The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing

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Huge accounting firms, seeking to become one-stop shopping centers for clients, wish to add legal services to the audit, tax, information consulting, financial planning, litigation support, and other services they already provide—a phenomenon known as multi-disciplinary practice (MDP). MDP can aggravate problems already plaguing objectivity and independence in the auditing profession. Theoretically, auditors must be objective and independent. However, there is a large body of behavioral studies demonstrating that, overwhelmingly, people tend to behave inequitably if it benefits them and they think they can get away with it—a behavior known as the self-serving bias. Professor Prentice examines the self-serving bias by surveying the literature from psychology, decision theory, behavioral finance, and behavioral economics, and examines its operation in relevant analogous fields, such as law, medicine, and investment banking. Professor Prentice then applies what we know about the self-serving bias to the special problems of auditors' mandatory objectivity and independence. It turns out that auditors, no less than the rest of us, behave in accordance with the self-serving bias: for example, they are reluctant to issue qualified opinions and reluctant to refuse their clients' requests for improper accounting treatment. Moreover, they are even more reluctant to act against the interests of financially healthy clients and more likely to act in self-defensive ways with respect to financially troubled clients. Professor Prentice concludes by discussing appropriate SEC responses to the dangers created by the self-serving bias in auditors who are subject to the exacerbating effects of an MDP.

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> *[W]henever individuals face tradeoffs between what is best for themselves and what is morally correct, their perceptions of moral correctness are likely to be biased in the direction of what is best for themselves. . . . [I]t seems likely that the judgments of auditors, who ostensibly represent the interests of the shareholders but are hired (and fired) by the people they audit, are likely to be blinded to some degree by the incentive for client retention.*[1]

INTRODUCTION

The accounting and law professions are engaged in a struggle of potentially epic proportions.[2] Huge accounting firms, seeking to become one-stop shopping centers for clients, wish to add legal services to the audit, tax, information consulting, financial planning, litigation support, and other services they already provide. The legal profession is naturally not keen on this new development.[3] The controversy over multi-disciplinary practice (MDP) is more than just a turf battle, but it is largely a turf battle.[4] While some lawyers view MDP as an inevitable development, many decry the invasion of their territory as inconsistent with the best interests of consumers of legal services, noting differences between the two professions in ethical rules regarding confidentiality, privilege, conflict of interest, fee-sharing, advertising, and the like.[5] Accounting firms argue that the

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[1] Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Bias*, 11 J. ECON. PERSP. 109, 121–22 (1997).

[2] A vivid example of the invasion by the large accounting firms into the realm of legal services is Ernst & Young's recent raid of tax partners from King & Spalding. Because the average King & Spalding equity partner made "only" $723,881 in 1998, the motive for the switch was obvious. *See* Janet Conley, *Ernst & Young Set to Hire Tax Lawyers*, LEGAL INTELLIGENCER, Oct. 7, 1999, at 4. Currently, Ernst & Young is simply financing the new law firm, to be called McKee Nelson Ernst & Young, in a "special arrangement." Ernst & Young expects the boundaries between the professions to be eliminated soon and wants to be in position to offer "one-stop shopping." Tom Herman, *Ernst & Young Will Finance Launch of Law Firm in Special Arrangement*, WALL ST. J., Nov. 3, 1999, at B10.

[3] After substantial dithering, the legal profession finally took a strong anti-MDP stand when the American Bar Association's House of Delegates voted by a three-to-one margin on July 11, 2000, to continue the ABA's ban on partnering with nonlawyers in MDP. *ABA Emphatically Rejects MDPs*, NAT'L L.J., July 24, 2000, at A5.

[4] W. William Hodes, *Foreward: The Several Stances of the Modern American Lawyer*, 47 KAN. L. REV. 777, 789 n.51 (1999) (referring to MDP as a "turf battle between accountants and lawyers").

[5] *See* N.Y. STATE BAR ASS'N, REPORT OF SPECIAL COMMITTEE ON MULTI-DISCIPLINARY PRACTICE AND THE LEGAL PROFESSION 12–13 (1999) [hereinafter MDP REPORT]. *See also* Lawrence J. Fox, *New Firm: Wolf in Sheep's Clothing*, NAT'L L.J., Jan. 24, 2000, at A23 (decrying accounting profession's "contempt for [the legal] profession and its values"); John Gibeaut, *Squeeze Play*, A.B.A. J., Feb. 1998, at 42, 43 (noting that the essence of the conflict is

convenience and cost savings of the one-stop shopping concept[6] make this an idea whose time has come in the United States, as it already has in much of the rest of the world.[7] Both sides are speaking out of their pocketbooks,[8] so it is difficult to determine whose arguments to credit.

The MDP controversy has important ramifications for the viability of U.S. financial markets, which is based importantly on accurate financial reporting,[9] which, in turn, requires a reliable, objective, and independent auditing industry.[10]

"about the fundamental differences between the two professions: accountants' duty toward objectivity and public disclosure of financial statements, and lawyers' obligations to act as advocates and guard their clients' secrets"); Tia Breakley, Note, *Multidisciplinary Practices: Lawyers & Accountants under One Roof?*, 2000 COLUM. BUS. L. REV. 275, 293–94 (discussing an example of practical problems that can arise when lawyers and accountants have intertwining relationships).

[6] *See* MDP REPORT, *supra* note 5, at 11–12. *See also* Edward Brodsky, *Accountants and the Practice of Law,* N.Y. L.J., Aug. 12, 1998, at 3 (summarizing arguments made on both sides); Ginaluca Morello, Note, *Big Six Accounting Firms Shop Worldwide for Law Firms: Why Multi-Discipline Practices Should Be Permitted in the United States,* 21 FORDHAM INT'L L.J. 190, 247–52 (1997) (arguing in favor of MDP); Michael Paul, *Law Firms Shouldn't Be for Lawyers Only,* WALL ST. J., Aug. 9, 1999, at A18 (arguing for the benefits of one-stop shopping).

[7] *See* MDP REPORT, *supra* note 5, at 36 (noting that Arthur Andersen had the goal of becoming the largest law firm in the world by the year 2000, and in Europe the Big Five have acquired or created their own law firms in most major markets, including France where KPMG Fidal Pet International is the largest law firm); Jonathan Ames, *Partners Who Sleep with the Enemy,* INDEPENDENT (London), June 1, 1999, at 12 (noting the general acceptance of multidisciplinary practice in Europe, Australia, and Canada); Rocco Cammarere, *Invasion of the MDPs,* N.J. LAW., May 24, 1999, at 1 (noting a similar invasion in South America).

[8] Ian Hay Davison, *Let Lawyers into Our Firms,* TIMES (London), July 30, 1998, at 30 ("For accountants, it seems that the main reason for moving into legal services is fees.").

[9] *See* Louis Lowenstein, *Corporate Governance and the Voice of the Paparazzi* (Working Paper on file with author) [hereinafter Lowenstein, *Paparazzi*] ("Financial transparency does not alone explain the high confidence of the [American] investing public, but it is the cornerstone of all that follows.").

[10] As the Supreme Court has noted:

> 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.

United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984). *See also* BERNARD S. BLACK, THE LEGAL AND INSTITUTIONAL PRECONDITIONS FOR STRONG STOCK MARKETS: THE NONTRIVIALITY OF SECURITIES LAW 11–12 (Stanford Law School John M. Olin Program in Law and Economics, Working Paper No. 179, Sept. 1999) (pointing out the importance of a sophisticated accounting profession to the creation of reliable financial statements, which are, in turn, necessary to the creation of an efficient stock market); Tamar Frankel, *Accountants'*

Many observers are legitimately concerned that the objectivity and independence of the audit industry are already imperiled, and that as audit work becomes the mechanism by which Big Five firms increase revenue from other profit centers, such as legal practice, they will be further weakened.

The controversy over MDP creates an opportunity to focus attention on the question of whether ancillary activities undermine the objective audit function. The accounting profession believes that there is no strong, credible evidence that provision of consulting and other nonaudit services has created special independence problems.[11] However, the Securities and Exchange Commission (SEC) has tentatively concluded that the roles of auditors and lawyers are incompatible under a single roof[12] and called for research to examine the issue

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Independence: The Recent Dilemma, 2000 COLUM. BUS. L. REV. 261, 271 ("Investors who cease to trust the informational integrity of particular issuers may cease to trust the integrity of the entire markets. The available literature on public mania suggests as much."); David M. Martin, *An Effort to Deter Opinion Shopping*, 14 J. CORP. L. 419, 421 (1988) (noting importance of independent audit function in attaining the goal of full and fair audit disclosure); Gary Orren, *The Appearance Standard for Auditor Independence: What We Know and Should Know*, *in* AICPA, SERVING THE PUBLIC INTEREST: A NEW CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE app. A at 1 (1997) [hereinafter AICPA, WHITE PAPER] ("[I]f our financial markets are to work properly, the public must have confidence in the integrity and objectivity of auditors.").

High-quality audits do seem to help keep management honest. *See, e.g.*, Mark L. DeFond & James Jiambalvo, *Factors Related to Auditor-Client Disagreements over Income-Increasing Accounting Methods*, 9 CONTEMP. ACCT. RES. 415, 427 (1993) (finding that higher quality Big Eight firms are more likely to disagree with management's proposed treatments than lower quality firms); William R. Kinney, Jr. & Roger D. Martin, *Does Auditing Reduce Bias in Financial Reporting? A Review of Audit-Related Adjustment Studies*, 13 AUDITING: J. OF PRAC. & THEORY , Spring 1994, at 149, 155 (finding in a study of over fifteen hundred audits that auditor-induced adjustments directly reduced positive bias in pre-audit net earnings and net assets numbers and improved the precision of measurement).

11 A prestigious consulting group commissioned by the American Institute of Certified Public Accountants (AICPA) recently concluded that there was no major cause for concern. LAW & ECON. CONSULTING GROUP, INC. (LECG), AN ECONOMIC ANALYSIS OF AUDITOR INDEPENDENCE FOR A MULTI-CLIENT, MULTI-SERVICE PUBLIC ACCOUNTING FIRM (Oct. 20, 1997) [hereinafter LECG], *in* AICPA, WHITE PAPER app. B at ii-iii, *supra* note 10.

12 Darryl Van Duch, *SEC Opposes Legal Practice by Auditors*, NAT'L L.J., Mar. 15, 1999, at B1. In a letter to the American Bar Association's Commission on Multidisciplinary Practice, Lynne E. Turner, the SEC's Chief Accountant observed that the "SEC's auditor independence regulations specifically state that the roles of auditors and attorneys under the federal securities laws are incompatible," citing Rule 2-01(c) of Regulation S-X, 17 CFR § 210.2-01(c). *Letter from Lynne E. Turner, SEC Chief Accountant, to ABA Commission on Multidisciplinary Practice* (Jan. 22, 1999), at http://www.abanet.org/cpr/turner.html (on file with The Ohio State Law Journal).

The SEC has previously taken action against auditors who acted simultaneously as their client's attorney. *See, e.g.*, *In re* Samuel George Greenspan, Accounting and Enforcement No. 312, 50 SEC 672 (1991) (noting that legal counsel and their clients enter into a personal more thoroughly.[13] In response to that call, this article examines a wide-ranging set of behavioral studies and argues that the SEC is correct to view the marriage of auditors and lawyers with a jaundiced eye.[14]

Consider that in one recent laboratory study, auditors reviewed a number of sets of real financial statements and recommended going concern qualifications for 36% of them; yet in real life none of the statements had been qualified.[15] What accounts for this? What happens between the intellectual conclusion that a qualified opinion should issue and the real-life business decision not to issue one?[16]

Theoretically, auditors must be objective and independent.[17] Yet, constraints imposed by human nature mean they will have great difficulty being either objective or independent when compensated by the client they are auditing.[18] The

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relationship with the client of the type that necessarily appears inconsistent with the appearance of independence required of auditors).

[13] On August 15, 1999, the Commission's Chief Accountant, Lynne E. Turner, issued to the American Accounting Association a "Call for Academic Research on Key Accounting Issues," including independence issues arising from the nonaudit services that accounting firms now offer audit clients. *See* Lynne E. Turner, *Call for Academic Research on Key Accounting Issues* (Aug. 15, 1999), *at* http://www.sec.gov/news/extra/aaacall.htm (on file with The Ohio State Law Journal). *See generally* John Gibeaut, *MDP in SEC Crosshairs: Accounting Firms May Cool Their Urge to Merge,* A.B.A. J., Apr. 2000, at 16 (describing SEC Concerns).

[14] It is only the audit function of modern accounting that is inappropriate for linkage with the practice of law. The desirability of allowing accountants involved in other realms (tax, consulting, financial planning, etc.) to practice law is beyond the scope of this article.

[15] Sam Campisi & Ken T. Trotman, *Auditor Consensus in Going Concern Judgments,* 15 ACCT. & BUS. RES. 303, 309 (Autumn 1985).

[16] The General Accounting Office has recently asked a similar question: Why, despite recent increases in financial fraud and questionable accounting, were only six Section 10A reports filed during the first four years of the existence of the whistleblower provisions of the 1995 Private Securities Litigation Reform Act (PSLRA). PSLRA, 109 Stat. 737 (current version with additions and amendments at 15 U.S.C. §§ 77–78 and 18 U.S.C. § 1964 (Supp. I 1995)). The PSLRA imposed upon auditors a duty to "blow the whistle" on client fraud by filing reports with the SEC if the client did not turn itself in, yet all six registrants named in the filed reports are subject to active SEC enforcement actions. Ronald Taylor, *SEC Is Considering Three Cases for Section 10A Enforcement,* BNA SECURITIES LAW DAILY, Feb. 25, 2000, *available in* LEXIS, BNA Library, BNASLD File.

