The Failure of Auditor Independence: Cognitive, Structural, Legislative, and Political Causes

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Abstract

The collapse of Enron represents a pivotal point in U.S. business history. While many deficiencies in the U.S. business model have been highlighted, perhaps the key failure that has become salient is the failure of our auditing system to create true independence. We provide a brief history of attempts to create and prevent auditor independence in the U.S., and then outline the critical cognitive, structural, legislative, and political barriers to true independence.
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The efficiency of capital markets depends fundamentally on the availability of reliable information about the condition of the firms whose stock is traded. Therefore, law requires that all publicly traded firms submit to audits of their financial reports, performed by independent outside auditors, hired at the firm's expense. Independence requires that these audits be carried out without bias or subjectivity. Auditors are charged with ensuring that their clients' public financial reports have been prepared in accordance with Generally Accepted Accounting Principles (GAAP), or to issue an opinion stating otherwise. According to the American Institute of Certified Public Accountants (AICPA) Council, “Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession’s strength and its stature” (Carey, 1970 p. 182). Yet, in this paper, we will document that auditor independence remains an illusion in the United States, and that the reasons for its failure are cognitive, structural, legislative, and political. We will further argue that the current system is profoundly flawed and that it remains in need of dramatic reform if the promise of independence is to be realized.

Simply stated, auditors are required to be independent from and unbiased by the clients’ interests. As former Chief Justice Warren Burger wrote on behalf of a unanimous U.S. Supreme Court in the case of United States v. Arthur Young & Co (1984):

By certifying the public reports that collectively depict a corporation’s financial status, 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 corporation'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.

The failure of auditor independence was not high on the list of citizen concerns prior to the collapse of the Enron Corporation. However, the public’s attention to audit regulation and its trust in financial institutions witnessed an abrupt shift following Enron’s bankruptcy. Enron may have been the most important failure of auditor independence, but it was by no means the first, it was not the largest, and has not been the last. The earnings restatement that precipitated Enron’s fall revised profits downward by $650 million. Yet prior to Enron, Waste Management Inc. overstated earnings by $1.43 billion over a five-year period, and U.S. regulators found that their auditors, Arthur Andersen LLP, conspired to hide accurate accounting data from the public. Andersen agreed to pay $7 million to settle federal charges of audit fraud at Waste Management, and another $220 million to settle litigation with Waste Management shareholders. In another case, Andersen was charged with audit fraud by the Securities and Exchange Commission (SEC) in its audit at the Sunbeam Corporation. The shareholders of Sunbeam sued Andersen for fraudulent accounting and Arthur Andersen agreed, in April of 2001, to pay $110 million to settle the claims. Since Enron’s fall, WorldCom (another Andersen client) has restated earnings by revising its earlier profit reports downward by a shocking $9 billion. In all of these cases, the auditors clearly failed to provide thorough independent review of the client’s financial reports.

These cases are only the most vivid examples of the multitude of cases in which the Big Five (now the Big Four) audit firms paid to settle law suits or lost cases in courts, partially as a
result of a failure of auditor independence (Bazerman, Loewenstein, and Moore, 2002). Even in the short time since Enron plunged from the ranks of the Fortune 10 into bankruptcy, Adelphia, Bristol-Myers Squibb, Global Crossing, Halliburton, Qwest, Tyco, and Xerox quickly moved into the headlines for similar financial reporting problems. There is no shortage of speculation about the root cause of these disasters. Some theories attribute them to changes in institutional arrangements, such as the increased use of stock options to compensate top managers, which created new incentives for showing ever-growing earnings. Others point to an erosion of corporate ethics – to a focus on what is technically legal as opposed to what is morally right.

While corporate managers may attempt to manage earnings or manipulate reports so as to make them look as good as possible, the consequences would have been minor if these companies’ books had been subject to the kind of careful independent scrutiny that the U.S. system of auditing is supposed to provide.

Auditor independence is widely assumed by financial markets. Investors, employees, and strategic partners rely on audited financial statements as if they represent truthful and reliable information regarding firms’ financial health. While a corporation’s managers often have powerful incentives to make their performance appear better by improving reported earnings, yearly audits are supposed to help immunize the company’s financial reports from the threats posed by such incentives. Shareholders count on auditing firms to provide these independent reviews. Yet, for independence to exist, audit firms’ reports must not be affected by the interests of the client, or for that matter, the auditor.

