The rise of regulatory capitalism and the decline of auditor independence: A critical and experimental examination of auditors’ conflicts of interest

Carolyn A Windsor
Bent Warming-Rasmussen

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*Assoc. Professor Carolyn Windsor  
Dept of Accounting and Finance  
Monash University  
Clayton Campus 3800, Vic  
Australia

and

Assoc. Professor Bent Warming-Rasmussen  
Dept of Entrepreneurship and Relationship Management  
University of Southern Denmark  
6000 Kolding, Denmark

*Contact Carolyn Windsor  
Current contact details: email cwindsor@bond.edu.au  
Ph: 617 5595 1560  
Fax 617 5595 1160
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ABSTRACT

This study investigates the decline of auditor independence coinciding with the rise of regulatory capitalism. A critical analysis supported by experimental evidence reveals regulatory capitalism’s influence on auditor independence. Regulatory capitalism began in the United States during the 1970’s when state enforced neo-liberal free-market doctrines of competition and deregulation commercialized the profession. Since then, regulatory capitalism’s economic neo-liberal agenda has transformed the auditing profession and the employer firms into a transnational network of professional services firms that now promote and diffuse regulatory capitalism worldwide. Regulatory capitalism is further facilitated by the Sarbanes Oxley Act and the PCAOB that provide interconnections of powerful non-democratic private regulators such as the IFAC and IAASB. An experiment reveals auditors’ ethical predisposition to provide consistently high quality independence judgments required by IFAC’s code of ethics. The majority of this sample of 174 Danish auditors was not consistently independent in the context of client economic factors, indicating that the code of ethics’ appeal to auditors’ altruistic behavior has failed. Moreover the transformed profession has become the transformer but at a price, the loss of public confidence and the decline of auditor independence. Conflicts of interests still abound.

Key words: auditor independence, regulatory capitalism, competition, professionalism, moral development, beliefs in a just world.
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“The Sarbanes-Oxley act passed in the wake of the Enron and other scandals …. Yet more needs to be done. Accountancy firms remain riddled with conflicts of interests. The most basic is that they are responsible for auditing managements that, ultimately, pay them to do so.” Economist, 18 November 2004.

1. The rise of auditor independence

Fairness and justice are fundamental to society’s need for auditor independence (Mautz and Sharaf, 1961) hence auditors must balance the interests of various stakeholders to ensure credible corporate transparency of corporate reporting in the public interest (Goldman and Barlev, 1974; International Federation of Accountants or IFAC, 2005). Auditors became crucial to regain confidence in the integrity and credibility of the capital markets shortly after the massive corporate collapses that triggered the 1929 Wall Street Crash. The Crash brought misery to millions of people who lost their savings, their jobs and their dignity. Enduring detrimental social, economic and psychological effects of the Crash were felt worldwide. Following the crash, the Great Depression damaged the financial systems of several countries, in turn fermenting social unrest and disillusionment that culminated in World War II (Berg-Schlosser, 1998). In the United States, President Franklin D. Roosevelt’s administration was so concerned about society’s financial security and political stability that the Securities and Exchange Acts, 1933 and 1934 were signed into law to rebuild public trust in the governance of the capital markets. These acts mandated listed companies’ financial reports to be independently audited in the public interest (Zeff, 2003b).
Influential accountants successfully opposed proposals for the U.S. government to oversee business directly or conduct audits of public companies. Instead accountants in private practice were given the monopoly franchise to perform company audits on the condition that they abide by a code of ethical conduct mandating auditor independence (see Zeff, 2003a for more discussion). This regulatory arrangement had an inherent critical flaw identified by Mautz and Sharaf (1961). They questioned the ability of professional auditors to maintain an independent mind to ‘present fairly’ in the judicial sense (Reiter and Williams, 2004) when they are economically dependent on the client management. This regulatory flaw predisposes conflicts of interests because auditors have to negotiate compensation and employment conditions with the regulated, the auditee company.

The profession’s code of ethical conduct attempts to prevent obvious conflicts of interests that may occur between the auditor and auditee company. The code also legitimates and defends the self-regulation of auditor independence that essentially relies on the personal ‘virtues’ and altruism of its members (Limperg, 1985). The notion of personal independence is further enhanced by the inexorable objectivity and neutrality engendered in the measurement expertise of the accounting profession (Hines, 1991, Chua, 1986). For several decades the profession dealt with minor scandals from time to time and audits were performed without much incident until the 1970’s (Zeff, 2003a).

During the early 1970’s regulatory capitalism emerged in the United States as neo-liberalism gathered the political strength to radicalize government policies. These policies changed social relationships and institutions, including the auditing
profession. This study first critically examines the rise of regulatory capitalism and the decline of auditor independence. Specifically we argue that the commercialization of audit has exacerbated the inherent regulatory flaw of the auditor economically depending upon the auditee client company and its management. An experiment provides further empirical evidence about the affect of client economic considerations on practicing auditors’ independence judgments in an era of regulatory capitalism.

2. The rise of regulatory capitalism

The era of regulatory capitalism began in the 1970’s during the Nixon administration as political proponents of neo-liberalism radically transformed public institutions through privatization and deregulation along the lines of business (Crenson and Ginsberg, 2002). Business and the corporate ethos of transformation, innovation, efficiency, competition, and flexibility were promoted in the remaking of society (Clarke, 2004) displacing notions of fairness, equality and justice that were central to the superseded Keynesian welfare state (Van Kersbergen and Van Waarden, 2004). Regulatory capitalism is dominated by the neo-liberal doctrine that regulatory efficiencies may be gained by reducing reliance on the state through the competitive ‘free-market’ capitalist mechanisms such as competition and free trade (Friedman, 1962; Hayek, 1986/2002).

