



The impact of audit risk, materiality and severity on ethical decision making

Audit risk,
materiality and
severity

An analysis of the perceptions of tax agents in Australia

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Abstract

Purpose – The purpose of this paper is to focus on the role of the tax agent as a preparer of tax returns and provider of professional tax advice under a system based on self-assessment principles. It recognises the competing pressures under which tax agents attempt to discharge their professional responsibilities, and examines the implications for potentially unethical behaviour.

Design/methodology/approach – The paper uses a mail survey of tax professionals in Western Australia. Respondents are presented with realistic tax return scenarios, in which the demands of the client are varied according to the risk of audit, the severity of tax law and the materiality of dollar amounts involved.

Findings – The findings suggest that the severity of tax law violation is an important factor in ethical decision-making, but that audit risk and the amounts involved are not.

Research limitations/implications – The lack of support for audit risk as an influential variable is an important outcome, because policy makers have traditionally proceeded on the basis that increases in audit probabilities will reduce the likelihood of taxpayers adopting aggressive tax reporting positions. However, since the findings are based on an Australian sample, care must be taken in generalizing these findings elsewhere.

Practical implications – The implications are important in that alternative enforcement and compliance strategies must be considered by tax administrators.

Originality/value – The paper extends empirical research into taxpayer attitudes to those of the preparers of tax returns. The findings will be of relevance both to tax agents and to tax administrators.

Keywords Professional ethics, Tax returns, Auditing, Financial risk, Australia

Paper type Research paper



1. Introduction

The potentially ambiguous application of increasingly complex taxation laws to particular factual situations means that tax professionals often face dilemmas in arriving at appropriate and supportable tax reporting positions. Their decision-making

may also be subject to pressures, sometimes competing, from disparate groups such as clients, the government through its revenue authority – the Australian taxation office (ATO) in the Australian context, employers, the business and financial community, and professional accounting associations. In resolving these conflicts and in discharging their professional responsibilities inevitably ethical and moral issues will arise.

The fundamental ethical issue involves an evaluation of the appropriate role of the tax practitioner. It has been suggested that the:

... modern tax practitioner has either assumed or had thrust upon him certain responsibilities peculiar to his practice, and not common to all areas of practice within the legal and accounting professions (Oatway, 1965, p. 237).

Accordingly, it is necessary to consider whether tax practitioners have a collective or civic allegiance, albeit imprecisely defined, to the efficient administration of the tax system and the public at large (by reinforcing the community value of taxation) in addition to maintaining client loyalty. Carey and Doherty (1995, p. 82), in recognition of the important role played by certified public accountants (CPAs) in the US self-assessment tax system, note that:

The wide acceptance of the CPA as a tax adviser has contributed substantially to the successful administration of the income tax laws – often described as a voluntary self-assessing tax system. Thus, in tax practice, the CPA again finds himself in a position of multiple responsibilities. He obviously has a primary duty to his client. But he must also recognize an obligation to the government and to the public.

Tax practitioners may also be subject to a wide range of ethical issues pertaining to client loyalty and to preserving/developing their own tax practice income on a day-to-day basis. These issues include: acquiring and maintaining appropriate levels of technical competence; determining in what circumstances they should recommend the adoption of “overly aggressive” reporting positions with respect to contentious tax matters; whether previously undetected errors from earlier returns should be reported. Tax preparer literature in the US suggests that preparers contribute to taxpayer compliance in unambiguous areas but contribute to aggressive tax reporting/non-compliance in ambiguous areas (Kaplan *et al.*, 1988; Klepper and Nagin, 1989). Aggressive tax reporting refers to situations in which the tax practitioner selects the reporting position that represents events favourably to the taxpayer when that position is not indicated clearly by the facts, appropriate authorities or relevant professional literature (Cuccia *et al.*, 1995).

West and Clevenger (1995) have identified a number of areas of ethical concern arising from the tax preparation, reporting and planning activities of the tax practitioner’s role as the intermediary agent between the client and the revenue authority. The broad ethical issues that arise from the various aspects of the tax practitioner’s role are identified below.

1.1 Tax practitioner as advisor

Here the tax practitioner’s role is one of assisting the taxpayer to create transactions/establish tax-effective structures and develop relevant facts, rather than being limited to the presentation and legal characterisation of historical facts. The tax practitioner is placed in the position of attempting to balance the client’s desire to reduce tax liability to an acceptable minimum, while also considering any rights of

affected third parties, the public and the potential impact on the integrity of the tax system, when devising a strategy for the client. These supplementary duties arise from the privileged intermediary role enjoyed by the practitioner as the independent tax professional on whom the ATO relies for the efficient operation of the tax system.

1.2 Ethical standards in a tax planning context

Many transactions and arrangements categorised as “tax planning” will not be fraudulent and prohibited on legal grounds. In many instances, however, there will be doubt as to whether the matters will withstand close factual and legal analysis. These contentious issues inevitably raise concerns about a tax practitioner meeting his or her duty to the tax system in giving advice and in preparing tax returns. For example, Murphy (2003) reports on the disillusionment and hostility towards the tax system resulting from amended assessments issued to taxpayers involved in a mass-marketed aggressive tax planning scheme.

Cuccia *et al.* (1995) emphasise that tax practitioners are aware that they may have to justify their reporting positions in the future, and that the potential for penalties depends on an assessment by the revenue authority as to whether they are seen as applying standards appropriately. In this regard, it must be remembered that people do not have a uniform capacity to integrate factual and conceptual complexity, or to arrive at the same conclusions and judgments. Tax advice will depend heavily on individual tax agent judgment. Further, the capacity of statutory thresholds to constrain aggressive reporting may be diminished when expressions like “reasonably arguable” and “reasonable care” as used to denote the thresholds in the Australian legislation, are seen as vague and open to liberal interpretation:

Ceteris paribus, the more liberal the interpretation of the standard, the more likely the evidence will support an aggressive reporting position (Cuccia *et al.*, 1995, p. 230).

1.3 Extent of research required to render advice

A tax practitioner requires sufficient evidence, technical knowledge, experience and skill to reasonably expect to complete services rendered with professional competence. In the competitive environment of tax practice and for a variety of reasons, however, the client and tax practitioner may agree to limit the amount of research conducted. In these situations, the tax practitioner should still do enough to come to an informed judgment regarding the issue.