[17] An auditor who is not independent may well choose to act "in a technically *incompetent* fashion." Peter Moizer, *Independence, in* CURRENT ISSUES IN AUDITING 33 (D. Kent et al. eds., 1985).

[18] One observer notes:

> The key to investor confidence in auditor opinions is the independence of the auditor. It is ironic, then, that the very firm subject to the audit both selects and compensates the auditor. Because auditors can be replaced at any time and for virtually any reason (or for no reason at all), an inherent conflict of interest exists. The auditor is professionally concerned with

difficulty is exacerbated when the auditors' firms gain substantial income from the audit client by selling nonaudit services, such as legal services.[19]

A growing body of behavioral research indicates that acting contrary to one's self interest is not a natural or easy thing. It is not just that people consciously say: "I'm looking out for me; screw the other guy," although they sometimes do.[20] Rather, a menu of cognitive biases and limits on rationality affect how people perceive,[21] process,[22] and remember[23] information, and, consequently, how they choose among alternative actions, assess risk, and make many other types of decisions.[24] Many of these biases and limitations are shaped by a self-serving bias that encompasses a number of psychological phenomena. According to Kaplan and Ruffle, "[a] self-serving bias exists where an individual's preferences affect

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> rendering a truly independent assessment of the client's accounting treatment, yet he is also dependent on the client's satisfaction for continued audit revenue.

Dale R. Rietberg, Note, *Auditor Changes and Opinion Shopping—A Proposed Solution*, 22 U. MICH. J. L. REFORM 211, 213–14 (1988).

[19] *See* Moizer, *supra* note 17, at 38 ("The provision of . . . non-audit services clearly increases the size of the audit firm's economic interest in the client. The potential loss of revenues from losing a client could, therefore, be much larger than the value of the audit fee alone.").

This is not a concern strictly related to auditors. Hayward and Boeker recently noted in a study regarding financial analysts that lawyers, consultants, accountants, and even journalists must be concerned with conflicts of interest and posited that "as professional service firms expand and diversify their range of services and their client base, such conflicts become more pervasive." Mathew L.A. Hayward & Warren Boeker, *Power and Conflicts of Interest in Professional Firms: Evidence from Investment Banking*, 43 ADMIN. SCI. Q. 1, 1 (1998).

[20] *See* Moizer, *supra* note 17, at 35 ("Perhaps a more realistic view of human nature is that individuals start from a position of wanting to give an honest opinion but that this wish is counterbalanced by a desire to maximize their own self-interest").

[21] Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 144 (1997) ("When there is enough ambiguity to permit it, people naturally 'see what they want to see.'"); J. Edward Russo et al., *The Distortion of Information During Decisions*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 102, 102 (1996) ("People seek information that confirms their choice and depreciate encountered information that opposes it.").

[22] George Loewenstein, *Behavioral Decision Theory and Business Ethics: Skewed Trade-Offs between Self and Others*, *in* CODES OF CONDUCT 214, 221 (David M. Messick & Ann E. Tenbreusel eds., 1996) (observing that "[o]ne of the most important nonobjective influences on information processing is self-interest.").

[23] *E.g.*, Elisha Babad, *Wishful Thinking among Voters: Motivational and Cognitive Influences*, 9 INT'L J. PUB. OPINION RES. 105, 105 (1997) [hereinafter Babad, *Wishful Thinking*] (finding that voters' memories of poll results that they had seen were influenced by their candidate preference).

[24] *See generally* ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD (1988) (explaining generally human limits on rational decision-making); SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISIONMAKING (1993) (same).

his beliefs in an optimistic direction, one favoring his own payoff."[25] The bias is pervasive and strong, and its implications indicate that the SEC is wise to maintain its vigilance.

Part I gives a brief primer on the self-serving bias by exploring literature from relevant fields, such as psychology, decision theory, behavioral finance, and behavioral economics. Part II examines the operation of the self-serving bias in relevant analogous fields, such as law, medicine, and investment banking. Part III looks at the audit profession specifically.[26] If the self-serving bias affects auditors, various patterns of behavior should appear. For example, the self-serving bias literature predicts that auditors should be reluctant to issue qualified opinions regarding their clients, reluctant to refuse their clients' requests for improper accounting treatment, and reluctant to drop clients seeking such improper treatment for fear of imperiling a stream of revenue. As the stream of revenue from specific clients increases, whether through audit fees or nonaudit revenue, these effects should increase. They should also increase if the client is relatively healthy financially and therefore unlikely to go bankrupt because bad auditing will seldom come to light if the client prospers. On the other hand, as the client's financial situation weakens and the likelihood of litigation against the auditor rises, the scales should tip. It should be to the auditor's self-interest to more readily qualify the opinions and/or drop the clients, and auditors should react accordingly. Not to spoil the surprise, but numerous studies of auditors demonstrate these effects. Finally, Part IV discusses appropriate SEC responses to the dangers created by the self-serving bias in auditors.

I. AN INTRODUCTION TO THE SELF-SERVING BIAS

A. *Conscious Self-Serving Actions*

People tend to do what they think is in their own best interest.[27] Altruism exists, but there is distressingly little of it in the world.[28] Evidence indicates that

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[25] Todd R. Kaplan & Bradley J. Ruffle, *Correspondence*, 12 J. ECON. PERSP. 243, 243 (1998).

[26] *Infra* notes 149 to 281 and accompanying text.

[27] *See* Linda J. Keil & Charles G. McClintock, *A Developmental Perspective on Distributive Justice, in* EQUITY THEORY: PSYCHOLOGICAL AND SOCIOLOGICAL PERSPECTIVES 13, 19 (David M. Messick & Karen S. Cook eds., 1983) [hereinafter EQUITY THEORY] ("[I]t is safe to assume that humans are generally motivated to maximize their own gain."); ELAINE WALSTER ET AL., EQUITY: THEORY AND RESEARCH 6–7 (1978) ("Even the most contentious scientist would find it difficult to challenge [the] proposition" that "[i]ndividuals will try to maximize their outcomes.").

[28] Jane B. Baron, *Gifts, Bargains, and Form*, 64 IND. L.J. 155, 184 (1989) (noting that the rarity of personal altruism, as distinguished from business bargains, justifies scrutiny of the enforceability of promises prompted by affection); Loewenstein, *Skewed Trade-Offs*, *supra*

people tend to behave inequitably if it benefits them and they think they can get away with it,[29] and that people will present themselves in the best light when it is possible to do so.[30]

There is, thankfully, some evidence indicating that ethical standards and moral codes can impact human behavior.[31] Regrettably, there is also evidence that their impact is weak and inconsistent.[32] Although there is substantial truth in Hausman and McPherson's assertion that "[t]he morality of economic agents influences their behavior and hence influences economic outcomes,"[33] it is also true that a recent study of corporate financial disclosure found a high occurrence of fraudulent reporting and that neither personal values of corporate officers,

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note 22, at 216 ("Recent empirical investigations of altruism have found it to be a surprisingly weak force in human decision-making."); S.J. Stoljar, *A Rationale of Gifts and Favours*, 19 MOD. L. REV. 237, 249 (1956) ("[P]ersonal altruism is rare and from strangers even rarer."); WALSTER ET AL., *supra* note 27, at 100–01 (noting that a "few scientists believe that man does act unselfishly under very special circumstances," but that "[t]he vast majority of scientists, however, are cynical[,] ... interpret[ing] altruism in calculating terms").

This is certainly not to say that there is no altruism. *See, e.g.*, BURTON A. WEISBROD, THE NONPROFIT ECONOMY 132 (1988) (estimating that there is $74 billion worth of voluntary labor performed in the U.S. annually); Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1662 (1998) (noting the existence of "dutiful altruism," as when children take care of aged parents they dislike); Matthew Rabin, *Incorporating Fairness into Game Theory and Economics*, 83 AM. ECON. REV. 1281, 1281 (1993) (noting the economic implications of altruism, including, for example, the notion that "[i]f an employee has been exceptionally loyal, then a manager may feel some obligation to treat that employee well, even when it is not in his economic self-interest to do so.").

29 Elaine Walster et al., *New Directions in Equity Research*, 25 J. PERSONALITY & SOC. PSYCHOL. 151, 153 n.5 (1973).

30 Robert M. Arkin et al., *Social Anxiety, Self-Presentation, and the Self-Serving Bias in Causal Attribution*, 38 J. PERSONALITY & SOC. PSYCHOL. 23, 34 (1980).

31 *See* David M. Messick & Keith Sentis, *Fairness, Preference, and Fairness Biases, in* EQUITY THEORY, *supra* note 27, at 79 [hereinafter Messick & Sentis, *Fairness Biases*] (noting a study where subjects could have, but did not, keep all of a sum of money for themselves. They instead shared it in a self-serving manner, indicating support for their belief that "behavior is a compromise between egotistical impulses and ethical standards."); Eric Noreen, *The Economics of Ethics: A New Perspective on Agency Theory*, 13 ACCT., ORGS. & SOC'Y 359, 359 (1988) ("Casual observation suggests that while there may be some people who are unreservedly opportunistic, others do constrain their own behavior out of an ethical sensibility or conscience.").

32 *See* Noreen, *supra* note 31, at 367 ("Behavioral norms (or ethical rules) are clearly a most fragile enforcement mechanism.").

33 Daniel M. Hausman & Michael S. McPherson, *Taking Ethics Seriously: Economics and Contemporary Moral Philosophy*, 31 J. ECON. LITERATURE 671, 673 (1993).

codes of conduct of their firms, nor the interaction of the two played a significant role in minimizing that fraud.[34]

B. *Self-Serving Biases*

Man should not be characterized as egregiously biased or opportunistic. Kagan notes that "[t]he number of acts of rudeness, vandalism, theft, abuse, rape, and murder that occurred yesterday, throughout the world, is infinitesimal when compared with the total number of opportunities each adult had to display any one of these behaviors."[35] Nonetheless, humans have a pervasive tendency to act in a way they perceive as consistent with their own best interests. Although cognitive limitations, such as bounded rationality,[36] prevent humans' behavior from being especially efficient in this regard, this tendency is very strong for reasons that go well beyond the conscious desire to benefit one's self at others' expense. The causal factors are a deliciously complex blend of cognitive limitations and motivational drives.

Consider, for example, a team of employees who worked together to complete successfully an important project. Assume that the boss calls one of the employees into her office and says: "I intend to promote the team member who contributed the most to the group's overall success. Would it be fair to say that you are that team member?" Studies show that the employee being quizzed will have a strong tendency to conclude that he is indeed the employee who should be promoted. Causal attribution theory demonstrates that people tend to assign to themselves more responsibility for their group's successes and less for its failures.[37] More generally, people tend, through this self-attribution bias, to attribute their successes in life to their own skills and abilities and their failures to

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[34] Arthur P. Brief et al., *What's Wrong with the Treadway Commission Report? Experimental Analyses of the Effects of Personal Values and Codes of Conduct on Fraudulent Financial Reporting*, 15 J. BUS. ETHICS 183, 192 (1996); *see also* Loewenstein, *Skewed Trade-Offs, supra* note 22, at 215 (concluding that "[managers] put very little weight on the effect of their decisions on other parties, except insofar as those effects have repercussions for their own well-being").

[35] JEROME KAGAN, THREE SEDUCTIVE IDEAS 192 (1998). Kagan also notes that "[a]fter we have protected ourselves from actual or possible harm, the affirmation of virtue takes precedence over the search for sensory pleasure most of every day." *Id.* at 153.

[36] "Bounded rationality" is the notion that human cognitive abilities are not infinite, and that humans must often make decisions in the absence of perfect information or perfect understanding of the information they do have. *See generally* HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (2d ed. 1957) (noting that people are "*intendedly* rational, but only *limitedly* so."); James G. March, *Bounded Rationality, Ambiguity, and the Engineering of Choice*, 9 BELL J. ECON. 587, 590 (1978).

[37] *See* Barry R. Schlenker & Rowland S. Miller, *Egocentrism in Groups: Self-Serving Biases or Logical Information Processing?*, 35 J. PERSONALITY & SOC. PSYCHOL. 755, 762–63 (1977).

outside factors.[38] This is among "the best established, most often replicated, findings in social psychology."[39]

This hypothetical team member may wish to be objective about his contribution, but he will have difficulty doing so because the self-serving bias affects not only causal attribution, but also many other aspects of judgment,[40] including those related to fairness. People may wish to judge objectively the evidence regarding their contributions, but it is not that easy to do so, thanks to

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38 *See* MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 96 (4th ed. 1998) [hereinafter BAZERMAN, JUDGMENT] (noting President Kennedy's famous quote: "Victory has a thousand fathers, but defeat is an orphan"); Tom Pyszczynski & Jeff Greenberg, *Toward an Integration of Cognitive and Motivational Perspectives on Social Inference: A Biased Hypothesis-Testing Model,* 20 ADVANCES IN EXPERIMENTAL SOC. PSYCHOL. 297, 298 (1987) (noting the "well-replicated finding that people tend to make dispositional attributions for their successes and situational attributions for their failures.").