Regulatory capitalism was directed and advanced by state interventionist policies such as policies-for-competition (Levi-Faur, 2005). In contradiction to neo-liberal doctrine, the state actively enforced neo-liberal reforms thus blurring the boundaries between the state, markets and society. Hence, neo-liberal politics and ideology were imposed at the professional level to affect delivery of
professional services transforming the way accountants and auditors performed their work. For example, the influential American Institute of CPA (AICPA) was beset in 1979 by the U.S. Federal Trade Commission and Justice Department to change sections of the professional code of ethics that were considered to violate the rules against the restraint of trade. (Zeff, 2003b). Treadway (1984) argued that regulatory efficiency would reduce reliance on governments in the interest of taxpayers. The AICPA ultimately removed the ban on competitive bidding, the prohibition on advertising, the ban on contingent fees and commissions for nonattest clients from the code of professional conduct. When the code of conduct restricting auditors from advertising and competitive bidding was changed fierce competition was unleashed, thus transforming the judicial oriented profession to commercialized consultants (Reiter and Williams, 2004). About this time, audit firms expanded into consulting and became multi-disciplinary businesses selling everything from legal and management advisory services to the installation of computerized information systems. Auditors bringing in large client fees were lucratively rewarded and promoted to the detriment of their independence and professionalism (Mautz, 1988; Zeff, 2003b).

Consequently, regulatory capitalism was instrumental in the reinvention of the audit as a commodity driven by economic considerations of the ‘client’, the corporate auditee and its management (Power, 1997; Jeppesen, 1998). The blurring of regulatory boundaries continued as the standard setter, the financial report preparer and the auditor were mandated to report in the ‘the public interest’ by the code of ethics when clearly competition in the ‘private interest’ was enforced by the state. In fact Shaub (1988, p. 95) questioned the premise that
members inevitably “assume an obligation of self-discipline” in the restructured AICPA code that now included a broader constituency of accountants from industry, government and education (Anderson Committee, cited Shaub, 1988).

Yet, deregulation of the profession has seen massive corporate scandals where auditors gave clean opinions to companies that ended in bankruptcies and brought on the catastrophic collapse of the once reputable accounting firm, Arthur Andersen. The community including investors, employees, creditors, bankers, and retirees has suffered significant financial loss, employment and future economic security (Wyatt, 2004). Further, the benefits of competition are illusive, as the competitors in the market for audits has shrunk in a flurry of mergers over the last three decades and acquisitions that have swallowed several smaller professional audit firms into a transnational oligopoly of the ‘Big 4’ (Economist, November 18, 2004; McKee, McKee and Garner, 2003; Zeff, 2003b). Their professional employee auditors though, face a mountain of litigation estimated at $US50 billion in claims worldwide as a result of corporate scandals (Economist November 18, 2004).

2.1 **Regulatory capitalism and the Sarbanes-Oxley Act**

Corporate scandals and public anger continued to diminish public trust in professional self-regulation. To placate angry investors and restore confidence in the markets, the U.S. government quickly enacted the Sarbanes-Oxley Act (2002) with little public debate. The Act is intended to improve the quality and transparency of corporate financial reporting however legislation is only as good as its administration and enforcement. The SEC’s Public Company Accounting
Oversight Board was appointed to reform disclosure and auditing standards that were once the responsibility of the accounting profession. The notion of ‘Public’ in PCOAB is questionable though as regulatory capitalism favors private sector, non-profit corporations funded by industry. In this way regulatory capitalism effectively privatizes the administration of regulation rather than the traditional publicly funded civil service. The public interest and the common good are therefore, relegated by private interests as the PCAOB is “dedicated to protecting investors” (PCAOB, 2005).

For example, the PCAOB is funded by ‘accounting support fees’ from the corporate sector (www.pcaob.org) coincidently audit clients too, thus raising questions about PCAOB’s impartiality. Moreover this Board is vulnerable to powerful lobbyists from the accounting profession on behalf of their clients (Reiter and Williams, 2004; Glater, 2005) as well as the specter of regulatory capture that “undermines accountants’ moral duty to promote transparency” (Kane, 2004). Accountants and managers who benefited from pre-existing gaps and loopholes in reporting and governance controls (Briloff, 1972) have exerted political and economic counter pressure on the follow-up standard setting process.

The corporate and the profession’s counter pressure and lobbying sought to weaken genuine reform by limiting the effectiveness of the standards, penalties and enforcement procedures the SEC had finally established for auditor

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1 The 2005 PCAOB annual report does not mention other important stakeholders. Symbolically the front cover of the report has “Protecting Investors’ Interests” in very large print followed by a perfunctory public interest statement in very small print.
independence, legal conduct and off-balance-sheet transactions. Further, Kane (2004, p.163) argues that,

“Although observers such as the Financial Economists Roundtable (2002) attribute the Sarbanes-Oxley Act to a three-way crisis in accounting, auditing and corporate governance, follow-up rule making has focused disproportionately on strengthening the corporate Audit-Committee and governance links in the informational chain. The SEC has exempted the self-interested ethical codes of the auditing industry and accounting profession from the actionable obligation to affirm the material economic accuracy of audited reports that the Act imposed on the information producers and might symmetrically have imposed on informational watchdogs as well.”

The act also mandates audit committees must comprise independent directors responsible for the appointment, compensation and retention of the auditor. The SEC’s new independence rules do not explicitly prohibit auditors from providing training for their client’s audit committee members. Ehrlich (2003) argues,

“There could be virtues to having the Big Four train audit committees: They know what they tend to do wrong, and if they were wholly candid, their lessons would be worthwhile. But what are the chances that they will honestly discuss their failures in detail? One hopes that audit committees will resist hiring their auditor to teach them how to deal with their auditor.”

Evidence however does suggest a decline in auditors performing non-audit services (Morgenson, 2004), but the Act still has flaws that do not address the fundamental auditor’s conflicts of interests and the profession’s economic dependence on corporate auditees (Cullinan, 2004; Cox, 2003). In fact, S-OX has had the perverse effect of increasing audit work and associated costs by demanding more compliance. It has had the notable unintended consequence of providing “a bonanza for accountants and auditors, a profession thought to be
much at fault in the scandals that inspired the law, and which the statute sought to rein in and supervise” (Economist May 19, 2005).

3. The diffusion of regulatory capitalism and transnational audit firms

State initiated privatization, the delegation of governance from politicians to experts, the proliferation of non-elected institutions in the shadow of the state, and the influence of experts are characteristics of regulatory capitalism (Levi-Faur, 2005) which have favored transnational professional services firms. The network of transnational professional services firms not only advance the neo-liberal paradigm, but also profit from and participate in the spread of transnational capitalism that benefits the network of global corporations and elite policy groups (Carroll and Carson, 2003). In fact the transnational professional services firms have made undisclosed profits estimated at tens of billions by selling advice deregulation, privatization and self-regulation worldwide through their global network of franchises at the behest of multilateral economic organizations such as the World Bank, the International Monetary Fund and the World Trade Organization (Barker, Carr, Kehoe and Littman, 1998). Chomsky (1999) argues that the WTO is the most effective way to export “America’s passion for deregulation” and free market values such as competition and individualism.