In this paper, we will provide a short history of auditing in the United States, identify the continuing bases of conflict of interest in the auditing system, and specify the structural, cognitive, legislative, and political causes for the failure of auditor independence. Specifically,
we will show that the structure of the auditing industry makes the claim of auditor independence psychologically implausible, given evidence on human cognition. We will ask how the legislative process has allowed these flawed structures to persist, given the evidence of their failure. And, finally, we will show how politics prevents us from making meaningful changes in the legislative system. In sum, we will show that the United States has institutionalized a corrupting system.

An Abbreviated History of Auditor Independence

Prior to the market crash of 1929, there was relatively little regulation of the securities markets in the United States. Financial disclosure was not required, as investors were concerned mainly with price appreciation, without regard to actual financial performance of the firms whose stock they owned. Many of these investors lost large amounts of money in the stock market crashed in October 1929 and the depression that followed. These events caused public confidence in financial markets to falter, and in order to restore faith in capital markets, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, establishing what we now recognize as the Securities and Exchange Commission (SEC). Furthermore, it was the Securities Exchange Act of 1934 that required publicly traded firms to file financial reports with the SEC, so that the SEC could make the reports public. The same law also required that financial statements filed with the SEC be reviewed by an independent outside auditor.

The SEC was given statutory authority to set accounting standards and oversee the activities of auditors, while the accounting profession was given the role of establishing auditing standards (AICPA, 2002). Despite the SEC’s mandate to set accounting standards, it has generally relied on private sector standard-setting bodies to lead in the establishment and
improvement of accounting standards. The American Institute of Certified Public Accountants (AICPA) was the main standard-setting body until 1972, when the primary responsibility of standard setting was transferred to the Financial Accounting Standards Board (FASB), which still sets the accounting standards today. The FASB accounting standards are officially recognized as authoritative by the SEC. The AICPA, through its Accounting Standards Executive Committee, works with the FASB in setting and clarifying accounting standards. Thus, the auditing profession has been self-regulated through the AICPA, which is a voluntary membership organization consisting of over 350,000 individual members, and approximately 1,200 national, regional, and local accounting firms are part of its SEC Practice Section (SECPS), which is a self-regulatory group whose aim is to improve the practice of CPA firms. In terms of total revenues, the Big 5 accounting firms in 2002 (which still included Arthur Andersen) accounted for $22.3 billion (78 percent) of the Top 100 firms’ total revenue of $28.5 billion.\(^1\) In 1980 these firms were collectively known as Big Eight. Mergers and the recent collapse of Arthur Andersen have left four: KPMG, PriceWaterhouseCoopers, Deloitte & Touche, and Ernst & Young. All AICPA member firms auditing public clients are under the regulatory authority of the SEC, and are required to comply with a peer review requirement every three years.

Although the auditing profession has always been largely self-regulated, several regulatory bodies have been set up, partially as a result of highly publicized bankruptcies in the 1970s, to support the auditing profession and to ensure that standards are in place. For instance, the Public Oversight Board (POB) oversaw the peer review and quality control inquiry processes from the SECPS, from which it operated independently. The Quality Control Inquiry Committee was established in 1979 to investigate alleged audit deficiencies of a firm’s quality

\(^1\) Accounting Today (www.electronicaccountant.com)
control systems. The Independence Standards Board (ISB), was a private-sector body formed to provide a conceptual framework for independence issues related to the audits of public companies (Arens, Elder, and Beasley, 2003).

It is interesting to note, however, that despite—or perhaps because of—the frequency and magnitude of accounting fraud and earnings manipulations cases that have been exposed in the last few years, the ISB, which was originally created in 1997, has ceased operations on July 31, 2001, and the POB, which was formed in 1977, also terminated its activity on May 1, 2002. Both events were endorsed by the AICPA and the SEC—the very same regulatory bodies who initiated the creation of the ISB and the POB. These events raise the question of whether these bodies helped or hindered self-regulation during their existence.