1.4 Duty to ascertain facts provided by the client

The tax practitioner is entitled to rely on facts given by a client, without the need for independent verification or audit. Where the tax practitioner discovers inconsistencies or inadequacies in any data or information supplied, then reasonable enquiries should still be made.

1.5 Tax practitioner obligation with respect to transaction documentation

The fundamental ethical issue is whether or not facts shown or created in documents are in substance consistent with the standards governing the tax practitioner’s professional conduct. The tax practitioner should not create or support false or misleading information. For example, when timing issues are essential to the tax treatment of transactions, the tax practitioner cannot falsify the dates surrounding the transaction.

The quality of any professional advice ultimately is a function of technical competence and the exercise of professional judgment. Ethical questions will arise whenever the decision maker has the freedom to exercise choice within a range of options and those decisions have consequences for the welfare of others (Jones, 1991; Shaw and Barry, 1992). This judgment/decision-making function will, in turn, be dependent upon the integrity, professional experience and personal values of the professional making the decisions between the various alternatives. As a consequence, the advice will generally not be value-free. The tax practitioner must operate within a decision-making environment which is characterised by potential conflicts or tensions which involve considerations such as: the technical provisions of the tax law; the preferences, expectations and risk propensities of clients; directives (and potential penalties) of the revenue authority (ATO); and the application of professional ethical rules and standards. This is a process which Bandy *et al.* (1993, p. 5) describe as “as clear cut as distinguishing between shades of gray”.

A consequence of the reliance of Australian taxpayers on tax agents in the preparation and filing of accurate tax returns is that tax agents are in a position to exert a strong and direct influence on the compliance and tax administration processes (see Erard (1993) in the US context). To the extent that a failure of a tax agent (acting as the moral agent of their clients) to act ethically in transacting tax matters results in an “inaccurate” return or causes taxation auditors to not detect an item which would otherwise be challenged, the failure can contribute to a reduced level of taxpayer compliance. This influence is even more pervasive in a tax system in which ATO audit and collection resources are limited. Although the final decision on any course of action will be made by the taxpayer, that person will inevitably be influenced significantly by the advice and actions of the tax professional to whom a fee is being paid. A major potential conflict then arises because codes of conduct and ethics only establish lines of consensus impropriety. Theoretically, ethics requires more from a person than technical compliance with rules (Falk, 1985).

In spite of an increasing awareness of the ethical perspective of tax practice, very little empirical research in this area has been conducted in Australia. The dearth of such research means that little is known about the personality, demographic, organizational and situational factors that may have an impact on tax practitioners’ ethics-related decision-making within the range of potentially conflicting aspects of the tax practitioner’s role analysed by West and Clevenger (1995).

This study attempts to redress this research void by undertaking a survey of Western Australian tax agents. A behavioural experimental component was incorporated into the study to determine whether selected situational variables influence or moderate tax agent ethical perceptions in decision-making.

Various descriptive “causal” models have been developed to provide a theoretical framework for the ethical decision-making process within a business context (Ferrell and Gresham, 1985; Hunt and Vitell, 1986; Lampe and Finn, 1992). In summary, all of these “models” of ethical decision-making drawn from business ethics literature contain four common elements, identified by Brady and Hatch (1992, p. 308) as:

- (1) a decision process, modified by (2) internal and (3) external factors, leading to (4) ethical or unethical behavior, all of which are connected by arrows representing causes or consequences.

Thus, two broad categories of variables are catalogued to interact with and influence decision-making when individuals confront ethical dilemmas. The first category incorporates individual factors, including level of moral development. The second category consists of those situational/background factors that are viewed as moderators between behavioural predisposition and actual behaviour. There is, however, no consensus as to which specific situational variables should be included in such a model.

The particular variables under review in this study: audit risk, materiality of the issue and severity of the tax law in dispute, were selected from business ethics empirical research in the accounting/auditing, management and marketing disciplines because of their likely relevance to tax practice. Tax compliance research was used to supplement the paucity of specific tax evidence in this area. They were characterised by three basic selection criteria. First, they can be associated with the individual tax practitioner, rather than with the firm or organizational structure within which the practitioner may operate. Second, they are present (potentially, at least) in all tax practice situations. Third, they have been the subject of empirical research in business ethics and/or compliance related literature.

The purpose of this paper is to report on the impact of these factors on decision-making, with a particular emphasis on the “audit risk” variable.

2. Literature review and hypothesis development

2.1 Audit risk

The independent variable of primary interest is the influence of the risk/probability of audit by the ATO on the ethical perceptions of tax agents. The potential practical costs of that risk in terms of loss suffered by the tax agent’s professional practice or employer, i.e. “business risk” as identified by Brumfield *et al.*(1983), are outside the scope of this study. These costs include: the time and expense of defending law suits brought by clients, the imposition of penalties/deregistration, diminution of professional reputation, and possible loss of clients.

The reviewed empirical literature indicates that opportunity to engage in unethical behaviour has an influence on the unethical behaviour of CPAs (Loeb, 1972). However, it is unclear how much opportunity is necessary for it to become an influential factor in determining unethical behaviour, and whether ethical perceptions of issues are influenced by the opportunity to act unethically.

Expectations about the probability of an event’s detection were found to be more important in determining risk taking than the magnitude of the expected consequence (Dickson, 1978). Further, Malone and Roberts (1996) conducted a study into the failure of auditors to properly execute all appropriate audit steps (reduced audit quality-RAQ-behaviours). A significant empirical finding of their study was that of a strong inverse relationship between auditors’ perceptions of their firm’s ability to detect and punish those who commit RAQ acts and the auditors’ incidence of RAQ behaviours. Thus, in a tax context, it would be anticipated that a perceived low probability of detection through an ATO audit activity would be reflected in an increased level of unethical behaviour such as aggressive tax reporting, i.e. exploration of the “audit lottery” as examined by Marshall *et al.* (1997), and defined by Temple (1991, p. 325) as:

... the taxpayer's statistical likelihood of over 98 per cent that she would not be audited, augmented by the additional possibility that the issue would not be uncovered by the IRS examiner in the unlikely event of an audit.

Alm *et al.* (1992) also suggest that individuals tend to overweight the probability of an audit relative to what would be anticipated with regard to the expected utility model.