The interweaving of powerful private regulators is evident as American style regulatory capitalism influences the audit of transnational capital. For example “IAASB issued a revised international standard on audit documentation that was based substantially on the principles of the (PCAOB) Board’s Auditing Standard No. 3” (PCAOB, 2005 p.7). PCAOB also initiated its inspection
program in selected non-U.S. countries (p. 3). PCAOB further reports (2005) that it has observer with speaking rights at meetings of IFAC and the International Auditing and Assurance Standards Board (IAASB). The IAASB similarly participates in the PCAOB’s Advisory Group. European regulators are also concerned the surreptitious international influence of S-OX and the PCAOB. For example, the recently corporatized NYSE has bought Paris based Euronext exchange. “Thee new firm will have its US base in New York and international headquarters in Paris and Amsterdam. NYSE and Euronext said the move was a ‘merger of equals’” (BBC News, Business, 6 June, 2006).

The Sarbanes Oxley Act is also being shared by legislative bodies such as the European Union’s 8th Company Law Directive finalized in late 2005. The Directive provides cooperation with non-E.U. regulators such as the PCAOB (PCAOB, 2005). As policy-makers in Anglo Saxon countries grapple with the public crisis confronting the auditing profession, the E.U.’s 8th Company Law Directive proposes European member states institute statutory external auditor oversight provided by private audit firms in accordance with the international accounting and auditing standards and IFAC’s code of professional conduct (Economist, November 18, 2004; Holm and Warming Rasmussen, 2006).  

3.1 IFAC, Auditor independence and client economic influence: Danish evidence

The rise of regulatory capitalism also coincides with the transnational phase of capitalism (Carroll and Carson, 2003) aided by non-democratic organizations such as the International Federation of Accountants (IFAC). Headquartered in New York, IFAC is the global non-government organization for
the accountancy profession. Funded by the World Bank and World Trade Organization, IFAC supports international capital markets and global trade through the internationalization of accounting and auditing necessary for regulatory capitalism. Further, IFAC established a transnational Forum of Firms (FOF), an organization of international audit firms that perform audits of financial statements that are or may be used across national borders (www.IFAC.org).

The self regulation of the accounting profession is also being promoted internationally as the IFAC president recently stated,

“the professional body’s separation from government can mean that it can react faster and more flexibly than a comparable government agency. In those countries where the profession needs to be strengthened, granting the profession self-regulatory powers can assist it in gaining the necessary expertise” (Ward, 2005).

Although IFAC prescribes various independence requirements involving the client relationship in the code of conduct Part B (IFAC 2005), the auditing profession is more than ever economically dependent on the corporate client. While independence is no longer a fundamental principle in Part A of IFAC Code of Ethics (2005), the notion of ‘self discipline’ is mandated in Professional Practice Part B where members of the profession must have,

“Independence of mind and appearance for the professional accountant … to express a conclusion” (IFAC, 2005, para 280.2).

This study investigates auditor independence in Denmark where national private regulation is augmented by IFAC. In fact, Denmark followed the Anglo model of audit regulation by deregulating and internationalizing the profession
The transnational audit firms in Denmark therefore provide insight about the effectiveness of national and international regulatory systems on sustaining auditors’ independence judgments in a commercialized audit context.

Windsor and Ashkansy (1995) found that Australian auditors were more acquiescent to management when the client company was in good financial condition and the audit was not tendered. To test the independence of Danish auditors, this study is based on Windsor and Ashkanasy (1995). From a *critical realist perspective* this study is not an exact replication of Windsor and Ashkanasy (1995) but an empirical generalization where a researcher repeats a study on a different population in a different culture (see Tsang and Kwan, 1999). Hence this experiment also examines the generalizability of Windsor and Ashkanasy (1995) findings to another sample of auditors employed in Danish transnational audit firms. Moreover this study contributes to a greater understanding of internationalized audit regulation supported by regulatory capitalism to enhance transnational capitalism.

The specific purpose of this experiment is to examine whether auditor independence is affected by client economic factors and personal characteristics. Here, auditor independence is analyzed as a moral human decision-making process where varying degrees of client economic strength stimulate moral intensity to assess auditors’ ethical predisposition during an audit conflict with management (see Jones, 1991).

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2 The Danish Institute of State Authorized Public Accountants and Auditors affiliated with the
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Dependent variable

The dependent variable attempts to capture the auditor-client management relationship as a measure of the extent of auditor acquiescence to the wishes of client management. Client management control is represented by auditors’ responses to provide a favorable opinion in eight scenarios (2 x 2 x 2) that represents moral intensity of varying degrees of client company economic strength: client financial condition (good, poor), size of fees (large, small) and if the audit is tendered or not (see Jones, 1991).

3.2.1 Audit conflict

An audit conflict involves the disclosure of an accounting transaction that would have a material negative effect on the client’s financial statements. The conflict is a short case study concerning the materiality of certain unrecorded liabilities discovered by the firm’s auditors but disputed by management. These liabilities consist primarily of expenses incurred in the previous year, which were neither paid nor recorded until the following year. Respondents were asked to assume that they are the auditor of the hypothetical company where client management disagreed with the auditor over the amount that was material at 8%. The figure of 8% materiality level\(^3\) was recommended by the senior audit partners in prior interviews as a way to create an element of realistic ambiguity, and to ensure that the decision-making task required professional judgment.

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\(^3\) The materiality level was mid-way between the immateriality threshold limit of 5% and the materiality threshold limit of 10%.
The audit conflict hypothetically places the participating auditors in eight scenarios where client management controlled varying degrees of company economic strengths (2x2x2) represented by company financial condition (good or poor), size of fees (large and small) and tender of audit (yes or no). Respondents were requested to make a judgment about each scenario using a seven-point Likert scale, where 1 indicated a very low likelihood that the auditor would accede to client management’s demand for a favorable opinion, and 7 indicated a very high likelihood of acquiescing.