This phenomenon holds in matters of sexual relations and, not surprising to many, men are more likely to use self-serving attributions of causation for an unsatisfactory sexual experience than are women. Anne Maass & Chiara Volpato, *Gender Differences in Self-Serving Attributions About Sexual Experiences,* 19 J. APPLIED SOC. PSYCHOL. 517, 535 (1989). It holds in matters of sports performance. *See, e.g.,* Peter E. De Michele et al., *Success and Failure of Wrestlers: Further Evidence of the Self-Serving Bias,* 21 J. SPORT BEHAV. 242, 250–51 (1998) (finding strong evidence of the self-serving bias among college wrestlers); Victor L. Santamaria & David M. Furst, *Distance Runners' Causal Attributions for Most Successful and Least Successful Races,* 17 J. SPORT BEHAV. 43, 43 (Mar. 1994) (finding that distance-runner subjects gave more internal attributions for their most successful races than for least successful races). It also holds in matters of the stock market. Kent Daniel et al., *Investor Psychology and Security Market Under- and Over-Reactions,* 53 J. FIN. 1839, 1844–45 (1998) (arguing that stock analysts and investors suffer from a combination of overconfidence and the self-attribution bias).

39 Michael Ross & Garth J.O. Fletcher, *Attribution and Social Perception, in* 2 THE HANDBOOK OF SOCIAL PSYCHOLOGY 79, 104 (G. Lindzey & E. Aronson eds., 3d ed. 1985).

40 James Madison recognized that politicians' view of the public interest will be swayed by their self-interest even if they are well intentioned because a politician's "opinions and his passions will have a reciprocal influence on each other; and the former will be objects to which the latter will attach themselves." THE FEDERALIST NO. 10, at 43 (James Madison) (Garry Wills ed., 1982).

Studies have shown that peer-company stock-return benchmarks chosen by corporate managers tend to be downward biased, making the managers' performance look better by comparison. Wilburn Lewellen et al., *Self-Serving Behavior in Managers' Discretionary Information Disclosure Decisions,* 21 J. ACCT. & ECON. 227, 249 (1996). In addition, studies show that parties engaged in school district negotiations are biased in which districts they choose as "comparable." Linda Babcock et al., *Choosing the Wrong Pond: Social Comparisons in Negotiations that Reflect a Self-Serving Bias,* 111 Q. J. ECON. 1, 1 (1996). *But see* Gordon B. Dahl & Michael R. Ranson, *Does Where You Stand Depend on Where You Sit? Tithing Donations and Self-Serving Beliefs,* 89 AM. ECON. REV. 703, 704 (1999) (finding less evidence of self-serving bias in how Mormons defined income for purposes of tithing than has generally been found in studies of the self-serving bias in other contexts).

the self-serving bias.[41] Messick and Sentis note that equality is the core of the human concept of fairness, but that "there is a fundamental asymmetry in one's ability to make the kind of equality judgment that fairness requires."[42] Thus, while humans have a well-developed sense of fairness that affects both their opinions and actions,[43] their desire to act fairly[44] is often frustrated by the self-serving bias.[45] "[P]eople tend to conflate what is personally beneficial with what is fair or moral."[46] Thus, even the judgment of an auditor who truly wishes to fairly evaluate a client's financial reports will inevitably be adversely affected by

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[41] *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics,* 50 STAN. L. REV. 1471, 1501 (1998) ("[P]arties may tend to see things in the light most favorable to them; while people care about fairness, their assessments of fairness are distorted by their own self-interest. This is a form of bounded rationality—specifically, a judgment error; people's perceptions are distorted by the self-serving bias.").

[42] Messick & Sentis, *Fairness Biases, supra* note 31, at 69.

[43] *See* Daniel Kahneman et al., *Fairness and the Assumptions of Economics,* 59 J. BUS. S285, S299 (1986) (noting that the standard rational economic actor model is deficient for failing to take into account the preference people have for being treated fairly and for treating others fairly); Rabin, *supra* note 28, at 1281 (exploring economic implications of evidence from psychology that "[i]f somebody is nice to you, fairness dictates that you be nice to him. If somebody is being mean to you, fairness allows—and vindictiveness dictates—that you be mean to him."). It has been noted that this concern with fair treatment is part of a broader phenomenon known as "bounded self-interest." Jolls et al., *supra* note 41, at 1479.

[44] There is no doubt that this general desire is bounded. For example, "[s]everal theorists have noticed that those who materially benefit from inequity are more tolerant of injustice than those who are deprived." WALSTER ET AL., *supra* note 27, at 43.

[45] As Bazerman notes:

> People frequently have the goal of reaching a fair solution. However, assessments of what is fair are often biased by self-interest. For example, it is common for all parties in a conflict to suggest viable, but self-serving, solutions, and then to justify them based on abstract fairness criteria. Egocentrism works to make everyone believe that it is honestly fair for them to have more of the resource than an independent advisor would judge. The problem lies not in our desire to be unfair but in our inability to interpret information in an unbiased manner.

BAZERMAN, JUDGMENT, *supra* note 38, at 99–100.

[46] Loewenstein, *Skewed Trade-Offs, supra* note 22, at 221. *See also* Linda Babcock et al., *Biased Judgments of Fairness in Bargaining,* 85 AM. ECON. REV. 1337, 1341 (1995) (reporting results indicating systematic self-serving biases in judgments of fairness that affect settlement negotiations in litigation and other bargaining contexts); Messick & Sentis, *Fairness Biases, supra* note 31, at 61, 70–71 (noting that "there may be systematic biases that influence one's perceptions or judgments of fairness" and reporting studies demonstrating that an "*egocentric bias* ... [is] a tendency for subjects to judge more money to be fair for themselves than for another in the same situation"); David M. Messick & Keith P. Sentis, *Fairness and Preference,* 15 J. EXPERIMENTAL SOC. PSYCHOL. 418, 432, 434 (1979) [hereinafter Messick & Sentis, *Fairness and Preference*] (reporting results of study finding an egocentric bias in fairness judgments and noting that "people are capable of ignoring or compromising what they know to be ethically correct in order to achieve a hedonically more preferred outcome").

the auditor's self-serving desire to keep the client's stream of revenues, unless the risk of adverse consequences stemming from inaccurate reporting is sufficient and immediate.

Causes of the self-serving bias are both cognitive and motivational, and to fully tease one out from the other is impossible. Clearly the two reinforce one another.[47]

1. *Cognitive Effects*

To address cognitive causes first, Thompson and Loewenstein suggest three cognitive mechanisms to explain why judgments of fairness are biased in a self-serving direction, causing our hypothetical employee likely to conclude that he is the team member most deserving of the raise.[48] First, they note that people perceive and encode information in a biased manner.[49] A classic study found that that students who watched film of a football game had dramatically different views of the violations committed during the game. Princeton students thought the

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[47] The Schlenker and Miller study was unable to determine whether the effect was primarily a result of perceptual biases (subjects tended to remember themselves as truly having more to do with successful outcomes) or self-presentational effects (subjects sought to improve their image) or a combination of both. Schlenker & Miller, *supra* note 37, at 762. This issue is unresolved. *See generally* Gifford Weary Bradley, *Self-Serving Biases in the Attribution Process: A Reexamination of the Fact or Fiction Question,* 36 J. PERSONALITY & SOC. PSYCHOL. 56, 68–69 (1978) (finding evidence for at least a partially-motivational explanation for people's tendency to accept responsibility for positive outcomes and to deny responsibility for negative outcomes and concluding that it is largely a matter of self-presentation); Dale T. Miller, *What Constitutes a Self-Serving Attributional Bias? A Reply to Bradley,* 36 J. PERSONALITY & SOC. PSYCHOL. 1221, 1222 (1978) (finding little evidence that people alter their *perceptions* of causality to protect their self-esteem, but admitting to evidence that people often alter their *description* of causality in order to do so); Dale T. Miller & Michael Ross, *Self-Serving Biases in the Attribution of Causality: Fact or Fiction,* 82 PSYCHOL. BULL. 213, 223–24 (1975) (evaluating existing evidence as supporting a cognitive explanation for this phenomenon); Tom Pyszczynski et al., *Maintaining Consistency between Self-Serving Beliefs and Available Data: A Bias in Information Evaluation,* 11 PERSONALITY & SOC. PSYCHOL. BULL. 179, 185–88 (1985) (concluding that both cognitive and motivational forces accounted for the fact that students who thought they had done well on a social sensitivity test found more persuasive articles favoring the validity of the test and students who thought they had done poorly on the test found more persuasive articles arguing that the test had low validity); Pyszczynski & Greenberg, *supra* note 38, at 332–34 (suggesting a model reflecting how motivations affect cognitive perceptions, with both factors working together to influence in a self-serving way humans' causal attributions).

[48] Leigh Thompson & George Loewenstein, *Egocentric Interpretations of Fairness and Interpersonal Conflict,* 51 ORG. BEHAV. & HUM. DECISION PROCESSES 176, 180–81 (1992). Although these observations are tied specifically to judgments of fairness, they similarly impact other types of decisions.

[49] *Id.*

Dartmouth team committed twice as many flagrant penalties and three times as many mild penalties as the Princeton team, whereas Dartmouth students thought each team had committed approximately the same number of penalties.[50] Reflective sports fans can identify easily with this tendency to see what they wish to see. Another example is the 1960 Kennedy-Nixon debate, where viewers who were pro-Kennedy tended to perceive that he won the debate while viewers who were pro-Nixon tended to think that Kennedy lost.[51]

Second, Thompson and Loewenstein note that selective recall can impact fairness judgments.[52] If you ask basketball players about their games, they will usually report that the turning points were keyed by their teammates' actions rather than actions of the players on the other team.[53] Studies indicate that if you ask most married couples what percentage of the housework they do, the numbers you get back will add up to more than one hundred percent.[54] Similarly, as noted earlier, members of organizations tend to overvalue their contributions to its success,[55] perhaps because they can remember their own actions more clearly than those of their colleagues. Taylor has studied the phenomenon of "egocentric recall," the ability to bring to mind one's own contributions somewhat better than those of another person.[56] Thompson and Loewenstein have documented a self-

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[50] Albert H. Hastorf & Hadley Cantril, *They Saw a Game: A Case Study,* 49 J. ABNORMAL PSYCHOL. 129, 131 (1954).

[51] David O. Sears & Rochard E. Whitney, *Political Persuasion, in* HANDBOOK OF COMMUNICATION 253, 255 (Ithiel de Sola Pool et al. eds., 1973) ("The major effect was that partisans thought their own candidate won the debate.").

[52] Thompson & Loewenstein, *supra* note 48, at 180.

[53] Michael Ross & Fiore Sicoly, *Egocentric Biases in Availability and Attribution, in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 179, 186 (Daniel Kahneman ed., 1982) [hereinafter JUDGMENT UNDER UNCERTAINTY].

[54] *Id.* at 184. The authors conclude that their research "demonstrates the prevalence of self-centered biases in availability and judgments of responsibility." *Id.* at 189.

[55] *See* BAZERMAN, JUDGMENT, *supra* note 38, at 98–99 ("Positive illusions lead organizational members to claim an inappropriately large proportion of the credit for positive outcomes, to overestimate their value to the organization, and to set objectives that have little chance of success.").

[56] Shelley E. Taylor, *The Availability Bias in Social Perception and Interaction, in* JUDGMENT UNDER UNCERTAINTY, *supra* note 53, at 190, 195 (noting that egocentric recall is a manifestation of the well-known "availability bias," the tendency to remember certain things more clearly than others because of their recency, vividness, or other characteristics).

This self-serving memory bias is exacerbated by the fact that people, in part because of the overconfidence bias, tend to believe that their memories are better than they truly are and that false memories are accurate. *See* Jonathan B. Holmes et al., *The Phenomenology of False Memories: Episodic Content and Confidence,* 24 J. EXPERIMENTAL PSYCHOL. 1026, 1027 (1998) (finding that people "often rate their false memories with high degrees of confidence, indicating a firm belief in their false memories."); Rand J. Spiro, *Accommodative Reconstruction in Prose Recall,* 19 J. VERBAL LEARNING & VERBAL BEHAV. 84, 94 (1980) serving bias regarding fairness judgments in negotiation and have shown that negotiators tended to recall information that favored their position more than information that did not favor their position.[57] It is not just that the memory selects certain self-serving facts to recall while ignoring others; it also massages the facts in a self-serving way. For example, Fischoff and Beyth, in studying the hindsight bias,[58] found that students remembered having made more accurate predictions of an event in an earlier study than they truly had.[59]

Finally, Thompson and Loewenstein note the phenomenon of differential weighting of information, the fact that we tend to perceive information that favors our preferred position as more important than information that undermines our preferred position.[60] Messick and Sentis studied perceptions of fairness and asked subjects who had worked either seven or ten hours at a task how much a person who worked ten hours should be paid if the person who worked seven hours was paid $25. Subjects who had worked seven hours thought (on average) that $30.29 was the right payment, but those who had worked ten hours thought $35.24 was the fair amount.[61] Cook and Yamagishi have also performed a study supporting the notion that people who have put more effort into a task tend to think that effort is the touchstone for compensation, whereas those who have put less effort into the task think that equality is the more important factor.[62]

Although Thompson and Loewenstein were analyzing fairness judgments, these same cognitive factors should similarly impact other types of judgments as well.

2. *Motivational Factors*

Clearly the human tendency to act in one's own best interest contains a cognitive component. But that component is strongly shaped and supplemented by motivational factors, both conscious and unconscious. The conscious part is obvious—some people would lie, cheat, and steal in order to get a ten thousand

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(finding that subjects were more confident in their recall of events that did not happen than of events that did).

[57] Thompson & Loewenstein, *supra* note 48, at 189–90.

[58] The hindsight bias causes people who know how an event turned out to falsely overestimate the probability with which they would have predicted it beforehand. *See generally* DAWES, *supra* note 24, at 119–20; PLOUS, *supra* note 24, at 35–37.

[59] Baruch Fischhoff & Ruth Beyth, *"I Knew It Would Happen"—Remembered Probabilities of Once-Future Things,* 13 ORG. BEHAV. & HUM. PERFORMANCE 1, 13 (1975).

[60] Thompson & Loewenstein, *supra* note 48, at 180–81.