Over the decades, the definition of auditor independence and what is required for independence to exist has evolved along with the accounting profession itself. In the 1920s and 1930s, the concept of independence was already considered of great importance, but was focused on eliminating conflicts of interest that arose from financial relationships between auditors and their clients. However, over the following decades, the appearance of auditor independence became as important as independence in fact, as the appearance of independence is most important for reassuring the readers of the financial statements that these statements are free of material misstatements. Indeed, many in the accounting community argue that the primary value of hiring independent auditors is to reassure current and potential investors (Antle, 1984; Dopuch, King, & Schwartz, 2001). As early as 1932, the AICPA Council noted the need for ensuring that the appearance of objectivity exists, apart from actually being independent in fact (POB Panel on Audit Effectiveness Reports and Recommendations, 2002). More recently, the SEC released an appearance-based standard governing auditor independence, stating that “an
auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment” (SEC Standard Release, 2000).

Given this history, it may not be surprising that the profession’s response to many accounting- and audit-related crises has focused on cosmetic changes that improve the appearance of independence. However, independence in appearance but not in fact has tended to increase the problem of the so-called “expectations gap.” The expectations gap refers to the gap between (1) the expectation that companies with “clean” audit opinions are free of the risk of short-term business failure and (2) the reality of sudden collapse among firms whose reports make them look healthy. Baker (1993), Fogarty, Heian, and Owen (1991), and Lee (1995) have all noted that the US accounting profession in the 1980s responded to this problem by setting up new committees to review the problem and by intensifying peer review. However, solutions that could have improved independence in fact, such as the setting of more tangible standards, the threat of disciplinary action, and the development of new audit procedures, were not pursued (Fogarty et al., 1991; Reiter & Williams, 2000).

The quality of financial reporting and earnings management have topped the regulatory and enforcement agenda of the SEC since late 1998, but it was not until June 2000 that the SEC drafted a strong proposal designed to improve auditor independence. This proposal came after numerous technical violations of financial and employment relationships with audit clients were uncovered. For example, in the summer of 1998, the SEC learned that executives in Price-Waterhouse’s Tampa office had been investing in companies the firm was auditing, in direct violation of SEC rules (Mayer, 2002). More than eight thousand such violations were uncovered within the firm. The SEC fined Pricewaterhouse $2.5 million and asked the independent Public
Oversight Board (POB) to investigate compliance with independence rules at the other major firms. Before the POB could finish its assigned task, its funding body, the accounting industry trade group AICPA, cut off funds for the investigation.

In 2000, the SEC held hearings focused on the problem of conflict of interest in auditing. Arthur Levitt, then the chairman of the SEC, argued that conflict of interest already had harmed the integrity of the nation's financial system. Consistent with the arguments made by Bazerman, Morgan, and Loewenstein (1997), the SEC argued that independence is compromised when auditors simultaneously depend on the companies they oversee for large and highly profitable consulting contracts. The SEC proposal explicitly spelled out limitations on financial and personal relationships between the employees of auditing firms and the audit clients, and enumerated a list of banned non-audit services, including financial system design and implementation, and internal audit outsourcing. Furthermore, the proposal recommended disclosure of fees paid for non-audit services.

The major accounting firms lobbied against the proposed limitations on their consulting work, and it was at this time that accounting firms dramatically increased their political contributions (Mayer, 2002). Shortly thereafter, members of Congress pressured Levitt and the SEC to implement much weaker reforms than those initially sought. The resulting compromise allowed auditors to continue offering consulting services, but firms had to disclose how much they paid their auditors for both audit and non-audit services. The final watered-down version of the Auditor Independence Rule was adopted in November 2000.