The ATO maintains a system of controls to encourage compliance with tax laws. These are represented by enforcement or punishment policies (e.g. audit activities, penalty provisions); preventive controls (e.g. withholding systems of taxation collection); and administrative efficiency in detecting and policing under-reporting practices. Strader and Fogliasso (1989) suggest that these measures collectively represent a significant contributing factor to the overall level of taxpayer non-compliance, though D'Ascenzo and Polulakis (2002) suggest that misunderstandings prevail regarding the operation of a self-assessment system and associated taxpayer obligations.

The amount of compliance or non-compliance depends on a complex mix of conditions and factors (see Richardson and Sawyer (2001), for a review of such factors). In a number of empirical, experimental studies of US taxpayer behaviour, the influence of the probability of audit on compliance decisions has been found to be highly significant (Chang *et al.*, 1987; Smith and Kinsey, 1987). The evidence in support of this finding is more equivocal when the argument is extended to tax practitioners. In a modelling of taxpayer compliance using tax professionals as subjects, Madeo *et al.* (1987) found that the probability of audit (measured as the likelihood of detection through varying the source of income) was the most significant factor affecting adopted tax positions on contentious tax issues. Kaplan *et al.* (1988), in their study, also identified the probability of audit (manipulated experimentally) as a major influence on the tax advice offered by their tax preparer subjects.

Duncan *et al.* (1989) examined, in an experimental setting, tax professionals' recommendations to taxpayers on reporting positions. In contrast to the findings of the above studies, they found that the change in audit probability had no significant effect on tax practitioners' recommended reporting positions. Part of the explanation for the contrasting results may lie in the extreme levels of variation of audit rates in the studies of Madeo *et al.* (1987) and Kaplan *et al.* (1988) compared with the more modest 10-25 per cent variation in the Duncan *et al.* (1989) study.

The above discussion provides the basis for the following hypothesis to be tested:

H1. The probability of ATO audit detection will influence a tax practitioner's perceived ethical judgments (Audit Risk).

2.2 Materiality

The ethical perceptions of tax agents are also likely to be influenced by the level of financial return. The two dimensions to this materiality factor are:

- (1) the amount of tax involved ("quantitative materiality"); and
- (2) the severity of violation of the tax law ("qualitative materiality"), e.g. whether expenses are arguably deductible or clearly not deductible.

Conventional economic models of tax compliance are based on the assumption that taxpayer reporting behaviour is primarily financially motivated, having regard to the perceived costs and benefits of the action. This expected utility theory, in which people

are regarded as amoral, rational decision makers, was first applied (in explanation of tax evasion) by Allingham and Sandmo (1972). The approach was expanded by Cowell (1985) to take account of the source of income with trade-offs between legal income (subject to withholding tax at source) and illegal income (those sources of income which the revenue authorities find difficult to detect). Within this economic-based theoretical framework, taxpayers/tax practitioners acting on behalf of taxpayers are expected to make compliance decisions that will maximize the value of marginal tax dollars and minimize the risk of penalties (Carroll, 1992). Two of the most significant factors found to influence the compliance decision are, therefore, the individual's level of income and the tax rate, which acting together determine the level of the taxpayer's disposable income.

Hutton (1985) investigated the perceptions of US tax practitioners regarding the impact of the introduction of a number of "new" penalties (imposed on the taxpayer) on professional tax practice. The penalties were specifically directed at aggressive tax planning. That is, the treatment of questionable or contentious items in a tax return in a manner that was clearly not a correct treatment under existing taxation law and its interpretation, having regard to a perceived widespread practice of playing the "audit lottery". The provisions provided penalties for the substantial understatement of tax liability, i.e. the larger the understatement (amount of tax involved), the greater the penalty imposed. Almost 60 per cent of respondent tax practitioners in Hutton's study perceived the understatement penalty legislation as having a strong to very strong effect on their approach to aggressive tax planning.

A similar shortfall penalty regime, with particular focus on "reasonable care" and "reasonably arguable positions" has been introduced in Australia in support of the move towards a full self-assessment income tax system. Although the penalties are imposed on the taxpayer, the tax practitioner is likely to feel the impact of these penalties in the form of damage to client relationships, potential civil liability and loss of professional reputation/challenge to personal and professional ethics. Taxpayers who, because of their high level of income and tax liability, are most at risk in relation to the imposition of such penalties are likely to have a professional tax practitioner prepare their tax returns.

Buttross (1991), in a study of US management accountants with responsibility for income tax compliance, found a statistically significant relationship between the severity of the tax law violation and ethical decision-making. The severity of the tax law was considered important because the law is assumed to establish a base for ethical behaviour. Also of interest, is the question of whether tax practitioners make distinctions between different levels of the law. Violation of the spirit or intent of income tax law, although satisfying the letter of the law, would be expected to result in lower levels of ethical perceptions than would more blatant violations of the substantive provisions.

These considerations lead to the following hypotheses for testing:

- H2.* The dollar amount of a client's tax law violation will influence a tax practitioner's perceived ethical judgments (Amount).
- H3.* The severity of violation of the tax law by a client will influence a tax practitioner's perceived ethical judgments (Severity).

3. Research method

3.1 Subjects

Most tax work in Australia, particularly in relation to tax return preparation work, is performed by registered tax agents (or their employees) who generally have accounting qualifications. Solicitors seldom prepare tax returns and their involvement tends to be in an advisory capacity, or where an adversarial situation has developed between the ATO and the tax agent and his/her client. The concept of a single "tax profession" or tax practitioner is difficult to comprehend. In practice, the term "tax practitioner" covers a diverse group of individuals, business structures and professional groups who provide a range of tax services for their clients. Self-employed and "in-house" accountants, tax advisers, registered tax agents, tax agent franchisees and legal practitioners in the tax arena are all embraced by the term "tax practitioner". This study is limited to those tax practitioners who were registered as tax agents.

The entire population of Western Australian tax agents registered with the Tax Agents' Board comprised the sample frame. A self-reporting questionnaire, described in the next section, was mailed to the 1,960 subjects. After four weeks, a copy of the questionnaire, with a modified covering reminder letter, was mailed to each subject.

3.2 Research instrument

The research being reported on was part of a study conducted to explore both the perceptions of tax agents regarding the ethical environment in which they practice and to investigate the effect of selected variables on ethical decision-making in tax practice. As a consequence, the self-administered questionnaire developed for the study had two primary components. The first part of the instrument, designed to measure the frequency of occurrence and importance of ethical issues in tax practice, was a close-ended question format. The other section, directly relevant to this study, presented two variations of a common scenario to test the effect of selected situational variables (manipulated across respondents on a random basis) hypothesised to influence tax agents' perceived ethical judgments.

