

## Creating Auditor Independence

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Fifteen years ago, in 1997, when I first published a paper on auditor independence, the American Institute of CPAs' Code of Conduct required that auditors "shall be free of conflict of interest." In 1984, Chief Justice Warren Burger argued that auditors were required to "maintain total independence from the client at all times." Yet in our 1997 paper, Kimberly Morgan, George Loewenstein, and I argued that massive conflicts of interest existed in the structure of the auditing industry and that auditors failed the independence test suggested by Chief Justice Burger. Today, more than a decade after presenting our argument to the SEC in 2000, after the collapse of Enron and Arthur Anderson, and after the ineffective compromise created by Sarbanes Oxley, our conclusion remains the same: Auditors are not independent in the United States, and they are affected by conflicts of interest.

Fifteen years ago, we also highlighted the importance of understanding the psychological aspects of conflict of interest. We argued that, too often, decision makers view conflict of interest as simply an intentional choice between meeting one's obligations versus acting in a self-serving manner. This view of conflict of interest as exclusively intentional leads to the theory that moral suasion or sanctions can prevent the destructive effects of conflict of interest.

Undeniably, intentional corruption occurs. However, it is much more likely that auditors will be affected by self-serving biases that lead them, like all of us, to view data in a light that reflects what they want to see. Due to the often-subjective nature of accounting and the close relationships that exist between accounting firms and their clients, even the most honest auditors can be unintentionally biased in ways that mask a client company's true financial status, thereby misleading investors, regulators, and even the company's management.

Research convincingly documents that our desires influence the way we interpret information, even when we are trying to be objective and impartial. As a result, most of us think we are better-than-average drivers, have smarter-than-average children, and choose stocks or investment funds that will outperform the market—even when there is clear evidence to the contrary. Unintentionally, we discount facts that contradict the conclusions we want to reach, and we uncritically accept evidence that supports our positions. Unaware of our skewed information processing, we erroneously conclude that our judgments are free of bias.

Experiments going back 50 years have demonstrated the power of self-serving biases. In one famous study, Babcock, Loewenstein, Issacharoff, and Camerer had participants simulate a negotiation between lawyers for a plaintiff and a defendant. Pairs of

participants were given the same police and medical reports, depositions, and other materials from a lawsuit involving a collision between a motorcycle and a car. The pairs were asked to try to negotiate a settlement to be paid by the plaintiff to the defendant. They were told that if they couldn't reach a settlement, a judge would decide the amount of the award, and both parties would pay substantial penalties. Before negotiating, the participants were asked to predict the amount the judge would award the plaintiff if the negotiation failed. Participants were assured that the other party wouldn't see his or her estimate and that the estimates would not influence the judge's decision. Participants were also given incentives to be accurate. Nonetheless, on average, study participants representing the motorcyclist plaintiff predicted their side would receive awards about twice as large as those representing the defendant predicted. My work with Don Moore and Lloyd Tanlu shows that actual auditors will be more likely to conclude that the accounting behind a firm's financial reports complies with GAAP if they are working as the firm's auditor than if they are not.

When we first presented this work in the early part of the new millennium, the psychological research community generally responded as follows: "We already know this, and we knew it a long time ago." Essentially, they were saying that psychological research had long shown that people who have a self interest in seeing data in a particular direction are no longer capable of independence. In other words, we were accusing auditors of being human. Meanwhile, members of the accounting field treated our results with disdain, since they assumed that auditors were fully independent. This group included the major accounting firms, accountants in academia, and, as shown by their inaction, regulators. I believe this group could only see bias as an intentional process; and because they viewed auditors as honest, they assumed this made auditors immune from bias.

Our current institutions prevent true auditor independence from occurring in the United States. Characteristics that destroy the possibility of independence include the fact that:

- 1) auditing firms have incentives to avoid being fired and incentives to be rehired,
- 2) auditors profit greatly from selling non-audit services to their auditing clients, and,
- 3) individual auditors often end up taking jobs with the client firm.

As long as these factors are present, auditor independence will not exist in our country. Yet the minimal steps necessary to create auditor independence are clear:

- 1) Auditors should be hired under fixed contracts that stipulate true rotation of both individual auditors and the auditing firm. During the time period specified in the contract, the client should not be able to fire the audit firm. In addition, the client should not be allowed to rehire the auditor at the end of the contract (for a legally specified amount of time).

- 2) When a client changes auditors, personnel working on the audit for the outgoing auditing firm should not be allowed to move to the new auditing firm to resume work on the same client.
- 3) Auditors should not be allowed to provide any non-audit services.
- 4) The auditing personnel for a particular client should be barred from working for the client for a specified period of time.

Opponents of audit reform will be quick to note, correctly, that these recommendations will create costs for audit firms and their clients. These opponents will call for cost/benefit analyses before changes are made, knowing that conclusive, undisputed empirical evidence on auditor bias will be somewhere between extraordinarily difficult to impossible to create. My reaction is that the choice should not be between the status quo (which the auditing industry has invested many millions of dollars in lobbying efforts to create) and the reforms being proposed. Rather, the choice should be between whether our society wants independent audits or whether it does not. If we do want independent audits, it is time to recognize that, without a massive overhaul of the existing system, this goal will elude us. Society is currently paying enormous costs without getting the very service that the industry claims to provide: independent audits.

Consider the following two options aimed at achieving auditor independence:

- 1) Auditors are prohibited from establishing durable, long-term cooperative partnerships with their clients, from providing non-audit services to their clients, and from taking jobs with their clients.
- 2) After a variety of incentives that lead auditors to want to please their clients have been institutionalized, a complex set of legislative and professional incentives are put in place in an attempt to counteract the corrupting influences created by the auditors' underlying desire to please their clients.

When I show these two options to executive audiences, they say that the former option obviously makes more sense than the latter. Yet, for decades, we have chosen the latter; an illogical, politically motivated arrangement.

The auditing industry has avoided responding to the obvious arguments that my colleagues and I have made as far back as our 1997 article and in my 2000 testimony before the SEC. The industry has spent tens of millions of dollars to block the creation of auditor independence in the United States. Only recently, the academic accounting audience has become open to the obviousness of our work, as indicated by the fact that I was the invited keynote speaker at the 2011 meeting of the Management Accounting section of the American Accounting Association. It is time for policymakers to change as well. It is time for you to take the actions needed to create auditor independence in this country—something that has been absent for far too long. As the financial disasters that occur on a regular basis suggest, the failure to create auditor independence has

inflicted very high costs on society. The steps we need to take to address the problem are clear, and I urge you to act in a forceful manner.

### **Sources for the Arguments Presented:**

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