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There are many practical difficulties involved with imposing an auditor rotation requirement for American public companies. Those difficulties are well known and have been discussed at length in several of the comments submitted to the PCAOB over the past several months.

Whether the benefits to auditor independence of imposing a rotation requirement would outweigh these costs is not clear. Unfortunately, we have little experience with auditor rotation and therefore no definitive empirical studies indicating whether costs outweigh benefits. That makes the decision whether to impose a rotation requirement and, if so, in what form, a difficult one.

I do not opine on that ultimate question.

What I do want to emphasize is the pervasive nature of the self-serving bias that afflicts everyone, including trained auditors. The nature of that bias leads me to conclude that the PCAOB should always be looking for ways to increase independence.

People do not wish to admit to themselves or others that they are subject to self-serving biases, and yet they are. The self-serving bias means simply that even when people are trying to be objective and to act in good faith, how they gather, process, and even remember information is affected by their own perceived best interests. The effect may be subtle and often subconscious, but it is often there and has a profound impact on conclusions that people reach and actions that they take.

Consider judges. They are paid to be impartial. Impartiality is the essence of the judicial function. Justice Scalia has emphatically taken the position that he can socialize with parties before the Supreme Court and still remain completely impartial with no need to recuse himself from those cases. Yet, there are now many, many empirical studies using a wide variety of methods that demonstrate clearly that judges' political views affect their judicial decisions, at least subconsciously.[1]

[1] *See* Orley Ashenfelter et al., *Politics and the Judiciary: The Influence of Judicial Background on Case Outcomes*, 24 J. LEGAL STUD. 257 (1995) (studying influence of judges' attitudes on civil rights cases); EILEEN BRAMAN, LAW, POLITICS & PERCEPTION: HOW POLICY PREFERENCES INFLUENCE LEGAL REASONING 4-5 (2009); James J. Brudney et al., *Judicial Hostility Toward Labor Unions? Applying the Social Background Model to a*

Consider physicians. When surveyed , only five percent of physicians believed that benefits provided by pharmaceutical companies could possibly affect their prescribing behavior.[2] Yet numerous studies show that financial interests subconsciously affect physician behavior. Physicians do prescribe drugs more often after receiving gifts from pharmaceutical companies.[3] Physicians who have a financial interest in MRI, CT, or similar equipment refer their patients for those tests more often—often four times or more as often—as physicians who have no such interests, and they tend to charge more for the tests as well.[4]

Celebrated Concern, 60 OHIO ST. L.J. 1675, 1761 (1999) (finding numerous personal and political background factors that affected judges' decisions in cases involving unions); Frank B. Cross & Emerson H. Tiller**,** *Judicial Partnership and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals*, 107 YALE L.J. 2155, 2175 (1998) ("Partisanship clearly affects how appellate courts review agency discretion."); Lee Epstein et al., *Ideology and the Study of Judicial Behavior, in* IDEOLOGY, PSYCHOLOGY & LAW 705 (Jon Hanson, ed. 2012) ("…explanations of judicial behavior that fail to incorporate ideology are incomplete at best."); Joshua Furgeson & Linda Babcock, *Legal Interpretation and Intuitions of Public Policy, in* IDEOLOGY, PSYCHOLOGY & LAW 684, 695 (Jon Hanson, ed. 2012) ("We believe judges' decisions can be explained by motivated reasoning and the associated cognitive biases in processes used to search for, evaluate, and retrieve information. This biased processing can cause judges to unknowingly conflate seemingly necessary legal outcomes with the policies they simply prefer."); Erick D, Knowles & Peter H. Ditto, *Preference, Principle, and Political Casuistry, in* IDEOLOGY, PSYCHOLOGY & LAW 341, 357 (Jon Hanson, ed. 2012) ("Legal scholars have long noted the tendency for political ideology to influence even the highest level of judicial reasoning."). Deborah Jones Merritt & James J. Brudney, *Stalking Secret Law: What Predicts Publication in the United States Courts of Appeals*, 54 VAND. L. REV. 71 (2001) (reporting study finding that political affiliation helped predict votes in labor-management disputes dispositions); Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 813 (2008) (finding significant differences between voting of Republic judges and Democratic judges); Richard E. Redding & N. Dickon Reppucci, *Effects of Lawyers' Socio-political Attitudes on Their Judgments of Social Science in Legal Decision Making*, 23 LAW & HUM. BEHAV. 31, 43-48 (1999); Richard L. Revesz, *Congressional Influence on Judicial Behavior? An Empirical Examination of Challenges to Agency Action in the D.C. Circuit*, 76 N.Y.U. L. REV. 1100 (2001) (providing evidence linking political affiliation and ideological preferences of judges to judicial outcomes); David B. Spence & Paula Murray, *The Law, Economics, and Politics of Federal Preemption Jurisprudence: A Quantitative Analysis*, 87 CALIF. L. REV. 1125, 1195 (1999) (finding in empirical study that decisions about federal preemption in environmental cases are the result of "actions of (partly) ideologically-motivated federal judges"); CASS R. SUNSTEIN ET AL., ARE JUDGES POLITICAL?: AN EMPIRICAL ANALYSIS OF THE FEDERAL JUDICIARY 3, 45 (2006).

