REPLY

REPORTS OF SOLVING THE CONFLICTS OF INTEREST IN AUDITING ARE HIGHLY EXAGGERATED

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Nelson argues that we should trust the auditing profession and collect more data before taking action to reform the auditing system. We argue that the risk of doing nothing is greater than the risk associated with reform, and that the arguments Nelson makes have been exploited by the auditing industry to defend a system that destroys the independence of audits for the financial benefit of the auditors themselves.

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy (Smith, 1976).

From the early days of auditing in the United States, a few visionaries recognized that the motivation to please their clients represented a conflict of interest threatening both their reputations and their objectivity. The law requires auditors to be independent from their clients, and independence generally serves the interests of firms’ owners (i.e., its shareholders). Over time, however, these visionaries gave way to more practical managers who recognized that pleasing clients helped them retain auditing business and sell other profitable services (McRoberts, 2002). These changes may have helped accounting firms make more money than they would have otherwise, at least in the short term, but they have compromised the integrity of the auditing profession. This is the case that we document in Moore, Tetlock, Tanlu, and Bazerman (2006), and this view is central to the disagreements that we appear to have with Nelson (2006).

Nelson (2006) argues for incremental changes within the existing system, for tweaking the margins of the Sarbanes-Oxley Act (SOX), and for conducting more research. He argues for the necessity of cost-benefit analyses before implementing changes to the existing system, and for making changes with care and only when there exists a consensus of opinion in favor of change. We believe that this “careful” approach ignores overwhelming evidence suggesting that the current system is profoundly flawed.

This careful incremental approach is endorsed by accounting firms themselves, and it bears a striking resemblance to the approaches advocated by the leaders of other industries attempting to stave off regulation in the face of strong evidence that they have been misleading the public. For example, tobacco industry executives have argued that we need more research on the causal effects of smoking, or that we need more research on the causal effects of secondhand smoke. Similarly, a number of energy companies (e.g., ExxonMobil) have attempted to question the strong scientific consensus regarding the reality of climate change and the causal
role that humans have played (Watson & The World Bank Core Writing Team, 2001).

As in the cases of second-hand smoke and global warming, we believe that the evidence is in: if the auditing industry honestly wants to provide independent audits, major changes are needed—and we know what we need to know to reach this conclusion.

In this reply, we try to avoid repeating the arguments in Moore et al. (2006) and Nelson (2006). Rather, we try to express as simply as possible the key differences between our view and Nelson’s on a number of issues.

HOW WOULD YOU CREATE AN INDEPENDENT AUDITING SYSTEM?

Imagine that you have two options for creating an independent auditing system. Which one would you choose?

1. To maintain auditor independence, prohibit auditors from establishing durable, long-term cooperative partnerships with their clients, from providing nonaudit services to their clients, and from taking jobs with their clients.
2. Start by creating a variety of incentives that lead auditors to want to please their clients, and then try to identify a complex set of legislative and professional incentives to counteract the corrupting influences created by the desire to please the client.

We prefer option 1, and our society has created option 2. More to the point of this reply, Nelson (2006) endorses option 2. He is more sanguine than we about the potential for SOX and future adjustments to it to create auditor independence.

We simply do not see how option 2 will ever create true independence. Remember U.S. legal precedent regarding auditors’ role: in the words of Chief Justice Warren Burger, “This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust” (Burger, 1984). We do not differ with Nelson on the importance of independence. In his words:

Law requires that audits be performed by CPAs who are “independent” of the company. The key attribute of independence is that auditors not bias their opinion in favor of their client—auditors should strive for accuracy or, at worst, for conservatism that introduces a slight negative bias to the client’s financial situation (Nelson, 2006: 31).

We do not believe that “total independence” and “complete fidelity to the public trust” will result from the current system—or minor reforms to it.

In addition to the obvious point that it makes sense to design the institution the right way from the start, we believe that it is important to note that a firm is not a monolithic actor. So when the auditing industry pursues option 2 above, this will undoubtedly lead many individuals to have the short-term and personal incentives to please the client over the long-term and ambiguous firm objectives of maintaining the integrity of the audit. Perhaps more important, it is also worth noting the differing interests between a firm’s managers and its owners. Nelson points out correctly that SOX moves authority over hiring and firing of auditors to the audit committee of the board of directors. We would have more confidence in the value of this change if corporate boards of directors truly represented the interests of shareholders. However, control of many American corporations (including their boards of directors) rests in the hands of the firms’ CEOs and their managers.

