Professor King has written an interesting and creative paper. As a discussant I could give my reactions to its research method and results, or I could look at the implications of this research for auditing, audit policy, and current regulatory issues. I shall try to do both, starting with research method and results.

Professor King has designed and conducted a research experiment that straddles, and tries to bridge, the experimental literatures in psychology and economics. While they may not seem too different to those not involved in this research, psychologists and economists approach the design and conduct of experiments from different perspectives, and emphases.

Consider the consequences of telling the auditor subjects that the name of the person who suffers the largest loss will be announced to all. Some people, as the paper does, will characterize this as a psychological, and not an economic variable. However, economists may not agree that it is a non-economic variable. In economics, agent preferences may have many arguments besides monetary payoffs, including reputation. Indeed, an economist may argue that posting the name of the worst performer subjects people to tournament type incentives and induces them to engage in extreme risk avoidance such as minimax behavior. Perhaps it is not a coincidence that (f3, f3*, defensive, cheat) is the minimax equilibrium of the game; and when such incentives are introduced in the game, the outcomes shift in that direction. In any case, in spite of somewhat different perspectives used by our fellow social scientists, for the purpose of the current paper, it is not necessarily useful to set it up as a contrast between economic and psychological factors.

To get back to the research method and results, I would like to share three reactions. These should be taken as my thoughts about continuation of the research agenda, and not necessarily as things that need to be changed in the current paper.

My first reaction concerns the discretization of auditor and manager decision variables in the lab experiment. The auditor decision variable (belief about managers) as well as the manager decision variable (fraud level) are continuous in range (0-1). In the experiment, King uses a frequently followed strategy of identifying two or three discrete equilibrium values of these continuous decision variables, and restricts the subject choices in the lab to these discrete values. This experimental strategy has the advantage of giving us a better chance of identifying which, if any, of these small numbers of discrete strategies (three) and outcomes (nine) seem to organize the observations better.

However, in research design, there is always a price to pay for all advantages. Since the subjects’ options have been constrained to three candidates suggested by theory, the chances of our arriving at inferences about the validity of these theoretical candidates are artificially raised. Correspondingly, the chances that we shall reach an inference in favor of strategies or outcomes outside the chosen set are reduced to zero.
Alternatively, if we were to consider an experimental strategy in which the subjects were free to pick any point on the continuum of the relevant range, the chances that the equilibrium strategies and outcomes will be picked will be reduced. Therefore, if the experiment does reveal that the data are best organized by one of the discrete equilibria, our trust in the power of such equilibria to organize the data would be that much higher. In other words, strong results from an experiment that allows decision choices from a continuous scale would be less probable, but also more robust. However, I should also mention that what King has done is closer to the standard operating procedure in the literature, and it would not be fair to pick on this paper alone on this account.

A second experimental issue concerns repetition and learning. Experimental outcomes change as subjects learn through experience and modify their behavior in the later rounds of laboratory experiments. This nonstationarity throws up a difficult issue for experimentalists to address: Does the substantive interest of a research experiment reside in the initial behavior and outcomes? Does it reside in any behavior and outcome that might be the fixed points of the learning process of the subjects in the specified environment? Or, are we interested in the learning process and the path of the behavior and outcome variables themselves? What is appropriate design for, and inference from, an experiment depends crucially on which of these questions we are trying to address.

From King’s experiment and analysis, it is not clear to me which of these questions he believes is of primary interest here. On the one hand, subjects play the game over many rounds, suggesting that the interest is in the fixed point. On the other hand, the auditor subject is not given the chance to learn from outcomes of his past behavior, and experience with either a single client or with a variety of clients. This feature would suggest that the primary interest lies in the initial, inexperienced behavior. However, such interest would be in conflict with the presumed purpose of better understanding auditor-client relationships in the field that usually extend over many years.

Third, I should mention a minor point that concerns the test of Hypothesis 3. I am not sure why the strong group (SG) treatment should be expected to induce the auditors to trust managers less. Is it not possible (though the results clearly go the other way) that the dynamics of group interaction among auditors may induce them to place greater, not less, trust in managers. Their group interaction includes features other than the announcement of the auditor who suffers the greatest damage. I guess the issue is: does interaction among members of a group lead them to trust their fellow beings (the managers) more or less. In spite of the empirical findings of the paper, I would like to gain a better understanding of why the results go one way, and not the other. Will the results go in the same direction if the announcement feature of the SG treatment was cut out of the design?

