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Opinion: The Impossibility of Auditor Independence

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Audit failures rarely result from the deliberate collusion of auditors with clients. Instead, auditors may find it psychologically impossible to remain impartial and objective.

In 1992, Phar-Mor, Inc., the largest discount drug-store chain in the United States, filed for bankruptcy court protection following discovery of one of the largest business fraud and embezzlement schemes in U.S. history. Coopers & Lybrand, Phar-Mor's former auditors, failed to detect inventory inflation and other financial manipulations that resulted in \$985 million of earnings overstatement during a three-year period. A federal jury unanimously found Coopers & Lybrand liable to a group of investors on fraud charges. The attorney for one investor argued that "this sends a strong signal to the accounting community that investors take very seriously the role of audited financial statements and rely on them for their integrity."¹

The investors who successfully sued Coopers & Lybrand contended that Gregory Finerty, the Coopers & Lybrand partner in charge of the Phar-Mor audit, was "hungry for business because he had been passed over for additional profit-sharing in 1988 for failing to sell enough of the firm's services."² In 1989, Finerty began selling services to relatives and to associates of Phar-Mor's president and CEO (who has been sentenced to prison and fined for his part in the fraud). Critics claim that Finerty may have become too close

to client management to maintain the professional skepticism necessary to conduct an independent audit.

The Phar-Mor case is one of many in which auditors have been held accountable for certifying faulty financial statements. Investors in the Miniscribe Corporation maintained that auditors were at least partially responsible for the now-defunct company's falsified financial statements; at least one jury agreed, holding the auditors liable to investors for \$200 million. In the wake of the U.S. savings and loan crisis, audit firms faced a barrage of lawsuits, paying hundreds of millions of dollars in judgments and out-of-court settlements for their involvement in the financial reporting process of savings and loan clients that eventually failed.

The accounting profession maintains that it is being unfairly assaulted by plaintiffs looking for a convenient "deep pocket" from which to recover losses that may result from their own poor investment decisions. The investing and lending public, on the other hand, has become cynical about the accounting profession and its role in the financial reporting process. How could auditors not see that so many of their savings and loan clients were about to fail? How could a prominent auditing firm with a reputation for integrity overlook such large misstatements in Phar-

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Mor's financial records? Critics of the profession suggest that auditor neglect and corruption may be responsible. We argue, however, that only very rarely are audit failures the result of deliberate collusion of auditors with clients in issuing faulty financial statements. Instead, we maintain that audit failures are the natural product of the auditor-client relationship. Under current institutional arrangements, it is psychologically impossible for auditors to maintain their objectivity; cases of audit failure are inevitable, even with the most honest auditors.

Many professional roles call for impartial judgments. We expect judges to pass sentences that are free from racial prejudice, doctors to recommend treatments that are best for their patients rather than for their wallets, and teachers to put aside their personal feelings toward their students when grading their papers and exams. However, research in each area has shown that judges, doctors, and teachers are biased by their own interests and prejudices. There is no claim that these professionals are corrupt, only that biased judgment prevents them from making purely impartial, objective decisions.

In no profession is impartiality more important than in auditing. Auditors provide information to shareholders and to other stakeholders that is vital to firms' public ownership. An auditor's failure to detect significant misrepresentations in a company's financial statements can lead not only to losses by individual investors, but also to an overall decline of trust in capitalist institutions. Like members of other professions, however, auditors often face challenges to their independence. Many challenges arise because auditors are hired, paid, and even fired by the organizations that they audit rather than by the people they ostensibly represent.

The accounting profession is sensitive to the potential for bias in audits. The American Institute of Certified Public Accountants (AICPA) states in its Code of Professional Ethics:

"In the performance of any professional service, a member shall maintain integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. . . . Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism."¹

The AICPA thus acknowledges the pressures on the integrity and objectivity of the auditor but contends that auditors can achieve a level of independence such that users can rely on audited financial statements as unbiased assessments of the reporting companies' positions.