This new rule, however, did not prevent the financial scandals at Enron and WorldCom. This recent wave of financial disasters created enough public outrage that the U.S. Congress passed the Sarbanes-Oxley Act of 2002. The Act includes a number of stipulations that increase
auditor independence, but this change comes more in appearance than in fact. For example, many have endorsed the Act’s stipulation that auditors rotate every five years. Yet the Act in fact only stipulates the rotation of the lead audit partner, not the audit firm itself. Press reports also highlighted the Act’s ban on the provision of non-audit services, but typically ignored two facts: (1) the ban omits important services, such as tax services; and (2) Provision 201b of the Act allows the new Public Company Accounting Oversight Board to “exempt any person, issuer, public accounting firm, or transaction from the prohibitions on the provision of services…” on a case by case basis. Furthermore, while the Act prohibits employees of audited firms from changing jobs and serving as auditors, this prohibition applies only to those who had served as CEO, CFO, controller, or chief accounting officer at the client firm, and only places a one-year limit on them auditing their former employers. In other words, while the Act appears to address important issues surrounding auditor independence, it does so in a superficial way that is insufficient to create true auditor independence.

Structural Threats to Auditor Independence

The current auditing system institutionalizes many potential threats to independence. This section focuses on the three: auditors providing non-audit services, managers hiring and firing auditors, and auditors taking positions with clients.

Non-audit services. Much of the proposed regulation on auditor independence has focused on the provision of non-audit services, also known as management advisory services (MAS) by audit firms to their audit clients, which is perhaps the most common factor that apparently affects auditor independence. As early as 1925, the issue of whether or not accounting firms should engage in non-accounting activities was brought up in the Journal of
Accountancy. Richardson (1925) mentions two schools of thought on this question: The first advocates spreading out into new fields and performing services for clients that are “of accountancy or otherwise.” The second endorses the idea that accounting firms should stick only to their accounting and auditing duties. In 1953, the AICPA established its first committee on management services to tackle the issue of accounting firms performing MAS, but not much regulation or significant standard-setting was performed until 1978, when the SEC required companies to disclose any non-audit services performed for the companies by their auditors if and when the fees paid to the external auditor for non-audit services were at least 3% of the audit fees paid. However, this requirement was repealed in 1982, when the SEC concluded that the required disclosure “was not generally of sufficient utility to investors to justify continuation.”

Over the last two decades, however, the business model and earnings mix have drastically changed for accounting firms. According to records compiled by the SECPS, fees for non-audit services have increased from 47 percent of total revenues in 1990 to 66 percent in 1999 for the major accounting firms (POB Panel on Audit Effectiveness Reports and Recommendations, 2002). Meanwhile, highly profitable audit services grew from providing 30 percent to 70 percent of earnings for the major accounting firms. Investor Responsibility Research Center also surveyed 1,200 firms in 2000 and found that $5.7 billion had been paid to auditors—72% of which related to non-audit services (including consulting, actuarial, and valuation services). Finally, the SEC estimated that for accounting firms, 50% of total revenues were received for non-audit services in 1999, which is a stark contrast to 1981, when only 13% of total revenues were from non-audit services (SEC Standard Release, 2000).

Turpen (1995) argues that the provision of non-audit services by auditors creates a perceived lack of auditor independence. These perceptions have been documented among
partners of accounting firms of various sizes, loan officers, members of US companies’ boards of directors, and financial analysts (Farmer, Rittenberg, & Trompeter, 1987; Gul, 1991; Knapp, 1985; Pany & Reckers, 1983; Shockley, 1981). Frankel, Johnson, and Nelson (in press) suggest that the provision of non-audit services does, in fact, reduce auditor independence. They found that the more firms paid their auditors for non-audit services, the more likely they were to just meet or beat earnings expectations, suggesting that those firms’ auditors were more willing to help them engage in so-called “earnings management.”

However, not all studies have reached the same conclusion. Craswel, Stokes, and Laughton (2002) failed to find a relationship between audit fees as a percentage of total fees and the propensity to issue critical audit reports, but there are many reasons why research might fail to find such a relationship, including small sample size or large error variance in the data. McKinley, Pany, and Reckers (1985) showed that the provision of MAS need not necessarily lead to a perceived failure of independence. They asked bank loan officers to consider lending money to hypothetical firms. The firms were all presented as having unqualified audit reports, and the experimenters manipulated how much the loan officers were told the auditors had been paid in non-audit services. The results show (1) hypothetical lending decisions were not affected by the provision of MAS; and (2) subjects were more confident that financial statements prepared by the auditors whose fees include 30% of management advisory services were perceived to be more significantly free of fraud than auditors providing only audit-related services, perhaps because respondents believed that MAS performance led to tighter controls.