Scenarios (vignettes) are considered to have significant advantages over alternative data-gathering techniques in studies of judgment formation on sensitive topics such as ethics research. The key benefit, according to Alexander and Becker (1978, p. 103), is that:

... by employing systematic variation in vignette content, the researcher is able to measure the determinants of respondent opinion more accurately than could be accomplished by the use of direct questioning ...

A potential problem with scenario formats, however, is that of vagueness and generality (Randall and Gibson, 1990). In anticipation of this problem, the aim was to develop realistic scenarios. Accordingly, each of the scenarios involved a specific ethical dilemma that a tax agent might face in a day-to-day situation. Further, each of the scenarios should have been understandable to anyone with a sound technical background in tax matters. The factual statements were followed by several action choices/responses. In relation to the testing of the independent variable "audit risk" there were two primary variations on the first factual scenario presented to respondents. The full version of each of these two variations of the first scenario is at Appendix 1.

A pilot study was conducted in an attempt to increase the reliability and validity of the measures contained in the instrument. It also facilitated a scrutiny of any

ambiguity or lack of clarity in the instructions or wording of the questionnaire, missing/inappropriate questions, confusing response categories, etc. and the appropriateness of the mailing procedure. A small number, seven, of pilot subjects was selected to participate in the pre-test. An attempt was made to achieve the broadest range of respondent types, so as to ensure that the instrument would be understandable across a wide spectrum of the population. Accordingly, subjects ranged from an academic, a tax partner in a Big 5 public accounting firm, through to a part-time sole practitioner with only 20 clients.

Subjects were advised that feedback was being sought on such issues as the length of the questionnaire (time taken to complete) and whether the presented scenarios did involve ethical tax issues. As a result of the pre-test, a number of changes were made to the instrument. The final mailing consisted of the revised questionnaire, a cover letter (which explained the nature of the study, provided general instructions for completing the survey instrument and assured confidentiality of responses) and a stamped pre-addressed return envelope.

This scenario centred on the deductibility of overseas travel expenses (undocumented versus personal expenses/fraud) for an individual taxpayer. This tax issue was chosen for three reasons. First, the use of a deduction issue was anticipated to provide more realism to the case. Research involving CPAs in the US (Westat Survey, 1987) indicated that 70 per cent of tax preparer/client conflicts involving a tax return position were related to a deduction issue. There is no evidence to suggest that the situation in Australia would differ significantly. Second, given the various levels of technical knowledge and experience of tax agent respondents, the issue was designed to be familiar to, and capable of resolution by all respondents. Finally, it provided for a simple differentiation of the severity of the tax law violation: lack of documentation (failure to adhere to the letter of the law) versus potential fraud.

To overcome a possible tax rate effect identified in some experimental studies, i.e. an incentive to report less income as the tax rate increases (Collins and Plumlee, 1991), the income was set at such a level that the tax rate was constant regardless of the action adopted by the tax agent. Manipulation of the independent variables (audit risk, materiality and severity of the issue) was accomplished by varying the information given in the two situations (see Appendix 2 for the range of presented situations) across individual respondents. The aim was to determine the significance of the three independent variables in influencing perceived ethical judgments. This defined 12 possible combinations of scenario 1 according to: size of tax deduction \times type of claim \times audit risk. All tests of hypotheses were, therefore, of a between subject design in order to avoid hypothesis guessing by the respondents.

Respondents were instructed to read the scenario and then to code their specification of the likelihood of taking each of the presented action choices, considered independently, on a seven-point Likert scale. These action choices/responses are identified and described in Table I. The scale ranged from 1 ("definitely would not take this action") to 7 ("definitely would take this action"). The dependent variable was the respondent's likelihood of taking each action choice. To operationalise the testing, the hypotheses were specified with respect to the specific respondent action choices which reflected deontological norms/rules established in the codes of the professional accounting bodies.

Table I.
Scenario action
choices/responses

Action choice response	Action response description
A	Advise the client of your concerns and the relevant requirements under the Income Tax Assessment Act. Take whatever action you are directed to by the client
B	Notify or threaten to notify the ATO if the travel expenses are deducted against your advice
C	Discuss the matter with the client. If you are directed to claim the expenses prepare the tax return deducting the expenses, but refuse to sign the return
D	Deduct the travel expenses and sign the return without consulting the client
E	Discuss the matter with the client. If you are directed to claim the expenses, refuse to prepare the tax return
F	Prepare the tax return leaving out the travel expenses, without informing the client

Action choices A, C and D are considered unethical acts in that they violate responsibilities imposed by income tax law as well as the professional aspects of tax practice addressed in APS 6. Specifically:

16. A member shall in no circumstances become associated with any return or submission on behalf of a client if the member finds that material on which the return or submission is to be based contains incorrect or misleading information or omits material information.

Action choice E is ethical in that it does not violate income tax law or the professional code of ethics:

17. A member who becomes aware of a return or submission being based on incorrect or misleading information ... must immediately discuss the matter with his client and endeavour to persuade the client to correct any misstatement or omission involved and to have the return or submission prepared on a proper basis. If the client fails to do so, the member must not be further associated with that return or submission, and must refuse to act in any capacity with respect to such a return or submission ...

The action choices B and F are not clearly ethical or unethical choices (i.e. "mixed" or "neutral"). Action F is considered, at one level, ethical in that the return is prepared in accordance with the law. However, the lack of discussion with the client taxpayer would violate an "integrity" requirement to communicate to the client unfavourable as well as favourable information and professional opinions and to maintain open, frank and effective communications with their clients. Although action choice B represents the exercise of reasonable professional care, it is contrary to the confidentiality requirements of APS 6:

15. Unless he has a legal or professional duty to disclose, a member must not convey any information relating to a client's affairs to a third party without his client's permission.

4. Data analysis and results

4.1 Response and subjects' demographics

The returned questionnaires provided a usable response rate of 23.6 per cent (409/1,734 from a sample of 1,960 letters sent minus 226 out of frame). This rate lies within the model range of 20-40 per cent for most social science mail surveys (Kerlinger, 1973). It is comparable to response rates of 26.6 and 21.5 per cent as reported by Finn *et al.* (1988)

and Leung *et al.* (1993) in studies of ethical issues in public accounting in the US and Australia, respectively.