[61] Messick & Sentis, *Fairness and Preference, supra* note 46, at 425–30 (concluding that "there is clear evidence of an egocentric bias in [the] fairness judgments").

[62] *See* Karen S. Cook & Toshio Yamagishi, *Social Determinants of Equity Judgments: The Problem of Multidimensional Input, in* EQUITY THEORY, *supra* note 27, at 95, 122–23.

dollars annual raise. However, more people would honestly conclude, in part because they were psychologically motivated to do so, that they truly were the ones to deserve the promotion. While the line between conscious self-serving actions and actions unconsciously influenced in a self-serving direction is unclear, the end result is often the same.[63]

Individuals have a psychological need to feel good about themselves and to feel good about their futures. As noted above, this need motivates them to attribute causality in a self-serving manner.[64] It motivates them to describe successful people in ways that closely resemble themselves.[65] It also motivates them to exhibit overconfidence and overoptimism biases.[66] Overconfidence and overoptimism are generally good for people's mental health,[67] but can cause them to make serious errors of judgment.

People tend to be overconfident in a wide variety of settings[68] and think that they are better at doing most things than they really are.[69] For example, studies

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[63] *See* Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules,* 5 S. CAL. INTERDISC. L.J. 375, 428 n.120 (1997).

[64] *See* Paul Rosenfeld, *Self-Esteem and Impression Management Explanations for Self-Serving Biases,* 130 J. SOC. PSYCHOL. 495, 495 (1990) (finding that the need for self-esteem, more than impression management, underlies the tendency to attribute success to internal factors and failure to external factors).

[65] David Dunning et al., *A New Look at Motivated Inference: Are Self-Serving Theories of Success a Product of Motivational Forces?,* 69 J. PERSONALITY & SOC. PSYCHOL. 58, 65 (1995) (reporting on three studies providing evidence that "egocentric definitions of success are, indeed, prompted by the motive to maintain positive images of self").

[66] Overoptimism or "wishful thinking can be considered as a type of self-serving bias, and it can be accounted for by similar explanations as other self-serving biases in social psychology." Babad, *Wishful Thinking, supra* note 23, at 106.

[67] Studies show that the only people who have an objective view of themselves are those who tend toward clinical depression and other mental problems. *See* Shelley E. Taylor & Jonathon D. Brown, *Illusion and Well-Being: A Social Psychological Perspective on Mental Health,* 103 PSYCHOL. BULL. 193, 204–05 (1988) (finding that overoptimism and unrealistic self-confidence are highly adaptive mechanisms allowing people to be happy and that people who are more realistic in their assessment of themselves and the world around them tend toward depression).

[68] Gilovich notes:

> [A] large majority of the general public think[s] that they are more intelligent, more fair-minded, less prejudiced, and more skilled behind the wheel of an automobile than the average person. This phenomenon is so reliable and ubiquitous that it has come to be known at the "Lake Wobegon effect," after Garrison Keillor's fictional community where "the women are strong, the men are good-looking, and all the children are above average." A survey of one million high school seniors found that 70% thought they were above average in leadership ability, and only 2% thought they were below average. In terms of ability to get along with others, *all* students thought they were above average, 60% thought they were in the top 10%, and 25% thought they were in the top 1%! Lest one think that such inflated self-assessments occur only in the minds of callow high-school students, it should be pointed out that a survey of

have shown that most people believe that they are above average drivers,[70] even after they have been in a serious accident.[71] They disproportionately think they are better managers,[72] more ethical,[73] more intelligent,[74] and even less self-serving[75] than others. Eyewitnesses are chronically overconfident,[76] as are stock traders.[77] More broadly, people also overestimate their own knowledge and ability to make accurate judgments.[78]

> university professors found that 94% thought they were better at their jobs than their average colleague.

THOMAS GILOVICH, HOW WE KNOW WHAT ISN'T SO: THE FALLIBILITY OF REASON IN EVERYDAY LIFE 77–78 (1991).

69 In a recent highly-publicized study, Kruger and Dunning demonstrated that incompetent people suffer the "dual burden" of not only being bad at a task, but being unable to judge their own competence. Thus, in four studies, they found that people averaging performance in the 12th percentile judged themselves as performing in the 62nd percentile. Justin Kruger & David Dunning, *Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self-Assessments,* 77 J. PERSONALITY & SOC. PSYCHOL. 1121, 1121 (1999).

70 *See* Ola Svensen, *Are We All Less Risky and More Skillful than Our Fellow Drivers?,* 47 ACTA PSYCHOLOGICA 143, 143 (1981).

71 *See* Caroline E. Preston & Stanley Harris, *Psychology of Drivers in Traffic Accidents,* 49 J. APPLIED PSYCHOL. 284, 286 (1965).

72 Laurie Larwood & William Whittaker, *Managerial Miopia: Self-Serving Biases in Organizational Planning,* 62 J. APPLIED PSYCHOL. 194, 198 (1977) (noting that "[s]tudies indicate that self-serving biases are a wide-ranging phenomenon that can affect managerial decision-making through the process of overly optimistic planning").

73 *See* RAYMOND C. BAUMHART, AN HONEST PROFIT 20–22 (1968).

74 David Dunning et al., *Ambiguity and Self-Evaluation: The Role of Idiosyncratic Trait Definitions in Self-Serving Assessments of Ability,* 57 J. PERSONALITY & SOC. PSYCHOL. 1082, 1088 (1989) [hereinafter Dunning et al., *Ambiguity*] (finding evidence of the "above average" effect, which comes from most people responding that they are above average in most tasks).

75 James Friedrich, *On Seeing Oneself as Less Self-Serving than Others: The Ultimate Self-Serving Bias?,* 23 TEACHING OF PSYCHOL. 107, 108 (April 1996) (finding that "students who had been informed of the research on self-serving biases in judgment nevertheless saw themselves as engaging in such distortions less often than the average person").

76 *See* John S. Shaw III & Kimberly A. McClure, *Repeated Postevent Questioning Can Lead to Elevated Levels of Eyewitness Confidence,* 20 L. & HUM. BEHAV. 629, 650 (1996) (finding that overconfidence, but not accuracy, rose with repeated questioning of subjects in study).

77 *See* Babcock & Loewenstein, *supra* note 1, at 120 (referencing Terrance Odean, *Volume, Volatility, Price and Profit when All Traders Are above Average* (1996) (unpublished paper explaining excessive trading in foreign exchange markets and on the NYSE as a product of overconfidence)); Werner F.M. De Bondt, *A Portrait of the Individual Investor,* 42 EUR. ECON. REV. 831, 839–40 (1998) (reporting on results of a survey of investors showing substantial overconfidence as well as overoptimism); David Hirshleifer et al., *Security Analysis and Trading Patterns when Some Investors Receive Information before Others,* 49 J. FIN. 1665,

People also tend to be unduly optimistic. They exhibit overoptimism about their futures, believing in large percentages that they are more likely than the average person to succeed in their marriages,[79] their professional careers,[80] and their investment decisions.[81] They think that they are less likely to be victims of lung cancer,[82] AIDS,[83] and drug addiction[84] than other people.[85] They have

1686 (1994) (finding substantial hubris among investment professionals); *Electronic Commerce: New Online Traders Vulnerable to Overconfidence, UC Davis Scholars Find,* BNA SEC. L. DAILY, Sept. 14, 1999, *available in* LEXIS, BNA Library, BNASLD File (citing Brad Barber & Terrance Odean, *The Common Stock Investment Performance of Individual Investors* (reporting a UC Davis Working Paper) (finding substantial evidence of overconfidence and other cognitive biases in online stock trading)).

[78] *See* Lyle A. Brenner et al., *Overconfidence in Probability and Frequency Judgments: A Critical Examination,* 65 ORG. BEHAV. & HUM. DECISION PROCESSES 212, 218 (1996) (finding overconfidence as well as poor use of base rate information and vulnerability to representativeness heuristic); Hillel J. Einhorn, *Overconfidence in Judgment,* 4 NEW DIRECTIONS FOR METHODOLOGY OF SOC. AND BEHAV. SCI. 1, 14 (1980) (quoting Will Rogers: "It's not what we don't know that gives us trouble. It's what we know that ain't so.").

[79] *See, e.g.,* Lynn A. Baker & Robert E. Emery, *When Every Relationship Is above Average: Perceptions and Expectations of Divorce at the Time of Marriage,* 17 LAW & HUM. BEHAV. 439, 443 (1993) (finding that people estimate that half of married couples will divorce but place their own chance at zero).

[80] *See, e.g.,* Neil D. Weinstein, *Unrealistic Optimism about Future Life Events,* 39 J. PERSONALITY & SOC. PSYCHOL. 806, 809–14 (1980) (finding, for example, that there were six times as many college students who believed that they were more likely than the average person to own their own home than those who believed that they were less likely).

[81] *See* HERSH SHEFRIN, BEYOND GREED AND FEAR 131–32 (2000) (reporting studies showing overoptimism as well as overconfidence by investors).

[82] Linda S. Perloff & Barbara K. Fetzer, *Self-Other Judgments and Perceived Vulnerability to Victimization,* 50 J. PERSONALITY & SOC. PSYCHOL. 502, 508–09 (1986) (finding both cognitive and motivational factors accounting for people perceiving themselves as "unique[ly] invulnerab[le]" to victimization).

[83] Jill G. Joseph et al., *Perceived Risk of AIDS: Assessing the Behavioral and Psychosocial Consequences in a Cohort of Gay Men,* 17 J. APPLIED SOC. PSYCHOL. 231, 234–35 (1987) (finding in a cohort of 637 gay men that "very few men believed that either their absolute or comparative risk of AIDS was great" even though 40% of the cohort was already demonstrating HIV antibodies).

[84] Neil D. Weinstein, *Unrealistic Optimism About Susceptibility to Health Problems: Conclusions from a Community-Wide Sample,* 10 J. BEHAV. MED. 481, 493–497 (1987) (finding unrealistic optimism regarding drug addiction and a variety of potential health problems among the populations as a whole, and finding that the bias is "largely unrelated to age, sex, level of education, or occupational prestige").

[85] *See also* GILOVICH, *supra* note 68, at 77–78 (surveying several studies and noting that "people tend to think that they are more likely than their peers to experience a variety of favorable events like owning a home or earning a large salary, but less likely to experience aversive [sic] events like getting divorced or suffering from lung cancer. Recent public opinion

unrealistic expectations regarding the election prospects of the candidates they favor[86] and the prospects of their favorite football team to win a game, even when it is trailing at halftime.[87]

The overconfidence bias[88] and the related phenomenon of overoptimism[89] are extremely robust, helping to explain phenomena from excessive litigation[90] to the large premiums acquiring companies pay in corporate takeovers.[91] In general, the self-serving bias has also proved to be hardy in most of its manifestations, including excessive litigation[92] and large takeover premiums, even among accountants.[93]

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polls indicate that although only 25% of the population believes that the country as a whole will be better off financially in the coming year, 54% nevertheless think that *they* will do better.").

86 Babad, *Wishful Thinking*, *supra* note 23, at 105 (finding "[s]trong" wishful thinking by voters in the 1993 mayoral election in Jerusalem and noting several other studies finding this effect).

87 *See id.*

88 *See* Dunning et al., *Ambiguity*, *supra* note 74, at 1088 (finding evidence that self-serving evaluations arise partly from people's idiosyncratic definitions of the traits they are asked to assess); E. Scott Geller & Gordon F. Pitz, *Confidence and Decision Speed in the Revision of Opinion*, 3 ORG. BEHAV. & HUM. PERFORMANCE 190, 199 (1968) (finding confidence often grew even following disconfirming events); Gerd Gigerenzer et al., *Probabilistic Mental Models: A Brunswikian Theory of Confidence*, *in* RESEARCH ON JUDGMENT AND DECISION MAKING 95, 96 (William M. Goldstein & Robin M. Hogarth eds., 1997) (noting near total failure of debiasing attempts).

89 *See* BAZERMAN, JUDGMENT, *supra* note 38, at 95 ("[P]eople have been found to perceive themselves as being better than others across a number of traits, including honesty, cooperativeness, rationality, driving skill, health, and intelligence."); Babad, *Wishful Thinking*, *supra* note 23, at 105 ("[T]he undeniable conclusion [of seven large-scale studies] is that the self-serving bias of wishfully distorted predictions of game or election outcomes is intense, and largely resistant to change."); Kevin M. Taylor & James A. Shepperd, *Bracing for the Worst: Severity, Testing, and Feedback Timing as Moderators of the Optimistic Bias*, 24 PERSONALITY & SOC. PSYCHOL. BULL. 915, 915 (1998) (noting that studies have "shown the optimistic bias to be quite robust [and wide-ranging]").

90 *See* Don L. Coursey & Linda R. Stanley, *Pretrial Bargaining Behavior within the Shadow of the Law: Theory and Experimental Evidence*, 8 INT'L REV. L. & ECON. 161, 175 (1988) (showing that "as much of the law and economics literature suggests ... litigating parties are overly optimistic about their chances at trial" and therefore unwilling to settle for a reasonable amount).

91 *See* Mathew L.A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q. 103, 120 (1997) ("Our results suggest that CEO hubris, manifested as exaggerated pride or self-confidence, plays a substantial role in the acquisition process, particularly in the decision of how much to pay.").

