Business ethics 17792

Business, Marketing

Accounting Ethics

When examining the effect of open marketing on the profession of accounting it is important to view it from three perspectives: the client's, the profession's, and society's. Additionally, two key areas that are affected by marketing must be addressed, these are concerning competition, and ethical implications. Marketing in public accounting is here to stay therefore making an argument against its existence would be fruitless; however, in order to achieve maximum benefit to the firm, the client, and s ociety more stringent guidelines must be implemented at the firm level.

The first, and most obvious, of the effected areas is competition. Within competition several points are discussed. First, the implications advertising has on public accounting-- the model of perfect competition versus the model of monopolistic compet ition. Secondly, the relationship between firm size and advertising expenditures. Thirdly, the effect of advertising on firm specialization, the implications of client turnover on public accounting practice.

Before making the comparison, a brief explanation why the two models are chosen is in order. Monopolistic competition has been chosen for the pre-advertising era because it most closely resembles the market structure in an extreme sense. The elements o f monopolistic competition are as follows: product differentiation, the presence of large numbers of sellers, and nonprice competition. Although accounting services between firms offer very little service differentiation, the absence of advertising serve s as a replacement because clients are not necessarily aware that other options are easily attainable. The post-advertising era is explained through the model of perfect competition for which the qualifications are as follows: very little or no service d ifferentiation, many sellers, and price as the only means of distinguishing one firms service from anothers.

In a perfectly competitive market the price of a particular service is established solely by the interaction of market demand and supply. (Thompson p. 277) When market demand for accounting services increases the resulting demand shifts right causing pri ces to increase returning the market back to equilibrium. However when supply increases, such is the theoretical effect of adding advertisement to public accounting practice, the supply curve shifts right causing prices to fall. The model of monopolistic competition is also price sensitive, however only at the firm level. For example, the CPA firm of XYZ has an established clientele base and uses referrals as its sole means of growth. They increase prices only as their cost o f providing the service increases and therefore are able to maintain their client base. In this example a gently downsloping demand curve exists (Thompson p. 304) causing only drastic changes in pricing to send their client base shopping for a new firm. The result is XYZ can continue to grow by practicing fair pricing and providing a reputable service. Cut rate pricing only marginally effects their client base because there is little means to make their pricing publicly known, and only drastic, unwarran ted increases sends clients packing.

Conversely, in the post-advertising era, XYZ must always be aware of market pricing because the demand curve is steeper and more volatile. Therefore the client base of XYZ is not stable as in the previous example and measures must be taken to keep price s competitive with other firms regardless of cost inferences. The result is the necessity of a more aggressive policy regarding new client recruiting and a higher turnover of existing clients.

Now that the differences are established, the resulting issues in public accounting can be discussed. The first area deserving discussion is the relationship between firm size and advertising. expenditures. A study made of CPA firms in Britain in 1985 asserted " the most dramatic contrast between advertisers and non-advertisers was their size." (O'Donohoe p. 122) The obvious reason for this anomaly is availability of resources. Larger firms ha ve, at their disposal, a much larger profit level; therefore advertising expense is easily included only marginally affecting bottom line. This implies larger firms to have gained a great deal more from inclusion of advertising than small firms. Consequ ently, small firms could be pushed out of the picture entirely in the area of audit services.

Why? In the area of audit services, small firms have little to offer to differentiate themselves from their larger counterparts who can now freely move in and perform the service at a lower price. This, unfortunately, will be a byproduct of the adverti sing era. Smaller firms only hope is to emphasize " personalized service" in tax and full service areas in hope that audit services can result. The major drawback is small firms are offered little room for growth because of the expense involved. Adverti sing in public accounting causes perspective clients to become bottom line oriented meaning the firms with the most available revenue to dump into advertising, coupled with the resources to offer lowest fees are the ones which grow. These resources are h eld by Big Six firms and large regional firms. As a result these firms will grow while small firms struggle.

The second inference drawn from the model of perfect competition is some smaller firms being forced to specialize. In order to differentiate themselves some smaller regionally operated firms have chosen to specialize. In the March 1990 issue of the CPA Journal Arvid Mostad, CPA published an article in which he set up " Seven Marketing Guidelines." His first guideline was " Create your own special niche." (Mostad p. 54) He goes on to encourage small firms to establish an area of expertise. (Mostad p. 54)

This develops significant implications regarding firm longevity in a capitalistic market of industry upswings and downturns. An example of this is the construction industry in the Baltimore-Washington corridor. The industry experienced phenomenal growt h in the Eighties followed by a near halt. The result? many small to medium size firms following the advice of specialization went belly up along with their clients. This uncertainty exists with any firms who specialize. !