Who hires and fires the auditors? Clients have the freedom to choose their auditor, and to the extent that management has control of the selection of auditors, they will have many reasons to select the auditor based on characteristics that would lead to a greater likelihood of an
affirmative audit opinion. Auditors may engage in the practice of "low-balling": offering a discounted price for audit services in order to build a relationship that could become profitable later, either by increasing audit fees or by cross-selling services. Some have denied that this practice will increase the auditor's motivation to acquiesce to the client's desires in order to maintain the business relationship (DeAngelo, 1981a; Lee & Gu, 1998). Nevertheless, the fact that the probability of a client switching auditors increases following a critical audit report is likely to reduce the auditor's desire to do so (Levinthal & Fichman, 1988; Seabright, Levinthal, & Fichman, 1992).

Some researchers have posited that the size of the audit firm would affect the degree to which they are affected by the threat of being fired. DeAngelo (1981a) and Simunic (1984) argue that larger audit firms ought to be less resistant to management pressure to manage earnings, and Eichenseher (1984) and Palmrose (1986) have suggested that “brand-name” auditors are perceived to be more independent. However, research in this area has been inconclusive. Pany and Reckers (1980), and McKinley, Pany, and Reckers (1985) failed to find an effect of audit firm size. Even if the audit firm itself does not depend on any specific client for its survival, the careers of particular audit partners depend a great deal on the success with individual accounts, even if those accounts represent a tiny proportion of the audit firm’s earnings. Finally, several studies (Beck, Frecka, & Solomon, 1988; Dies & Giroux, 1992; Mautz & Sharaf, 1961) have suggested that auditor independence and the quality of auditing decisions deteriorate as the tenure of the auditor increases. Overall, however, we only have indirect evidence on whether hiring and firing decisions have a negative causal influence on audit quality.
Auditors taking jobs with clients. Auditors’ independence from their clients is compromised by any relationship that builds a common identity between the two. Psychological research on the so-called minimal group paradigm has demonstrated how easy it is to establish a group identity that leads people to treat fellow in-group members with favoritism (Tajfel & Turner, 1986). Thompson (1995) has shown that even the most superficial affiliation with a partisan leads people to interpret ambiguous information in ways that are consistent with the partisan’s interests. There can be few more effective means of establishing a common identity between auditor and client than rotating personnel through a revolving door between the two of them. This was the case in Andersen’s relationship with Enron, as it is at other accounting firms and their clients. Obviously, independence is compromised when an auditor hopes to develop job opportunities during the course of the audit. The minimal restrictions on personnel rotation established by the Sarbanes-Oxley Act are clearly insufficient.

Collectively, the provision of non-audit services, the hiring and firing of auditors, and the career paths of accountants all pose significant threats to auditor independence. We argue that our cognitive, legislative, and political systems take advantage of these structural characteristics to prevent the creation of true auditor independence.

Cognitive Threats to Independence

The field of accounting has been dominated by an economic lens of analysis. Consistent with this approach, models of auditor independence have assumed that independence is a question of whether the auditor chooses to carry out a thorough audit and whether to collude with a firm’s managers (Antle, 1984; DeAngelo, 1981b; Simunic, 1984). Psychological research on the impact of motivated reasoning and self-serving biases questions the validity of this
assumption. This evidence suggests that intentional corruption is probably the exception, and that unconscious bias is far more pervasive. Auditors are human, and evidence suggests that humans are not very good at disregarding their own self-interest in order to evaluate information impartially, even when they try. In choosing how to allocate scarce resources, people believe that they deserve more than reality suggests (Messick & Sentis, 1979). People justify this pattern of behavior by reference to whatever arguments favor them (Diekmann, 1997; Diekmann, Samuels, Ross, & Bazerman, 1997; Messick & Sentis, 1983), without being aware of this selective perception. This tendency can have important consequences in consequential economic decisions (Babcock & Loewenstein, 1997; Thompson & Loewenstein, 1992).