Although the credibility of mail survey research findings is considered to be largely a function of response rates, Leslie (1972) suggests that significant non-response bias is unlikely in a situation such as this, where the survey is made of relatively homogeneous populations, i.e. persons having a strong group identity. Further, no significant differences were found between “late” respondents (those whose questionnaires were received after the second mailing) and “early” respondents (those received prior to the first mailing).

Table II contains demographic data for individual respondents. A review of the data indicates that a wide variety of tax agents were represented. The majority of respondents were male (88 per cent), with an average of 17.7 years of tax experience. The respondents’ age distribution was relatively uniform across categories from 31 to 60, with some diminution in the above 60 and below 31 age groups.

Although firm size (based on the number of tax professionals and gross tax fee income) varied substantially, a large percentage of the respondents operated as sole practitioners, practicing either in their own name or through a private company structure (71 per cent). Professional accounting qualifications were held by a large majority (76 per cent), while 40 percent of respondents were members of an independent professional tax association, the Taxation Institute of Australia. A majority of respondents (53 per cent) conduct tax planning, research and tax return preparation, but many (43 per cent) only prepare tax returns.

4.2 Descriptive statistics

Table III shows the observed means for each of the six action choices arising from the manipulations of the three independent variables.

Two general and preliminary observations can be made regarding this data. First, the means for those action choices identified previously as neither ethical nor unethical, i.e. “notify the ATO” (B) and “leave out the expenses without informing the client” (F), congregate around the lower end of the evaluation scale (< 2). This indicates that regardless of the manipulation of the variables, tax agents perceive little likelihood of adopting either of these action choices.

The second observation relates to the apparent strength of the tax agent-client relationship in the adoption of tax reporting positions when the interpretation of the tax law, or its application to the taxpayer’s facts, is unclear. The mean for action choice A, i.e. “Take whatever action you are directed to by the client” remained relatively high (approx. 5) for all manipulations of the variables. It is worth noting that similar data, consistent with a client driven tax preparer-client relationship, were obtained by Schisler (1995), even in the US environment of tax preparer penalties. In contrast to tax practice in Australia where the direct penalty structure applies only to the taxpayer, in the US, a monetary penalty is imposed directly on tax return preparers who fail to exercise a certain degree of care and accuracy (“realistic possibility of being sustained on the merits”) in determining a taxpayer’s tax liability.

4.3 Analysis of variance

To test the hypotheses, the data were subject to univariate analysis of variance (ANOVA) in order to identify any statistically significant effect ($p < 0.05$) on

MAJ 21,5		No.	Per cent
508	<i>Tax practice</i>		
	Sole practice	269	65.8
	Partnership (2 partners)	58	14.2
	Partnership (3 or more partners)	47	11.5
	Partnership ("Big 6")	8	2.0
	Private company	19	4.6
	Tax return preparation service (shop front)	5	1.2
	Other	3	0.7
	Total	409	
	<i>Tax experience (years)</i>		
	Range	3-50	
	Mode	20	
	Mean	17.7	
	<i>Age</i>		
	21-30	43	10.6
	31-40	108	26.5
	41-50	135	33.2
	51-60	81	19.9
	Above 60	40	9.8
	Total	407	
	<i>Dominant tax work</i>		
	Return preparation	174	43
	Tax planning consulting	17	4.2
	All of the above	214	52.8
	Total	405	
	<i>Level of education</i>		
	No tertiary education	35	8.6
Technical college	86	21.2	
Undergraduate/graduate degree	284	70.2	
Total	405		
<i>Gender</i>			
Male	357	88.1	
Female	49	11.9	
Total	406		
<i>Ethics training</i>			
No ethics training	88	21.5	
Professional development	260	63.5	
During tertiary studies	50	12.3	
Other	11	2.7	
Total	407		
<i>Membership of professional bodies</i>			
<i>Accounting associations</i>			
None	54	13.3	
CPA	218	53.8	
ICAA	78	19.3	
CPA and ICAA	28	6.9	
NIA	27	6.7	
Total	405		
<i>Taxation institute of Australia</i>			
Yes	160	39.3	

Table II.
Tax agent characteristics

(continued)

	No.	Per cent	Audit risk, materiality and severity
No	247	60.7	
Total	407		
<i>Firm size</i>			
<i>Tax professionals</i>			
Range	1-120		
Mode	1		
Median	1		
Mean	5.4		
<i>Tax work (per cent)</i>			
0-25	29		
25-50	59		
50-75	114		
75-100	203		
Total	405		
<i>Gross fees (tax work)</i>			
\$0-25,000		25.7	
\$25,000-50,000		10.2	
\$50,000-500,000		49.0	
Above \$500,000		15.1	

Note: The totals vary for some demographic items because a few respondents did not complete particular items

Table II.

Action choice	Amount		Severity		Audit risk		
	0	1	0	1	0	1	2
A	5.87	4.79	5.11	4.77	4.81	4.87	5.13
B	1.50	1.66	1.58	1.56	1.59	1.64	1.51
C	2.53	2.73	2.38	2.88	2.61	2.66	2.61
D	1.69	1.49	1.38	1.81	1.61	1.56	1.61
E	2.89	3.27	2.67	3.46	3.12	3.13	2.97
F	1.69	1.28	1.41	1.59	1.51	1.35	1.61

Table III.
Mean assessments for
scenario attributes

the various action choices as the respective independent variables (audit risk, amount and severity) were manipulated. Separate ANOVAs were required for each action choice, i.e. the analysis attempted to associate the variation in each dependent variable (action choice) with a single independent explanatory variable.

4.4 Testing hypothesis: H1

The probability of audit detection will influence a tax agent's perceived ethical judgments.

To test this hypothesis, three levels of audit probability were manipulated within the alternative factual statements of Scenario 1. The lowest level, corresponding with the overall percentage level of ATO audit penetration (i.e. 1 per cent of all taxpayers), was set at 1 per cent, with higher levels presented as 10 and 50 per cent.

Consistent with the approach of Duncan *et al.* (1989) in their study of the judgment processes of professional tax managers, the aim was to set more "realistic" rates than

had been common in earlier studies. For example, Kaplan *et al.* (1988) only used rates of 10 and 50 per cent whilst a rate of 90 per cent was applied in the study conducted by Chang *et al.* (1987). In determining “realistic” rates for this study, regard was paid to the fact that the respondents were tax agents. Many would, therefore, have been familiar with the ATO audit selection process and been involved in audit activities on behalf of their clients. Their knowledge of actual/normal audit levels, therefore, limited the breadth of believable manipulations.