Firm specialization clearly is n

The final implication of the new competitive market is client turnover. Gone are the days when firms could guarantee retaining a client by providing a quality service at a fair price. New market pressures require firms to constantly evaluate pricing st rategies, and, in some cases bid on jobs yearly. This creates high levels of client turnover. The result is firms must always actively seek new clients. Several drawbacks of this are increased overhead costs to firms, less stability, and greater servic e cost. Firms overhead costs increase because the expenses of replacing clients must be absorbed. This expense comes from both marketing tools used to attract clients, and costs of preparing a bid to perform a service. Firms which previously served a client base from year to year must face the uncertainty of retention of their client base now. The cost of providing a service to a new client greatly exceeds that of providing the same service to an existing client. When !

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Now that the difference in the competition aspect of public accounting is established emphasis is changed to examine the ethical implications derived as a result. In the area of ethics one must examine differences in independence, and integrity, and eva luate the changes in quality of service resulting from these areas.

When examining independence one must maintain an emphasis on the competitive structure of the market and new pressures in the area of client retention. Independence, one may argue, never existed before; however an assumption is made that independence, t o some extent, historically exists. With the competitive structure now present the process of gaining a new, and retaining an existing, client has become increasingly costly and time consuming. One may then infer that once a client is obtained, a firm would wish to do business with that client for an extended number of years, in order to realize the benefit of expenses incurred. Put simply, a firm would not look kindly toward a partner who lost a new client. This, inherently, decreases auditor indep endence during the first several years of the engagement. The partner overseeing the audit must always concern himself with the consequences of losing the engagement. Previously, firms worked mostly with longstanding clien!

ts and the relationship developed

The second major area of ethical effect is that of integrity.

Competition has resulted in some firms damaging the integrity of the profession. This damage has occurred mainly through pricing practices.

Two deviant practices have become commonplace in today's market. These are below cost pricing, and discount pricing. Many firms have adopted policies of below cost pricing as a tool of market penetration, (Formichella p. 199) implications regarding the motives and integrity of these firms must be explo red. Is it reasonable to assume that a firm would be willing to absorb a loss from an engagement, or would a more practical assumption state that firms which lowball would seek means to cut service costs at the expense of quality? It is not possible to answer this question; however its mere existence creates a damaging effect on the integrity, or at least perceived integrity, of the profession.

The second pricing strategy which is cut-rate pricing provokes similar questions. In his commentary Mario Formichella states the following:

It is no longer unusual to find firms willing to take on work at substantial discounts from standard fee levels. While there may be justifications for performing services at reduced rates during off-peak periods in special situations such as for non-profit institutions or similar organizations, the extent to which this practice has grown cannot be justified on any logical or professional basis. (Formichella p. 81)

The distaste shown by Mr. Formichella in the area of cut-rate pricing shows it as an issue of concern and one which damages integrity. Mr. Formichella goes on to call for the implementation of professional standards to prohibit actions such as this which are damaging to the image and integrity of the profession. One would have to agree with his statement; however difficulties arise, in the area of monopolistic activity when guidelines are established regarding pricing strategies across an industry. Unf ortunately the profession must rely on the integrity of individual firms to guard against this strategy. As a result, this is a practice likely to continue, albeit damaging to the profession and those which rely on the statements made by the profession.

The existence of advertising in public accounting creates a new environment to which firms are still adapting. This new environment is largely the result of increased competition and a clientele which is increasingly more bottom line oriented. In order to compete firms must place more emphasis on marketing and accept it as a cost of doing business. The result of this will be more difficult penetration and an increasingly limited number of small firms in the business. Market pressures also are forcing creating situations where ethical issues such as independence and integrity are questioned making it imperative that the AICPA create guidelines from which the evolving profession must base itself. In the age of deregulation accounting jumped on the boa t, now it is becoming increasingly fashionable to re-regulate, accounting, as a profession must not miss that boat, lest they drown in the result-- government intervention.