THE EFFECT OF ETHICAL LAPSES ON THE REPUTATION OF INDEPENDENT AUDITORS

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ABSTRACT

Independent auditors strive to maintain a reputation for providing high quality audit services. This positive reputation brings many benefits to the auditor. One aspect of maintaining a positive reputation is the avoidance of ethical difficulties. The primary value of an audit report is the credibility it lends to the financial statements, yet this credibility is undermined if the ethics of the auditor are questionable. In this study, we explore how ethical lapses affect the reputation of auditors.

The ethical lapses involved in this study have two components each hypothesized to be important in determining how the lapse affects reputation: the punishment effect and the service effect. Because ethics are crucial to the credibility of audit reports, the accounting profession has a strong commitment to see that its members adhere to ethical standards. State Boards of Accountancy are authorized to discipline members that violate ethical standards and have discretion in the levels of punishment meted for an ethical violation. The more serious punishments should correspond to the more serious violations. We call this the punishment effect. Because the purchasers of audit services are often trying to assess

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the quality of future audit services, a newly revealed ethical lapse should provide some ability to infer about audit quality. This ability to infer about future audit quality should vary depending on the type of professional service being performed when the ethical lapse occurred. We call this the service effect.

Our results show that *any* announcement of an ethical lapse is associated with a diminished reputation ($p < 0.0001$). In addition, both the punishment effect ($p = 0.0005$) and the service effect ($p = 0.0001$) are significantly associated with a diminished reputation. These results suggest a strong link between the ethics of the auditor and the auditor's reputation.

INTRODUCTION

Audit reports lend credibility to financial statements by attesting to their compliance with an established standard (Kinney 1999). This credibility is based, in part, on the credibility of the auditor issuing the audit report, which in turn is based, in part, on the auditor's reputation. As a result, auditors carefully nurture and protect their professional reputation (St. Pierre and Reeve 1987; Kinney 1999). Besides providing credibility to their audit reports, a positive reputation should be associated with several other benefits (including attraction and retention of clients, possibility of a fee premium, and attraction the best employees).

Development of a reputation is particularly important in the area of financial statement auditing because the quality of the audit services provided is difficult to objectively evaluate (DeAngelo 1981). Many of the key factors that differentiate a high quality audit from a low quality audit are not observable. For example, many of the key decisions made in an audit require the exercise of professional judgment that may be difficult for an inexperienced person to contemporaneously evaluate. Often a judgment made by an auditor can only be evaluated in hindsight and then only after new information is revealed. Because many of the most salient characteristics of an auditor's work quality are unobservable, those wishing to evaluate audit services are forced to use observable characteristics to proxy for those unobservable characteristics.

Used in such a fashion, these observable characteristics help mold the auditor's reputation for quality work.

A potentially negative signal about an auditing firm's quality of work is the ethical breaches of their employees (Carcello *et al.* 1992). Because ethical sanctions are publicly announced, these could serve as an observable measure of the auditor's skill or professionalism. A serious ethical lapse could indicate, among other things, the lack of control within the firm, poor hiring practices, failure to follow professional standards either due to disregard or lack of knowledge, or some combination of the these items and others.

The accounting profession, like other professions, regulates its members in several significant areas including establishing and administering a code of professional ethics. Self-regulation through the application of a code of ethics is one way to protect the reputation of the profession as a whole. Acting with integrity and in compliance with high ethical standards gains the trust and confidence of the clients and the financial statement users which is crucial to the development and maintenance of the individual auditor's reputation and that of the firm with which the auditor is affiliated. In fact, guarding this reputation is so crucial that accounting firms often seek private resolution methods to settle client complaints and so avoid negative publicity (Garrison and Hansen 1999). Therefore, public announcements of ethical lapses are informative events that convey negative signals about the auditor's professionalism to not only current but also potential clients.

