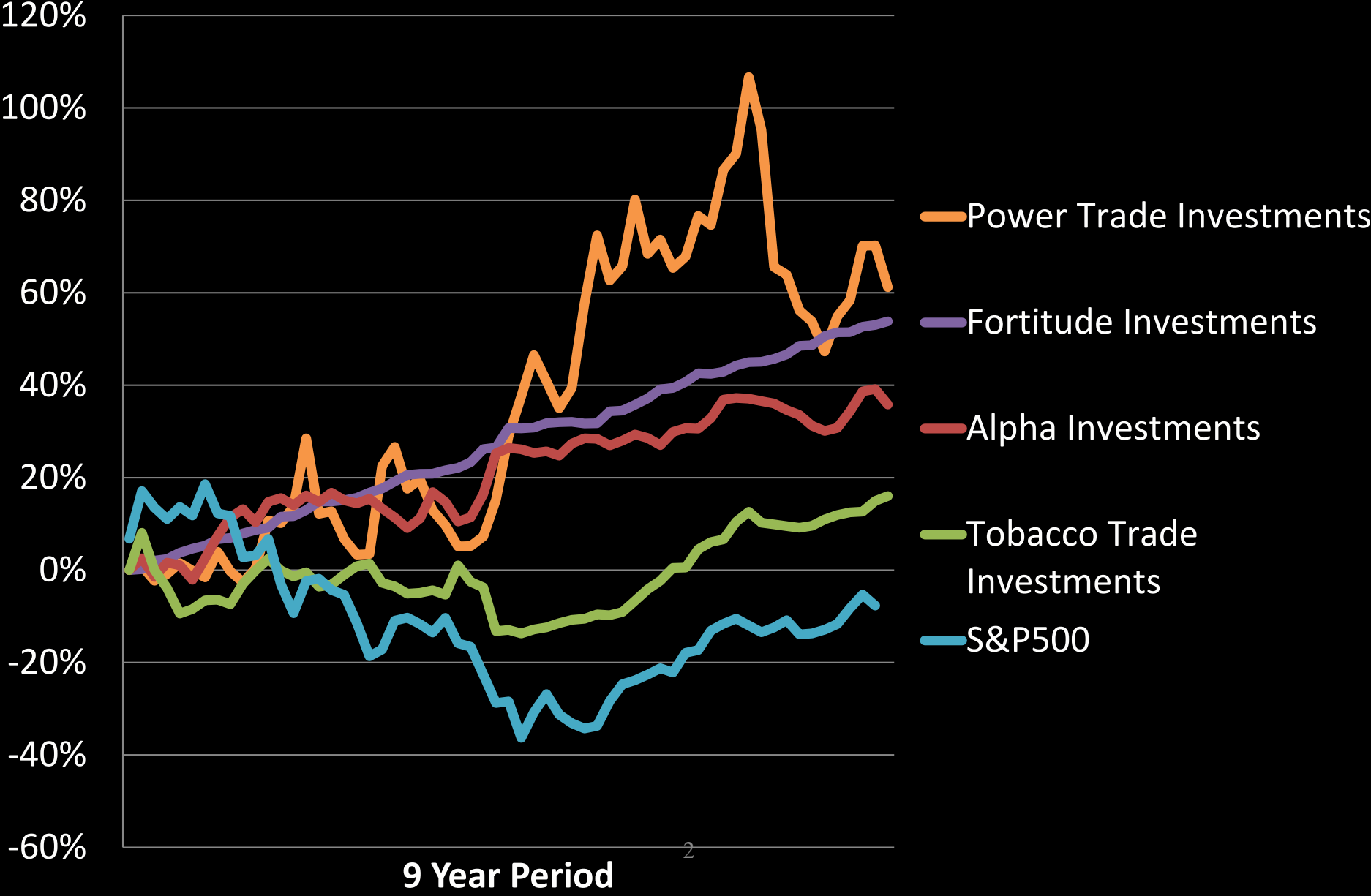


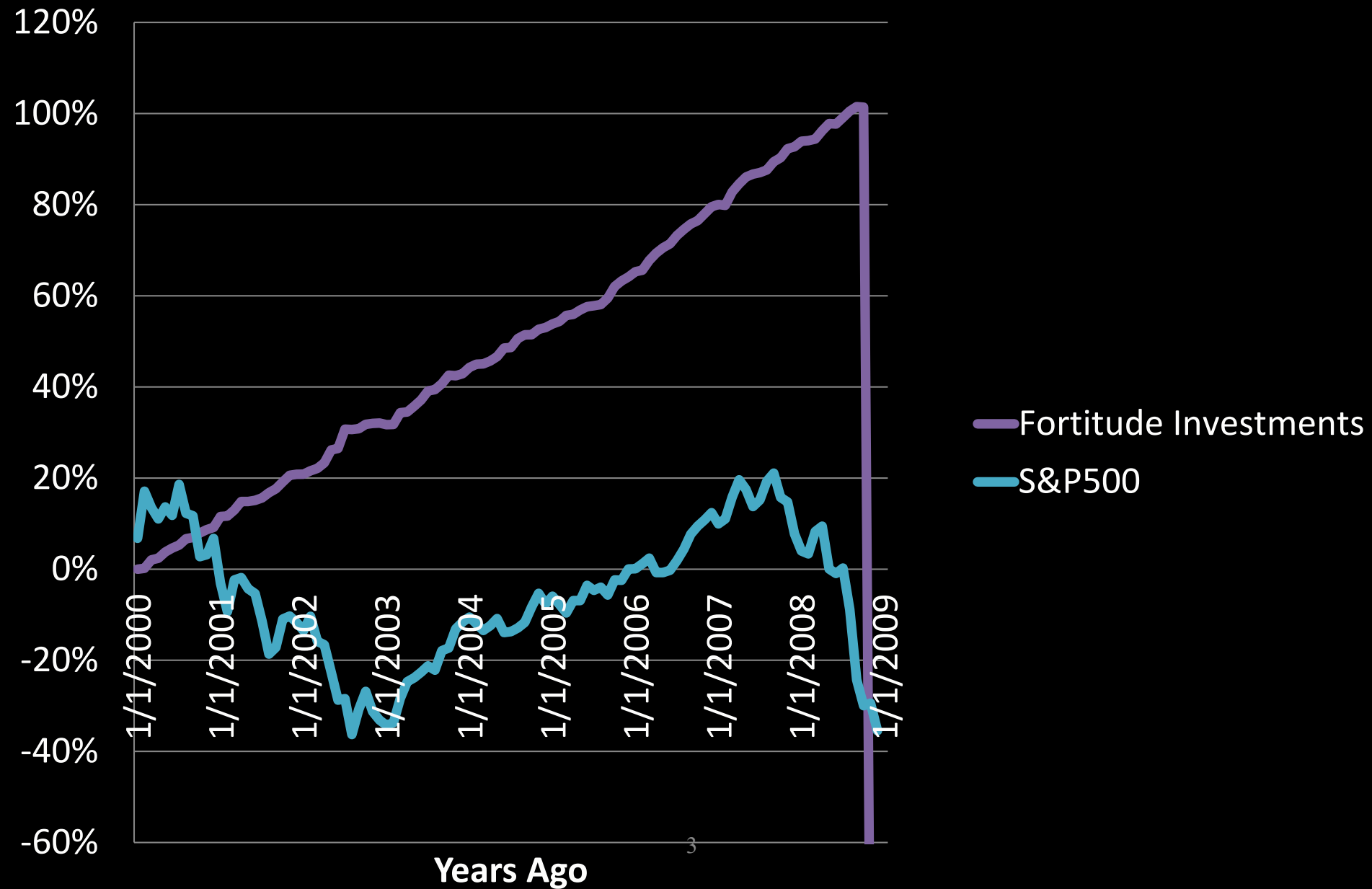
The Moral Obligation of Auditor Integrity: Avoiding Conflicts of Interest