Skeptics could argue that, although in the best of all possible worlds they would prefer option 1 above, we live within a complex matrix of institutional and legal constraints. The only way to get from our world to a world with rigorously independent auditors would be to abandon our pluralistic democratic capitalist system—a system that makes it exceedingly difficult to run roughshod over highly concentrated interest groups. In this view, we (the authors of this reply) have the mindset of platonic philosopher kings who refuse to descend to the real world and engage in the real debate. We have forgotten the maxim that politics is the art of the possible. And it is curious that we should have this lapse of memory, because the maxim is so central to our own issue-cycling framework advanced in the original article.

The contradiction is illusory. There is no tension here between (1) the macro issue-cycling component of our analysis, which recognizes that well-connected interest groups can block reform—or roll back reform on those occasions when it does take hold (and there are numerous signs of growing pressure for roll back of the SOX reforms; see Glater, 2005, and Norris, 2005),
and (2) the micro social psychological component of our analysis, which holds that the post-SOX accountability regime for the accounting profession is inadequate for checking the powerful intrapsychic and interpersonal forces that continue to create conflicts of interest. The behavioral and social science quest to identify and fix system design flaws should not be limited by a political calculus of what is or is not feasible at the moment.

WHY PSYCHOLOGY MATTERS

Nelson notes:

Moore et al. indicate that the field of accounting has been dominated by an economic lens of analysis, implying that this has somehow blinded the field as to the potential for motivated reasoning, self-serving biases, accountability effects, or incentives affecting auditor decisions in subtle ways. Actually, the judgment and decision-making perspective has had a persistent influence on the accounting literature, particularly in auditing (2006: 32).

We hope that we did not convey the argument that psychology is nonexistent in the accounting—and, specifically, auditing—literature. Our comment had to do with dominant influence. We do find it striking that the "psychological" influence in the accounting literature missed the unintentional role of biased auditors prior to the fall of Enron and that, even now, psychological factors in decision making are often reduced to simple platitudes, such as the uncontroversial notion that auditors' judgments are subject to social influences (King, 2002). But Nelson does clarify the economic dominance of the accounting literature when he writes, "I don't see the 'economic/psychological' and 'conscious/unconscious' dichotomies as centrally important for understanding the conflicts of interest that Moore et al. discuss" (2006: 32). Nelson is correct that economic theories of auditor behavior do not assume a specific psychological mechanism; auditors are assumed to act in self-interest, and it does not matter whether they are completely conscious of the various influences on their professional judgments.

However, we do see the distinction as centrally important. The question of conscious intentionality has long been central to regulatory intervention and to the legal cases involving charges of fraud. This is because the legal definition of accounting fraud includes intentional misrepresentation. It is intentionality that distinguishes fraud from error (Avey, Baskerville, Brill, & American Institute of Certified Public Accountants, 2000). When the Securities and Exchange Commission (SEC) has considered reforms to conflicts of interest in the accounting industry, one of their key concerns has been whether there is any evidence of auditors intentionally biasing their reports as a result of their conflicts of interest. In 2000, Arthur Levitt and the SEC looked for but could not find evidence for such a "smoking gun." The commission heard testimony from three audit industry CEOs, all of whom delivered the message, "We are professionals—trust us" (Securities and Exchange Commission, 2000). We now know that there was plenty of reason to not trust their integrity. But assume for the clarity of the argument that the firms, and the leadership of the firms, were trustworthy. Our argument in Moore et al. (2006) is that their benign intentions would not be sufficient evidence to prove that their audit reports were truly independent.