In this study, we examine the effects of a public announcement of an ethical breach by its employees on the reputation of a CPA firm. The announcement is manipulated to capture two factors likely to affect the ability to make inferences about the quality of a future audit. The degree of punishment handed out should be positively correlated to seriousness of the ethical violation. This we call the punishment effect. The type of service being provided when the ethical lapse occurs should also affect one's ability to make inferences about the quality of a future

audit. This is manipulated to provide what we call the service effect. Data is collected from those who are likely to be purchasers of auditing services.

The results indicate that *any* announcement of an ethical violation significantly affects the auditor's reputation ($p < 0.0001$). In addition, both the service effect ($p = 0.0001$) and punishment effect ($p = 0.0005$) significantly influence the auditor's reputation. These results suggest that the auditor's reputation is subject to change and that efforts to protect this reputation are well founded. Also, these results suggest that because public announcements of ethical violations damage an auditor's reputation, such announcements are useful in the profession's efforts to self-regulate since the announcement itself serves as a punishment.

HYPOTHESIS DEVELOPMENT

Audit Quality

A reputation for providing high quality audits is valuable to the auditor because audit quality itself is difficult to observe. This inability to directly observe audit quality has hindered even defining the phrase "audit quality." Indeed, audit quality is not explicitly defined in the technical standards nor can all agree on a definition (Schroeder, et al. 1986). A frequently used definition of audit quality is DeAngelo's (1981) which includes two components: the ability to detect misstatements and the willingness to report the misstatements.

The inability to directly observe audit quality also makes its measurement difficult. As a result, those purchasing or assessing audit quality are often limited to examining observable factors assumed to correlate with the unobservable audit quality. Several observable factors assumed to be correlated with audit quality have been examined in the literature including: the size of the auditing firm (DeAngelo 1981), tenure on the engagement (Williams 1988), audit structure (Knapp 1991), litigation (Palmrose 1988), SEC actions (Wilson and Grimlund 1990), and client composition (DeFond 1992). In this study, we are examining the role of

announcements of ethical lapses in altering the reputation of independent auditors.

Ethical Lapses and Inferences about Audit Quality

CPAs, the only professionals that may perform an independent financial statement audit, are licensed by the state and each state establishes the ethical standards to which their licensed professionals are held. The establishment and enforcement of a code of ethics is an important part of the profession's self-regulation. Violation of the code of professional ethics, once reported, is adjudicated in a disciplinary hearing. Any punishment taken by the disciplinary board is publicly announced. Such a public announcement, presumably, accomplishes two things. First, the announcement may foster public acceptance of self-regulation by providing an example of the process working as designed. Such an act should enhance the credibility of the accounting profession as a whole and the credibility of individual, non-sanctioned members as well. Second, such an announcement should punish the offender. If reputations are important, such an action should harm the ethics violator since the professional reputation of the individual violator and his or her firm is likely diminished.

Public announcements of ethical lapses may provide information about the audit quality that could be expected from an auditor (Wilson and Grimlund 1990, Davis and Simon 1992). Indeed, Carcello, *et al.* (1992) find that high ethical standards of the audit team is one of the highest rated attributes of audit quality.[1] Since disciplinary actions for ethical lapses are publicly announced, a party wishing to use them as means of assessing audit quality can do so. The disciplinary action is taken only after a hearing by the state Board of Accountancy during which the practitioner has had the opportunity to offer a defense. For discipline to be administered, the ethical lapse must have been serious and the defense offered for the lapse insufficient. Therefore, the credibility of the announcement of an ethical violation should be high since the disciplinary action is taken after

consideration of the CPA's defense and is evaluated by knowledgeable arbitrators. All this suggests the following hypothesis:

H1: The announcement of any ethical lapse is associated with a diminished reputation.

However, not all announcements are likely to be of a uniform value in making inferences about the audit quality expected from the auditor. More refined inferences can be made as one obtains more information about the seriousness of the ethical violation and the type of service on which the ethical lapse occurred. We propose that the seriousness of the announcement of ethical lapses is a function of these two factors that we are calling the punishment effect and the service effect, respectively.