Max H. Bazerman
Harvard Business School

Cumulative Returns



Leaders Need to Notice



Max and Accounting

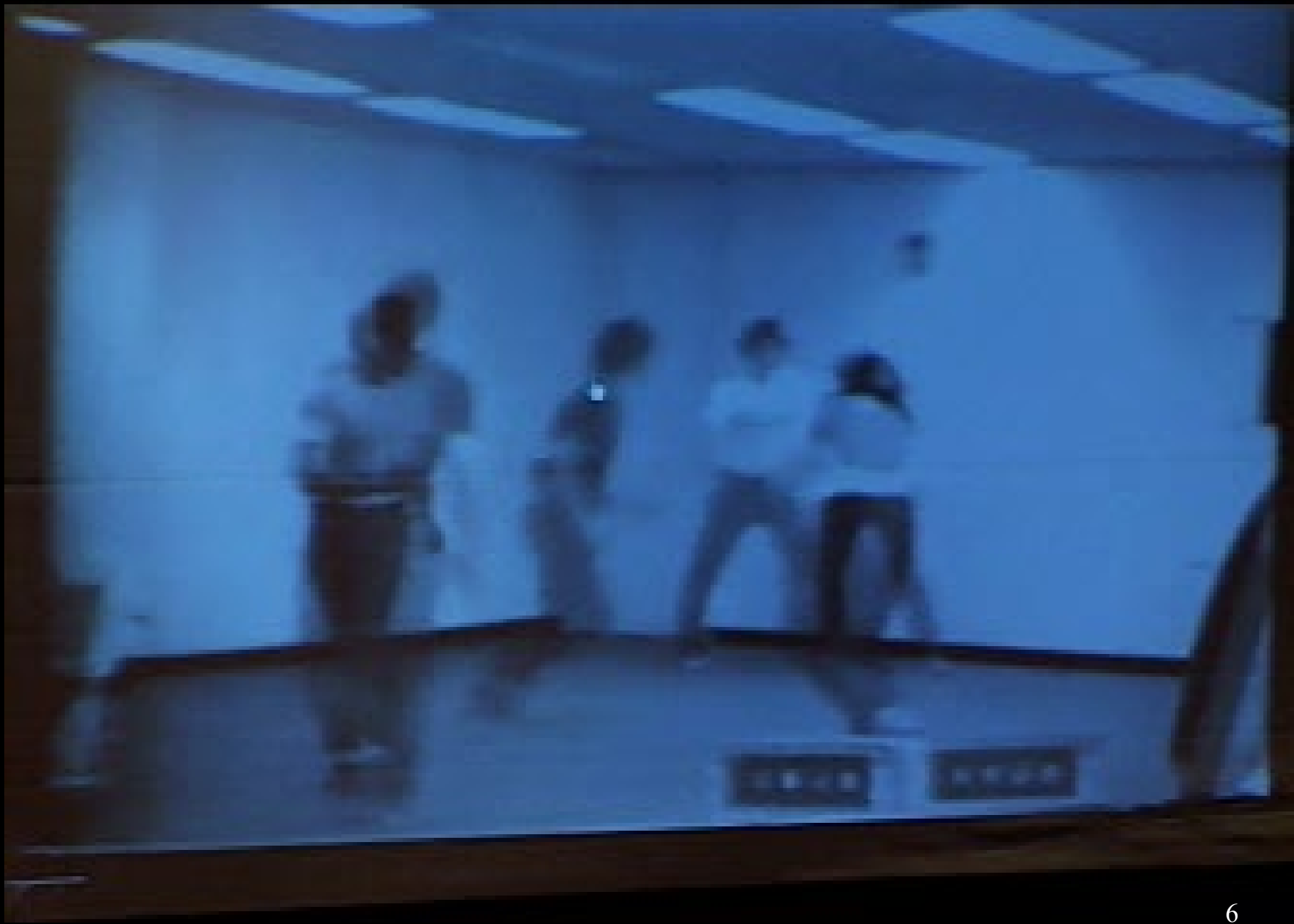
- 1) University of Pennsylvania (Wharton), B.S.E. in Accounting, 1976
- 2) 1987-1997: Lots of experience teaching employees of the Big X accounting firms
- 3) Our 1997 paper – Bazerman, Morgan, and Loewenstein – no more work with the Big X accounting firms
- 4) SEC call in 2000
- 5) The changes made were weak – focusing on disclosure
- 6) Bazerman, Loewenstein and Moore 2002 HBR paper
- 7) A handful of invited talks in the last two decades

Core Argument on Auditor Independence

Psychologists have known for a long time that individuals with a vested self-interest, even honest ones, are incapable of unbiased (independent) judgment.

- a) Auditors have made tremendous profit from selling other services to their audit clients.
- b) Auditors want to be rehired.
- c) The personnel on the audit often take jobs with the client firm.

As long as these other motives are present, auditors are not independent.



Bounded Ethicality

(Chugh, Bazerman, and Banaji, 2005)

Bounded ethicality refers to the systematic and predictable ways in which humans act unethically beyond their own awareness.