One of the clear findings of the psychological perspective on auditing is that bias can exist in auditors without their being aware of it (Bazerman, Loewenstein, & Moore, 2002; Chugh, Bazerman, & Banaji, 2005). Another key fact is that while people often agree that conflicts of interest can influence behavior, they do not see such influence in their own behavior or their firm's behavior (Ehrlinger, Gilovich, & Ross, 2005; Pronin, Lin, & Ross, 2002). People are generally unaware of the mental heuristics they use to decide what evidence to attend to and how much scrutiny to give it (Gilovich, 1991). This blind spot was evident in the arguments of the CEOs before the SEC in 2000: they recognized the incentives for conflict of interest, but they argued that the integrity of their firms kept their audits independent.

If auditors "see" the evidence through a biased lens, motivated by the desire to benefit their firms and their careers, there is no issue of intentional integrity, because biasing influences are operating at an unconscious level. Psychologically and legally, the auditor is then free to act in a self-serving manner, help the client, and put the shareholders at risk, all without any intentional corruption. Our core argument is that while reputation and incentives for integrity—especially fear of lawsuits—may
work in responding to intentionality, they will fail to address the critical role of unintentional audit corruption, especially because bias without conscious awareness does not constitute fraud and is therefore difficult to prosecute (Bazerman, Morgan, & Loewenstein, 1997).

The law appears to be at odds with the accounting literature in this respect. Accounting scholars, especially those who use the tools of economics to study accounting, generally are not concerned with a distinction between conscious corruption and unintentional bias (e.g., Antle, 1982, 1984). They routinely argue that we ought to consider the balance of incentives auditors face when we attempt to determine whether they will be biased in favor of their clients, and one of the primary incentives weighing against client-favoring decisions is the fear of legal prosecution for fraud (Antle, Griffen, Teece, & Williamson, 1997; Nelson, 2006). Yet the current definition of accounting fraud includes only conscious corruption. Logical consistency would appear to demand that accounting scholars recommend that the definition of accounting fraud be broadened to include all deviations from accuracy, whether or not auditors engage in intentional misstatements. Yet we know of no such movement.

THE STATUS QUO EFFECT, OBFUSCATION, AND COST-BENEFIT ANALYSES

There are many problems in society where the best scientific evidence argues for action. The debates in the serious scientific community over whether climate change exists and whether humans are playing a role as a causal agent are basically over. The scientific consensus is that climate change is underway and that humans are playing a role (Watson & The World Bank Core Writing Team, 2001). Similarly, the major tobacco companies continue to question the role of second-hand smoke in causing disease, despite the fact that the public health community long ago reached a consensus on the issue (Baron & Glantz, 2005). What is the goal of the oil and tobacco firms? Quite simply, their goal is to avoid disruption of their current ways of making money for as long as possible. And the tools that they use in this effort are effective: (1) rely on public acceptance of the status quo (Bazerman, Baron, & Shonk, 2002), (2) obfuscate the evidence, and (3) call for the need for careful, precise cost-benefit analysis before any action is taken. The auditing industry appears to pursue similar strategies.

Bazerman, Baron, and Shonk (2002) document many ways in which our society has created inefficient rules and laws, and they address the issue of why we accept the inefficient status quo. Part of the answer comes from the work of Baron and Ritov (Baron, 1998; Ritov & Baron, 1992), who find that people, organizations, and nations tend to follow the often-heard rule of thumb "Do no harm." Far too often, we fail to make changes that create some minor harm yet would create a far greater benefit. People and organizations tend to maintain the status quo (Samuelson & Zeckhauser, 1988). The net result is that we accept, as a society, faulty systems far longer than we should.

How does a firm that knows the system is broken but makes money through faults in the system keep society from acting? The common strategy has been to obfuscate, or to use what is known as the "open question" defense. Given the human desire to maintain the status quo, when forced to address the problems, firm managers note the necessity of change is still an open question because the evidence remains inconclusive—even when the evidence is overwhelming. Firms highlight the costs of change and then call for more research on the issue.

Of course, no amount of evidence within the next decade is likely to change the minds of the firms in question; obfuscation and the call for more research is a diversionary tactic, not an actual desire to find the information needed for action. To see a version of this tactic in action, we recall the testimony of Joseph Berardino, then CEO of Arthur Andersen, as he testified before the SEC:

The problem that the Commission wants to "solve" has already been addressed. In the past year or so, with the Commission’s blessing and our strong support, significant new measures have been instituted to bring greater audit committee scrutiny over scope of practice. With audit committees just beginning to exercise this new authority, we see no reason to conclude that they will not discharge their oversight duties responsibly. . . . Before we radically alter the audit landscape with new rules, we should give audit committees a chance to do their job. We share the conclusion of the majority of the Panel on Audit Effectiveness, which viewed “any notions that audit committees have not made or cannot make reasoned judgments about independence mat-
ters” as unfairly impugning the abilities and integrity of these committees (Securities and Exchange Commission, 2000).