People appear to evaluate evidence in a selective fashion when they have a stake in reaching a particular conclusion. They focus on evidence supportive of the conclusion they would like to reach (Holyoak & Simon, 1999; Koehler, 1991; Lord, Ross, & Lepper, 1979; see Rabin & Schrag, 1999 for a theoretical model; Russo, Medvec, & Meloy, 1996; Russo, Meloy, & Medvec, 1998). Conflicting evidence tends to be either ignored or subjected to special scrutiny (Gilovich, 1991). This tendency toward biased information processing prevails even when people on different sides of an issue are exposed to the exact same information (Babcock et al., 1997). While some observers have suggested that professional auditors might be less subject to these biases, research has found professionals to be vulnerable to the same motivated biases as are other people (Buchman, Tetlock, & Reed, 1996; Cuccia, Hackenbrack, & Nelson, 1995; Moore, Loewenstein, Tanlu, & Bazerman, 2003). Once auditors take a partisan perspective, they are no longer able to objectively assess the data, and see ambiguous data consistent with the preference of their clients (Babcock et al., 1997; Messick et al., 1979).
When it comes to biased judgments, evidence suggests that people are more willing to endorse a biased proposal made by someone else than they are willing to make on their own. Diekmann, Samuels, Ross, and Bazerman (1997) showed that people tend to be somewhat more cautious about indulging their biased preferences when they are asked to make their own independent proposals than when they are asked only to approve or reject a proposal made by someone else. The current system, in which auditors are charged only with assessing whether or not the client's reports comply with GAAP, is likely to exploit the tendency to "go along" with the actions of another even when that action raises some questions or concerns.

Some have argued that firms have a real interest in reporting a breach of accounting if it exists, given the threat of legal penalties and shareholder lawsuits. It is further argued that this interest should lead firms to establish systems that could counteract the threats to independence posed by the issues described above. While it is clearly true that accounting firms do have an interest in preserving their reputations and avoiding legal charges of fraud, it is entirely unclear whether these interests are sufficient to counteract the real and immediate incentives to build relationships with clients and sell them services, especially given the reductions in the threat of civil penalties.\(^2\) Furthermore, even if firms have an interest in creating unbiased reports, individual auditors, whose careers may depend on building relationships with their clients, and who may even be interested in jobs with those clients, face very different incentives.

Legislative Threats to Independence

In the SEC hearings of 2000, the Commissioners focused on the search for a “smoking gun” proving bias. Lobbyists for the accounting industry and CEOs from Big Five accounting

\(^2\) The Securities Reform Act of 1995 changed the standard for assessing liabilities in securities fraud cases from joint and several to proportionate liability, thereby reducing the liabilities faced by the accounting firms.
firms had noted that there is no evidence of a single audit being tainted as a result of the auditing-consulting relationship. The Commissioners were looking for the email or the memo that provided clear evidence of knowing and intentional corruption. Although such evidence may sometimes come out, as it did in hearings on Waste Management, proving that a particular case of audit fraud was caused by non-audit services is nearly as difficult as proving that any particular smoker’s lung cancer is due to smoking; any single case is complicated by numerous confounding factors. More importantly, this standard of proof makes the error of assuming that the most common threat to auditor independence lies in intentionally corrupt behavior. If the real threat is unconscious bias, auditors may be profoundly biased without ever having had the intention to indulge in corruption. If the problem is bias, then we need to change the system, not simply lock up the guilty parties. Thus, we argue that the search for a “smoking gun” is a legislative error of focusing on finding the corrupt individual, rather than addressing the real cause of a corruption.

This search for the corrupt people is broadly consistent with the fundamental attribution error in psychology (Ross & Nisbett, 1991). This judgmental error describes the tendency to attribute the cause of an event or problem to an individual, rather than the broader situation or context. Thus, when error is in this system, we seek to find the corrupt person to punish. We do not search first for what is wrong with the overall system that will create problems even with honest auditors, nor do we attack the parties that corrupt the system by lobbying to keep the inefficient system in place.