- 1) Boundedness in your ethicality
- 2) Boundedness in noticing the ethicality of others

Boundedness in Your Ethicality

- 1) Implicit Attitudes (lots of work by Banaji, Greenwald et al.)
- 2) In-group/Out-group Biases (Messick op-ed)
- 3) Discounting the Future (Wade-Benzoni, 1999, 2002; Bazerman and Watkins, 2008)
- 4) Overclaiming Credit (Ross and Sicoly, 1979; Caruso, Epley, and Bazerman, 2006; Epley, Caruso, and Bazerman, 2006)

Boundedness in Noticing

- 1) **Conflicts of Interest** (Chugh and Bazerman, 2007; Moore, Tanlu, and Bazerman, 2010)
- 2) *Slippery slope* (Gino and Bazerman, 2009)
- 3) Outcome bias in judging ethics (Baron and Hershey, 1988; Gino, Moore, and Bazerman, 2009)
- 4) *Indirect blindness in judging unethical behavior* (Paharia, Kassam, Greene, and Bazerman, 2009)

Surgeons versus Non-Surgeons: Should We Operate?

Lots	0
0	Lots

The Case

(Moore, Tanlu, and Bazerman, 2010)

E-Settle is an Internet-based dispute resolution firm that is interested in being acquired.

Crilley is an established player in the field of alternative dispute resolution services. Crilley is interested in acquiring E-Settle.

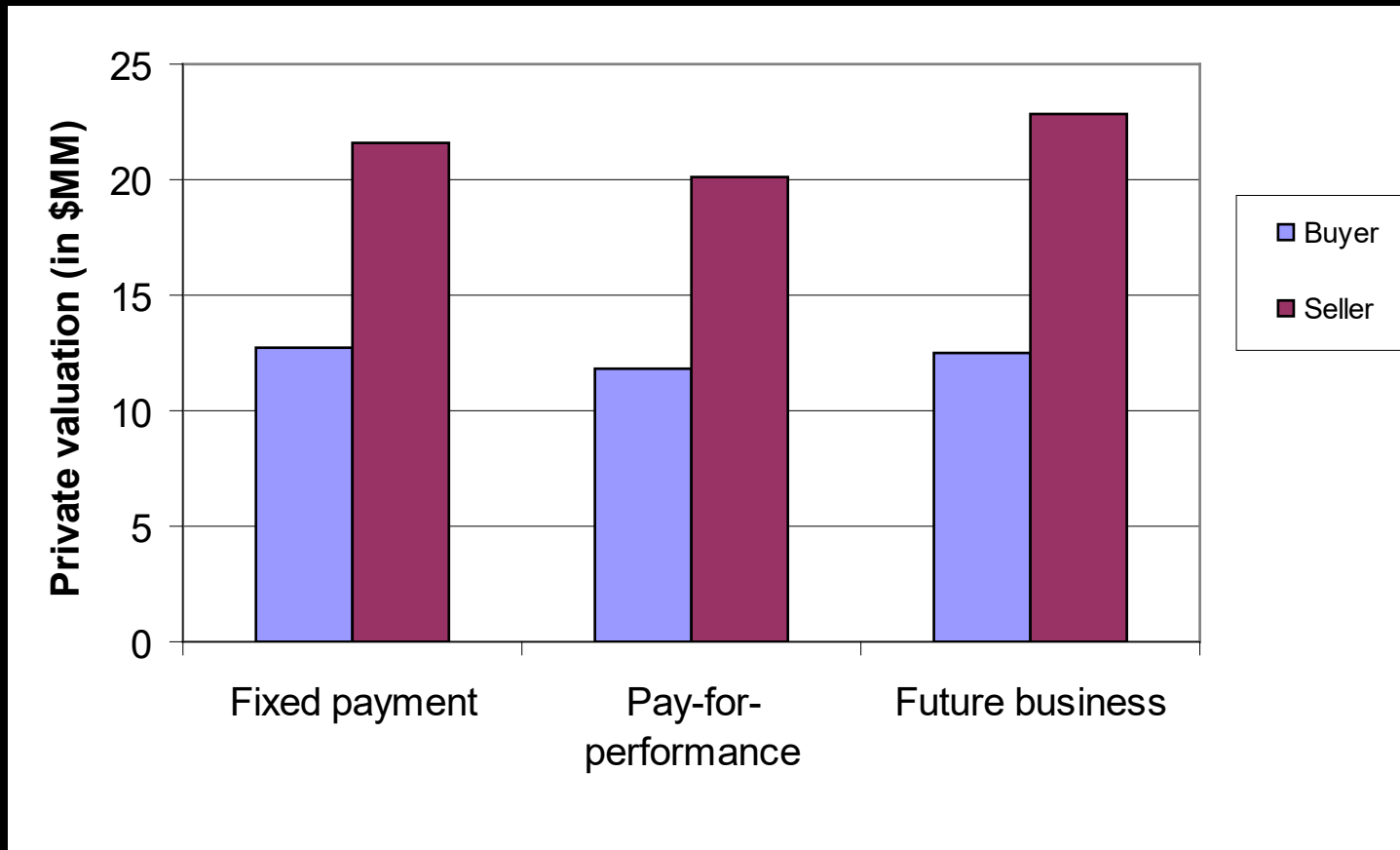
Participants are given a variety of information regarding E-Settle's revenues, earnings, market share, and competition, as well as information about prices for other pre-IPO Internet-based service firms in related industries.