Finally, members of the accounting field call for a cost-benefit analysis before instituting any changes. Nelson (2006) questions whether the reforms we propose will yield benefits that outweigh their costs. Nelson and others (Antle et al., 1997) want to see a clear cost-benefit analysis before changing the status quo. This request appears eminently sensible. Who would disagree with the idea of comparing the costs and benefits of a course of action? But this question raises a more fundamental issue about the very reason the auditing industry exists to begin with.

Audits exist to provide the benefit of an independent assessment of the financial condition of a firm. Without independence, the auditor is redundant with the firm’s own internal accounting staff, and the benefit is of questionable value to begin with. Concerns about the costs of reform imply that we should accept biased auditing to limit the costs to the firm and to the auditor. We are more concerned about capital markets, investors, and other stakeholders who assume independence. While the social and economic benefits of having a trustworthy, transparent, and reliable system of capital markets and financial reporting are exceedingly large, they are also difficult to estimate in a way that makes them easy to weigh against the costs to the accounting firms. We believe that cost-benefit analysis has more obvious value assessing alternative strategies to create true independence. Cost-benefit analysis should not be used, however, to assess whether independence is worth the costs, where the default is to maintain the status quo. Rather, if it is not worth the costs to create independence, we need to question why we even have an auditing profession.

BY THE WAY, WE WERE WRONG

Despite our many disagreements with Nelson (2006), it is appropriate to mention that we believe he does an excellent job of capturing the perspective of the auditing/accounting literature. We simply disagree with core aspects of this field. In addition, Nelson provides useful details on SOX that go beyond our expertise, and we appreciate these details. And in one case Nelson identifies a factual error in our original paper. Our paper falsely claims that SOX prohibits employees of audited firms from being hired by their auditors. Nelson clarifies that, actually, SOX prohibits audit staff from being hired by their clients into just four specific positions, and for a period of just one year.

We concede that Nelson is indeed correct. It would have been even more helpful for him to highlight our error in one of his multiple reviews of our paper. But there may have been a conflict of interest between his role as a reviewer and his role as an accounting scholar who has a very different view of the effect of bias than we do. Of course, if you read our paper, you know that this does not mean that we assume that he intentionally failed to note the mistake as a reviewer so that he could allow us to discredit ourselves or so that he could point out the flaw in his writing. Rather, as we note in our original paper and earlier in this reply, deviation from unbiased judgment due to conflict of interest is much more likely a result of unintentional distortion than intentional distortion. Once again, the difference between unintentional and intentional distortion may be a critical distinction. Of course, Nelson’s not recognizing our error earlier merely could have been an unbiased oversight. Recognizing the plausibility of all three alternatives is central to our argument.

CONCLUSION

In 1997 John Browne, the CEO of British Petroleum (BP), broke ranks with the energy industry and announced that BP believed climate change is occurring and that humans are playing a role in causing it. He also said that he saw it as an obligation of BP to respond to this societal concern. Browne’s courageous announcement has had a tremendous influence on the behavior of a “dirty” industry. BP is not perfect, and makes no claims to be perfect, but Browne’s announcement was a clear step in cutting through the obfuscation and putting BP on the side of science with respect to the issue of climate change.

The auditing profession has a choice to make. It can continue to try to maximize profits by

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1 We accept the fact that he was not aware of his future role as a commentator when he wrote his reviews.
2 In the interest of a full disclosure, Bazerman is a consultant to BP.
using auditing as a mechanism for selling other services (such as SOX compliance). It can continue to call for cost-benefit analyses. It can continue to spend money to maintain the status quo against public interest. Or it can decide that it is time to act to become a responsible part of society. We believe that the evidence clearly shows the need for change.

REFERENCES


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