The courts share the view that auditors must act in the interests of external users of financial statements and also assume implicitly that it is possible for them to do so. Former Chief Justice of the U.S. Supreme Court Warren Burger described the role of the auditor, in a 1984 opinion:

"The independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the company's creditors and stockholders, as well as to [the] investing public. 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."⁴

How realistic is the assumption that auditors — even those of high integrity — can provide impartial judgments that respond to the interests of creditors, stockholders, and the general public, rather than to the interests of the companies that hire them? Psychological research points to an inescapable conclusion: such impartiality is impossible under current institutional arrangements.

In this paper, we review the structure of the auditing system in the United States. We then discuss psychological research that points to the impossibility of auditor independence. Next, we describe contemporary aspects of the auditing profession that exacerbate independence issues. Finally, we enumerate some potential solutions.

The Structure of the Auditing Relationship

Stockholders, potential stockholders, financial advisers, underwriters, regulators, lending institutions, and businesses that extend credit are among the users of audited financial statements. These users make decisions based on the information in the statements, which are prepared and issued by a company's management. Management typically has incentives to present the company's financial position in the best possible light. Com-

pensation plans often tie management's pay to reported financial results. Management might consider financial statements to be public relations documents, instrumental as a means to influence external users. Thus management may be motivated to present financial information that is overly optimistic, misleading, or false.⁵

To obtain some assurance that financial statements presented by management are valid, reliable, and complete, external users look to the report of the company's independent auditor. An audit is an examination of a company's financial statements to give an opinion on whether the information in those statements is reliable and is prepared and presented in accordance with generally accepted accounting principles (GAAP). The company presents the auditor's opinion of its financial statement in a report along with the financial statement. An auditor's unqualified opinion states that, based on an examination in accordance with professional auditing standards, the accompanying financial statement "fairly presents" the company's financial position and results of operation in accordance with GAAP.

An unqualified audit report lends credence to the company's financial statement, providing external users with reasonable assurance that the information is reliable, consistent, and comparable across all periods covered by the report.⁶ If the audit opinion is to provide the desired degree of assurance, the auditor

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must be able to form and express an opinion without bias. Accountants traditionally use the term "independence" to refer to an auditor's ability to make audit judgments objectively, "free and clear of any influence that other parties or factors might bring to bear."⁷

Although the auditor examines a company's financial statement on behalf of external users, the management of the company that prepared and is-

sued the statement under examination hires and pays the auditor. The company under audit and the individuals who manage that company are the "client." Clients may hire and fire auditors at will. In addition to economic incentives that may bias an auditor's judgment in favor of the client who pays the fees, the relationship that auditing firms strive to develop with the clients may add to the auditors' psychological difficulty to make truly independent judgments.

The Psychology of the Impossibility of Independence

Calls for auditor independence, such as the AICPA's (quoted above), implicitly adopt a naive, unrealistic model of auditor psychology. This model assumes that auditors form unbiased judgments but that the potential for bias arises at the point of reporting those judgments. Expressed differently, auditor bias, to the extent that it occurs, is viewed as a form of deliberate misrepresentation. The assumption of deliberativeness is important because it implies that any tendency toward bias can potentially be rectified by moral suasion and/or the threat of sanctions.

Psychological research shows that this model is unrealistic. Bias typically enters unconsciously and unintentionally at the stage of making judgments, not of reporting on them, although there may be some deliberate misreporting as well. When people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self-interest. Psychologists call this the self-serving bias.⁸ When presented with identical information, individual perceptions of a situation differ dramatically depending on one's role in the situation. People first determine their preference for a certain outcome on the basis of self-interest and then justify this preference on the basis of fairness by changing the importance of attributes affecting what is fair.⁹ Thus the problem lies not in our desire to be unfair, but in our inability to interpret information in an unbiased manner. Self-serving biases exist because humans are imperfect information processors. One of the most important non-objective influences on information processing is self-interest. People tend to confuse what is personally beneficial with what is fair or moral.¹⁰