One factor that should influence the inference about audit quality that can be derived from the announcement is the seriousness of the underlying ethical lapse. The announcement itself should help make this inference since it would be expected that the punishment is positively correlated with the seriousness of the underlying ethical violation.[2] State Boards of Accountancy generally have the authority to administer several types of punishment for ethical problems but we focus on three: admonishment (censure), temporary suspension of the practitioner's license, and permanent termination of the practitioner's license (American Institute of Certified Public Accountants and National Association of State Boards of Accountancy (AICPA/NASBA) 1998).[3,4] In terms of making inferences about audit quality, the seriousness of the punishment (which should reflect the seriousness of the offense) should rank in this order:

admonishment < suspension < termination

Therefore, the level of punishment administered for the ethical lapse should indicate the seriousness of the underlying ethical lapse. This information could be used to infer the potential audit

quality that this auditor may provide on a future audit, suggesting this hypothesis:

> **H2:** A more severe punishment administered for the ethical lapse is associated with greater diminishment of the auditor's reputation.

The type of service on which the ethical lapse occurred could also provide information to make an inference about the level of audit quality that could be expected on a subsequent audit. As the service type becomes more like audit services, it should be easier to infer about the performance on a future audit. If the ethical lapse occurs in an area not related to professional service, the inference made about audit quality is likely to be weak since little or no information is provided about the quality of their professional services.[5] When the ethical lapse occurs in the performance of a non-audit professional service, a stronger inference about future audit quality is likely to be drawn than when then the ethical lapse occurs in an area unrelated to professional service. The strongest inference about future audit service should be available when the ethical lapse occurs in the performance of previous audit services. We provide three levels of manipulation on this variable (no professional services involved, non-audit professional services involved (management advisory services), and audit services involved). The ability to make inferences about future audit services from the type of service provided should be ranked in this order:

no professional service involved < management advisory services < audit services

Therefore, we suggest this hypothesis:

> **H3:** The more direct the inference that can be drawn about the level of future audit service the more the reputation of the auditor will be diminished by the announcement of an ethical lapse.

METHOD

Data Collection

Data was collected from two sources resulting in a total of 129 observations. In both cases, the data was generally collected from subjects in a position to influence the purchase of audit services.

For our first source of subjects, we randomly selected 524 CEOs from the Russell 3000 List of Companies which contains the largest publicly traded companies in the U.S. To each selected CEO, we sent a cover letter and a research instrument (see Appendix). Those not responding to the first request were sent a second. No further follow-up was attempted. Ninety-one (91) CEOs responded to our requests. The response rate of approximately 17% is comparable to other studies that have used CEOs as subjects (Baruch 1999).

After obtaining the responses from the CEOs, we compared the earliest 2/3s of the responses (n = 61) to the latest 1/3 of the responses (n = 30). The comparisons are made on the mean response on each of the five forms that are used; no significant differences are noted in the responses of the early respondents and the late respondents ($0.2942 < p < 0.9826$). To the degree that the late respondents were similar to the non-respondents, a response bias was not evident.

We also obtained 38 subjects from a financial industry conference sponsored by the state society of CPAs. The conference participants were primarily financial industry executives (n = 26), however twelve CPAs were also in attendance.

Since we have three different types of subjects (CEOs, executives in the financial industry, and CPAs), we tested to see if there are differences in their responses. Prior studies have found few differences between audit suppliers and audit purchasers/users on the perceptions of audit quality (Carcello *et al.* 1992, Schroeder *et al.* 1986). In our study, the CEOs would be primarily purchasers of auditing services and the financial executives could be either purchasers or users of auditing services and based on prior research, we would not anticipate significant differences in their

responses. Yet, in comparing the responses of the CEOs to the conference participants, we find significant differences in their mean responses to two forms (p = 0.0263 and p = 0.0009). These differences are not driven by the responses of the CPAs who were participants in the conference. A comparison mean responses of the CPAs on each form to those of the CEO's reveals no significant differences (p = 0.2208 or higher).