[2] James P. Orlowski & Leon Wateska, *The Effects of Pharmaceutical Firm Enticements on Physician Prescribing Patterns,* 102 CHEST 270 (1992).

[3] *Id.*

[4] *See, e.g.,* B.J. Hillman et al., *Frequency and Cost of Diagnostic Imaging in Office Practices—A Compensation of Self-Referring and Radiologist-Referring Physicians,* 323 N. ENG. J. MED. 1604 (1990); B.J. Hillman et al., *Physician Utilization and Charges for Outpatient Diagnostic Imaging in a Medicare Population*, 268 JAMA 2050 (1992); M. Jacobsen et al., *How Medicare's Payment Cuts for Cancer Chemotherapy Drugs Changed Patterns of Treatment,* 29 Health Affairs 1391 (2010); J. Mitchell, *Urologists' Self-Referral for Pathology of Biopsy Specimens Linked to Increased Use and Lower Prostate Cancer Detection,* 31 HEALTH AFFAIRS 741 (2012); J.M. Mitchell, *The Prevalence of Physician Self-Referral Arrangements After Stark II" Evidence from Advance Diagnostic Imaging,* 36 HEALTH AFFAIRS 415 (2007); J.M. Mitchell & E. Scott, *Physician Ownership of Physical Therapy Services: Effects on Charges, Utilization, Profits, and Service Characteristics,* 268 JAMA 2055 (1992); B.R. Shah et al., *Association Between Physician Billing and Cardiac Testing Patterns Following Coronary Revascularization,* 306 JAMA 1993 (2011); J.B. Shreibati & L.C. Baker, *The Relationship Between Low Back Magnetic Resonance Imaging, Surgery, and Spending: Impact of Physician Self-Referral Status,* 46 HEALTH SERVICE RESOURCE 1362 (2011). For a lengthy discussion of these and other studies, *see* Christopher Robertson et al, *Effect of Financial Relationships on the Behaviors of Health Care Professionals: A Review of the Evidence,"* Arizona Legal Studies Discussion Paper No. 12-30 (August 2012).

Accountants also prefer to believe that they are above the influence of self-interest. In 2000, an AICPA official testified before the SEC: "We are professionals that practice by the highest moral standards. We would never be influenced by our own personal financial well being." However, the evidence is compelling that, being human, accountants, including when they act in their role as auditors, are affected by the self-serving bias.