In a series of experiments examining the self-serving bias, which we think represent a close analogy to the situation in auditing, Loewenstein et al. presented participants with diverse materials (depositions, police reports, doctors' reports, and so on) from a lawsuit that resulted after a collision between a car and a motorcycle.¹¹ Participants were assigned the role of plaintiff or defendant and attempted to negotiate a settlement. If unable to do so, they paid substantial penalties and were told that an impartial judge, who had earlier read the same case materials and reached a judgment, would determine the amount paid by the plaintiff to the defendant. Before they negotiated, participants were asked to predict the judge's ruling. They were told that the estimate would not be communicated to the other party and would not affect the judge's decision (which had already been made). Nevertheless, plaintiffs' predictions of the judge's award amount were substantially higher than those of defendants, and the degree of discrepancy between plaintiff and defendant strongly predicted whether they settled the case (as opposed to relying on the judge's decision).

In follow-up experiments, the same researchers attempted to reduce the magnitude of the bias. They paid participants for accurately predicting the judge's ruling and had them write an essay arguing the other side's viewpoint. Neither intervention had a measurable effect. Participants consistently believed that the judge would perceive judgments that were in their own material interest as fair. The researchers also attempted to reduce the magnitude of the self-serving bias by describing it to participants in detail and having them take a test to ensure that they understood the description. The experimental intervention was successful insofar as participants became convinced that their negotiating opponent would be highly biased, but participants believed that they themselves would not succumb to the bias. The fact that participants were unable to rid themselves of the bias when rewarded for doing so and their belief that they were not subject to bias both demonstrate clearly that the self-serving bias is unconscious and not deliberate.

Other findings from the same experiments point to a likely psychological mechanism underlying the self-serving bias. Researchers gave participants eight arguments favoring the side they had been assigned (plaintiff or defendant) and eight arguments favoring

the other side. They asked them to rate the importance of the arguments as perceived by "a neutral third party." Participants tended to view arguments supporting their own position as more convincing than those supporting the other side, suggesting that the bias operates by distorting interpretation of evidence. Consistent with this interpretation, when the

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parties were assigned their roles (plaintiff or defendant) only after they read the case materials, the magnitude of the bias was substantially reduced and almost all the plaintiff-defendant pairs reached rapid agreement on damages.

In the studies we just reviewed, participants received no actual pecuniary benefit by reaching biased judgments; the only incentive for misrepresentation came from the subjects' identification with their roles. Moreover, as we mentioned, in many experiments, there were explicit monetary incentives for arriving at unbiased judgments. Nevertheless, in approximately six studies with hundreds of subjects, the bias was consistently large.

The self-serving bias is exacerbated by a number of characteristics of the auditing relationship. First, the people who will be hurt by any misrepresentation are "statistical" — an auditor cannot identify them at the time the decision is made.¹² People tend to be far less concerned about imposing harm on statistical victims than on known victims. Many people might lose a small amount of money, but it isn't clear who will. In contrast, the auditor is likely to be well acquainted with the people within the client firm who would be hurt by a negative opinion on the audit. Second, the negative consequences of a negative opinion are likely to be immediate — loss of a client's friendship, potential loss of the contract, and possible unemploy-

ment — whereas the effects of a positive report when a negative report was appropriate are likely to be downplayed because they are delayed.¹³ Third, auditors form an ongoing relationship with the organizations they audit, and any deterioration in the audited company is likely to unfold gradually.¹⁴ Auditors may unknowingly adapt to small imperfections in the company's financial practices. Fourth, financial reporting standards are often flexible or ambiguous, so it may be easy for an auditor to rationalize a judgment that is consistent with self-interest rather than the interests of external users. Fifth, people possess a remarkable ability to mislead themselves about the nature of trade-offs, to rationalize to themselves and to others the accuracy of their biased judgments.

In sum, auditors' judgments are likely to be biased in favor of their own and their client's interests. This bias occurs indirectly as a result of selective sifting and integrating audit information. As a result, the bias is likely to be unintentional and impervious to moral suasion or the threat of delayed and probabilistic sanctions, which are likely to seem quite remote.