How much is E-Settle worth?

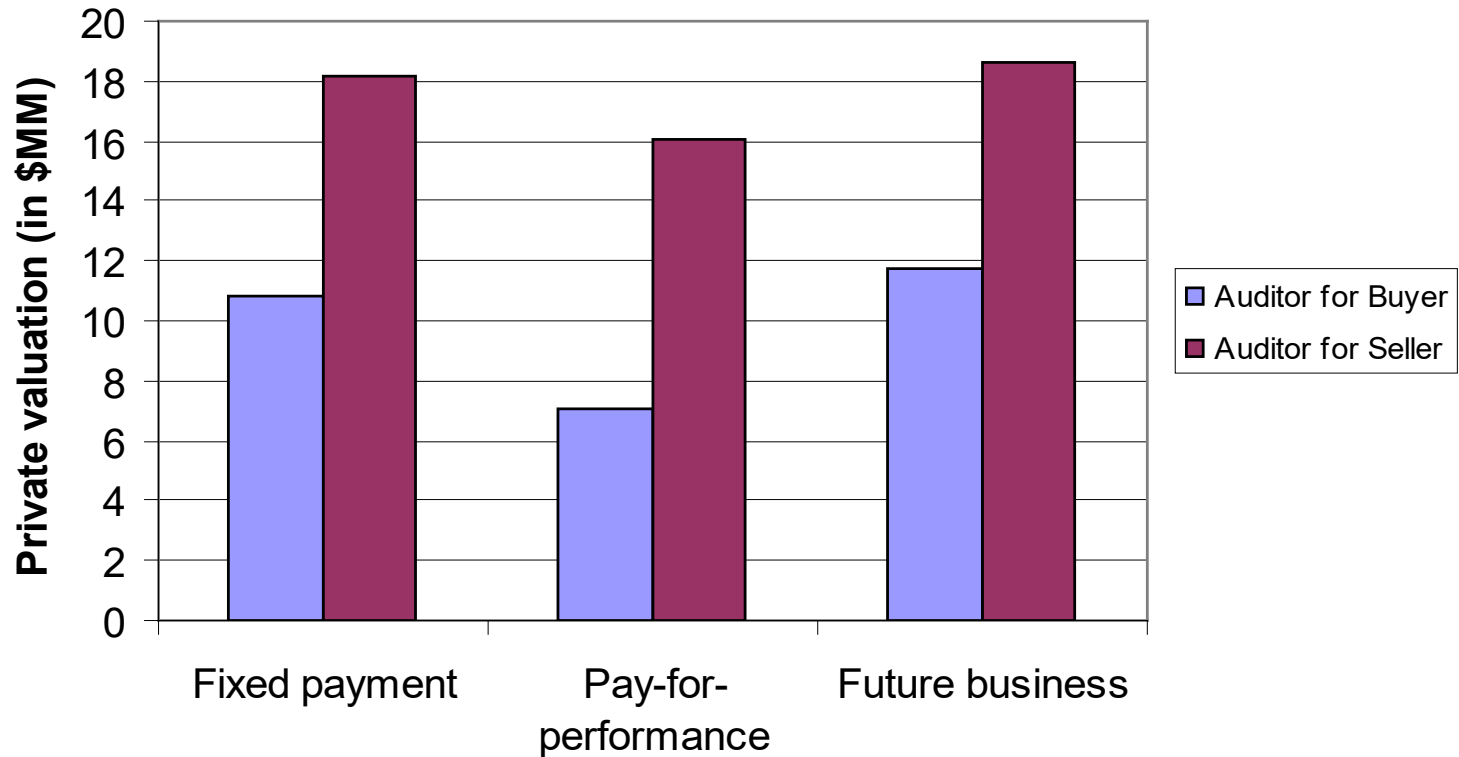
The Case

Year	E-Settle's revenues	E-Settle's earnings	E-Settle's market share	Price-to-earnings ratio for all acquisitions of professional service dot-coms
1997	\$854,000	\$150,000	44%	6:1
1998	\$2,324,000	\$400,000	31%	10:1
1999	\$6,216,000	\$1,100,000	26%	14:1
2000	\$11,597,000	\$2,000,000	24%	7:1
2001	?	?	?	4:1

Principals' Public Valuations



Auditors' Private Valuations



Conflict of Interest

How could Arthur Andersen vouch for the financial health of Enron, concealing billions of dollars in debt from its shareholders?

