Taking the Bias Out of Bean Counting

by Max H. Bazerman and George Loewenstein

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opinion

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Proposed changes by the SEC don't go far enough to guarantee impartial audits by the accounting profession.

by Max H. Bazerman and George Loewenstein

The accounting profession has drawn heavy fire over the past year. Last January, the partners in one Big Five accounting firm were discovered to be holding investments in the companies they audited, a practice unambiguously forbidden under SEC rules. The scandal provoked the SEC to undertake a thorough review of the profession.

The SEC's main focus, however, has not been on the assets held by individual auditors but on the accounting firms' consulting businesses, which now contribute up to 70% of their revenues. Accounting and consulting are indeed strange bedfellows; advising companies on ways to *improve* profitability while at the same time impartially scrutinizing the books to *assess* profitability is a precarious balancing act, akin to having the defense attorney in a criminal case also serve as judge and jury. Accordingly, the SEC is proposing formal restrictions on the range of consulting services that auditors' firms can provide.

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The accounting firms have, predictably, protested the changes. Citing the integrity and professionalism of their personnel, they argue that auditors are deterred from behaving unethically by the negative consequences of violating existing rules. They point out that there have been no documented cases in which the provision of consulting services is known to have produced a violation of auditor independence. But, even setting aside the evidence of last year's scandal, their claims to impartiality are hard to believe, and, in our opinion, it's time for a new regulatory approach.

Auditors Are Only Human

The accountants' claim that there are no known cases in which conflicts of interest have led to violations of auditor impartiality is technically true. But that doesn't mean such cases don't exist. For a start, specific violations of impartiality are almost impossible to detect. It is as difficult to demonstrate that any one audit is biased as it is to prove that any one person's lung cancer was caused by his smoking habit.

More important, though, auditors will be quite unconscious of their bias because it stems from human nature rather than any act of will. Research by psychologists and economists consistently shows that the human mind automatically discounts information that is inconsistent with what a person already believes or wants to believe and places disproportionate weight on information consistent with the person's beliefs and desires. Even the most professional and upright auditors will have an unconscious but nonetheless real bias. This bias is all the more pernicious because people seldom believe it applies to them personally – even when confronted with the research.

Since the bias is inherently unintentional and unconscious, attempts to deter people from its influence are doomed to failure. What's more, publicizing potential conflicts of interest to warn customers that information may be biased is unlikely to be effective because the public, like the auditors themselves, fails to recognize or underestimates the bias.

Conflicts Beyond Consulting

The SEC's proposed regulations would certainly go a considerable way toward reducing the accounting profession's conflicts of interest arising from consulting. But in our view, the reforms do not go far enough. Indeed, the debate about conflicts of interest in consulting actually obscures a far more important problem: auditors are hired and fired by the companies they audit. To use another trial metaphor, it is as if the defendant were responsible for recruiting and paying the judge and jury.

This flaw virtually ensures violations of auditor independence. An unbiased judgment cannot occur when an auditor has such a strong motivation to please the client with a favorable report.

One solution to that problem would be to require client companies to engage auditors on irrevocable and nonrenewable fixed-term contracts. The auditor would gain little from producing overly favorable audits because there would be no chance of renewing the engagement for a considerable period of time.

That kind of reform would represent a fundamental change in the auditor-client relationship, and given the powerful interests involved, we would expect even stronger opposition from the profession than we have seen to date. Yet that is precisely where the debate on auditor independence needs to go from here. Auditors are only human, and their impartiality can be assured only by removing the conflicts of interest that create their biases.

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