3.2.2 Independent variables

Independent variables are client economic power, and two personality factors, auditors’ cognitive moral development (CMD) and beliefs in a just world (BJW). The context of client economic power is conceptualized in terms of situational factors that exert varying control on auditors’ independent decision-making (Jones, 1991). Three influential client economic factors were (1) client financial condition, (2) size of client fees, and (3) whether or not the client calls tenders for audit work (see Windsor and Ashkanasy 1995).

3.2.3 Financial condition of the client.

Auditors dealing with clients in poor financial condition are more likely to face a higher level of legal liability than if the client was in good financial condition (Farmer, Rittenberg, and Trompeter, 1987; Palmrose, 1987). Knapp (1985) found also that financial statement users perceive that management is more likely to obtain its preferred resolution in a conflict when the client is in a good, rather than poor financial condition. It follows, therefore, that auditors would be likely to respond more favorably to clients in good financial condition. On the
other hand, auditors would exercise more caution when dealing with clients in poor financial condition.

3.2.4 Size of the client fee

Mautz and Sharaf (1961) drew attention to the problem of the auditor's dependence on client fees as a potential economic factor that could affect auditor independence. For example, Gul (1991) found that when fees are a significant proportion of the auditors’ total revenue, third party perceptions of the auditors’ ability to withstand management control are adversely affected. Gul (1991) explained this finding in terms of Knapp’s (1985) observation that auditors are more responsive to client management control when the client provides a significant proportion of the auditor’s income.

3.2.5 Tendering

Tendering of audits resulted from the deregulation of the profession to enforce competition and to reduce perceived monopoly pricing of audits (see Zeff, 2003b). When client firms invite prospective audit firms to tender for provision of audit services at a competitive cost, there is a risk that auditors may experience difficulty in remaining independent. Management can threaten the auditor by putting the audit out to tender, thus surreptitiously switching auditors. Craswell (1992), for example, showed that the introduction of tendering led to an increase in the frequency of auditor switches and fee reductions. On the other hand, the client may give preferential treatment to the incumbent auditor in the bidding process, thus creating the potential for corruption (Menezes, Pitchford and Wait, 2003). For example, client management could provide information to the incumbent audit firm to ensure their bid wins. In return the auditor agrees to give the client a favorable report, thus corrupting independence. Hence, client management can use tendering to control the auditor and impair even corrupt independence.
3.3 **Cognitive moral development**

One of the most widely used theories in socio-moral psychology is Kohlberg’s (1969) theory of developmental moral reasoning (see Rest, Narveaz, Bebeau and Thoma 1999). Kohlberg (1969, 1986) identified three broad levels of cognitive moral development (CMD). The lowest level of CMD is the pre-conventional level, where a person decides what is right or wrong based upon personal consequences (i.e., punishment, reward, or an exchange of favors). The next is the conventional level, where the decision about what is ‘right’ conforms to society’s expectations, family, or peer groups. The highest category is the post-conventional level. Here, thinking about what is ‘right’ is influenced by universal values or principles; the individual defines moral values apart from the authority of groups, and relies upon self-chosen but non-arbitrary principles of justice and rights to guide reasoning.

Kohlberg’s theories have attracted a good deal of attention in the auditing literature (see Louwers et al., 1997 for an overview). In particular, higher levels of moral reasoning have been found to be associated with more ethical decisions (Ponemon and Gabhart, 1994). The theory argues that CMD should be associated with ethical decisions and behavior because of the individual’s need for consistency between thought and action.

Of course, Kohlberg’s approach has limitations. For instance, Rest et al. (1999) noted that moral judgment is only one step in a multi-stage psychological process of morality. They argue that there are four components that lead to moral behavior: moral judgment, moral motivation, moral sensitivity, and moral character. Rest et al. (1999, p. 10) however, maintain that “the special function of the construct of moral judgment is to provide conceptual guidance for action choice in situations in which moral claims conflict”. In this respect, auditors must balance the interests of the client-firm’s management, the shareholders, creditors,
lenders and the public interest when providing an opinion about the financial statements (Johnstone, Sutton and Warfield, 2001).

3.3.1 Defining Issues Test (DIT).

The short (3-story) version of Rest’s (1979b) scale was used as a measure of CMD and is based on Kohlberg's (1969) theory of moral reasoning development. The experimental instrument consists of brief stories that present moral dilemmas in everyday life (Colby and Kohlberg, 1987). The DIT has been extensively validated in accounting and auditing research (See Ponemon and Gabhart, 1994; Rest et al., 1999). The 3-story version of Rest’s scale was used in preference to the 6-story version because of the time constraints on professional auditors. The 3-stories were updated to reflect universal issues in a contemporary way (see Fisher and Sweeny, 1998). Rest (1979a) cites Cronbach alpha reliability for the 3-story DIT typically about 0.7. Respondents answered questions concerning the importance of considering various aspects of each story using five-point response scales, where 1 indicates least importance, and 5 indicates greatest importance. Scoring of responses is based on a formula set out by Rest (1979b).

3.3.2 Belief in a Just World

Lerner (1980, 1981) and, more recently Dalbert (2001) argue that justice plays a central role in culture and in the lives of individuals. BJW is a personal belief system that reflects an investment in the notion that good things happen to good people but bad things happen to bad people. To the extent that people generally think of themselves as good people, BJW can act as a kind of psychological buffer that protects the self from potential threats in one’s environment. The idea that BJW serves as a psychological buffer from perceived harm is perhaps the most important principle of belief in a just world theory (Dalbert, 2001).
Individuals with a strong belief in a just world think that people generally deserve what they are entitled to receive in the long run. These individuals are more likely to believe that they have control over life’s events and they are more likely to relinquish immediate outcomes for long-term rewards. People with strong just world beliefs have a realistic view of injustice in the world. But they plan their lives “as if” they live in a just world as a means of bringing order and as a way of coping with life’s tragedies. Those with a weak belief in a just world tend to see themselves as victims. They believe that they have little control over life’s events but refer to outside sources or authority such as luck or a divine being when good or bad things happen to them. The belief in a just world operates at a preconscious level and is revealed in the person’s reactions to a given event (Lerner, 1980).

3.3.3 Belief in a Just World scale

BJW is measured as a sub-scale of Collins’ (1974) 46-item Likert-scale version of Rotter’s (1966) internal-external control questionnaire. The BJW subscale has been separately validated by Zuckerman and Gerbasi (1977a, b) and verified by Ashkanasy (1985). Responses to each of the items were based on a seven-point Likert scale, where 1 indicated strong disagreement, and 7 indicated strong agreement.