Moving forward from the method and findings of this presentation, I think King has designed and presented convincing evidence (subject to my robustness caveat). He has created a real doubt in my mind if the Bazerman and Loewenstein conclusions about auditor behavior are robust enough to support the inferences some people in Washington and elsewhere may have drawn from them. What can we say about what has been and can be learned about auditing and audit policy?

About twenty five years ago a colleague presented a game theoretic model of auditing decisions at the Chicago Conference. At the time it was the conference practice to have each paper discussed by a professional accountant and an academic. In his discussion of the paper, the expert audit partner
expressed his bewilderment at the research he had been asked to discuss: auditing is serious business, not just a game! We have come a long way in this quarter century. We are willing and able to abstract the essential elements from the complexity of our profession, and subject them to analyses using mathematics, field data, or lab experimentation. I would like to comment briefly on the application of King’s research to an important policy issues being discussed in Washington in Fall 2000—auditor independence.

The SEC has published its proposals to enhance auditor independence through a variety of constraints of individual and audit firm actions. Not surprisingly, these are opposed by many elements in the audit industry as well as accounting scholars. While SEC sees the need for auditor independence, and lack of independence in the present environment to be self-evident, its critics ask for concrete evidence. The Bazerman and Loewenstein study, mentioned by the SEC in its proposal, since it claims independence to be impossible, hardly provides a rational basis for inducing greater independence. King’s study has shown, in a manner that I find persuasive, that B & L conclusions are not sufficiently robust to serve as a basis for policy making at this stage.

However, the issues that lie behind the current independence controversy go beyond these studies. Various aspects of auditor behavior and industry structure are not independent of one another, and should not be treated that way. A quarter century ago, the U.S. Department of Justice and the Federal Trade Commission made a big push to improve competitiveness in professions such as medicine, law, and accounting. Under this pressure, the AICPA revised the provisions of its Code of Ethics that were regarded as being anticompetitive; allowing auditors to advertise and hire employees away from one another and approach the clients of competing firms. As the audit firms gradually learned to compete with each other, their audit engagement margins narrowed. Given the unobservability of the quality of their output, the audit market has even more severe market failure problems than car mechanics or physicians. At least you know for sure if, after receiving the benefit of professional services, the car runs, and if the patient lives. Free competition in the environment of market failure cut the auditors’ ability to earn money and attract employees. They soon turned to exploit the positive externality between audit services-generated credibility and the client demand for advisory services. The auditors balanced the consequences of full competition in the audit market by seeking their margins in the market for advisory services.

This system seems to have worked well until it was the auditors’ chance to upset the apple cart. This time, not happy with advisory revenues, they went to the Congress in the nineties to cut their liability exposure by placing limits on what they could be sued for. Under heavy lobbying, the Congress agreed and the balance shifted in favor of the audit firms – at least temporarily (I say temporarily because in the long run, reducing the liability risk they are exposed to will simply reduce their audit revenues. Their plea to the Congress to place limits on audit liability would be analogous to the insurance industry’s (imaginary) plea to Congress to not let them write larger insurance policies). In any case, the SEC’s independence proposals can be seen as a consequence of the perceived imbalance between audit liability and earnings.

I do not know what the SEC will do. I am uncomfortable with regulatory solutions to such problems that require continual bureaucratic monitoring of the industry. It is more efficient to set up the rules of the game properly, and let everyone play. I believe the rules of the game for auditors should include one of the following two solutions:
Either: Full disclosure of all fees received by audit firms.

Or: Regulatory relief from full competition in audit markets combined with prohibition on provision of non-audit services.

Under the first proposal, the data about fees and services and the presumed dependence and independence will be in public domain, allowing all concerned to make their own decisions with full knowledge of the facts about independence.

If the first solution is too distasteful for the audit industry, the second will provide them some protection from full competition and ability to earn a decent margin on audit services. This proposal could then be combined with prohibition of non-audit services to the audit clients.

I am glad that King’s paper addresses important matters of audit policy. I hope there will be more such work in the future.