92 Regarding one of its manifestations, the biased view of a fair settlement amount and the overoptimism regarding what a judge or jury will actually award, Babock and her colleagues have had mixed results attempting to debias the self-serving bias. *See* Babcock & Loewenstein, *supra* note 1, at 115 (having no luck debiasing subjects by explaining the self-serving bias to

3. *Interplay of Cognitive and Motivational Factors*

So, facets of the self-serving bias, such as the fairness bias or the self-attribution bias, may be either cognitively-based or motivationally-based, or a combination of the two.[94] Causation is unclear.[95] Perhaps cognitive biases cause people to access only information dealing with themselves and to fail to access less vivid information about others, creating a self-serving effect. Or perhaps a self-serving motivation causes people's memories to access only information that supports their goals, beliefs, and attributions. In either event, the result is the same—a strong self-serving bias that affects people's attitudes, beliefs, inferential strategies, attributions of causation, fairness judgments, and the like. Many

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them or by having them write an essay arguing the opponent's case as convincingly as possible, but having modest success by asking them to list the weaknesses of their own case); Linda Babcock et al., *Creating Convergence: Debiasing Biased Litigants,* 22 L. & SOC. INQUIRY 913, 922–23 (1997) (having success by forcing study subjects to list the weaknesses in their own case). *See also* Frank P. McKenna & Lynn B. Myers, *Illusory Self-Assessments—Can They Be Reduced?,* 88 BRIT. J. PSYCHOL. 39, 47–48 (1997) (finding strong overconfidence effects among student drivers, but reporting some luck in reducing those effects using accountability).

[93] Numerous studies show that accountants are subject to the overconfidence bias. *See, e.g.,* Jeffrey R. Cohen, *An Exploratory Examination of International Differences in Auditors' Ethical Perceptions,* 7 BEHAV. RES. IN ACCT. 37, 58 (1995) [hereinafter Cohen, *Exploratory Examination*] (showing that most auditors believe they will act more ethically than their peers); Pamela Kent & Ron Weber, *Auditor Expertise and the Estimation of Dollar Error in Accounts,* 34 ABACUS 120, 137 (1998) (finding considerable overconfidence by auditors in their ability to make accurate judgments about dollar errors that might exist in accounts because of internal control weaknesses); Thomas Kida, *An Investigation into Auditors' Continuity and Related Qualification Judgments,* 18 J. ACCT. RES. 506, 519 (1980) (finding no correlation between auditors' confidence in their ability to make going-concern judgments and their accuracy in so doing); Lawrence A. Ponemon, *The Objectivity of Accountants' Litigation Support Judgments,* 70 ACCT. REV. 467, 484 (1995) (finding that 83% of auditors believe that they have above-average skill in estimating missing inventory); Wilfred C. Uecker, *The Effects of Knowledge of the User's Decision Model in Simplified Information Evaluation,* 18 J. ACCT. RES. 191, 205 (1980) (finding that as auditors practiced estimating optimal sample sizes, their confidence grew, but not their accuracy).

[94] *See* Babad, *Wishful Thinking, supra* note 23, at 107 (noting that "[i]t would seem reasonable to view wishful thinking [overoptimism] as a motivational construct that influences cognitive processing"); Messick & Sentis, *Fairness Biases, supra* note 31, at 70.

[95] It has been noted that:

> There is much disagreement in psychology about the origin of self-serving biases. Some argue that the biases are caused by the motivation to feel better about oneself. Others argue that self-serving biases are simply an artifact of cognitive processes and serve no motivational or adaptive purpose.

George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining,* 22 J. LEGAL STUD. 135, 141 (1993).

sophisticated studies indicate a role for *both* cognitive and motivational views.[96] It is quite possible that "[p]eople rely on cognitive processes and representations to arrive at their desired conclusions, but [that] motivation plays a role in determining which of these will be used on a given occasion."[97]

Consider the confirmation bias: the tendency of people to search for and credit information that supports their pre-existing beliefs more than information that contradicts them.[98] Although the confirmation bias clearly has cognitive aspects, it is a self-serving motivation to be right and consistent that frames the question, shaping the impact of the confirmation bias. Supporters of 1960 Presidential candidate Richard Nixon were motivated to evaluate the evidence in such a way as to support the proposition that Nixon won the debate with Kennedy. Kennedy's supporters were motivated to evaluate the evidence in such a way as to support the proposition that Kennedy won the debate. Both groups had the same cognitive limitations, but their motives tended to lead them to polar opposite, self-serving conclusions.

Consider the phenomenon of cognitive dissonance: the tendency of people to reduce or avoid psychological inconsistencies.[99] People are motivated to think of themselves as accurate, consistent decision-makers. Having communicated to the superior the conclusion that he was the most worthwhile member of his team, the hypothetical employee in the earlier scenario will have a strong motivation to

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[96] *See* Amber L. Story & David Dunning, *The More Rational Side of Self-Serving Prototypes: The Effects of Success and Failure Performance Feedback*, 34 J. EXPERIMENTAL SOC. PSYCHOL. 513, 525–28 (1998). The subjects studied, who succeeded in an experiment testing their ability as clinical psychologists, tended to infer both that skills and characteristics they previously believed they possessed were important to the task and that they must possess the skills and characteristics that they had previously believed to be important to the task. Although many studies had indicated a motivational basis for such conclusions, Story and Dunning concluded that perhaps they were just learning from experience.

[97] Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480, 480 (1990) (citing other sources).

[98] The confirmation bias is to some extent a tendency of people to see what they expect to see. When testing a hypothesis, individuals tend to preferentially solicit evidence that confirms their hypothesis and to downplay or ignore evidence that undermines it. *See* Jerome S. Bruner & Leo J. Postman, *On the Perception of Incongruity: A Paradigm*, 18 J. PERSONALITY 206, 222 (1949) (finding that "perceptual organization is powerfully determined by expectations built upon past commerce with the environment"); Michael E. Doherty et al., *Pseudodiagnosticity*, 43 ACTA PSYCHOLOGICA 111, 118 (1979) (finding that people are unskilled in detecting potentially disconfirming information); Joshua Klayman & Young-Won Ha, *Confirmation, Disconfirmation, and Information in Hypothesis Testing*, 94 PSYCHOL. REV. 211, 225 (1987) (arguing that the confirmation bias is better understood as a "positive test strategy" which generally serves well as a broad heuristic, although it can lead to systematic errors or inefficiencies); PLOUS, *supra* note 22, at 232–34 (noting several studies confirming the confirmation bias); Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LIT. 11, 26 (1998) ("People tend to *misread* evidence as *additional* support for initial hypotheses.").

[99] *See generally* LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1957).

cognitively recognize only, or at least give substantially more weight to, evidence that supports that conclusion. Contradictory evidence is often largely suppressed by cognitive processes,[100] but self-serving motivational factors play a key role.

Additionally, consider the related notion of belief perseverance. Several studies show that information that is inconsistent with previously held beliefs is processed neither fully nor accurately and is often discounted significantly.[101] Previously-held beliefs often persevere in the face of evidence that completely discredits them.[102] Again, although cognitive phenomena are clearly at work, motivational forces cannot be ignored because many have argued that "individuals engage in belief-maintaining reasoning because it produces a variety of positive short-term outcomes, such as enhanced self-esteem, self-righteous feelings, a heightened sense of control, and an optimistic view of the self."[103]

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[100] Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 102–03 (1993) [hereinafter Langevoort, *Where Were the Lawyers?*] ("When people voluntarily commit themselves to a certain position, attitude or belief, the subsequent discovery of information that indicates harmful consequences flowing from that commitment directly threatens their self-concept as good, worthwhile individuals. Thus, cognitive processes will work to suppress such information if at all possible.").

[101] *See, e.g.*, Peter H. Ditto & David F. Lopez, *Motivated Skepticism: Use of Differential Decision Criteria for Preferred and Nonpreferred Conclusions*, 63 J. PERSONALITY & SOC. PSYCHOL. 568, 569 (1992) (noting "the robust tendency of individuals to perceive information that is consistent with a preferred judgment conclusion . . . as more valid than information that is inconsistent with that conclusion").

[102] *See* Craig A. Anderson et al., *Perseverance of Social Theories: The Role of Explanation in the Persistence of Discredited Information*, 39 J. PERSONALITY & SOC. PSYCHOL. 1037, 1045 (1980) (finding that people will persevere in beliefs even after a strong discrediting of the evidence upon which the beliefs were formed); Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098, 2108 (1979) [hereinafter Lord et al., *Biased Assimilation*] (noting "a number of studies showing that once formed, impressions about the self, beliefs about other people, or theories about functional relationships between variables can survive the total discrediting of the evidence that first gave rise to such beliefs"); Lee Ross & Craig A. Anderson, *Shortcomings in the Attribution Process: On the Origins and Maintenance of Erroneous Social Assessments*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 53, at 129, 144 ("It appears that beliefs—from relatively narrow personal impressions to broader social theories—are remarkably resilient in the face of empirical challenges that seem logically devastating.").

[103] Paul A. Klaczynski & David H. Gordon, *Self-Serving Influences on Adolescents' Evaluation of Belief-Relevant Evidence*, 62 J. EXPERIMENTAL CHILD PSYCHOL. 317, 318 (1996). *See also* Mark Schaller, *In-Group Favoritism and Statistical Reasoning in Social Inference: Implications for Formation and Maintenance of Group Stereotypes*, 63 J. PERSONALITY & SOC. PSYCHOL. 61, 71 (1992) (finding that group members selectively engage in statistical inference strategies as a means of justifying in-group favoritism and that the motivation affects inferential reasoning even if facts are remembered accurately).

The impact of motivational forces is not unlimited. The literature in motivational reasoning provides substantial evidence that people reach the conclusions they desire to reach for self-serving reasons, but that this effect is constrained "by their ability to construct seemingly reasonable justifications."[104] In other words, people are generally unable to reach self-serving conclusions in the absence of *any* evidence to support that view. An auditor who wished for self-serving reasons to please a client who was undoubtedly and drastically insolvent would be unlikely to issue a clean opinion. As Professor Kunda notes, "when one wants to draw a particular conclusion, one feels obligated to construct a justification for that conclusion that would be plausible to a dispassionate observer."[105] However, under ambiguity, people are motivated and able to reach conclusions that can plausibly be supported by the available ambiguous evidence. In other words, with a few ambiguous facts on which to hang her hat, a self-interested auditor may be able to certify financial statements that are wildly inaccurate. To put a slightly broader gloss on the matter, many studies of motivated reasoning demonstrate the "tendency for individuals to utilize a variety of cognitive mechanisms to arrive, through a process of apparently unbiased reasoning, at the conclusion they privately desired to arrive at all along."[106] In this regard, the human capacity for rationalization is potent.[107]

II. ILLUSTRATIONS OF THE SELF-SERVING BIAS

The same factors that induce a person to believe that he is the most deserving candidate for a raise and tend to induce auditors to conclude that their lucrative clients are entitled to the clean audit opinion they desire, also affect other economic actors. Although the law asks much of auditors when it demands that they be purer than Caesar's wife when doing attest-related work, other professionals are also asked to be objective, if not independent. The evidence indicates that these other professionals, such as attorneys, physicians, and

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[104] Kunda, *supra* note 97, at 480; Rasyid Sanitioso et al., *Motivated Recruitment of Autobiographical Memories,* 59 J. PERSONALITY & SOC. PSYCHOL. 229, 238–40 (1990) (finding that when subjects were led to believe that a given trait was desirable, their autobiographical memories reflecting that trait became more accessible to them and concluding that motivation affects the recruitment of autobiographical memories).

[105] Kunda, *supra* note 97, at 493.

[106] Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problems of Market Manipulation,* 74 N.Y.U. L. REV. 630, 653 (1999).

[107] *See* Loewenstein, *Skewed Trade-Offs, supra* note 22, at 222 (citing a 1994 study by Chris Hsee, finding that when faced with two job candidates, one of whom is more competent and the other more attractive, people tend to hire the more competent person only when the information they are given is extremely clear that the less attractive candidate is more competent).

investment bankers, often fail miserably in their attempts to be objective, largely because of the self-serving bias and related effects.

A. *Attorneys*

Although their highest duty is to the integrity of the legal system,[108] attorneys, when representing clients in court, are asked to be zealous advocates for their client's cause.[109] In this setting, attorneys are not asked to be objective in their presentation of the facts.[110] Nonetheless, the attorney's professional code requires, even in the advocate's role, "that the professional exercise his or her best judgment in advising the client and not parrot that which the client would like if the professional did not believe that this was correct advice, or even the best advice."[111] And certainly in other contexts, such as where corporate attorneys serve as trusted advisers, the clients need (and at some level want) objectivity and what Langevoort calls "cognitive independence."[112]

Many corporate legal clients have a bundle of organizational quirks of the type that can lead to serious mistakes in planning, ethics, and legal compliance.[113] Yet, Langevoort has argued persuasively that it is extremely difficult for attorneys to overcome their own cognitive biases and other limits on rational thought in order to give the objective and independent advice that is so needed.[114] Langevoort and Rasmussen have predicted, based on economic reasoning with a large infusion of behavioral research, that attorneys will act self-interestedly in a number of ways, including the giving of overly pessimistic advice to corporate clients regarding litigation risk in order to increase their importance to, and fees paid by, the client.[115] Edelman, Abraham, and Erlanger's detailed study of legal

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108 MODEL RULES OF PROF'L CONDUCT R. 5.3 (1983).

109 *Id.*, at R. 1.3 cmt. (1983).

110 *See* MODEL CODE OF PROF'L RESPONSIBILITY EC 7-15 (1980) ("A lawyer appearing before an administrative agency, regardless of the nature of the proceeding it is conducting, has the continuing duty to advance the cause of the client within the bounds of the law.").

111 *See* MDP REPORT, *supra* note 5, at 15–16.

112 Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 634 (1997) [hereinafter Langevoort, *Epistemology*].

113 *See* Robert Gibbons, *Taking Coase Seriously*, 44 ADMIN. SCI. Q. 145, 146 (1999) (noting that "[r]ecent models of internal organization predict that organizations will be a mess but not a mystery").