The following is an excerpt from a draft of an article that I wrote which was later published in the Northwestern University Law Review:[5]

> [People] tend to see what they want to see because their perceptions and judgments are heavily influenced by self-interest.[6] For example, proponents of candidate A are likely to conclude that he won the debate with candidate B; candidate B's proponents will likely perceive that she won the same debate.[7] And fans of opposing football teams are likely to leave the game with each group thinking that the referees were partial to the other team.[8] In one set of experiments, college and law students were given basic information about a tort case and asked to play the role of plaintiff or defendant while negotiating a settlement. Students were asked to specify an amount that would be a fair settlement. In just the small amount of time it took to read the packet, students began to identify with their assigned role as plaintiff or defendant. That identification and the accompanying self-serving bias led subjects acting as plaintiffs to suggest a much higher fair settlement value than those acting as defendants.[9]
>
> Accountants are subject to the self-serving bias in terms of what they perceive, how they remember, and what judgments they make. This has been confirmed in studies involving accountants serving no audit roles.[10] For example, when accountants act in a litigation support role, despite a professional responsibility to act objectively, they favor their clients' economic interests and will provide a higher estimate of an inventory destroyed by fire if hired by the plaintiff and a lower estimate if hired by the defendant.[11] Therefore, it is not surprising that studies also show that if there is any question as to the appropriate outcome the auditor tends to favor the client,[12] and even if there is a conflict between client and

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[5] Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation,* 95 NW. U. L. Rev. 133 (2000). Footnotes 6 through 16 below were all contained in this article.

[6] *See* George Loewenstein, *Behavioral Decision Theory and Business Ethics: Skewed Trade-Offs Between Self and Others,* in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 214, 221 (David M. Missick & Ann E. Tenbrunsel, eds 1996)[hereinafter Loewenstein, *Skewed Trade-Offs*]("…people tend to conflate what is personally beneficial with what is fair or moral.").

[7] *See, e.g.,* Robert P. Vallone, et al., *The Hostile Media Phenomenon: Biased Perception and Perceptions of Media Bias in Coverage of the Beirut Massacre,* 49 J. PERSONALITY & SOC. PSYCHOL. 577 (1985)(showing that opposing groups on political spectrum each thought that the media had been biased in favor of their opponent).

[8] *See* Albert H. Hastorf & Hadley Cantril, *They Saw a Game: A Case Study*, 49 J. OF ABNORMAL & SOC. PSYCHOL. 129, 131 (1954)(showing that fans of different teams watching a replay of a football team tended strongly to believe that the other team had committed more penalties than their own).

[9] *See* George Loewenstein, *et al., Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135, 151.

[10] *See* C. Bryan Cloyd & Brian C. Spilker, *The Influence of Client Preferences on Tax Professionals' Search for Judicial Precedents, Subsequent Judgments and Recommendations*, 74 ACCT. REV. 299, 301 (1999) (finding that after studying certain provided precedents, one-half of accountant subjects recommended a postion known to be favored by their clients, even though a panel of experts concluded that there was only a 14% chance that the position would be sustained if challenged); Andrew D. Cuccia, Karl Hackenbrack & Mark W. Nelson, *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 ACCT. REV. 227, 243-44 (1995)(finding self-serving bias in tax context).

[11] Lawrence A. Ponemon, *The Objectivity of Accountants' Litigation Support Judgments,* 70 ACCT. REV. 467, 484 (1995).

[12] *See* Steve Salterio & Lisa Koonce, *The Persuasiveness of Audit Evidence: The Case of Accounting Policy Decisions*, 22 ACCT., ORGS. & SOC'Y 573, 583-85 (1997)(finding that if precedents all point in one direction, the auditor will go that way, but if they are conflicting auditors will tend strongly to favor client's preferred position,

auditor as to the appropriate outcome, the client is more likely to get its way if it is in good financial shape.[13] In other words, if the auditors believe that the client is unlikely to fail and thus they are unlikely to be sued, they are more likely to make inappropriate concessions than if they fear that they will be sued. The auditors' self-serving interests may weigh heavily in the calculation:

