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Is it time for auditor independence yet?

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Introduction

In his 1984 ruling in the case of United States v. Arthur Young & Co., Supreme Court Chief Justice Warren Burger argued for the fundamental importance of auditor independence. Auditors, he wrote, played a watchdog role that is essential to the efficient operation of and public trust in capital markets: "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."

Professional auditors have historically expressed similar views (Mautz & Sharaf, 1961). More recently, Nelson (2006) wrote, "Law requires that audits be performed by certified public accountants that are 'independent' of the company." Independence is necessary to prevent auditors from biasing their opinions in favor of their clients. As Nelson (2006) argues, "auditors should strive for accuracy, or at worst strive for conservatism that introduces a slight negative bias to the client's financial situation."

Creating an auditing system that delivers the independence it requires has not proven so simple. Consider the following two alternatives:

(A) To maintain auditors' independence, prohibit auditors from providing non-audit services to their clients, taking jobs with their clients, or establishing durable long-term partnerships; or
(B) Start by creating a variety of incentives that motivate auditors to want to please their clients, then try to identify a very complex set of legislative and professional incentives to counteract the corrupting influences created by the desire for auditors to please their clients.

We, along with our colleagues (Bazerman, Loewenstein, & Moore, 2002; Bazerman, Morgan, & Loewenstein, 1997; Moore, Tanlu, & Bazerman, 2010; Moore, Tetlock, Tanlu, & Bazerman, 2006), are on record supporting Option A, yet today there are numerous apologists for Option B, including accounting firms, accounting scholars, and legislators. A notable exception from the accounting field was Arthur Andersen (the person), who argued strongly against auditing firms providing consulting services to their audit clients on the basis that it would compromise the integrity of their audits. We believe that Andersen's failure to win this argument has been a key barrier to the integrity of the auditing profession.

Well before the collapse of Enron and Arthur Andersen (the firm), Bazerman et al. (1997) argued that the auditing system had been corrupted by the incentives auditors face to please their clients. We stated that even honest auditors were incapable of independence within the current regulatory framework. This is not because auditors are any more corruptible than the rest of us, but simply because the human mind is so adept at interpreting ambiguous evidence, such as questionable financial data, in self-serving ways (Babcock & Loewenstein, 1997; Kunda, 1990; Thompson and Loewenstein, 1992). Thus, following Option A above, we believe that auditors should only provide auditing services; that auditing firms (not just lead auditors) should work on a contract for fixed number of years that cannot be terminated by the client or renewed; and that auditors should not be allowed to take jobs with the firms that they audit for a significant amount of time specified by federal rules. These reforms would impose short-term costs on firms, which would have to restructure their professional service procurement, but would serve the larger goal of beginning to restore integrity to the auditing function. Many believe that the failure of auditor independence has contributed to the collapse of corporations, the loss of jobs, and a widespread lack of trust in the US financial system. Despite paying a dear cost, our society thus far has failed to act to create a truly independent auditing system.

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In 2000, SEC chair Arthur Levitt held congressional hearings on the issue of auditor independence due to his concern that delivering consulting services could impair auditor judgment. For reasons we detail below, those hearings produced little action. Since then, our economy has seen financial disasters in which the rate of auditor involvement is disturbing. Yet we still have failed to reform the auditing system to provide meaningful auditor independence.

There are many barriers to change. In this short article, we highlight two of the most significant barriers.

Barriers to independence

One critical barrier to auditing reforms is the political activity of accounting firms. During Levitt's 2000 congressional hearings, the leading accounting firms engaged no fewer than seven lobbying firms to fight his reform proposal. According to the information available at www.OpenSecrets.org, the leading accounting firms donated over $10 million to national political campaigns and spent another $12.6 million on federal lobbying during 2000.

Levitt received dozens of letters opposing his efforts from corporate executives and congressmen. On September 20, 2000, Enron Chairman Kenneth Lay wrote to Levitt to attest to the benefits his energy trading company had received from one-stop-shopping with Arthur Andersen: "...Enron has found its 'integrated audit'[1] arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions" (Lay, 2000). Andersen's services to Enron were more comprehensive than Levitt knew; it turned out that David Duncan, the Andersen partner in charge of Enron's audits, had written Lay's letter with help from Andersen's Washington lobbying firm (Smith, 2002).

During the 2000 hearings, Joseph Berardino, the CEO of Arthur Andersen, testified that his firm had put "significant new measures" in place "to bring greater audit committee scrutiny over scope of practice." According to Berardino, "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 matters' as unfairly impugning the abilities and integrity of these committees."

Also during this time, Representative Billy Tauzin led the campaign against auditing reform in Congress, after receiving more than $280,000 in campaign contributions from the accounting industry in the 1990s. Finally, House Appropriations Committee Member Henry Bonilla threatened to slash the SEC's budget if Levitt did not back down on auditor independence (Mayer, 2002). Reluctantly, Levitt gave up the fight—a decision he later called his biggest mistake as SEC chief (Levitt, 2002).

A second and related barrier to creating auditor reform is the human tendency to overvalue the status quo. Virtually whenever a significant reform is proposed, some people can be expected to resist it by insisting that more evidence is needed before a change is made (Bazerman, Baron, & Shonk, 2001). At the 2000 SEC hearing, Berardino was joined by KPMG Vice President J. Terry Strange and Deloitte and Touche Partner Robert Garland in demanding that, before moving ahead with reform, the SEC provide evidence of past instances of audit fraud caused by auditing firms' consulting business. "Given what is at stake," Garland argued, "and the fact that there is no demonstrated problem, it would be irresponsible to take on the considerable risks surrounding the proposed rule" (Norris, 2000). According to Strange, "nonaudit services improve audit effectiveness" (Norris, 2000). Berardino went on to argue that "[T]he more the auditors know about their client the better the audit is." If they believed what they were saying, audit firms should be willing to provide data to academic investigators and federal regulators that might allow for more systematic tests of their assurance.

The auditing industry succeeded in preventing the reforms that might have saved us from the disasters of the new millennium. Meanwhile, academics stood on the sidelines and offered too little to the debate over the conflicts of interest that were destroying the independence expected by the auditing function, other than the results of a few equivocal studies. The interesting proposals that academics did make (Ronen, 2006) failed to receive anywhere near the support they would have required to introduce meaningful change to the current system.

Restoring trust requires massive change

Krugman (2009) highlighted the importance of having an honest auditing system by quoting a speech given by Lawrence Summers in 1999, when he was President Clinton's deputy Treasury secretary (from 2009–11, he was the Obama administration's top economist): "If you ask why the American financial system succeeds," Summers said, "at least my reading of the history would be that there is no innovation more important than that of generally accepted accounting principles: it means that every investor gets to see information presented on a comparable basis; that there is discipline on company managements in the way they report and monitor their activities." Krugman went on to add "So here's what Mr. Summers – and, to be fair, just about everyone in a policy-making position at the time – believed in 1999: America has honest corporate accounting; this lets investors make good decisions, and also forces management to behave responsibly; and the result is a stable, well-functioning financial system. What percentage of all this turned out to be true? Zero."

We agree with the high value that Summers places on comparability and discipline. Yet much more could have been done to ensure an ethical system of accounting. In the years since Summers spoke, we have paid substantial

[1] Lay was referring to services where the audit was part of a broader set of professional services, including consulting services. He was not referring to the PCAOB's current use of the term "integrated audit".

penalties for our failure to act. Perhaps these costs can provide executives and academics with sufficient motivation to work for true independence in our auditing system.

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