3.4 Hypotheses

We propose that CMD will interact with belief in a just world to influence auditors’ ethical decision-making behavior in an audit conflict with client-management, thus revealing a range of inconsistent decision-making styles. Our hypotheses is formulated in line with Kohlberg’s (1969, 1986) theory. We viewed levels of moral reasoning as a categorical variable at three levels, high (post-conventional), mid (conventional) and low (pre-conventional). This is consistent with the methods adopted in other studies of auditor independence (e.g., see
Belief in a just world is also a categorical variable at two levels, strong and weak as adopted in studies in the social justice literature (Dalbert, 2001). When a response to an ethical dilemma becomes difficult, the individual’s personal belief system is likely to be activated in the preconscious and acts heuristically. We propose that this activation is reflected in an interaction with CMD. In effect, six groups of auditors with three levels of CMD by two levels of BJW are hypothesized to emerge. We hypothesize that auditors’ acquiescence to client management will be affected in the following way:

**Hypothesis 1.** Auditors’ acquiescence to client management will be influenced by their personal characteristics CMD, BJW, and contextual client economic factors: client financial condition, size of fees and whether the audit was tendered.

**Hypothesis 2.** Auditors with high CMD and strong BJW will be less acquiescent to client management in the context of client economic factors.

**Hypothesis 3.** Auditors with mid CMD and strong BJW will be less acquiescent to client management than auditors with mid CMD and weak BJW in the context of client economic factors.

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4 Several studies viewed levels of moral reasoning as dichotomous (high, low) following Ponemon and Gabhart, (1990). This dichotomous categorization, however fails to take into account the unpredictable responses by those people at mid CMD level.
Hypothesis 4. Auditors with low CMD and weak BJW will be the most acquiescent group out of the six auditor decision-making groups.

3.3.1 Analysis method

This experiment focuses on the interaction between auditors’ personal characteristics; moral reasoning and beliefs in a just world with client economic factors to reveal differing independence judgments. To test such interactive hypotheses, a mixed factorial ANOVA research design with three repeated measures and two between-group independent variables were appropriate. The three within-subject measures are the economic factors identified by the senior audit partners: (1) client financial condition, (2) size of fees, and (3) tendering. The two between-group independent variables are: (1) level of moral reasoning and (2) belief in a just world. The dependent variable is a measure of the extent to which the auditor would acquiesce to the wishes of client management.

3.3.2 Method

The experimental instrument consisted of a questionnaire booklet similar to that used in the Windsor and Ashkanasy (1995) studies. An independent translator translated the questionnaire booklet into Danish then translated back into English by another translator to ensure accuracy. This paper examines three parts of the questionnaire booklet: (1) the audit conflict, (2) BJW measured as a subset of locus of control (LOC) scale (Collins, 1974), and (3) Rest’s (1979a) DIT scale. The CMD and BJW measures were administered after the audit conflict to ensure

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5 A copy of the questionnaire can be obtained from Carolyn Windsor.
6 We are grateful to Ingeborg Uldahl for her expertise in translating the questionnaires.
that the scenarios used in the DIT did not bias respondents’ perceptions of the audit conflict (see Trevino and Youngblood, 1990; Trevino, 1986).

3.3.3 Procedure

Audit partners from each the participating international assurance and advisory services firms in Copenhagen were approached for permission to distribute the questionnaires. The co-opted partners were instructed not to participate in the experiment. The questionnaire booklets and DIT instructions were distributed to experienced auditors using secretarial services provided by the participating firms, under supervision of the co-opted audit partners. Participating auditors were guaranteed full anonymity and confidentiality. Neither the researchers nor the senior partners knew who participated in this experiment. Results of this experiment were made generally available through preliminary papers presented at accounting conferences.

3.3.4 Sample

Participants came from the audit divisions of the large transnational assurance and advisory services firms in Copenhagen7. Care was taken in the distribution of questionnaires to ensure that there was no dominance by a particular audit firm. 500 questionnaires were couriered to the participating audit partners in Copenhagen. 195 were returned but 21 were eliminated from the study because they were either incomplete or meaningless responses. Rest’s (1979a) DIT includes an internal validity check that detects unreliable responses to the scenarios. 174 useable questionnaires were analyzed, a 35% response rate. Table 1 describes the respondents.

Table 1 here

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7 The data for this study was collected after Denmark’s IFAC affiliation in 2000.
3.3.5 Analyses

The data were analyzed using SPSS statistical package. Calculation of scores on Collins’ (1974) BJW dimension was performed using Collins’ original factor structure, which included 11 items with a range of 11 to 77. The mean score on this was 39 (s.d. = 7.26), with Cronbach alpha = .64. Using the BJW mean score auditors were divided into two groups. From the original 174 respondents, auditors with a BJW mean of 39 were dropped from the analyses leaving 163 respondents. Auditors were then divided into those who scored high or strong BJW (n = 84) and those who scored low or weak BJW (n = 79). Mean scores were 32.98 (s.d. = 4.72) for the weak BJW group, and 44.43 (s.d. = 4.21) for strong BJW group.

Rest’s (1979a) DIT measures moral reasoning development known as the P Score and ranges from 0 to 70. The P score is based on respondents’ scores of Kohlberg’s stages five and six, the highest level of moral reasoning or post conventional level (see Rest et al., 1999). The higher the P-score, the more highly developed is the respondent’s moral reasoning. Rest (1979a) recommended that the P-scores could be used to categorize the auditors into high, mid, and low groups, corresponding, respectively, to Kohlberg’s (1969) pre-conventional, conventional, and post-conventional levels of moral reasoning development.

Based on a large normative sample, Rest determined that P-scores of 27 and 41 were the appropriate cut-off scores to define the three groups. These values were adopted in the present experiment, where the overall mean P-score was 35.48 (s.d. = 15.19). The auditors were thus divided into low (n = 63, mean = 19.95, s.d. = 5.89), mid (n = 48, mean = 34.90, s.d. = 3.61) and high (n = 52, mean = 52.82, s.d. = 8.18) moral reasoning development groups.