114 Langevoort, *Epistemology*, *supra* note 112, at 647–56.

115 Langevoort & Rasmussen, *supra* note 63, at 437–38.

advice given in the wrongful discharge field seems to provide a vivid empirical illustration of just this result of the self-serving bias.[116]

B. *Physicians*

Ideally, physicians would exercise objective and independent judgment in their diagnoses and prescriptions for treatment of patients, but the ideal seems often to go unrealized, in part because physicians are also victims of the self-serving bias.[117] For example, before Congress put a stop to the practice via the Stark law (which many physicians are currently trying to have repealed),[118] physicians routinely referred patients for tests to facilities in which they owned an economic interest.[119] Numerous studies documented that physicians would order more tests and longer treatments when they referred patients (particularly well-insured patients) to facilities that they owned than when they referred patients to facilities owned by others.[120] The results of the studies were dramatically

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[116] Lauren B. Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge,* 26 L. & SOC'Y REV. 47, 73–77 (1992) (finding that both attorneys and personnel professionals appear to exaggerate the threat of wrongful discharge liability in order to increase their importance to the client and, in the case of attorneys, their revenue stemming from the client). In other contexts, attorneys can be overly optimistic in the advice they give to clients. Elizabeth F. Loftus & Willem A. Wagenaar, *Lawyers' Predictions of Success,* 28 JURIMETRICS J. 437, 450–51 (1988) (finding that attorneys, while not very accurate at judging the outcome of litigation, tend toward overoptimism).

[117] Eric H. Marcus, *Unbiased Medical Testimony: Reality or Myth?,* 6 AM. J. FORENSIC PSYCHIATRY 3, 4 (#4) (1985) (noting that if a diagnosing doctor is also the doctor who will render—and charge for—treatment, he or she often has "a bias in favor of finding something wrong to treat").

[118] Kristen Hallam, *Providers Unite on Repeal of Compensation Ban,* MOD. HEALTHCARE, Aug. 2, 1999, at 12 (noting that physicians support dilution of the Stark law).

[119] Jean M. Mitchell & Elton Scott, *New Evidence of the Prevalence and Scope of Physician Joint Ventures,* 268 JAMA 80, 83 (1992) (finding a surprisingly high amount of physician financial involvement in health care businesses outside their own practice).

[120] Thomas L. Carson, *Conflicts of Interest,* 13 J. BUS. ETHICS 387, 394 (1994) ("[W]hen physicians are paid according to how much work they do for their patients, many physicians succumb to the temptation to provide their patients with unnecessary, even dangerous treatments."). *See* Thomas S. Crane, *The Problem of Physician Self-Referral under the Medicare and Medicaid Antikickback Statute,* 268 JAMA 85, 86 (1992) (citing studies by the Office of the Inspector General and the State of Florida Health Care Cost Containment Board showing how physicians respond to financial incentives in their treatment practices); David Hemenway et al., *Physicians' Response to Financial Incentives,* 322 NEW ENG. J. MED. 1059, 1061 (1990) (finding that when compensation of physicians changed from a flat fee to a bonus system where they could earn extra revenue by ordering laboratory tests for patients on machines owned by employers, physicians increased their orders for lab tests by 23%); Bruce J. Hillman et al., *Frequency and Costs of Diagnostic Imaging in Office Practice—A Comparison of Self-Referring and Radiologist-Referring Physicians,* 323 NEW. ENG. J. MED. 1604, 1606

inconsistent with the Hippocratic oath, but well aligned with the physicians' economic self-interest. The American Medical Association (AMA) reacted to this conflict of interest, much as the accounting profession often does, by declaring such self-referrals to be unethical only after Congress outlawed them.[121]

C. *Investment Bankers and Securities Analysts*

Investors would make more efficient decisions if investment bankers and securities analysts rendering opinions could do so objectively, but this does not seem to be the case. Investment bankers are often hired to render fairness opinions in major corporate transactions, but the fairness of the opinions is often extremely questionable. Investment bankers have some conflicts of interest that resemble those of auditors, and others that are much worse. A management is not trying very hard if it cannot find an investment bank that will express the opinion that management wants expressed. At least three factors create unreliable, self-serving opinions by investment bankers, and two of those apply to auditors:

(1990) (finding that self-referring physicians employed diagnostic imaging at least four times as frequently than their colleagues who referred patients to others); Bruce J. Hillman et al., *Physicians' Utilization and Charges for Outpatient Diagnostic Imaging in a Medicare Population*, 268 JAMA 2050, 2050 (1992) (finding self-referral resulting in 1.7 to 7.7 times more frequent performing of imaging examinations than radiologist-referral); Jean M. Mitchell & Elton Scott, *Physician Ownership of Physical Therapy Services*, 268 JAMA 2055, 2055 (1992) (finding that visits per patient were 39% to 45% higher in facilities where referring physicians were joint venturers and that more revenues were generated from patients with well-paying insurance). *See also* George J. Annas & Frances H. Miller, *The Empire of Death: How Culture and Economics Affect Informed Consent in the U.S., the U.K., and Japan*, 20 AM. J. L. & MED. 357, 383 (1994) ("The medical literature also documents persuasively that when physicians receive additional income from their diagnostic methods or their treatment recommendations, utilization increases dramatically."); Julie E. Mathews, *The Physician Self-Referral Dilemma: Enforcing Antitrust Law as a Solution*, 19 AM. J. L. & MED. 523, 525 (1993) (citing evidence that financial incentives motivate self-referring physicians to recommend tests or treatment for patients even when patients do not need them and to refer patients only to facilities where they have an economic stake whether or not they provide the best care).

121 Mark Taylor, *Healthcare Struggles with Stark Reality*, MOD. HEALTHCARE, July 5, 1999, at 30. Congress outlawed such self referrals via the Ethics in Patient Referrals Act of 1989 ("Stark I"), 42 U.S.C. § 1395nn (1989) (amended in 1993 by Stark II), later amended and expanded by "Stark II" that banned additional potential conflicts. Stark II, 42 U.S.C. § 1395nn (1993). The AMA did not act until 1991 and 1992. *Prepared Testimony of Kathy Buto, Deputy Director, HCFA Center for Health Plans & Providers Before the House Ways & Means Committee Health Subcommittee*, FED. NEWS SERV., *at* LEXIS, Academic Universe, http://web.lexis-nexis.com/universe (May 13, 1999); Marc A. Rodwin, *Strains in the Fiduciary Metaphor: Divided Physician Loyalties and Obligations in a Changing Health Care System*, 21 AM. J. L. & MED. 241, 250 (1995).

There are several reasons why fairness opinions may be extremely unreliable when provided by target management's own bankers. First, the fees for such opinions are large and a management which is not given the type of opinion it wants may shop elsewhere. Second, losing the corporation as a client for the fairness opinion may also mean losing all sorts of other business that the investment banker has been or would like to be providing to that client. Third, and most problematic, investment bankers frequently work on contingency fees where their compensation increases dramatically if a hostile offer is defeated and a management-sponsored alternative which they have prepared succeeds. The conflict of interest in such situations is glaring and, apparently, nearly irresistible.[122]

Not surprisingly, knowledgeable observers have deemed fairness opinions "made-to-order recommendations ... that support managers' pre-established positions,"[123] "virtually worthless,"[124] and a "deceit upon the investing public and the marketplace generally."[125] Several courts have also noted the general unreliability of these self-serving opinions.[126]

Securities analysts purport to provide objective analyses and recommendations to investors, of course. Yet they face similar pressures, and it has been stated that analysts "are under exquisite pressure to hear and see no 'evil,' to write only upbeat reports about the companies which they too see as the

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122 Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They be Allowed to?*, 15 DEL. J. CORP. L. 377, 468–69 (1990).

123 Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 211 (1988).

124 Richard B. Schmitt, *Suspect Opinions: If an Investment Bank Says the Deal Is Fair, It May or May Not Be*, WALL ST. J., Mar. 10, 1988, at 1 (quoting securities attorney Harvey Kronfeld).

125 Benjamin J. Stein, *Investment Banking's Dirty Little Secret*, N.Y. TIMES, June 8, 1986, § 3 , at 2. *See also* Paul Sweeney, *Who Says It's a Fair Deal?*, J. ACCT., Aug. 1999, at 44, 47 ("Academics and legal experts tend to agree that a fairness opinion from a company's merger adviser has little value to investors.").

126 *See, e.g.*, Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986), *reviewed on other grounds*, 481 U.S. 69 (1987) (noting that Smith Barney would have lost a $75,000 bonus had it advised the board that the tender offer was fair and deeming it "mystifying" that Smith Barney could render a fairness opinion on a tender offer before it knew the offer price); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275 (2d Cir. 1986) (shallow, conclusory opinion of investment banker held not to support target board's decision to grant lock-up option to white knight); City Capital Assocs. Ltd. P'ship v. Interco, Inc., 551 A.2d 787, 792 (Del. Ch. 1988) (regarding a contingent-fee based fairness opinion stating a $74–$87 "reference range" and noting that "[t]he so-called reference ranges do not purport to be a range of fair value; but just what they purport to be is (deliberately, one imagines) rather unclear").

source of business far more profitable than the trading commissions that are the immediate raison d'etre of those reports."[127]

Hayward and Boeker recently performed an extensive empirical study of security analysts' ratings of corporate equity securities.[128] They sought to determine, if the investment banking side of a securities firm was hired by a client to assist in a merger or some similar transaction, would the financial analysts on the other side of the firm tend to assign a higher rating to the client's securities than other analysts? Their study found such an effect, and concluded that it was a "dominant, entrenched outcome."[129] They also found that the larger the client, the greater the effect.[130] Although Hayward and Boeker ascribe much of this effect to the balance of power within investment banking firms, clearly firm self-interest helps account for the fact that analysts' "buy" recommendations outnumber "sell" recommendations by a ratio of 87 to 1.[131]

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[127] Lowenstein, *Paparazzi*, *supra* note 9, at 52 (citing Gretchen Morgenson, *See No Evil, Speak No Evil*, FORBES, Dec. 15, 1997, at 162). *See also* Debbie Galant, *The Hazards of Negative Research Reports*, INSTITUTIONAL INVESTOR, July 1990, at 73 (reporting results of a survey in which 61% of surveyed analysts reported that they had been pressured by employers into tempering negative reports and giving example of when Donald Trump successfully intimidated a client into firing an analyst with whom he was unhappy); Mark Hulbert, *Compromised Analysts? The SEC Is Shocked*, WALL ST. J., Dec. 29, 1999, at A14 ("Savvy investors always have been aware that Wall Street analysts operate under serious conflicts of interest and compromised objectivity."); Robert McGough, *Bearish Call on Banks Lands Analyst in Doghouse*, WALL ST. J., Nov. 23, 1999, at C1 (giving example of the grief an objective analyst may suffer and noting "[i]t is no longer news that analysts' recommendations may lack objectivity"); Gretchen Morgenson, *Flying Blind in a Fog of Data*, N.Y. TIMES, June 18, 2000, § 3, at 1 (reporting on study by Georgia State University Professor Siva Nathan finding that analysts writing about companies whose securities were underwritten by the analysts' firms issued 25% more "buy" recommendations and 46% fewer "sell" recommendations than other analysts); Suzanne Woolley & Linda Himelstein, *If You Can't Say Something Nice About a Company . . . Analysts Are Under Growing Pressure to Stifle Negative Reports*, BUS. WK., Nov. 11, 1996, at 119 ("The pressure [for analysts] to avoid issuing unfavorable reports is intensifying as investment banking comes to account for a greater portion of many firms' revenues.").

An interesting example of the lack of objectivity, coming from a different perspective, was Piper Jaffray's Ashok Kumar who praised eMachines while lobbying its CEO for underwriting work on its IPO. When eMachines did not allocate any of the IPO to Kumar's firm, his analysis of eMachines shifted 180 degrees as he went from lavish praise to calling it "sucker.com." Peter Burrows, *A Sudden Change of Heart at Piper*, BUS. WK., Dec. 6, 1999, at 6.

[128] Hayward & Boeker, *supra* note 19.

[129] *Id.* at 14.

[130] *Id.* at 15.

[131] James B. Kelleher, *Can You Trust Analysts?*, WICHITA EAGLE, Jan. 3, 2000, at 11A (noting a study by First Call research firm).

The occasional libel suit filed by companies given unflattering reviews by analysts could provide an additional self-serving reason to favor "buy" recommendations. Elizabeth

Like accountants, financial analysts have a code of ethics,[132] but Hayward and Boeker concluded that "[t]he props of self-governance, namely, codes of ethics and Chinese walls, may foster impressions that analysts' professional standards are being met. But these devices merely mask actual, backstage behavior, and the malleable, porous, and increasingly transparent nature of Chinese walls suggests that they actually resemble 'the emperor's clothes.'"[133]

D. *Expert Witnesses*

Expert witnesses should be objective,[134] but they are affected by the same cognitive biases and limitations on rationality that affect everyone else, [135] so it is not surprising that they are affected by the self-serving bias as well. For more than a century, their bias has been widely noted.[136] Long ago, Professor Himes observed:

MacDonald, *Libel Suits Pose a Risk for Analysts*, WALL ST. J., Dec. 29, 1999, at C1 ("Wall Street analysts who dare to take the unusual step of criticizing companies in their research reports routinely risk being pilloried by their institutional-investor clients, frozen out of company conference calls or even fired . . . [and now] they have another problem to contend with: libel suits.").

[132] Securities analysts have a code of ethics. *See generally* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH (AIMR) CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT (May 1999), *available at* http://www.aimr.com/ethics/code/full_code.html (on file with The Ohio State Law Journal).