> . . . whenever individuals face tradeoffs between what is best for themselves and what is morally correct, their perceptions of moral correctness are likely to be biased in the direction of what is best for themselves. . . . . [I]t seems likely that the judgments of auditors, who ostensibly represent the interests of shareholders but are hired (and fired) by the people they audit, are likely to be blinded to some degree by the incentive for client retention.[14]

Bazerman agrees, arguing that because of the self-serving bias, "it is psychologically impossible for auditors to maintain their objectivity; cases of audit failure are inevitable, even from the most honest of firms."[15] He gives the Phar-Mor audit failure as an example.[16]

The self-serving bias affects ethical decisionmaking as it does all other types. The following excerpt is from a textbook that I wrote with my colleague John Allison:[17]

> Perhaps the most influential of the heuristics and biases discussed in this chapter is the *self-serving bias*, the tendency we have to gather information, process information, and even remember information in such a manner as to advance our self-interest and support our pre-existing views. Bazerman and colleagues observe that teaching ethics in the traditional way in business schools will not have an impact on this bias.[18] It is imperative that students be educated about the self-serving bias because even when people try their hardest to be fair and impartial, their judgments are inevitably shaded by it. For example, when A, B, and C are each asked how much credit they each deserve for a joint project that they successfully completed at work, their allocations will typically add up to around 140% rather than just 100% because in each of their minds they were more responsible for the success than an objective observer would likely have concluded.

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and noting that the finding "does suggest that conflicting precedents provide the basis for the auditor to side with the client which, in turn, may give the appearance of a lack of independence.").

[13] *See* Michael C. Knapp, *Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure,* 60 ACCT. REV. 202 (1985)(also finding clients are more likely to get their way when the issue in conflict is not dealt with precisely by technical standards); Carolyn A. Windsor & Neal M. Ashkanasy, *The Effect of Client Management Bargaining Power, Moral Reasoning Development, and Belief in a Just World on Auditor Independence,* 20 ACCT., ORGS. & SOC'Y 701, 711 (1995)(finding more acquiescence by auditors if client is in strong financial shape).

[14] *See* Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self- Serving Biases*, 11 J. ECON. PERSP. 109, 121-22 (1997). *See also* George Loewenstein, *Behavioral Decision Theory and Business Ethics: Skewed Trade-Offs Between Self and Others,* in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 214, 215 (David M. Messick & Ann E. Tenbrunsel, eds 1996) (concluding that "…managers put very little weight on the effect of their decisions on other parties, except insofar as those effects have repercussions for their own well-being").

[15] MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 2 (4th ed. 1998). *See also* Max Bazerman, et al., *The Impossibility of Auditor Independence,* SLOAN MGMT. REV., June 22, 1997, at 89 (making the same point); Mark E. Peecher, *The Influence of Auditors' Justification Processes on Their Decisions: A Cognitive Model and Experimental Evidence,* 34 J. ACCT. RES. 125, 127(1996) ("… even auditors who try to remain objective in spite of justifiee preferences probably cannot ignore known preferences of justifiees [such as their superiors, their clients, and the profession at large]").

[16] *See* BAZERMAN, *supra*, at 101 (concluding that instead of being guilty of intentional manipulation, Coopers & Lybrand "may have been guilty of the motivational bias of egocentrically interpreting and searching for data in order to maintain the client relationship).

[17] JOHN R. ALLISON & ROBERT A. PRENTICE, BUSINESS LAW (13th ed., 2012). Footnotes 18 to 26 are from that textbook.

[18] Max Bazerman et al., *Why Good Accountants Do Bad Audits* 80 HARVARD BUSINESS REVIEW 97 (Nov. 2002).

Is it possible that Andy Fastow believed that he deserved the millions of dollars he took out of the Enron special purpose entities (SPEs) in exchange for his "creative" efforts in taking debt off Enron's books? Is it possible that Bernie Ebbers thought he was really worth the hundreds of millions of dollars that he took (much of it secretly) out of WorldCom? Is it possible that Arthur Andersen's auditors believed that Enron's financial statements truly represented Enron's financial condition? Research on the self-serving bias suggests that these things are possible.