3.4 Results
The results overall indicate that auditors’ independence judgments are inconsistent because auditors’ personal characteristics interact with contextual client economic factors. Even though auditors in this experiment had a similar education and training (all participants worked for the large transnational assurance and advisory services firms in one city) the findings suggest that auditors have varying ethical predispositions in response to the same hypothetical audit conflict. Six decision-making groups emerged demonstrating the influence of beliefs in a just world (BJW) in conjunction with moral development (CMD) to affect independence judgments in Table 2. Client financial condition is the factor that affected all decision-making groups. When client financial condition was good, all of the six groups of auditors were less independent.

The ANOVA results in Table 2 indicates main effects on acquiescence for tendering, \(F = 4.75, \text{d.f.} = 1,162, p > .05\), for size of fees \(F = 49.36, \text{d.f.} = 1,162, p > .001\), and for client financial condition \(F = 147.739, \text{d.f.} = 1,162, p > .001\).

**Table 2 about here**

Hypothesis 1 was supported. Table 2 reports a significant interaction of client economic factors: tendering, client financial condition, auditors decision making represented by high, mid and low level of moral reasoning with high and low beliefs in a just world personal factors. \(F = 3.01, \text{d.f.} = 5,158, p > .05\).

Table 3 reveals the means of the interaction effect, the lower the mean score the less likely auditors acceded to client management. This result indicates that in an audit dispute with management and the strength of client economic factors do influence auditors’ independence judgments.

**Table 3 about here**
To investigate the interaction further, Figure 1 depicts the interaction effects of client financial condition (good and poor) and tendering the audit (yes or no). Figure 1 show six auditor decision making groups, categorized into high, mid and low CMD with strong and weak BJW using the mean scores in Table 3. Figure 1 reveals that all six groups were more acquiescent when the client financial condition was good than when client financial condition was poor. Apparently, good client financial condition indicated a stable source of revenue and a reduced risk of litigation for all groups (see Farmer et al. 1987).

Hypothesis 2 was partially supported. Those auditors with high CMD and strong BJW are the least acquiescent to management out of all six groups. It was anticipated that this group’s acquiescence would be similar in the good and poor client financial conditions. Good financial condition, however affected this group’s acquiescence suggesting that economic context is particularly influential in auditors’ independence judgments.

Hypothesis 3 was also partially supported. Auditors with mid CMD were less predictable overall suggesting that these auditors maybe more easily swayed by powerful authority, in this case client management. Auditors with mid CMD and strong BJW were less acquiescent in the good client financial condition but more so in the poor financial condition as shown in Figure 1. It appears when the client audit is tendered the mid CMD auditors with strong BJW are more acquiescent than when the audit is not tendered in the poor client financial condition. Moreover, auditors with mid CMD and strong BJW were less acquiescent to management in the poor client financial conditions than auditors with high CMD and weak BJW, strengthening the evidence that strong BJW can act as a coping mechanism even when the level of moral reasoning is lower.
Client tendering appears to affect auditors with mid CMD and weak BJW more, particularly in the good client financial condition.

Beliefs in a just world did affect the low CMD auditors supporting hypothesis four. The low CMD and weak BJW were more acquiescent than the low CMD with strong BJW in good and poor client financial conditions. Moreover, the low CMD and weak BJW group appears to follow management demands when the audit is tendered, even though the client is in poor financial condition. Perhaps, this most acquiescent group is keen to attract any sort of client, no matter the risk.

Interestingly low CMD and strong BJW group acceded less than the mid CMD groups with strong and weak BJW in the good and poor client financial conditions. This suggests that the mid CMD auditors were most likely to defer to a powerful management in line with Kohlberg’s theory that people with conventional level of moral reasoning are more likely to follow those in power or authority. The other unexpected finding was that low CMD and strong BJW group acceded less than the high CMD and weak BJW in good and poor client financial conditions. Tendering of the audit in the good client financial condition appears to reduce independence of this group. The self-interest imbued in low moral development interacts with this group’s personal beliefs to protect them from powerful management: hence this group is unwilling to cooperate with management (Schatzberg, Sevcik, Shapiro, Thorne and Olusegun Wallace, 2005).

This result indicates that the powerful influence of BJW acts not only as a coping mechanism for those auditors with high moral development but also acts as self-protection for those auditors with low moral reasoning (see Dalbert, 2001).

3.5 Discussion

The results of this experiment reveal that personality factors have a significant effect on auditors’ independence, suggesting an ethical inconsistency in
response to client management. Moreover, auditors’ ability to resist management economic considerations may not be largely influenced by the profession’s decree to follow codes of ethical guidelines. In effect, the ability to maintain auditor independence (or not) is a human process, integral to the whole person’s life experiences and personal predisposition, not a just “state of mind” that can be excised from the auditor’s life experiences as described in the code of ethics.

Even though auditors in this experiment have had a similar education and training (all participants worked for the large international assurance and advisory services firms in one city) the findings suggest that auditors have varying ethical predispositions in response to the same hypothetical audit conflict. Six decision-making groups emerged demonstrating the influence of beliefs in a just world (BJW) on auditors’ moral reasoning to affect independence judgments: Client financial condition and whether the audit is tendered are the factors that affected all decision-making groups. In particular, when client financial condition was good, the six groups of auditors were less independent (see Table 3 and Figure 1).

An explanation for this response is that managements of client firms with good financial condition have more economic strength to bargain with. Auditors were more willing to be independent when the client is in poor financial shape, where there is a situational risk of corporate collapse and subsequent litigation (deep pockets theory). A corporate collapse could not only result in the auditor being sued but also in losing the client. The findings also show that auditors with mid moral reasoning and weak BJW were the most acquiescent when the client was in good financial condition and tendered audit work.

Tendering in conjunction with good financial condition of the client also affected auditors (Figure 1). This gave client management more effective control over the working conditions of auditors as well as career success linked to client revenues (Wyatt, 2004; Goldman and Barlev, 1974). Hence, when the audit was
not tendered but the client was in good financial condition, auditors were less likely to acquiesce, suggesting tendering increased the client’s economic influence.