Despite the differences noted above, we combined the subject groups for the analysis that follows. In both cases where the mean responses of the conference attendees and the CEOs differ, the conference participants reacted more negatively to the ethical lapse. Yet, the reported results for the entire sample are qualitatively the same as those obtained when either the CEO sub-sample or the conference sub-sample are used.

Empirical Design

The study is a between-subjects design with each subject receiving a research instrument that has a pair of manipulations: one level of the punishment effect and one level of the service effect. Although three levels of two separate manipulations suggests a 3 x 3 design, we opt for a design of two 3 x 1's. This type of design reduces the possibility of cells containing a small number of observations that may limit statistical analysis.[6] This design allows us to hold one effect constant while examining changes in the other but does involve a trade-off. With this design, there are insufficient degrees of freedom to completely test for any interaction between the punishment and service effects.

Five manipulations are used in the study (see Appendix for the exact wording). Three levels of punishment effect and three levels of service effect are used. The coding for the manipulations is as follows. The punishment effect manipulation is indicated by the letter (the further into the alphabet, the greater the punishment) and the service effect manipulation is indicated by the number (the higher the number, the closer to auditing services). The service effect is held constant at its low level while the punishment effect is varied throughout the three levels. The punishment effect is held

constant at its high level while the service effect is varied throughout the three levels.[7]

The research instrument is included in the Appendix, along with the five manipulations used. Each subject is asked to evaluate how the announcement of an ethics violation by the auditor would affect an already-made but not-yet-communicated decision to hire the auditor.[8] The responses are recorded on an 11-point Likert scale with the endpoints of "no chance of acceptance" and "certain acceptance now" and a midpoint of "no effect on acceptance."[9] Additionally, several administrative questions are included for use as possible controls. Since there is no detectable relationship between the responses to these questions and the responses to the primary question, these questions are not included in the Appendix.[10]

Several controls are introduced in the research instrument (see Appendix):

- An orderly replacement of the prior auditor is described.
- The scenario is the same for each subject in order to normalize the process and reduce any idiosyncrasies of the subject's actual industry.
- The initial decision on the auditor is by consensus.
- The credibility of the ethics violation announcement is high since it is issued by the state Board of Accountancy.
- All submitted bids are of the same amount so price should not enter into the decision.
- All the CPA firms under consideration are Big 4 firms to act as a control if audit quality is a function of firm size (DeAngelo 1981) or if the selection process is biased against non-Big 4 firms (Cottell and Rankin 1988).
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RESULTS

Table 1 reports the responses to each of the five manipulations. We expected that form A1 would be the weakest manipulation (least negative) and form C3 would be the strongest manipulation (most negative) with forms A2, A3, and B3 lying in this order between the endpoints. Responses on form A3 are

certainly out of line with expectations. One plausible explanation for this result is that Form A2 specifies the suspended CPA is returning to service and would work on the upcoming audit while Form A3 specifies that the CPA who would have worked on the audit has had her license terminated. In one case the CPA who potentially has compromised ethics is working on the audit while in the other case the CPA is gone.[11] In any case, it is clear that the subjects did not feel comfortable with an audit manager who is just returning from a license suspension due to ethical concerns. Additionally, the responses to form C3 are not as high as anticipated given the level of form B3. This result could easily be due to the subjects not distinguishing between professional services. As long as the ethics violation occurs in the performance of a professional service as opposed to occurring in a non-professional setting (such as form A3), the subjects seem concerned about the ethical violation.

Surprisingly, seven subjects have a positive response to the news of an ethical violation. Three of the positive responses are to Form A1, one each to Forms A2 and B3, and two to Form A3. We know of no theory that would explain why this event is viewed positively. Despite the possibility that these responses may evidence a carelessness on the part of the subjects (including a misunderstanding of the presented situation, a misreading of the manipulation or the response scale), the responses remain in the overall sample since their inclusion does not affect any of the major results.