Consider Enron, for example. Enron was extraordinarily entrepreneurial. It sought to reward success. Indeed, so eager was the firm to incentivize its employees that it often generously rewarded perceived successes long before the success of the transaction could be manifested:

> When Enron employees valued proposed deals, which affected the numbers Enron could put on its books, which in turn determined whether or not employees met their bonus targets, which in turn determined whether millions of dollars in bonuses were paid to the very people who were deciding what the numbers should be, even assuming good faith (and at least some of the Enron officers must have been acting in good faith), the self-serving bias must have had an impact. This is especially so because Enron employees were often not choosing between legitimate Option A and legitimate Option B; rather 'the prices were pulled from [someone's ass]…because there was nowhere else to get them!'[19]

Or think of Arthur Andersen's David Duncan, the auditor in charge of the Enron account. Enron was one of Andersen's largest clients and Duncan's career essentially hung on the success of Enron. Andersen was making a healthy $25 million a year auditing Enron and another $27 million by providing nonaudit services. Andersen expected that its Enron related revenue would soon double to $100 million a year. In other words, Andersen, Duncan, and Duncan's subordinates all had a strong self-interest in concluding that Enron was in good financial shape and that its various financial machinations were consistent with good accounting practices. In the shadow of such a strong self-interest, it would have been very difficult for even an auditor with the best of intentions to make judgments in an objective manner.[20]

In valuing their deals, Enron employees would be prone, the psychological studies show, to seek out information that would support the higher valuations that were consistent with their self-interest. Similarly, in auditing Enron's books, the auditors would be prone to search for information that supported the conclusion that the financial statements accurately represented Enron's financial condition and to ignoring evidence that contradicted that conclusion. This is called the *confirmation bias*. Psychologists are well aware of this tendency, and studies show that even auditors and research scientists who are supposedly trained to be skeptical are as prone to it as anyone else.[21] Related is the notion of *belief persistence*--the fact that people tend to persist in beliefs they hold long after the basis for those beliefs is substantially discredited.

The self-serving bias and its closely related phenomena of confirmation bias and belief persistence unconsciously affect the information that people seek out. They also cause them not only to search for confirming rather than disconfirming evidence and to hold on to beliefs even if the face of conflicting evidence, they also affect how people process the information that they do access. Thus, when psychologists give a relatively ambiguous document to two groups of people holding opposing views, members of each side tend to interpret the document as supporting their point of view. When scientists review articles, they will tend to conclude that those supporting their preexisting point of view are of higher quality than those opposing that view. When scientific studies of drug efficacy are funded by the drug company they are 5.3 times more likely to conclude that this is the treatment of choice than studies independently funded.[22] A British civil servant in charge of helping his government make the case for invading Iraq recently spoke eloquently of the impact of this bias:

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[19] Robert A. Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AMERICAN BUSINESS LAW JOURNAL 417 (2003), *quoting* BRIAN CRUVER, ANATOMY OF GREED: THE UNSHREDDED TRUTH FROM AN ENRON INSIDER (2002).

[20] Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NORTHWESTERN UNIVERSITY LAW REVIEW 133 (2000).

[21] E. Michael Bamber, *An Examination of the Descriptive Validity of the Belief-Adjustment Model and Alternative Attitudes to Evidence in Auditing*, 22 ACCOUNTING, ORGANIZATION, AND SOCIETY 249 (1997).

[22] *Zyprexa Products Liability Litigation,* 253 F.R.D. 69 (E.D.N.Y. 2008).