Accordingly, audit risk manipulation represented the independent variable for testing relevant to this paper. The base level case (coded “0”) provided a “1 per cent chance that the ATO would detect the claim through a random audit process”. In the second treatment (coded “1”), there was a “10 per cent chance of the claim being detected by an ATO random audit process”. In the most extreme manipulation of the audit risk variable (coded “2”), the focus was on the tax agent’s own clients with a correspondingly high risk of audit detection: “There is a 50 per cent chance that the ATO will detect this claim through an audit of all your clients”. The dependent variable was the score on the 1-7 Likert scale in terms of a respondent’s willingness to take each of the presented action choices. These actions had been categorised by the researcher as “ethical” “unethical” or “mixed/neutral”.

Table IV presents the ANOVA results for the independent variable “audit risk”

The results indicate that changes in audit risk/probability (at 1 per cent, 10 per cent and 50 per cent levels) have no significant effect, at the 0.05 level, on tax agents’ perceptions of ethical judgments as represented by the various action choices A-F.

Based on these results, Hypothesis *H1*. cannot be supported for any of the action choices. These findings contrast with those found in other studies (Chang *et al.*, 1987; Madeo *et al.*, 1987; Kaplan *et al.*, 1988), in which audit probability was found to be significantly related to the tax positions that subjects adopted. Those studies, as previously described, did involve variation of audit levels at more extreme levels and used taxpayers rather than tax practitioners as subjects.

The results are, however, consistent with the findings of Duncan *et al.* (1989). Apparently the audit probability at the manipulated levels is not strong enough to affect the tax practitioner’s decision-making, notwithstanding the empirical evidence referred to above which indicates that the reporting positions of taxpayers (particularly those who are risk averse) are influenced by changes in the audit risk.

4.5 Testing hypothesis: *H2*

The dollar amount of a client’s tax law violation will influence a tax agent’s perceived ethical judgments. Two levels of disputed deductions were manipulated for the testing of this hypothesis. The amount of overseas travel expenses manipulation was

Action choice/response	df	Mean square	F	Sig.
A between groups	2	4.069	1.104	0.332
B between groups	2	0.636	0.391	0.677
C between groups	2	0.121	0.031	0.970
D between groups	2	0.0069	0.035	0.965
E between groups	2	1.223	0.254	0.776
F between groups	2	2.267	1.400	0.248

Table IV.
Effect of audit risk

a binary variable specified as either \$400 (coded "0"), a relatively insignificant amount, or \$10,000 (coded "1").

Table V shows the univariate results of the effect of the amount of the tax law violation, as operationalised through the probability of engaging in the various tax return preparation action choices.

The amount of the tax law violation was only significant at the 0.05 level in respect of the neutral ethical action choice F, i.e. "Prepare the tax return leaving out the travel expenses, without informing the client". Although this effect is statistically significant, and intuitively in the expected direction that tax agents are less likely to take this action when the contentious amount is large, the difference in the absolute magnitude of the means is relatively small and is activated from a very low base. For all practical purposes, then, Hypothesis *H2*. cannot be supported on the basis of these results.

4.6 Testing hypothesis: *H3*

The severity of violation of the tax law by a client will influence a tax agent's perceived ethical judgments. The specific issue used as the defacto variable "severity of violation of the tax law" was the deductibility of overseas travel expenses. In the first treatment (coded "0"), the claim represented a situation in which deductible expenses had been incurred but the supporting documentation had not been maintained (substantiation-letter of the law not satisfied). By contrast, in the second version (coded "1") the claim related to legally non-deductible expenses:

The problem, however, is that on the basis of information from another client you are certain that the expenditure relates to personal expenses of Mr Smith's wife. Mr Smith's wife is not associated with the business.

Table VI summarises the ANOVA results of the effect of the "severity" independent variable.

Action choice	df	Mean square	F	Sig.
A between groups	1	7.750	2.108	0.147
B between groups	1	2.589	1.597	0.207
C between groups	1	4.066	1.047	0.307
D between groups	1	3.888	2.003	0.158
E between groups	1	14.853	3.114	0.078
F between groups	1	16.738	10.564	0.001

Table V.
Effect of the amount of
the tax law violation

Action response	df	Mean square	F	Sig.
A between groups	1	11.560	3.153	0.077
B between groups	1	0.0040	0.025	0.876
C between groups	1	24.379	6.363	0.012
D between groups	1	18.490	9.710	0.002
E between groups	1	63.203	13.597	0.000
F between groups	1	3.339	2.064	0.152

Table VI.
Effect of the severity of
the tax law violation

Severity of the tax law violation – essentially lack of documentation versus fraud – was significant at $p < 0.05$ to three action choices: C – “Prepare the return deducting the expenses, but refuse to sign the return” (unethical; $p = 0.012$); D – “Deduct the travel expenses and sign the return without consulting the client” (unethical; $p = 0.002$); and E – “Refuse to prepare the tax return” (ethical; $p = 0.000$). These results indicate that the severity/type of tax law violation does have a significant influence on the ethical perceptions of tax agents in relation to a range of ethical choices available to them in the preparation of a tax return. However, the most likely/“typical” action choice (based on respondent means), i.e. A – “Take whatever action you are directed to by the client” was not similarly influenced by manipulations of the severity variable.

The results for the two action choices presented in this study as neither ethical nor unethical (“neutral/mixed”): B – “Notify the ATO”; and F – “Prepare the tax return leaving out the travel expenses without informing the client” can be excluded from the analysis. These choices had been included on the questionnaire for response completeness. However, as there is no conceptually “right” action choice from an ethical perspective, the interpretation of any results for these choices would merely be speculative.

5. Discussion

5.1 Severity

The results in respect of the independent variable “severity” particularly when considered in conjunction with the means in Table II, provide some support for the expectation that tax agents are more likely to be reluctant to prepare a tax return where the disputed issue represents an unambiguous violation of tax law. That is, where the reporting position is legally deterministic, given the facts and circumstances, rather than a mere lack of documentation (mean responses for action choice E of 2.67 and 3.46, respectively).