Limitations of this experiment include, firstly, that the research methodology relies on auditors’ responses to hypothetical scenarios, which varied on client economic situational variables that can be used by management to control auditor independence. Given that the respondents in this study were practicing auditors expected to meet high professional and ethical standards (in the present instance: IFAC, 2001, 2004; 2005), it would be surprising if they were to indicate high likelihood of acquiescence to management demands. In reality, auditors have been successfully sued for malpractice and are currently facing multi-billion dollar lawsuits. Nonetheless, the audit conflict situation was constructed with the active participation and close consultation of the senior audit partners, so that it constituted a realistic conflict between client management and the auditor.

The second limitation of the present investigation is that it was based on a repeated-measures design, and therefore possibly subject to problems of demand characteristics (see Knapp, 1987, Gul and Windsor, 1994). Demand characteristics are ameliorated in this study by including the between-groups design with belief in a just world and moral reasoning development (Kepple, 1991). The third limitation concerns the construct validity of the psychological measures used in this research, and the extent to which they reflect respondents’ actual cognitions and belief (see Rest, 1986; Rest, et al., 1999). Collins’ (1974) belief in a just/unjust world scale, however, is justified in the present research on the basis that the scales are well validated in the literature (see Dalbert, 2001) and provide theoretically interpretable results.

4. The decline of self-regulated auditor independence
A contribution of this study is that it examines auditor independence from an international regulatory perspective with respect to international professional requirements promulgated by IFAC (2005). Auditors who participated in the experiment were affected by the conflict of interest between client economic considerations and professional obligations to present fairly an independent opinion in the public interest. This experiment also shows that auditors’ judgments were particularly affected client financial condition and tendering, hence economic considerations were a powerful influence on auditors’ decision-making. Windsor and Ashkanasy (1995) found similarly that Australian auditors’ independence judgments were affected by the same client economic factors, thus demonstrating conflicts of interests are a wider threat to auditor independence.

Further the experiment revealed inconsistencies in auditors’ judgments, therefore contravening IFAC’s (2005, p. 2) code of ethics “to provide consistently high quality in the public interest”. Auditors’ responses to the hypothetical audit conflict were varied, even though the experiment included only two personality factors from a multifarious array of personal factors, traits and influences that make the whole person.

This evidence indicates that auditors are human beings with a range of different predispositions and personality traits that may or may not provide the moral fortitude to withstand powerful influences such as client economic factors. The evidence further suggests that motivating personal auditors’ ethical conduct is complex and requires more than the moral suasion of the professional code. In fact, appealing to auditors’ personal ethics, virtues and altruism may not be sufficient to ensure honest corporate reporting in a political and regulatory system that promotes the neo-liberal doctrine of competitive self-interest (Mintzberg et al., 2002). The commercialization and enforced competition of company audits emphasizes efficiencies to the detriment of auditor independence.
Moreover, the transnational professional services firms that employ auditors receive little public scrutiny. These firms are not required to provide independently audited reports to the public and therefore, are basically unaccountable\(^8\) (Fuerman, 2004). The proclaimed professional principles of integrity and objectivity that guide auditors’ personal virtues contradict a state enforced marketized regulatory system acquiescent to corporate private interests that promote competitive induced efficiencies. The combination of a marketized regulatory system, the reliance on the ‘self discipline’ of auditors’ personal ethics, the profession’s economic dependence on the corporate client and the lack of transparency of audit firms not only threatens the auditing profession’s legitimacy but also democracy.

Van Waarden (2003) argues that democratic governance is no longer about the delegation of authority to elected representatives who are accountable directly to their citizenry (cited Levi-Faur, 2005). Regulatory capitalism at best is a form of second-level indirect representative democracy where elected representatives let ‘experts’ formulate and administer policies autonomously from their regulatory bastions such as IFAC, IAASB, and IASB. These expert oriented policies have the potential to affect billions of people world-wide who have very little direct participation or debate about these policies and their social impact. At worst, regulatory capitalism ignores the fundamentals of democracy (Stiglitz, 2003).

In conclusion, the implications of our findings described in this paper are that merely prescribing more rules in the professional code of ethics will fail to achieve actual and perceived auditor independence. The code assumes the humanly impossible, that all members of the profession have the ethical predisposition to consistently perform the altruistic requirement of putting the

\(^8\) The PCAOB inspects a number of audit firms mainly in the U.S, but the results are not reported publicly at this point in time (PCAOB, 2005).

“The strategy of relying on the personal honor, professional ethics, and reputational risk aversion of watchdogs to refute dishonest reporting has failed dramatically.”

The reality is that auditors are dependent on corporate clients in a contrived competitive, marketized environment imposed by the State and controlled by regulatory capitalism. In turn regulatory capitalism relies on the accounting profession’s expertise and legitimate power to spread that regime’s neo-liberal policies of deregulation and privatization worldwide through the transnational network of professional services firms. Thus, the transformed profession has become the transformer but at a price, the loss of public confidence and the decline of ethicality necessary for auditor independence. Conflicts of interests still abound.
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Table 1: Respondents from the Danish Audit Divisions of the International Assurance and Advisory Firms

<table>
<thead>
<tr>
<th>Sample n = 174</th>
<th>Mean Age</th>
<th>Female</th>
<th>Male</th>
<th>Mean yrs experience (years)</th>
<th>Partner/owner</th>
<th>Employed CPAs</th>
<th>Supervisory Level</th>
<th>Non-m’ment employees</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>35.4 yrs (9.37)</td>
<td>52</td>
<td>122</td>
<td>12.4 yrs (9.54)</td>
<td>34</td>
<td>29</td>
<td>85</td>
<td>26</td>
</tr>
</tbody>
</table>
Table 2: Analysis of Variance of Tender (yes, no), Size of Fees (large, small), Client Financial Condition (good, poor) and 3 levels of cognitive moral development (CMD) x 2 levels of beliefs in a just world (BJW)