Hypothesis one predicts that *any* announcement of an ethical lapse is associated with a diminished reputation. Of the 129 subjects, only seven (5.43%) used the positive portion of the Likert scale, 38 (29.46%) used the neutral midpoint, and 84 (65.11%) used the negative portion of the scale. This results in a total mean response of –1.7442. Comparison of this mean to the midpoint on the Likert scale ("no effect on acceptance") shows that the mean is reliably different than zero (t = -10.0782, p = 0.0000). Comparison of the mean responses of each form to the midpoint ("no effect on acceptance") shows three of them significantly different (-5.4179 <

t < -7.6274, p = 0.0000 for all), one marginally significant (t = -1.7938, p = 0.0734), and one close to normal significance levels (t = -1.6427, p = 0.1010).[12] Taken together, these results support hypothesis one.

TABLE 1
Effects of Announcements of Ethical Lapses

Form	Count	Mean	S. D.	T-score [a]	P-value [b]	Max.	Min.
A1	23	-0.6087	1.7771	-1.6427	0.1010	4	-4
A2	25	-2.2400	2.0672	-5.4179	0.0000	2	-5
A3	26	-0.5000	1.4213	-1.7938	0.0734	3	-3
B3	33	-2.6061	1.8190	-8.2302	0.0000	2	-5
C3	22	-2.5455	1.5653	-7.6274	0.0000	0	-5
Total	129	-1.7442	1.9656	-10.0782	0.0000	4	-5

Description of Forms:

A1 An admonishment for an ethical violation that involves a fishing violation (gross misdemeanor).

A2 A suspension of professional license for an ethical violation that involves a fishing violation (gross misdemeanor).

A3 A termination of professional license for an ethical violation that involves a fishing violation (gross misdemeanor).

B3 A termination of professional license for an ethical violation that involves management advisory services.

C3 A termination of professional license for an ethical violation that involves auditing services.

a Test of whether means are equal to zero.

b Reported p-values are for a two-tailed test.

Table 2 presents the results of a pair-wise comparison of the means for the various manipulations. In all cases, a positive increment in either the letter or number of the form is predicted to be associated with a more negative response. Of the ten possible comparisons, five are significant in the predicted direction ($0.0000 < p < 0.0054$), one (form A2 v. form A3) is significant ($p = 0.0010$) in the direction *opposite* of predicted, and four are not significant ($0.4772 < p < 0.8988$).

TABLE 2
Pair-wise Comparisons of Form Means

Form (Mean)	**A2** (-2.2400)	**A3** (-0.5000)	**B3** (-2.6061)	**C3** (-2.5455)
A1 (-0.6087)	0.0054	*0.8132*	0.0001	0.0004
A2 (-2.2400)	-	*0.0010*	0.4772	0.5750
A3 (-0.5000)		-	0.0000	0.0000
B3 (-2.5455)			-	*0.8988*

Each cell in the table contains the p-value of a two-tailed test of the means of the two forms. A letter further in the alphabet or a higher number in the form name is predicted to be associated with a *more* negative mean. An italicized p-value indicates a difference in means opposite of predicted.

Description of Forms:

A1 An admonishment for an ethical violation that involves a fishing violation (gross misdemeanor).

A2 A suspension of professional license for an ethical violation that involves a fishing violation (gross misdemeanor).

A3 A termination of professional license for an ethical violation that involves a fishing violation (gross misdemeanor).

B3 A termination of professional license for an ethical violation that involves management advisory services.

C3 A termination of professional license for an ethical violation that involves auditing services.

The primary tests of hypotheses two and three use ANOVA and the results of these tests are presented in Table 3. The overall model has two main effects: the punishment effect and the service effect. The model associating these two effects with the decision to hire measure is significant (F = 9.56, p = 0.0001). This model explains approximately 24% of the variation in the responses.

Hypothesis two predicts that a more serious punishment is associated with a more diminished reputation. To test this hypothesis, the service effect is held constant (at the non-professional-services level of a fishing violation) while the punishment effect is varied from admonishment (low level) through suspension of the professional license (moderate level) through termination of the professional license (high level). As shown in Table 3, the type of punishment is significantly (F = 8.09, p = 0.0005) associated with the subject's desire to hire the auditor. As shown in Table 2, this result is driven primarily by the responses to form A2. These responses are significantly more negative than the responses to either form A1 (p = 0.0054) and form A3 (p = 0.0010). The first result is as predicted, the second is not. These results suggest that the subjects are more troubled by an ethical violation leading to suspension than one leading to a license termination.

