ELSEVIER Journal of Accounting and Public Policy 18 (1999) 339–363

Journal of Accounting and Public Policy

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

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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.

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PII: S0278-4254(98)00002-7

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.