Finally, our legislative system does not ask what would the ideal system look like. Rather, we ask what adjustment, if any, should be made to the status quo. Benartzi and Thaler (1999), Samuelson and Zeckhauser (1988), and Bazerman, Baron and Shonk (2001) provide
substantial evidence that humans and governments tend to be overly attached to the way things have been done in the past. Too often, overwhelming evidence is necessary to get governments to change their institutions. Thus, rather than asking what the best system would look like, governments ask whether there is sufficient public pressure to change the status quo. As we will see in the next section, the accounting industry was more than ready to muddy the clarity of this decision when politicians began considering reform.

Political Threats to Independence

In the presidential primaries of 2002, campaign finance reform finally caught the attention of the public. Both Bradley and McCain made campaign finance reform a key issue. We were educated about how some members of Congress portrayed the tobacco crop as the only defense against an economic collapse of Kentucky, North Carolina, and Virginia, that the U.S. government spends $83.5 million annually assisting tobacco growers, and that Congress routinely votes down efforts to lower these subsidies (Bazerman et al., 2001). All of this occurs despite the fact that tobacco subsidies mean cheaper cigarettes, with the net result that Americans smoke more cigarettes and more of them die from smoking-related illnesses. How do special interest group politics and the failure of meaningful campaign finance reform play out in auditing?

In 2000, Arthur Levitt and the SEC were considering significant reforms to our auditing system, which would have required the break-up the auditing and consulting functions of accounting firms. At that time, Levitt became the target of what he later called an “intensive and venal lobbying campaign” (Lobaton, 2002). The accounting industry convinced 46 members of Congress to call or write letters to Levitt questioning the proposed rule www.opensecrets.org,
2002). Most argued that the accounting firms were to be trusted. Some of the lawmakers threatened to withdraw funding from the SEC, or do conduct ethical reviews of the Commissioners. These 46 members of Congress included Rep. Billy Tauzin, who went on to oversee the House Energy and Commerce Committee’s investigation into Enron, and Rep. Dick Armey, the House Majority leader. In total, these 46 members received millions of dollars in campaign contributions from the Big Five accounting firms (see http://www.opensecrets.org, 2002 for details). The Big Five and the AICPA, their trade association, contributed over $38 million in contributions to the political process between 1989 and 2001 (see Table 1). In the face of this political pressure, Levitt largely backed down. He later called his decision to concede the biggest mistake of his time at the SEC (Mayer, 2002). Instead of forcing audit firms to sell of their consulting arms, the SEC merely required that firms' financial reports indicate how much was paid to auditors both for audit and for non-audit services. In 2002, the Sarbanes-Oxley Act passed, addressing some of the concerns that were discussed in 2000. While we do not yet have the details of the political process that weakened the new law as we do with the abortive 2000 attempt at reform, it is easy to observe that the details of the actual Act are far weaker than it was made out to be. The current law introduces some reforms, but they are insufficient. Most of the changes still deal with stopping intentional corruption, and still fail to account for the biases that are built into the current system.

Summary and Conclusions

Auditor independence is an easy concept to grasp, and yet extremely problematic to create. In the paper, we have attempted to show that a corrupting system has been institutionalized across levels—from the mind of the auditor to the structures that govern the industry to the legislation that exist to the political process that creates the legislation. Despite
the efforts of many different entities over the past 75 years to come up with ways to regulate the industry and profession, auditor independence remains a mirage, and current legislation will not make it a reality. We believe that only a radical reorganization of the industry will allow the term "auditor independence" to be used to accurately describe auditors’ work in the United States.

Clearly, there are multiple causes for the failure of auditor independence. Too many reform efforts have fallen victim to the human tendency to focus on a single cause when seeking to solve a problem (Gill, 1989). The political system has prevented the improvement of the legislative system that governs auditing; this faulty legislative system has institutionalized a corrupt set of structures; and, these structures lead to human corruption, and more commonly, bias.

Current laws have created an inefficient, unethical, and wasteful system. Stiglitz (1998) argues that a goal for wise government should be to create near-Pareto efficient changes. With 280 million citizens, it is difficult to create changes with no losers. However, in some cases, there exist parties that have an unfair advantage due to their distortion of the political process. We believe that this is the case in auditing. We believe that the extra costs of creating true independence are worthwhile for virtually all citizens. Only those audit firm partners and co-opted executives who have benefited by the corrupt system lose in the creation of true auditor independence. We believe that courageous leaders would move us in this direction.

