory suggests that personality not only influences, but often predicts what a person will do in a given situation (Hogan et al. 1996, pp. 469–470). With this in mind, consider a persona congruent with the lifestyle of the individual in the story. Is such a persona consistent with the stereotypic (DeCoster and Rhode 1971, pp. 651–653; Arayana et al. 1978, pp. 139–140; Bedeian et al. 1986, p. 113; Bougen 1994, p. 23) and ethical persona of an accountant: dull, conservative, conscientious, integrity, credible? Most likely, the two persona are in stark contrast.

A second question relating to persona is its part in determining the circumstances. The possibility that persona seized a role in setting the situation cannot be ignored. Thus, the persona of an individual may help create (rather
than avoid) a situation which the same individual is less suited to deal with from an ethical perspective.

The story supports the suggestion that the ethical disposition of any individual accountant may influence the probability of a laissez-faire approach’s success. For a number of individuals, relaxing strict ethical enforcement systems may not be plausible.

5. Conclusion

Three strategies discussed for inducing deny, deny play behavior are (1) control and monitor independent auditors’ behavior, (2) socialize independent auditors to behave in a certain manner, and (3) select independent auditors who will behave in a certain manner. The first is the strict approach; the second two are laissez-faire approaches. More likely than not a combination of all three is the best strategy to induce deny, deny play. Independent auditors with a disposition to behave ethically or to be socialized would certainly respond favorably to a laissez-faire approach. However, for those independent auditors lacking such a disposition a strict enforcement mechanism is required.

To summarize, a laissez-faire approach has a valid basis in rational economic theory. In addition, the laissez-faire approaches offer the greatest opportunity for professional prestige enhancement (increasing the level of community sanction). Thus, as the paper suggests, a movement toward a laissez-faire approach to ethics is a strategy the profession should not ignore.

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References