TABLE 3
Analysis of Variance on Likelihood of Employment
Model: Decision-to-hire = f(punishment effect, service effect)

Source of Variation	**SS**	*Df*	**MS**	**F**	**P > F**
Between Subjects:					
Model	116.6079	4	29.1520	9.56	0.0001
Subjects	377.9503	124	3.0480		
Within Subjects:					
Punishment	49.2885	2	24.6442	8.09	0.0005
Service	77.0540	2	38.5270	12.64	0.0001

$R^2 = 0.2358$
C. V. = -100.0953
Root MSE = 1.7458

The explanation to the somewhat puzzling result may lie in the perceptions of the firm's responses to the ethical violation. This study did not address a firm's response to the ethical violation but instead focuses on how the ethical violation by itself affects the firm's reputation. As a result, the manipulations are silent on what actions the firm may have taken in response to the ethical violation of the employee but the subjects may draw some inferences. In manipulation A2, the ethical violator is returning to work as an audit manager after serving her suspension. One might conclude from the fact that the ethical violator is returning to a position of responsibility that the CPA firm is not that concerned about her ethical violation. If this conclusion is drawn, a strong negative

effect on the firm's reputation is not surprising. On the other hand, manipulation A3 states the ethical violator is someone "who would have been the manager on your audit." This language could be interpreted as either she is not currently employed by the CPA firm or at least demoted from her previous position of responsibility which would imply that the firm punished her further for her ethical violation. With this in mind, it is not surprising that manipulation A3 does not strongly damage the reputation of the firm since it could be inferred that the firm took the ethical violation seriously.

Hypothesis three predicts that the more similar the service on which the ethical violation occurred is to auditing, the greater the diminishment of the auditor's reputation. To test this hypothesis, the punishment effect is held constant (at the high level where the CPA's license is terminated) while the service effect is varied with the ethical violation occurring on different types of activities. These activities range from activities unrelated to professional services (low level) through a professional service not auditing (moderate level) through auditing (high level). As shown in Table 3, the type of service is significantly (F = 12.64, p = 0.0001) associated with the subject's desire to hire the auditor. As shown in Table 2, this result is driven primarily by the differences in responses to form A3 as compared to forms B3 and C3. The responses to form B3 (p = 0.0000) and form C3 (p = 0.0000) are significantly more negative than the responses to form A3 while the difference in responses between form B3 and C3 is not significant (p = 0.8988). This suggests that subjects are not unduly upset by an ethical violation (even if strongly punished by the state board) as long as it is unrelated to professional duties. However, if the ethical violation occurs in professional duties, it strongly impacts the auditor's reputation.

SUMMARY

In this paper we examine the effect of the announcement of an ethical lapse by an employee on the reputation of the employee's CPA firm. We examine two separate factors

hypothesized to affect the reaction to the announcement. The first is called the punishment effect that assumes the severity of the punishment correlates with the severity of the ethical lapse. The second is called the service effect that assumes that the type of service being performed when the ethical lapse occurred influences the inferences that can be made about the quality of future audit services. Strong support is found for each suggesting that both factors are important in shaping the auditor's reputation once an ethical lapse is publicly announced.

The results suggest that the profession's monitoring of the ethical activities of its members is relatively effective. The simple announcement of a punishment for an ethical lapse negatively effects the reputation of the CPA firm which provides an additional punishment beyond the official sanctions. This at least partially assures compliance with the ethical code of the profession as the individual members feel that compliance with the code benefits them by avoiding the penalties associated with violations. Additionally, the public sanction of one of its members by the professional disciplinary body signals to society that it is meeting its oversight responsibility. All this suggests that the public can trust the accounting profession to monitor the actions of its members and that the public can rely on the work product of the profession.