These results are consistent with the findings of Buttross (1991) and provide qualified support for Hypothesis *H3*. A perhaps surprising result, though, is that the mean rating of the “fraudulent” position was still below the mid-point score of 4 (action choice E) and above 4 for action choice A. It is possible that subjects did not regard choice A as an unethical option, rather their responses indicated an aggressive versus conservative approach to tax reporting. Although there will always be controversy as to the boundaries of ethical responsibilities, there is general acceptance that a tax agent has a fundamental role as that of client advocate, i.e. that the tax agent acts in the best interest of the client (the taxpayer). Consistent with this role is an incentive to recommend or support reporting positions that are more or less aggressive as the client wishes (Klepper and Nagin, 1989; Johnson, 1993).

Studies at the taxpayer level (Hasseldine *et al.*, 1994; Christensen and Hite, 1997) indicate that income under-reporting and deduction overstating are affected by different variables. For example, and leaving aside non-compliant effects arising from mistake or accidental error, the findings of Thurman (1991) suggest that “guilt” feelings may operate to inhibit deduction overstating (acts of commission) relative to income under-reporting (acts of omission). In social psychology research (Spranca *et al.*, 1991) acts of harmful commission tend to be rated as more immoral or bad decisions than equivalent harmful commissions. In addition, income and deduction situations

will be subject to different structural opportunities to avoid taxation, so much so, that Hasseldine (2000) suggest that research designed to examine taxpayer compliance decisions should study income and deduction decisions separately.

5.2 Audit risk

Perhaps the finding of most practical significance arising from this study is the lack of support for audit risk as an influential variable in tax agents' ethical decision-making. Policy makers and revenue authorities have generally proceeded on the premise that under a self-assessment tax system increasing audit probabilities (or taxpayers' perceptions that audit probabilities/detection are increasing) will encourage taxpayers to adopt less aggressive tax reporting and compliance positions. Empirical research into taxpayer attitudes and audit risk provide support for this basic premise.

In contrast, at least with regard to the situations described in the scenario settings, this research at the tax practitioner level suggests that increasing the likelihood of tax audit activity may not significantly influence decision-making by tax agents when advising their clients. This assumes, of course, that audit levels need to be set at "realistic" rather than "saturation" levels given the limited resources of the ATO and the impact on compliance costs for tax agents and their clients. The consequence is that the efficacy of, and emphasis on, the basic audit function in monitoring and mitigating non-compliant tax behaviour of tax agents under a self-assessment tax system would need to be questioned. Alternative enforcement and compliance strategies would then have to be given greater consideration by tax administrators.

This study does not attempt to extrapolate tax agent perceptions of ethical issues and preferred action choices to ethical/unethical tax agent behaviour. If, however, these results are confirmed in subsequent studies involving different tax issues (including both income and deduction adjustments), tax scenarios and audit probability manipulations, then the strong inference is that tax practitioners may be moderating taxpayer concerns relative to audit risk. It has already been suggested by Erard (1993, p. 194) that audit risk is diminished significantly because of the notion that tax practitioners are more experienced and adept at finding a supportable/arguable basis for sustaining reporting positions:

Tax practitioners undoubtedly fulfil a socially beneficial role in reducing many of the informational and computational barriers to clients with tax laws. However, the results indicate that their use, most especially the use of CPAs and lawyers, is associated with a higher level of non-compliance, which can have negative consequences for both tax equity and tax efficiency.

The overall effect would be to dilute the effectiveness of increased levels of audit probability as an ATO policy measure under a self-assessment system. This is particularly so in a complex taxation environment in which Australian taxpayers increasingly are effectively transferring their taxation obligations, including the filing of accurate annual income tax returns, to tax agents. In such a context, impetus may be given to the introduction of a new penalty structure in Australia to govern both taxpayers and tax agents in relation to positions taken on tax return preparation.

Currently, under Australian tax law taxpayers are vicariously liable for a failure by their tax agents to exercise "reasonable care" or, in certain situations, to have adopted "reasonably arguable" reporting positions, when providing tax advice or preparing returns. Accordingly, they are liable for a penalty should there be a shortfall in

the amount of tax which arises. A taxpayer does have the right to recover from a tax agent any additional penalty tax or interest imposed, but only in circumstances where the taxpayer can prove negligence on the part of the tax agent (Section 251M of the Income Tax Assessment Act, 1936).

In conjunction with the National Review's recommendations for "safe harbour" legislation, and the drafting of a code of practice for tax agents, to protect clients from penalties arising from errors by their tax agents, consideration could be given to legislating for tax return preparer penalties similar to those introduced in the US in 1989. As currently applied, these penalties are directed to "unrealistic positions" adopted by tax return preparers. In essence, under this penalty regime US tax return preparers are required to undertake reasonable enquiries and to avoid positions that subject the client to penalties.

A perceived benefit of the stricter penalty regime would be the "encouragement" offered to tax agents to provide more positive directions to clients when recommending reporting positions to be adopted. Kinsey (1987), admittedly prior to the introduction of US preparer penalties, in a survey of Chicago tax practitioners had found that the basic reporting procedure of most respondents was to "outline the options and leave it to the clients to decide". This approach is mirrored in the action choice responses shown in Table I, with all mean responses to the action choice: "Take whatever action you are directed to by the client" exceeding 4.5 for each situation and for the manipulation of both of the variables: audit risk and severity.

There is, however, another aspect to be considered in the public policy debate as to whether "incorrect return penalties" should be imposed at the tax agent level. If the tax profession is to fulfill the "socially beneficial" role ascribed to it by commentators and the ATO by facilitating a reduction of taxpayers' uncertainty as to their tax obligations, then the introduction of tax preparer penalties might be counter-productive. This is particularly relevant where the issues are unambiguous and legally deterministic. In this environment taxpayers who engage tax agents to prepare their tax returns would incur two types of cost. One would be the cost of compensating the tax agent for his/her time. The other, and additional, cost would represent a "risk premium" to cover the possible imposition of preparer culpability penalties for endorsing inaccurate/otherwise non-compliant returns, or those returns which contain issues likely to be challenged by the ATO.

In relation to the less complex/unambiguous returns the "risk premium" to be borne indirectly by the individual taxpayer as part of the tax return preparation fee may be disproportionately high. This is because the preparer would not be able to mitigate penalties imposed for undetected non-compliance such as the omission of bank interest. In the case of more complex returns, there is likely to be disagreement between a well-informed tax agent armed with a "reasonable argument/reasonably arguable" position and the ATO (with the courts as the final arbiter), as to the correct interpretation or the application of the statute or case law to the particular facts. Here, the severity of any penalty imposed will be diminished in relative terms. It is in these circumstances and in regard to the more complex returns, where the revenue is most at risk, that clients will be more likely to be amenable to bearing a "risk premium". Certainly, it could be justified on economic grounds alone.