<table>
<thead>
<tr>
<th>Source</th>
<th>df</th>
<th>Mean Sq</th>
<th>F</th>
<th>Sig. p</th>
</tr>
</thead>
<tbody>
<tr>
<td>tender</td>
<td>1</td>
<td>.938</td>
<td>4.754</td>
<td>.031*</td>
</tr>
<tr>
<td>tender * CMD * BJW</td>
<td>5</td>
<td>.233</td>
<td>1.181</td>
<td>.321</td>
</tr>
<tr>
<td>Error (tender)</td>
<td>157</td>
<td>.197</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size of fees</td>
<td>1</td>
<td>20.807</td>
<td>49.360</td>
<td>.000***</td>
</tr>
<tr>
<td>Size of fees * CMD * BJW</td>
<td>5</td>
<td>.568</td>
<td>1.348</td>
<td>.247</td>
</tr>
<tr>
<td>Error(size of fees)</td>
<td>157</td>
<td>.422</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Client financial condition</td>
<td>1</td>
<td>638.095</td>
<td>147.739</td>
<td>.000***</td>
</tr>
<tr>
<td>Client financial cond. * CMD * BJW</td>
<td>5</td>
<td>2.179</td>
<td>.505</td>
<td>.773</td>
</tr>
<tr>
<td>Error(client financial cond.)</td>
<td>157</td>
<td>4.319</td>
<td></td>
<td></td>
</tr>
<tr>
<td>tender * size of fees</td>
<td>1</td>
<td>.074</td>
<td>.429</td>
<td>.513</td>
</tr>
<tr>
<td>tender * size of fees * CMD * BJW</td>
<td>5</td>
<td>.239</td>
<td>1.389</td>
<td>.231</td>
</tr>
<tr>
<td>Error(tender * size of fees)</td>
<td>157</td>
<td>.172</td>
<td></td>
<td></td>
</tr>
<tr>
<td>tender * client financial cond.</td>
<td>1</td>
<td>.314</td>
<td>3.223</td>
<td>.075</td>
</tr>
<tr>
<td>tender * client financial cond. * CMD * BJW</td>
<td>5</td>
<td>.294</td>
<td>3.010</td>
<td>.013*</td>
</tr>
<tr>
<td>Error(tender*client financial cond.)</td>
<td>157</td>
<td>.098</td>
<td></td>
<td></td>
</tr>
<tr>
<td>fees * client financial cond.</td>
<td>1</td>
<td>.023</td>
<td>.104</td>
<td>.747</td>
</tr>
<tr>
<td>fees * client financial cond. * CMD * BJW</td>
<td>5</td>
<td>.276</td>
<td>1.281</td>
<td>.275</td>
</tr>
<tr>
<td>Error(fees*client financial cond.)</td>
<td>157</td>
<td>.215</td>
<td></td>
<td></td>
</tr>
<tr>
<td>tender * fees * client financial cond.</td>
<td>1</td>
<td>.001</td>
<td>.008</td>
<td>.927</td>
</tr>
<tr>
<td>tender * fees * client financial cond. * CMD * BJW</td>
<td>5</td>
<td>.061</td>
<td>.954</td>
<td>.448</td>
</tr>
<tr>
<td>Error(tender<em>fees</em>client financial cond.)</td>
<td>157</td>
<td>.064</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

p = >.05*, p = >.01**, p = >.001***
Table 3: Means and Standard Error for the Interaction Auditors’ Six Decision-Making Groups (CMD 3x BJW 2) x tender x client financial condition

<table>
<thead>
<tr>
<th>Decision making Groups</th>
<th>Tender (yes = 1, No =2)</th>
<th>Client financial condition (good = 1, poor = 2)</th>
<th>Mean</th>
<th>Std. Error</th>
<th>95% Confidence Interval</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Mean</td>
<td>Std. Error</td>
<td>Lower Bound</td>
<td>Upper Bound</td>
</tr>
<tr>
<td>High moral; strong BJW</td>
<td>1</td>
<td>1</td>
<td>2.750</td>
<td>.315</td>
<td>2.127</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1</td>
<td>1.483</td>
<td>.196</td>
<td>1.096</td>
</tr>
<tr>
<td>n=30</td>
<td>2</td>
<td>1</td>
<td>2.683</td>
<td>.313</td>
<td>2.064</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>2</td>
<td>1.517</td>
<td>.192</td>
<td>1.137</td>
</tr>
<tr>
<td>High moral; weak BJW</td>
<td>1</td>
<td>1</td>
<td>3.114</td>
<td>.368</td>
<td>2.386</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1</td>
<td>1.841</td>
<td>.229</td>
<td>1.389</td>
</tr>
<tr>
<td>n=22</td>
<td>2</td>
<td>1</td>
<td>3.182</td>
<td>.366</td>
<td>2.459</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>2</td>
<td>1.841</td>
<td>.224</td>
<td>1.398</td>
</tr>
<tr>
<td>Mid moral; strong BJW</td>
<td>1</td>
<td>1</td>
<td>3.478</td>
<td>.360</td>
<td>2.767</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1</td>
<td>1.848</td>
<td>.224</td>
<td>1.406</td>
</tr>
<tr>
<td>n=23</td>
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<td>1</td>
<td>3.543</td>
<td>.358</td>
<td>2.837</td>
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<tr>
<td></td>
<td>2</td>
<td>2</td>
<td>1.739</td>
<td>.220</td>
<td>1.306</td>
</tr>
<tr>
<td>Mid moral; weak BJW</td>
<td>1</td>
<td>1</td>
<td>3.620</td>
<td>.345</td>
<td>2.938</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1</td>
<td>1.960</td>
<td>.215</td>
<td>1.536</td>
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<tr>
<td>n=25</td>
<td>2</td>
<td>1</td>
<td>3.420</td>
<td>.343</td>
<td>2.742</td>
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<tr>
<td></td>
<td>2</td>
<td>2</td>
<td>1.920</td>
<td>.211</td>
<td>1.504</td>
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<tr>
<td>Low moral; strong BJW</td>
<td>1</td>
<td>1</td>
<td>3.161</td>
<td>.310</td>
<td>2.549</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1</td>
<td>1.597</td>
<td>.193</td>
<td>1.216</td>
</tr>
<tr>
<td>n=31</td>
<td>2</td>
<td>1</td>
<td>2.984</td>
<td>.308</td>
<td>2.375</td>
</tr>
<tr>
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<td>2</td>
<td>2</td>
<td>1.653</td>
<td>.189</td>
<td>1.280</td>
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<tr>
<td>Low moral; weak BJW</td>
<td>1</td>
<td>1</td>
<td>3.266</td>
<td>.305</td>
<td>2.663</td>
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<tr>
<td></td>
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<td>2</td>
<td>2</td>
<td>1.906</td>
<td>.186</td>
<td>1.539</td>
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<tr>
<td>Total 163</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</table>
Figure 1: Auditors’ Acquiescent Mean Scores for the Client Financial Condition x Tender Interaction