Several important questions remain to be examined about the effect of ethical lapses on the reputation of the auditor. In this study, we examine only three types of punishments that could be administered by a state Board of Accountancy. Yet, other potential punishments exist and each may allow for different inferences and thus may have different effects on the reputation of the auditor. We also did not consider the effects of multiple ethical lapses by either the individual CPA or the accounting firm. When only one violation occurs or when one employee commits the multiple violations, it may say more about the renegade employee than it does about the overall firm. Also, what effect does a disciplinary action taken by the CPA firm against the violating employee have on protecting its reputation? Does a strong punishment handed out

by the CPA firm against the violating employee mitigate the damage that a public announcement of an ethical lapse might otherwise cause?

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ENDNOTES

[1]. An earlier study, Eichenseher and Shields (1983) did not find that ethical standards are highly associated with audit quality.

[2]. Although not addressed in this paper, a serious punishment could be administered for a less serious violation if the violation is a repeat violation. Such repeat behavior is likely to be seen as a negative signal when determining audit quality. A user of such information is safe to assume that harsh punishments are associated with more and/or serious violations and can be safely interpreted as a negative signal about audit quality.

[3]. The Uniform Accountancy Act and Uniform Accountancy Act Rules specifically refers to these three punishments in Section 10(a):

> …. the Board may revoke any certificate, permit, or registration issued…; suspend any such certificate….; reprimand, censure….for any one for more of the following reasons:
>
> [Reasons 1 through 6 and 8 through 11 are deleted.]
>
> (7) Violation of any rule of professional conduct promulgated by the Board…

[4]. Other punishments include such items as required continuing professional education, required peer evaluation, payment of the costs associated with disciplinary hearings, accepting no clients for a period of time, or not performing certain services. These punishments are ignored in this study.

[5]. The American Institute of Certified Public Accountants (AICPA) has developed Rules of Conduct as the enforceable portion of their Code of Professional Conduct. Rule 501, Acts Discreditable to the Profession, allows formal disciplinary actions for any action taken by a member of the AICPA which would bring discredit to the accounting profession. The AICPA Code of Professional Conduct has become the model for the code of ethical conduct adopted by the state Boards of Accountancy. It is under Rule 501 or its state equivalent that discipline against a member or licensee can be administered for actions taken outside their professional responsibilities. For example, a CPA convicted of a crime is likely to face a disciplinary hearing by the state Board of Accountancy (and/or AICPA) under Rule 501 (or its state equivalent) which may result in punishments beyond those administered by the courts. The Uniform Accountancy Act and Uniform Accountancy Act Rules adopts the new language for these types of violations: "any conduct reflecting adversely upon the licensee's fitness to perform services while a licensee (UAA 10-2)."

[6]. The historically low response rate from CEO subjects (Baruch 1999) is the source of this concern about low numbers of observations.

[7]. The decisions to hold the service effect at the low level while varying the punishment effect and to hold the punishment effect at the high level while varying the service effect are arbitrary.

[8]. The subjects are not asked directly about the influence of the new information on the auditor's reputation. Instead, they are asked to determine how this new information influences the auditor's likelihood of being hired for an upcoming audit. Any

change in this likelihood is interpreted as a change in the auditor's reputation.

[9]. Although we anticipate only negative responses or zero, the Likert scale is symmetric to prevent guiding the subject's responses.

[10]. In addition, a question for another research project is included in the research instrument. This question is not included in the Appendix.

The question used to obtain data for this study is the second question on the research instrument following the question used for the other research project. We varied the manipulations in the first question on several research instruments and then compared the responses to the second question (the question for this project). No significant differences are noted ($0.5543 < p < 0.7690$). This suggests that the responses to the question of interest in this study are not influenced by the preceding question in the research instrument.

[11]. Although the employment status of the CPA with the terminated license is not mentioned in the research instrument, it is reasonable to assume that she is no longer employed with the CPA firm. The experimental instrument describes the CPA as the one "who would have been the manager on your audit" which implies at a minimum she was demoted.