> The speeches I drafted for the Security Council and my telegrams back to London were composed of facts filtered from the stacks of reports and intelligence that daily hit my desk. As I read these reports, facts and judgments that contradicted the British version of events would almost literally fade into nothingness. Facts that reinforced our narrative would stand out to me almost as if highlighted, to be later deployed by me, my ambassador and my ministers like hand grenades in the diplomatic trench warfare. Details in otherwise complex reports would be extracted to be telegraphed back to London, where they would be inserted into ministerial briefings or press articles. A complicated picture was reduced to a selection of facts that became "factoids", such as the suggestion that Hussein imported huge quantities of whisky or built a dozen palaces, validated by constant repetition: true, but not the whole truth.[23]

Because of the self-serving bias, documents that a disinterested person might view as not supporting Enron's desired position or not of high quality, might be viewed much differently by a self-interested Enron employee or Arthur Andersen auditor. Likewise, makers of asbestos, tobacco and other harmful products who initially believed them to be beneficial products had difficulty processing new information regarding their carcinogenic effects, thus creating an ethical minefield.[24]

The self-serving bias even affects how people remember information. Studies show that people are more likely to recall evidence that supports their point of view than evidence that opposes it. People involved in negotiations tend to remember information that supports their bargaining position more than information that undermines it.

Inevitably, subjective judgments of fairness are also affected by the self-serving bias. In part, this means, according to one aspect of *causal attribution theory*, that people have a tendency to attribute to themselves more than average credit for their company's or team's successes and less than average responsibility for its failures.

Obviously, the more subjective the judgment and the less certain the facts, the more influential the self-serving bias is likely to be, but the bias is pervasive and unrelenting. Banaji and colleagues note:

> Research done with brokerage house analysts demonstrates how conflict of interest can unconsciously distort decision making. A survey of analysts conducted by the financial research service First Call showed that during a period in 2000 when the Nasdaq dropped 60%, fully 99% of brokerage analysts' client recommendations remained "strong buy," "buy," or "hold." What accounts for this discrepancy between what was happening and what was recommended? The answer may lie in a system that fosters conflicts of interest. A portion of analysts' pay is based on brokerage firm revenues. Some firms even tie analysts' compensation to the amount of business the analysts bring in from clients, giving analysts an obvious incentive to prolong and extend their relationships with clients. But to assume that during this Nasdaq free fall all brokerage house analysts were consciously corrupt, milking their clients to exploit this incentive system, defies common sense. Surely there were some bad apples, But how much more likely is it that most of these analysts believed their recommendations were sound and in their clients' best interests? What many didn't appreciate was that the built-in conflict of interest in their compensation incentives made it impossible for them to see the implicit bias in their own flawed recommendations.[25]

People have a psychological need to see themselves as "good and reasonable" and the self-serving bias subconsciously distorts evidence, allowing them to do so. Inevitably, self-interest clouds moral judgment, even that of well-intentioned people. Therefore, even well-intentioned people "have a tendency to credit themselves for their ethical decisions but to blame situational forces imposed by the environment for their unethical decisions."[26]

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[23] Carne Ross, *Believing is Seeing*, FIN. TIMES, Jan. 29-Jan. 30, 2005, at W1.

[24] Joshua Klayman, *Ethics as Hypothesis Testing, and Vice Versa*" in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 243 (1996). Obviously, the self-serving bias can play a role in "belief persistence" that was mentioned earlier.

[25] Mahzarin R. Banaji et al., *How (Un)Ethical Are You?*, HARV. BUS. REV., Dec. 2003, at 56.

[26] THOMAS OBERLECHNER, THE PSYCHOLOGY OF ETHICS IN THE FINANCE AND INVESTMENT INDUSTRY 29 (2007).

The self-serving bias does not universally adversely affect every single decision made by every single person. However, it is a strong, systematic, and pervasive influence. The AICPA's Code of Professional Conduct wisely contains many, many provisions that recognize this influence and attempt to minimize its impact by preventing auditors from entering into financial, employment, consulting, and other arrangements that would create conflicts of interest. Without opining directly on the wisdom of an auditor rotation requirement, I applaud the PCAOB for continuing its efforts to improve auditor independence by minimizing the impact of the self-serving bias.