We believe there are two possible solutions to fixing the problems with the current system. The first possibility would require a radical restructuring of the entire auditing industry. Ronen (2002) has proposed eliminating the legal requirement that publicly traded firms submit to regular audits of their financial reports. Instead, firms would be required to buy financial
statement insurance to insure against the possibility of being sued for issuing inaccurate financial reports. It is the sellers of such insurance, the insurance companies, who would hire the auditors.

The second possibility leaves the basic structure of the industry intact but regulates the client-auditor relationship more tightly. We propose a set of five recommendations that could go a long way toward creating true auditor independence. First, we believe that auditors should audit, and perform no other services. Any other profit-making opportunity creates an incentive that will lead to corruption and bias.

Second, we believe that an auditor should be hired for a fixed period, perhaps 5 years. During this period of time, the client must not be able to fire the auditor. If the client maintains the right to fire, again, the auditor has an incentive to please to avoid losing the client. Following this fixed period, we believe that the auditor assignment should rotate, not to another partner within the same firm (as is the case under the Sarbanes-Oxley Act), but to a different firm.

Third, auditors should not be allowed to take jobs with the firms that they audit. Allowing this revolving door creates dysfunctional incentives. This prohibition should exist not just for executives, but for all parties involved in the audit.

Fourth, auditors should make a set of independent assessments, rather than simply ratifying the accounting of the client firm. As Diekmann et al. (1997) has shown, we are much more likely to ratify than to reach the same level of self-serving decision on our own.

Fifth, the selection of the auditor should be a decision of the audit committee of the board of directors, not of management. Management will always have an incentive to make themselves look as good as possible. The value of an outside audit is to provide a reliable independent assessment of the firm’s finances for the firm’s board of directors, its investors, and other
constituents. The decision of whom to hire to make this independent assessment should not reside with the people whose work they will be evaluating.

The corporate financial scandals of 2001-2002 presented a unique opportunity to undertake serious reform of the auditing profession. The system on which investors, shareholders, and the financial markets depend for independent auditing of corporate financial reports has never provided true independence. Many may argue that such dramatic reforms may be costly. Yet doing nothing comes with even greater risks; indeed we may not be able to afford not to make these changes.
AICPA. 2002. The Enron crisis: The AICPA, the profession, and the public interest.  

AICPA SEC Practice Section. www.aicpa.org/members/div/secps/index.htm


POB Panel on Audit Effectiveness Reports and Recommendations. 2002.  


### Table 1

**Lobbying expenditures of accounting firms during calendar years 1997-2002.**

<table>
<thead>
<tr>
<th>Year</th>
<th>Arthur Andersen</th>
<th>Deloitte &amp; Touche</th>
<th>Ernst &amp; Young</th>
<th>KPMG</th>
<th>PriceWaterhouse Coopers*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$2,380,000</td>
<td>$785,000</td>
<td>$1,380,000</td>
<td>$600,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>1998</td>
<td>1,985,000</td>
<td>360,000</td>
<td>1,420,000</td>
<td>420,000</td>
<td>960,000</td>
</tr>
<tr>
<td>1999</td>
<td>1,840,000</td>
<td>890,000</td>
<td>1,200,000</td>
<td>850,000</td>
<td>1,220,000</td>
</tr>
<tr>
<td>2000</td>
<td>2,480,000</td>
<td>2,524,000</td>
<td>1,200,000</td>
<td>1,340,000</td>
<td>1,425,000</td>
</tr>
<tr>
<td>2001</td>
<td>1,540,000</td>
<td>580,000</td>
<td>1,320,000</td>
<td>1,175,000</td>
<td>1,240,000</td>
</tr>
<tr>
<td>2002**</td>
<td>-</td>
<td>160,000</td>
<td>100,000</td>
<td>980,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Data from the Office of Public Records, [http://sopr.senate.gov](http://sopr.senate.gov)

* The 1997 total is a combined total of Price Waterhouse and Coopers & Lybrand, which were then separate companies.

** Using filings made for the first six months of 2002. Not all companies have made complete filings at time of publication.