Issues That Exacerbate the Problem of Independence

The tensions regarding independence have existed for decades. Recent developments in auditing, however, threaten to exacerbate the problem. First, the auditing environment has become far more competitive in the 1990s than in earlier decades, increasing the consequences of losing a client and the incentives for maintaining good client relations. Previously, junior auditors were typically billed at a ratio of four times the cost of the employee. Now it is common for this ratio to fall below two and even below one when another firm tries to "steal" an account. In highly competitive markets, accounting firms often engage in lowballing — accepting unprofitable audit fees in the initial year or two in order to "buy" the business. When auditors accept drastically discounted fees, they are likely to be highly motivated to retain the client for several years. In the past, approaching another auditor's client was considered inappropriate. Today, slow economic growth has made it more difficult to "grow the business," so luring accounts away from competitors is a mark of success.

Intensified competition has occurred not only be-

tween accounting firms but also within them. In contrast to the gentlemanly nature of the auditing business twenty-five years ago, contemporary auditing firms expect partners to generate significant revenue, and failure to meet these expectations frequently leads to "retirement." Being a partner in this industry has financial implications for profit sharing but does not ensure employment. Both dimensions of increased competitiveness are likely to focus auditor attention on immediate profits and intensify the consequences of losing a client due to a negative audit.

Second, the leading auditors are entities within larger partnerships that include tax and (rapidly growing) consulting practices. Auditing is becoming less important to the overall profitability of the leading accounting firms. In many cases, a firm's audit client is also a consulting client, with the consulting component of the relationship being far more profitable than the audit. So an unfavorable opinion risks not only the audit but, potentially, the consulting relationship as well. In the past, firms have emphasized the independence of their three components (audit, tax, and consulting). Firms have been changing their structural form, however, to better integrate services within industries and for specific clients. Information from one part of the relationship with a client can help the accounting firm with another component. But the risk to independence is also increased. Imagine how difficult it is for an auditor whose firm has been providing consulting services to a company to submit a qualified report. Simultaneously playing consultant and watchdog further confuses the issue of whom the auditors are accountable to and working for.

Conclusion

What explains the current wave of lawsuits against auditors? Past critics of the auditing profession have focused on the obvious conflict of fulfilling responsibility to external users versus the financial benefits of pleasing the client. This conflict is typically viewed as a moral trade-off that auditors face. The larger problem, however, is not with the auditors' morality, but with limitations in the way that they process information. Thus independence remains a problem for even the most moral, honest auditor. Despite the auditors' best efforts to place the external users' interests

above the client's and to maintain objectivity, they may be unable to overcome cognitive or psychological biases that make them arrive at marginal decisions in the client's favor. As we cited earlier, the AICPA states that the auditor "shall not knowingly misrepresent facts or subordinate his or her judgment." The larger problem facing society is that there is good reason to believe that auditors will unknowingly misrepresent facts and will unknowingly subordinate their judgment due to cognitive limitations.

While audits are done for external users, the negotiated relationship between the auditor and the client creates them. Both the auditor and the client benefit from auditors' self-serving bias. We believe that the auditing profession and external users of financial statements should actively seek fundamental changes in the current structure of the auditing relationship. Observers of the profession have suggested various possibilities, such as prohibiting a firm that conducts a company's audit from simultaneously providing other services for that client, prohibiting audit firms from providing any related services, having external (perhaps governmental) bodies appoint auditors or set fee structures, requiring companies to periodically change auditors, increasing oversight of auditing practices, or, the most drastic, having governmental agencies rather than the private sector conduct audits.

While we do not know that any of these suggestions would be optimal, we believe we have made a convincing case for reform of the current auditing relationship. External users pay a huge price for the flaws in the current structure of the audit function, as do the accounting firms devoting huge resources to defending themselves against what they see as an "epidemic" of litigation. Much like the federal deficit, these problems are mounting and will get worse if not addressed. Ideally, the interested parties will deal with these problems before the government does. ♦

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