[133] Hayward & Boeker, *supra* note 19, at 20 (citations omitted).

[134] State *ex rel.* Lichtor v. Clark, 845 S.W.2d 55, 62 (Mo. Ct. App. 1992) (holding it is appropriate for a court to conduct a hearing concerning the professional objectivity of an examining physician).

[135] Michael L. Perlin, *The ADA and Persons with Mental Disabilities: Can Sanist Attitudes Be Undone?*, 8 J. L. & HEALTH 15, 33 (1993–94) ("Expert witnesses, like the rest of us, succumb to the meretricious allure of simplifying cognitive devices in their thinking.").

[136] *See, e.g.*, Winans v. N.Y. & Erie R.R. Co., 62 U.S. (21 How.) 88, 101 (1858) ("Experience has shown that opposite opinions of persons professing to be experts may be obtained to any amount."); Ferguson v. Hubbell, 97 N.Y. 507, 514 (1884) (noting that expert witnesses' views "cannot fail generally to be warped by a desire to promote the cause in which they are enlisted").

Over the years, the judgments of many courts have not softened any on this issue. *See, e.g.*, Butman v. Christy, 198 N.W. 314, 317 (Iowa 1924) (calling expert testimony "of the lowest order"); Opp v. Pryor, 128 N.E. 580, 583 (Ill. 1920) (noting that expert testimony is "the most unsatisfactory part of judicial administration"); United States v. Andreas, No. 96 CR 762, 1999 U.S. Dist. LEXIS 11166, at *43 (Ill. App. July 15, 1999) (noting that the government's and defendant's expert opinions diverged so substantially as to suggest bias); Knowledge Based Techs. Inc. v. Int'l Bus. Mach., Corp., No. 96 Civ. 9461 (JSR), 1998 U.S. Dist. LEXIS 4602, at *1 (N.Y. App. Div. Apr. 8, 1998) ("Claims of bias and self-interest could fairly be levelled [sic] at a great many experts whose testimony is routinely admitted in federal courts."); Rail Intermodal Specialists, Inc. v. Gen. Elec. Capital Corp., 154 F.R.D. 218, 221 (Iowa Ct. An.

> It is often surprising to see with what facility and to what an extent [experts'] views can be made to correspond with the wishes or the interests of the parties who call them. . . . [T]heir judgment becomes so warped by regarding the subject in one point of view that even when conscientiously disposed, they are incapable of expressing a candid opinion. . . . They are selected on account of their ability to express a favorable opinion, which, there is great reason to believe, is in many instances the result alone of employment and the bias growing out of it.[137]

The cause of expert bias may in some cases be the witnesses' conscious desire to please their employers in order to gain additional business by them or other attorneys involved in similar cases.[138] Many people now rely on expert witness fees for a substantial portion of their total income.[139] But, the subtle subconscious factors underlying the self-serving bias may also be at work.[140] Epstein worries that experts' association with the attorneys who hire them impairs their objectivity and neutrality.[141] Studies show that psychiatrists, psychologists, and other mental health professionals tend to slant their analysis and testimony toward the party who hired them, even in sensitive matters such as the insanity

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1994) ("[I]t is no secret that almost all retained experts will carry the same bias as counsel or they will not be retained."); Rosenblitt v. Rosenblitt, 107 A.D.2d 292, 299 (N.Y. App. Div. 1985) (noting that "it is hardly a secret that [the current expert witness system] contains the seeds of venally induced distortion"); State Highway Comm'n v. Superbilt Mfg. Co., 281 P.2d 707, 713 (Or. 1955) (stating that expert testimony is viewed with some suspicion).

137 William L. Foster, *Expert Testimony—Prevalent Complaints and Proposed Remedies,* 11 HARV. L. REV. 169, 170–71 (1897) (quoting Professor C. Himes, *The Scientific Expert in Forensic Procedure,* 135 J. FRANKLIN INST. 409 (1893)). *See also* Michael H. Graham, *Expert Witness Testimony and the Federal Rules of Evidence: Insuring Adequate Assurance of Trustworthiness,* 1986 U. ILL. L. REV. 43, 45, 47 (noting that "practicing lawyers can locate quickly and easily an expert witness to advocate nearly anything the lawyers desire" and that "many expert witnesses will testify to almost anything the client desires").

138 Richard A. Epstein, *A New Regime for Expert Witnesses,* 26 VAL. U. L. REV. 757, 759 (1992) [hereinafter Epstein, *New Regime*] (noting that an expert witness who "brings home the bacon" in one case is more likely to command larger fees in succeeding cases).

139 Graham, *supra* note 137, at 44.

140 Professor Epstein notes:

> The rule against contingent fees (and the power of cross-examination) may curtail the obvious forms of blatant prejudice through which the jury is likely to see in any event. Nonetheless, there are a lot of cases that are close to the line, and the expert who labors with a powerful financial inducement (indirect to be sure), and a close client identification is likely, just likely, to shade his opinion in favor of his client's position. The point here has little to do with plaintiffs or defendants. With human nature what it is, we can be confident that experts on both sides of the line will be prey to this particular failing.

Epstein, *New Regime, supra* note 138, at 759.

141 Richard A. Epstein, *Judicial Control Over Expert Testimony: Of Deference and Education,* 87 NW. U. L. REV. 1156, 1163 (1993). *See* Epstein, *New Regime, supra* note 138, at 759.

defense in criminal cases and child custody matters.[142] The bias has become so blatant that many courts and commentators view experts not as objective witnesses but as full-fledged members of the "adversarial team" of the party on whose behalf they are testifying.[143]

E. *Scientists*

Even scientists, who are generally trained to be objective, suffer from the self-serving bias. One recent study surveyed the various participants in a lively controversy over a particular type of heart drug (calcium channel blockers), showing clear evidence of the self-serving bias in that 96% of the drug's defenders had financial ties to its makers, 60% of neutral authors had such ties, and only 37% of critical authors had such ties.[144] Other studies have demonstrated that when scientists evaluate studies done by others, they have a

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142 Paul S. Applebebaum, *In the Wake of* Ake: *The Ethics of Expert Testimony in an Advocate's World,* 15 BULL. AM. ACAD. PSYCHIATRY & L. 15, 21 (#1) (1987) (noting the "frequency with which highly respected [psychiatric] experts arrive at conclusions favorable to the side for which they are working or to which they have been assigned"); Robert J. Howell, *Professional Standards of Practice in Child Custody Examinations,* 8 PSYCHOTHERAPY IN PRIVATE PRAC. 15, 17 (No. 2) (1990) (noting that the remedy for this problem is to be hired by the judge to act as a friend of the court); Eric H. Marcus, *Unbiased Medical Testimony: Reality or Myth?,* 6 AM. J. FORENSIC PSYCHIATRY 3, 4 (#4) (1985) (commenting on the inevitable bias that infects the judgments of medical expert witnesses); Randy K. Otto, *Bias and Expert Testimony of Mental Health Professionals in Adversarial Proceedings: A Preliminary Investigation,* 7 BEHAV. SCI. & L. 267, 271 (1989) (reporting results from laboratory study finding evidence in criminal case setting but not in civil case setting that mental health professionals' testimony often varies according to the side by which they are retained).

143 Kathleen Waits, *Opinion Work Product: A Critical Analysis of Current Law and a New Analytical Framework,* 73 ORE. L. REV. 385, 443 (1994). Professor Waits' analysis of the opinion work product issue notes that some courts and their supporters take this view and therefore oppose discovery of communications between experts and the attorneys that hired them. *Id.* at 445–47. *See also* Katherine A. Staton, Note, *Discovery of Attorney Work Product Reviewed by an Expert Witness,* 85 COLUM. L. REV. 812, 828 (1985) (arguing that the current legal system "has legitimized adversarial use of experts"). *See also generally, e.g.,* Bogosian v. Gulf Oil Corp., 738 F.2d 587 (3d Cir. 1984) (holding that opinion work product documents shown by lawyer to expert witness during deposition preparation are not discoverable).

Professor Waits prefers the opposing view of *Intermedics, Inc. v. Ventritex, Inc.,* 139 F.R.D. 384 (Cal. Ct. App. 1991), which, according to Professor Waits, "posits not only the importance of expert testimony, but of the need to have that testimony actually *be* as independent as it *purports* to be." Waits, *supra,* at 443.

144 Henry Thomas Stelfox et al., *Conflict of Interest in the Debate Over Calcium-channel Antagonists,* 338 NEW ENG. J. MED. 101, 101 (1998).

strong tendency to give better ratings to studies that agree with their pre-existing beliefs than to studies that do not.[145]

F. *Judges*

More than any actor on the American scene, judges should be independent and objective. When judges act to advance their own personal interests or ideologies, it "threatens the values of self-determination, accountability and representationalism that provide core notions of American political theory."[146] Empirical evidence is mounting, however, that whether on a conscious or subconscious level, judges of all types are affected by the self-serving bias.[147] As

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145 *E.g.*, Jonathan J. Koehler, *The Influence of Prior Beliefs on Scientific Judgments of Evidence Quality*, 56 ORG. BEHAV. & HUM. DECISION PROCESSES 28, 47 (1993) (finding in both a laboratory experiment and a quasi-experimental survey of practicing scientists that "[r]esearch reports that confirmed scientists' prior beliefs were judged to be of higher quality than those that did not"); Michael J. Mahoney, *Publication Prejudices: An Experimental Study of Confirmatory Bias in the Peer Review System*, 1 COGNITIVE THERAPY & RES. 161, 161–62 (1977) (finding that professional reviewers' judgments about experimental procedures and their resulting publication recommendations varied dramatically, depending on whether the reviewers' pre-existing beliefs agreed or disagreed with the results of the submitted articles).

Needless to say, lay people suffer from the same effect. *See* Lord et al., *Biased Assimilation*, *supra* note 102, at 2105 (finding that when opponents and proponents of the death penalty are given two opposing studies they tend strongly to find the one that agrees with them to be more persuasive and this ambiguous evidence actually increases the polarization of opposing viewpoints).

146 Martin H. Redish, *Taking a Stroll through Jurassic Park: Neutral Principles and the Originalist-Minimalist Fallacy in Constitutional Interpretation*, 88 NW. U. L. REV. 165, 166 (1993).

147 *See* Frank B. Cross & Emerson H. Tiller, *Judicial Partisanship and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals*, 107 YALE L.J. 2155, 2175 (1998) (finding that D.C. Circuit Court panels controlled by Republican-appointed judges were much more likely to defer to conservative administrative agency decisions than were panels controlled by Democrat-appointed judges); Richard J. Pierce, Jr., *Two Problems in Administrative Law: Political Polarity on the District of Columbia Circuit and Judicial Deterrence of Agency Rulemaking*, 1988 DUKE L.J. 300, 303–07 (criticizing ideological decision-making by the D.C. Circuit); Richard L. Revesz, *Environmental Regulation, Ideology, and the D.C. Circuit*, 83 VA. L. REV. 1717, 1770–71 (1997) (finding ideological effects in D.C. Circuit decision-making in environmental cases); Vicki Schultz & Stephen Petterson, *Race, Gender, Work, and Choice: An Empirical Study of the Lack of Interest Defense in Title VII Cases Challenging Job Segregation*, 59 U. CHI. L. REV. 1073, 1171 (1992) (finding Democrat-appointed judges much more favorable to discrimination claims than Republican-appointed judges); JEFFREY A. SEGAL & HAROLD J. SPAETH, THE SUPREME COURT AND THE ATTITUDINAL MODEL 72–73 (1993) (claiming that most Supreme Court decisions are determined not by the law, but by the Justices' political preferences); Laura A. Smith, *Justiciability and Judicial Discretion: Standing at the Forefront of Judicial Abdication*, 61 GEO. WASH. L. REV. 1548, 1613 (1993) (finding substantial evidence of serious ideological rifts affecting decision-making

Tiller and Cross have noted there is now substantial "evidence that partisan ideology often influences judicial case decisions on a variety of issues . . . [and] that judges exercise these partisan preferences through judicial decision-making instruments."[148]

III. AUDITORS AND THE SELF-SERVING BIAS

A. *Overview*

Although the self-serving bias is a broad and robust phenomenon that is manifested in the conduct of attorneys, doctors, securities analysts, expert witnesses, scientists, judges, and just about everyone else, auditors are trained and expected to be objective and independent. Yet, accountants, like everyone else, are (boundedly) rational maximizers of their expected utility. Leading accounting historians have described "the accountant [as] an enthusiastic income maximizer, who pursues self-interest at the expense of other groups, and welcomes the enhanced social status conferred by society."[149]

Accountants are very effective utility maximizers, as the profession is generally quite profitable.[150] Indeed, accountants generally seem to be relentless in their pursuit of profit. In recent times they have moved from their traditional three mainstays of accounting, audit, and tax into computer consulting, M&A advising,[151] personal financial advising, strategic planning, insurance sales, WebTrust,[152] ElderCare services,[153] feasibility studies, financing (securing and

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in the D.C. Circuit); David B. Spence & Paula Murray, *The Law, Economics, and Politics of Federal Preemption Jurisprudence: A Quantitative Analysis*, 87 CAL. L. REV. 1125, 1195 (1999) (finding that decisions about federal pre-emption in the environmental field are the result of "actions of (partly) ideologically-motivated federal judges"); Donald R. Songer, *The Circuit Courts of Appeals*, *in* THE AMERICAN COURTS: A CRITICAL ASSESSMENT 35, 42–43 (John B. Gates & Charles A. Johnson eds., 1991) (quantifying ideological decision-making by federal circuit courts).