[12]. Form A1 has an extreme outlier in the positive range that if dropped from the sample alters the results of this test. Without the outlier, the new mean is significantly different than zero ($t = -2.5578$, $p = 0.0052$).

APPENDIX
Experimental Instrument

In this questionnaire, you will be asked about the selection of an independent auditor. Assume the situation facing an audit committee is described below. Drawing upon your experience as a director, please answer all questions.

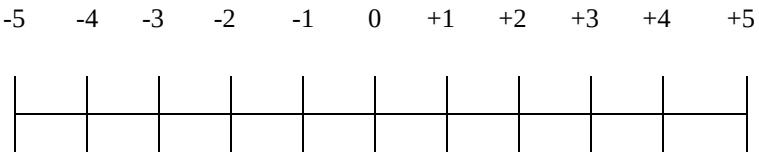
Assume the audit contract for your organization is coming up for bid. After a long relationship with your previous auditor, your company has decided it is time for a change. No significant disagreements were reported on the form 8-K which disclosed the previous auditor's dismissal. All submitted bids are from Big Four accounting firms and differ little in amount or services offered.

Assume the following for your company:

- Your company is in a reasonably competitive industry.
- Growth for your company and the industry has been moderate but steady over the past decade.
- The price of your company's stock has increased moderately over the past decade.
- A small cash dividend has been paid each year in the past decade.
- Debt obligations have always been paid on time.
- Debt covenants have never been violated nor does it appear likely in foreseeable future.
- Past audits have always resulted in an unqualified 'clean' opinion.

Finally, assume that after hearing the formal presentations of all the independent auditors, your committee reaches an informal consensus on which bid will be selected. Before a formal acceptance is finalized and before **any** communication with the auditing firms about possible acceptance, you become aware of these recent events.

Q2: After making the preliminary choice of an independent auditor, you learn that the CPA that would be the manager on your audit has just been **admonished** by the State Board of Accountancy. The admonishment arose from a conviction on a **gross misdemeanor fishing violation.** How does this situation affect this firm's chances of having its bid accepted? (Circle your response on the scale.)



No chance of acceptance now — No effect on acceptance — Certain Acceptance now

APPENDIX

Manipulations Used in Experimental Instrument

A1: Low punishment effect x low service effect:
After making the preliminary choice of an independent auditor, you learn that the CPA that would be the audit manager on your audit has just been **admonished** by the State Board of Accountancy. The suspension arose from a conviction on a **gross misdemeanor fishing violation.** How does this knowledge affect this firm's chances of having its bid accepted?

A2: Moderate punishment effect x low service effect:
After making the preliminary choice of an independent auditing firm, you learn that the CPA who would be the manager on your

audit has just completed a **one-year suspension of his license** imposed by the State Board of Accountancy. The suspension arose from a conviction on a **gross misdemeanor fishing violation.** How does this knowledge affect this firm's chances of having its bid accepted?

A3: High punishment effect x low service effect:
After making the preliminary choice of an auditor, you learn that the CPA who would have been the manager on your audit has just had her **license terminated** by the State Board of Accountancy. The suspension arose from a conviction to a **gross misdemeanor fishing violation.** How does this knowledge affect this firm's chances of having its bid accepted?

B3: High punishment effect x moderate service effect:
After making the preliminary choice of an auditor, you learn that the CPA who would have been the manager on your audit has just had her **license terminated** by the State Board of Accountancy. Her breach of ethics involved activities on a prior **consulting engagement.** How does this knowledge affect this firm's chances of having its bid accepted?

C3: High punishment effect x high service effect:
After making the preliminary choice of an auditor, you learn that the CPA who would have been the manager on your audit has just had her **license terminated** by the State Board of Accountancy. She has been found to have committed several serious ethical violations in **past audit engagements.** She has been dismissed by the CPA firm and replaced by another CPA who has comparable skills. This new CPA would serve as the manager on your audit. How does this knowledge affect this firm's chances of having their bid accepted?