➤ Enron was not unique: Adelphia, Cendant, Global Crossing, Haliburton, Tyco. Xerox, Worldcom, and Lehman

Chief Justice Warren Burger wrote on behalf of a unanimous U.S. Supreme Court (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.

Which makes more sense?

- 1) In order to maintain auditor independence, auditors are prohibited from establishing durable long-term cooperative partnerships with their clients, from providing non-audit 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.

Conflict of Interest

Other examples:

- 1) Trusting Audited Financial Statements
- 2) Trusting Ratings from Security Rating Agencies
- 3) Investment Advisers
- 4) Trusting Your Doctor to Give You the Best Possible
Medical Advice

The Misspecification of the Conflict of Interest Problem

Intentional Corruption

Vs.

Intentional and Unconscious Corruption

Covid: Honest and Intelligent Auditing Can Save Lives

- 1) Best use of funds avoids waste
- 2) Reducing waste controls inflation
- 3) Excellent auditing control corruption
- 4) Excellent auditing can prevent illness and save lives

Covid: Barriers to Honest and Intelligent Auditing

- 1) Looking the other way (often because of ambiguity)
- 2) Biases in favor of people you identify with (gender, ethnicity, lunch, future relationship)
- 3) Failing to look carefully at the data
- 4) A bureaucratic mindset; rather than an investigative mindset

Auditing for Equity: Let's look at the Data

- 1) Late 2020 email from Dolly Chugh (*The Person You Mean to Be*, Ted Talk)
- 2) Academy of Management Fellows announcement (20,000 AoM members, 200 Fellows)
- 3) Each year, Fellows are allowed to nominate 0-1 new Fellows per year.
- 4) How Dolly changed my 2021 nomination.
- 5) Need to look at the data; the data is prompting change.

Conflict of Interest

Upton Sinclair: "It is difficult to get a man (sic) to understand something when his salary depends on his not understanding it."



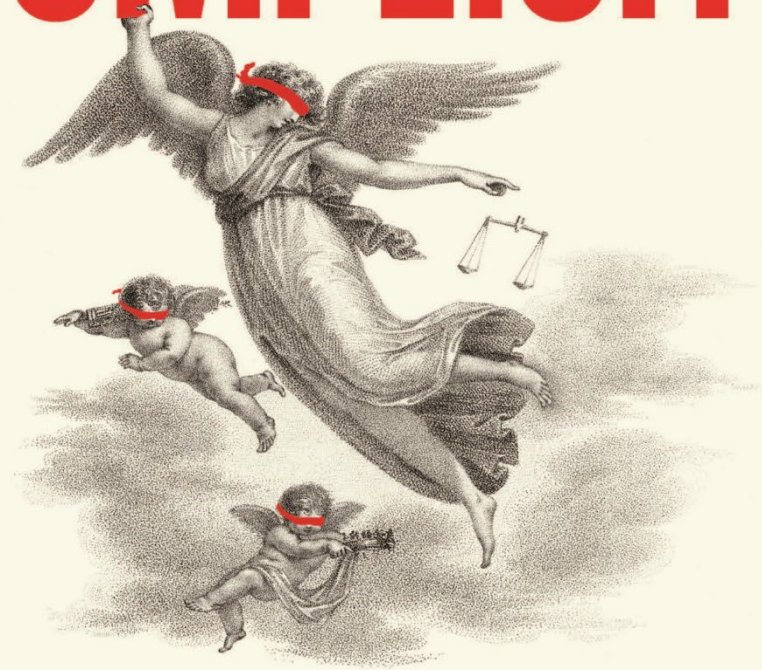
Decision Leadership

**Empowering Others
to Make Better Choices**

DON A. MOORE and
MAX H. BAZERMAN

Save 30% with code YEDL30 by calling
Trilateral Customer Care at 1-800-405-
1619

COMPLICIT



HOW WE ENABLE THE UNETHICAL AND HOW TO STOP

MAX H. BAZERMAN

20% discount code BAZR at
<https://press.princeton.edu/books/hardcover/9780691236544/complicit>