Tax preparer penalties may, therefore, discourage the use of tax agents to prepare returns and provide informed tax advice, safe harbour provisions

notwithstanding, in relation to that very range of clients that it is in the best interests of the ATO, and the efficient operation of the tax system generally, to foster an ongoing client-tax agent relationship. These “at risk” client taxpayers are likely to lack the time, knowledge or financial sophistication to be informed adequately as to their tax obligations.

6. Conclusions and limitations

This research was set against the background of a focus on the increasing role of tax agents in the preparation of tax returns and the provision of professional tax advice under a tax system based on self-assessment principles.

In considering the conclusions to be drawn, it should be borne in mind that the study represents only a “snapshot” of tax agent responses at a time when both the profession and the tax system are currently under review and subject to major and ongoing changes. The study necessarily makes assumptions about the current role of the tax agent and their anticipated conduct. An important extension to this study would be the development and implementation of longitudinal measures, preferably on a national basis, to track changes in perceptions over time.

Based on overseas empirical research into taxpayer attitudes towards audit risk, it was hypothesised that tax agents would also be influenced by the likelihood of audit action in their perceptions of decision-making in ethical situations. However, the results suggest that increasing levels of probability of audit (within realistic levels) do not significantly affect tax agents’ perceived ethical judgments. This lack of empirical evidence has important implications for the formulation of ATO audit policy to underpin the self-assessment tax system in Australia.

It may be that Australian tax administrators would be encouraged to push for the introduction of a US style tax agent penalty structure in an attempt to develop a more “conservative” approach on the part of tax agents in the adoption of reporting positions on contentious issues and with respect to the adequacy of information disclosure. However, by raising the stakes for tax agent decision judgments under such a system the inevitable consequence will be a strain on the client advocacy role of the tax agent. The general acceptance of the tax agent as a key player in the effective administration of a voluntary self-assessing tax system will then be put at risk.

Accordingly, the preferred tax compliance approach for the ATO may be to reduce its focus on the existing enforcement activities that are based primarily on an audit function with the threat of legal sanctions and penalties. More emphasis and resources could then be directed to “positive” tax enforcement strategies such as public education campaigns, identifying and targeting sub-groups of “at risk” tax agents/clients and the further development of tax agent support mechanisms.

The primary limitation associated with scenario research is the possibility of a lack of task realism. Although the scenario approach lends itself to manipulation of selected independent variables, realism and the ambiguity which often characterise tax agent deliberations may have been sacrificed for controllability. The exploratory nature of the research also adds potential problems, given that the research instrument was designed for this particular study and has not been validated externally. Validation could be achieved by longitudinal applications of the same instrument. Furthermore, the responses may not extend to scenarios based on other

tax issues, or which relate to clients exhibiting different characteristics and needs. Additional research, using different scenarios should be undertaken to overcome the possibility that the results are mere artefacts of the particular scenarios used in this research.

Future research will also be needed to investigate whether and/or to what extent situational variables such as audit risk interact with characteristics and personality traits of the tax practitioners themselves to influence their ethical perceptions and judgments. Relevant attributes for study may include tax agents' experience, level of technical knowledge, ethical predispositions, attitudes towards risk and perceptions of the equity and fairness of the tax system.

The final caveat is that the findings cannot be generalised to other population groups in the tax environment, beyond Australian tax agents. This study does, however, provide a methodology for researching the influence of situational variables such as audit risk on ethical decision-making. Longitudinal research, preferably on a national basis, and comparative international research is needed so that comparisons can be made with the results of this study before any general hypotheses can be formulated. Further, the extent to which the results here are applicable to other groups of tax professionals, e.g. in-house corporate tax accountants and lawyers, also is not known. Additional study is required in order to determine and evaluate whether these groups differ in their ethical perceptions of dilemmas which arise in the preparation of tax returns and in transacting other matters with the ATO on behalf of clients.

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Further reading

National Review of Standards for the Tax Profession (1994), *Tax Services for the Public*, Australian Government Publishing Service.

Appendix 1

Scenario: factual situation 1

You are preparing the income tax return for an individual sole trader, Robert Smith, who manufactures mining equipment. Sales and taxable income, without consideration of the following item are \$300,000 and \$85,000, respectively.

Robert Smith is a new client, but to the best of your knowledge he has always filed an accurate income tax return. You are concerned about a proposed deduction for expenses of \$400 associated with a trip to Europe undertaken by the client to review existing marketing and distribution arrangements for the equipment. You are certain the expenditures were actually incurred and that they are legitimate business expenses. The problem, however, is that Robert Smith cannot reconstruct accurately the expenses and has not kept any supporting documentation (e.g. travel diary, hotel receipts, etc.).

There is a 1 per cent chance that the ATO will detect this claim through a random audit process.

Scenario: factual situation 2

The same introductory facts are presented as in Situation 1 above. In this situation, however, the expenses were actually incurred and Robert Smith can reconstruct accurately the expenses. He has kept full supporting documentation (e.g. travel diary, hotel receipts, etc.). The problem, however, is that on the basis of information from another client you are certain that the expenditure relates to personal expenses of Mr Smith's wife. Mrs Smith is not associated with the business.

There is a 1 per cent chance that the ATO will detect this claim through a random audit process.

Appendix 2. Research scenario: independent variable manipulations

Independent variable: dollar amount

Level 1	\$400 taxable income reduction	(0) ^a
Level 2	\$10,000 taxable income reduction	(1)

Independent variable: severity of tax issue

Level 1	Undocumented travel expenses (Factual situation 1, Appendix 1)	(0)
Level 2	Personal expenses treated as overseas travel expenses (Factual situation 2, Appendix 1)	(1)

Independent variable: audit risk

Level 1	One per cent chance of the claim being detected by an ATO random audit	(0)
Level 2	Ten per cent chance of the claim being detected by an ATO random industry audit	(1)
Level 3	Fifty per cent chance of the claim being detected by an ATO audit of the tax agent's clients	(2)

Note: ^aRepresents the code for data recording

Table AI.

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