Restoring Professionalism to the Professions

By Gene Steuerle

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At a recent Tax Analysts session on the administration of the tax laws for large and midsize businesses, former IRS Commissioner Larry Gibbs spoke out, as he has done frequently, on the importance of professionalism. His concerns relate to the fundamental issue of whether we can count on professionals — largely accountants and lawyers — to maintain a viable tax system through their allegiance to high professional standards.

If recent history serves as any guide, the answer may well be no. The recent pervasive backdating of stock options involved thousands of executives in leading corporations. It could not have been accomplished without the widespread collusion of many of the nation's "professionals," who, if they advised and accounted for those efforts at all, did so in obscure footnotes that called minimal attention to what was going on. While only some of the questionable actions surrounding backdating relate to the tax laws, the backdating collusion serves as a strong warning that professionalism is threatened.

Is it lacking? Of course not. Most professionals do not engage in illegal actions and do avoid even shady behavior. Many accountants and lawyers have forgone business that would have forced them to lower their standards. Problems with backdating stock options and selling questionable tax shelters — again, sometimes involving illegal, sometimes merely shady, actions — were exposed and fought in part by members of the professional classes.

Still, there is a large cost to society when professionals abandon professionalism. Take accounting. Accounting is more than simply recording or bookkeeping. Good accounting promotes transparency, holds people responsible, and reports to interested parties the information that they are entitled to receive in the most usable manner possible. Good accounting not only protects people and maintains their rights, it also helps allocate resources to their highest and best use, expanding the productive capacity of the economy along the way.

Let's not mince words: Accountants and lawyers who help spread problems like the backdating of stock options and the selling of highly questionable tax shelters are harming the nation. Even if their activities were entirely legal, it's not good for the public. It's not good for the professions, either. You can legitimately say that many people engage in harmful behavior, whether it's advertisers who help sell bad products, producers who give us trash TV, or those who overwhelm our e-mail networks with spam. But those comparisons only increase the need for high professional standards. Allegiance to high standards adds to the integrity of professional classes, gives identity to their members, and, along the way, serves the people.

It is a mistake to count on "professionals" to maintain standards without a decent set of incentives in place. I base this on the presumption that most professionals want to be professional, but that their natural predilections must be reinforced. When significant portions of the accounting or legal professions engage in activity detrimental to the nation, it tells me less about their morality than about the inadequacy of the incentive structure in place.

What are some elements of an incentive structure?

First, training. Professionalism must be taught in schools where accountants and lawyers are first trained. It cannot be presumed. The potential approbation of teachers and classmates is a deterrent to bad behavior.

Second, censure. The professions themselves must at times censure their own members and embarrass those who would lower their standards. Groups like the American Bar Association and the American Institute of Certified Public Accountants must continually oppose the constant pressure to convert into nothing more than trade associations attempting to promote the self-interests of their members. When detrimental practices such as the widespread backdating of stock options or the selling of questionable tax shelters become pervasive, those associations must reexamine themselves to determine how it happened.

Third, consequences. Here's a simple one that could go a long way. The IRS should announce that those tax preparers and accounting firms found to have higher rates of noncompliance for audited clients will be subject to higher rates of audit for a period of time for existing and future clients.

In fact, the IRS should engage in that type of auditing even if it doesn't announce it, since audits should be focused on those companies most likely to be in noncompliance. One indicator of likely noncompliance is illegal behavior in the past.

Announcing to the public such a reasonable method of allocating audit resources would in turn create a new dynamic within the accounting and law firms themselves.

Consider the incentives facing professionals in accounting firms right now. The accountant who pushes the envelope on what is legal might be better able to attract clients. The firm's top management has a strong incentive to try to hold onto large clients who might be engaged in shady behavior and who clearly don't want their accountants to make what is going on more transparent to all the parties with legitimate interests (which include not just government agencies, but partners and stockholders). Those within the firm who hold onto higher standards find their own jobs threatened if they speak too loudly, object to the behavior of some of the partners, or lose a rich client.

But suppose we can turn the incentives upside down. When they potentially increase the audits for their firm's clients, those engaging in aggressive behavior become more of a liability to the firm. Now they threaten the ability of other partners to hold onto clients who might not want to face a higher audit probability simply because they hired an aggressive accounting firm. Those who promote high professional standards will be empowered. Their own well-being, as well as that of the firm, is enhanced when they work to reduce aggressive practices by others in the firm. Now incentives are structured to work in favor of, rather than against, professionalism.

An Invitation

I have mentioned only a few ways that incentives might be restructured. Perhaps the Securities and Exchange Commission should consider actions similar to those I suggest for the IRS. Perhaps there are better ways of determining IRS consequences than I have suggested. I invite the readers of *Tax Notes* to jump into the debate and use this essay as a catalyst for the discussion. Two responses, however, are inappropriate: that high professional standards are not good for the nation and that Gibbs's concerns about declining professionalism are not well grounded.