148 Emerson H. Tiller & Frank B. Cross, *A Modest Proposal for Improving American Justice*, 99 COLUM. L. REV. 215, 224 (1999).

149 DEREK MATTHEWS ET AL., THE PRIESTHOOD OF INDUSTRY: THE RISE OF THE PROFESSIONAL ACCOUNTANT IN BRITISH MANAGEMENT 7–8 (1998).

150 *Id.* at 8–10.

151 *See* Nikhil Deogun & Elizabeth MacDonald, *Winning by the Numbers: Bean Counters Now Figure Big in Merger-Advisory Game*, WALL ST. J., Feb. 10, 2000, at C1, C22 (noting that KPMG International advised on more mergers globally in 1999 than Morgan Stanley, Golden Sachs, or any other firm in the world).

152 *See* Richard J. Koreto, *A WebTrust Experience*, J. ACCT., Oct. 1998, at 99–102 (explaining how WebTrust, whereby CPA firms attest to the fact that online merchants conform to certain best practices, can boost Internet commerce).

structuring) services, family office services, legal services, and just about every other profit center they have been able to conjure up.[154] As the Big Eight have become the Big Six and then the Big Five (and almost the Big Four),[155] dwarfing the largest American law firms,[156] the image of a shark constantly moving and feeding increasingly comes to mind.[157] Small wonder that economists sit around modeling when it would be rational for auditors to accept bribes[158] or to conspire against their clients' shareholder/owners.[159]

The economists' rational utility maximizing model tells too simple a tale, however. Even if auditors were determined to be the most rational of rational utility maximizers, various biases and other limitations on human rationality would prevent it.[160] Furthermore, factors other than the desire to maximize their own utility certainly influence auditor behavior. For example, most auditors would not take bribes every time they knew they would escape detection and

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153 *See* Karen Duggan et al., *Opportunity Knocks: CPA ElderCare Services*, J. ACCT., Dec. 1999, at 43 ("ElderCare is intended to assure family members that elderly relatives no longer able to be totally independent are receiving the kind and type of care they need.").

154 Authors of a prominent hornbook recently rewrote the first chapter to address the expanding services being offered by accountants. DAN L. GOLDWASSER & M. THOMAS ARNOLD, ACCOUNTANTS' LIABILITY 1-1 to 1-39 (2000).

155 Ernst & Young and KPMG Peat Marwick announced merger plans to create the world's largest accounting firm and to reduce the Big Five to the Big Four, but later canceled the merger. Jim Kelly, *Maxwell's Legacy: The Fate of Coopers & Lybrand Suggests New Penalties Are Needed*, FIN. TIMES (London), Feb. 4, 1999, at 11 (discussing failed merger).

156 Geoffrey C. Hazard, *The Ethical Traps of Accounting Firm Lawyers*, NAT'L L.J., Oct. 19, 1998, at A27 (noting that the largest U.S. law firm has about 2,300 lawyers, whereas the Big Five accounting firms have more than 10,000 partners).

157 One attorney has referred to "the eat-what-you-kill economics of the omnivorous accounting firms." *Written Comments of Lawrence J. Fox before the American Bar Association's Commission on Multidisciplinary Practice, at* http://www.abanet.org/cpr/fox2.html (last visited Nov. 20, 2000) (on file with The Ohio State Law Journal).

158 *See* Fahad Khalil & Jacques Lawarree, *Collusive Auditors*, 85 AM. ECON. ASS'N PAPERS AND PROC. 442, 442 (1995) ("For instance, the manager has an incentive to bribe the auditor.").

159 *See* Stanley Baiman et al., *Optimal Contracts with a Utility-Maximizing Auditor*, 25 J. ACCT. RES. 217, 217 (1987) (using the utility-maximizing auditor in an economic model attempting to analyze how hiring auditors improves the principal-agent relationship and how the principal overcomes the moral hazard problem with the auditor).

160 *See* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 N.W. U. L. REV. 133, 143–280 (2000) [hereinafter Prentice, *Irrational Auditor*]. For example, the fact that auditors, like others, are irrationally optimistic, irrationally honor sunk costs, and are subject to cognitive dissonance, can cause auditors to stick with a dishonest client long after it has become economically unwise to do so. *Id.*

punishment. Auditors, like others, are often influenced by their ethical beliefs,[161] and personality type.[162] Auditors, like other employees, are also influenced by both the specific authority figures within their firms and the cultures of their firms.[163]

Nonetheless, the studies discussed in this section provide strong evidence that accountants are as self-serving as the rest of the populace, and it is not difficult to see how conflicts of interest arise to jeopardize an auditor's objectivity. When the results suggested by application of the proper standards do not match the results that the client's management desires, "[a]n auditor may find himself in a situation where he can benefit from violating professional standards or lose by refusing to violate the standards."[164] Auditors frequently have "substantial economic incentives to please their clients."[165] The auditor's self-interest may be framed in bold relief in this context because, as Lawler and Rhode have explained:

> The financial pressure first must be satisfied or else the CPA, for want of revenues, will no longer be able to operate. If the CPA doesn't have clients to audit, then he or she is soon out of business. This means that, although the CPA should be primarily concerned with an independent appraisal of the control system and resulting financial reports, the CPA has more than a casual interest in seeing that his or her clients are financially successful. Ideally, the client should be a success and the CPA should be

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161 *See* Judy S. L. Tsui & Ferdinand A. Gul, *Auditors' Behaviour in an Audit Conflict Situation: A Research Note on the Role of Locus of Control and Ethical Reasoning,* 21 ACCT., ORGS. & SOC'Y 41, 47 (1996) (finding that both levels of ethical reasoning and personality type affected auditor pliancy in response to client pressure for improper accounting treatment).

162 *See* Tim Kelley & Loren Margheim, *The Impact of Time Budget Pressure, Personality, and Leadership Variables on Dysfunctional Auditor Behavior,* AUDITING: J. OF PRAC. & THEORY, Spring 1990, at 21, 23–24 (citing several studies tending to find that Type A individuals are more productive auditors than Type B personalities, but that they make poorer decisions when patience is needed in conducting a complex task); Tsui & Gul, *supra* note 161, at 47 (finding that whether an auditor's personality had external control or internal control affected responsiveness to client pressure for improper accounting treatment).

163 *See* Frances L. Ayres & Dipankar Ghosh, *Research in Ethics and Economic Behavior in Accounting,* 18 J. ACCT. & PUB. POL'Y 335, 337 (1999) (noting that "inherent ethical behavior may be fostered in an organization (and in policy-making) through the careful structuring of incentives, rewards and penalties" within the firm); Carolyn A. Windsor & Neal M. Ashkanasy, *Auditor Independence Decision Making: The Role of Organizational Culture Perceptions,* 8 BEHAV. RES. IN ACCT. 80, 94 (Supp. 1996) [hereinafter Windsor & Ashkanasy, *Auditor Independence*] (finding that organizational culture of an accounting firm has some impact on auditor decision-making).

164 Arieh Goldman & Benzion Barlev, *The Auditor-Firm Conflict of Interests: Its Implications for Independence,* 49 ACCT. REV. 707, 709 (1974).

165 Christine M. Haynes et al., *The Relationship between Client Advocacy and Audit Experience: An Exploratory Analysis,* 17 AUDITING: J. OF PRAC. & THEORY, 1998, at 88, 90.

independent. However, these attributes may be in conflict, and this can create pressure-laden problems for the CPA.[166]

Unfortunately, when such a conflict arises, many believe that the client's bargaining power is far superior to the auditor's because of the auditor's dependence upon clients for its livelihood.[167] Managers are willing to switch and as many as eight hundred do switch per year.[168] There are documented cases of opinion shopping,[169] and "[d]espite SEC disclosure requirements, discharges

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[166] EDWARD E. LAWLER III & JOHN GRANT RHODE, INFORMATION AND CONTROL IN ORGANIZATIONS 116–17 (Lyman W. Porter ed., 1976). Nichols and Price made this same point:

> In the conflict situation, the [client] firm does not highly value the rewards that a specific auditor can mediate. The rewards an individual auditor offers are special skills in accurately assessing the financial operations of the firm. The firm may not be interested in the most competent audit or most accurate statement of its financial position and results of operations. Instead, the firm may desire to secure statements that have a particular expected impact on third parties. Since anyone with the appropriate credentials is able to perform this type of attest function, the individual auditor's expertise or special skills in accounting or auditing may have little significance to the firm. On the other hand, the auditor is likely to place a high valuation on the rewards that the firm can mediate, such as present and potential fees from the audit and, perhaps, other services. The auditor places a high valuation on these rewards because they are consistent with the auditor's needs.

Donald R. Nichols & Kenneth H. Price, *The Auditor-Firm Conflict: An Analysis Using Concepts of Exchange Theory,* 51 ACCT. REV. 335, 337 (1976).

[167] *See* LAWLER & RHODE, *supra* note 166, at 118 (arguing that as long as managers select and compensate auditors, there is strong pressure upon the auditors to violate professional standards); Goldman & Barlev, *supra* note 164, at 710 ("Auditors usually operate in a buyer's market: clients can choose the auditor they prefer from a large group of professionals. The firm (the paying client) selects the auditor, determines his employment conditions, and displaces him at will."); Carolyn A. Windsor & Neal M. Ashkanasy, *The Effect of Client Management Bargaining Power, Moral Reasoning Development, and Belief in a Just World on Auditor Independence,* 20 ACCT., ORGS. & SOC'Y 701, 703 (1995) [hereinafter Windsor & Ashkanasy, *The Effect*] ("Client management has an inherent bargaining advantage because auditors depend upon client fees for their livelihood."); J. Scott Whisenant & Srinivasan Sankaraguruswamy, *Evidence on the Auditor and Client Relationship: What Can Be Learned from Reasons Reported by Managers for Changing Auditors?* (Jan. 2000) (unpublished Working Paper on file with author) ("Conventional wisdom suggests that auditors do not like to lose clients. Our data support this argument since only 16 percent of auditor changes are initiated by auditors.").

[168] Robert R. Tucker & Ella Mae Matsumura, *Going Concern Judgments: An Economic Perspective,* 10 BEHAV. RES. IN ACCT. 179, 181 (1998) (citing sources).

[169] *See, e.g., In re* Broadview Fin Corp., Exch. Act Release No. 21,949 [Accounting and Auditing Enforcement Releases 1982–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,454, at 63,202 (Apr. 17, 1985); *In re* Stephen O. Wade; Ralph H. Newton, Jr.; Clark C. Burritt, Jr., Exchange Act Release No. 21,095 [Accounting and Auditing Enforcement Releases 1982–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,432 at 63, 136 (June 25, 1984); *In re* Frantz, Warrick, Strack & Assocs., 18 Sec. Reg. & L. Rep. (BNA) 332, 332–33 (Mar. 7,

relating to disputes over accounting methods are common."[170] However, the most serious result of this conflict-of-interest is probably not out-and-out auditor swapping by clients, but the tendency of auditors to grant inappropriate treatment to clients in order to retain them.[171] This pressure can lead even the most honest and determined auditor to stray from the path of objectivity. One survey indicates that 64% of security analysts (and 48% of regulators, 43% of accounting professors, and 49% of portfolio managers) believe that the audit profession gives in too easily to client pressure to "bend the rules."[172] Bazerman gives the famous Phar-Mor scandal as an example of audit failure prompted by such self-serving motives.[173]

These are matters of grave concern, even though auditing in America is generally good and likely the best in the world.[174] While the American Institute

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1986) (showing that a Maryland-based accounting firm settled charges of improperly issuing an unqualified opinion to a client who wrongly claimed a $1.8 million gain from a transaction).

170 Reid Anthony Muoio, *An Independent Auditor's Suit for Wrongful Discharge,* 58 ALB. L. REV. 413, 427 (1994) (citing several sources). *See also* Harvey Hendrickson & Reza Espahbodi, *Second Opinion, Opinion Shopping and Independence,* CPA J., Mar. 1991, at 26–27 ("It seems clear that companies do indeed shop for opinions ... [and] the extent of the practice may be underestimated because public disclosures [even under new SEC rules] probably do not reveal the underlying reasons for changing auditors."); Sharon LaFraniere, *Behind S&Ls, Lax Audits: Losses Vanished After 'Opinion Shopping,'* WASH. POST, Oct. 24, 1990, at A1, A7 (giving some apparently egregious examples in the savings & loan industry); Jerry E. Serlin, *Auditing Developments,* J. ACCT., AUDITING & FIN., Fall 1985, at 74, 75 (quoting SEC Enforcement Division's chief accountant as saying that "opinion shopping remains a serious problem"); Mindy Jaffe Smolevitz, Note, *The Opinion Shopping Phenomenon: Corporate America's Search for the Perfect Auditor,* 52 BROOK. L. REV. 1077, 1080 (1987) (noting that before SEC rule changes, the number of companies switching auditors rose 82% between 1981 and 1985, indicating that opinion shopping was on the rise).

Among other infamous examples of instances where opinion shopping seemed to play a part in egregious frauds are the Penn Square Bank case, PHILLIP L. ZWEIG, BELLY UP: THE COLLAPSE OF THE PENN SQUARE BANK 174, 258–59 (1985), and the Silverado Savings & Loan case, William Sternberg, *Cooked Books,* ATLANTIC, Jan. 1992, at 20, 26 (noting that bank examiners found the Silverado scandal, which engulfed President Bush's son Neil, a "clear example" of opinion shopping).

171 *See* Prentice, *Irrational Auditor, supra* note 160, at 209.

172 *To Financial,* PR NEWSWIRE, June 19, 1984, at *2 (reporting results of survey commissioned by then-Big Eight firm Peat Marwick).

173 *See* BAZERMAN, JUDGMENT, *supra* note 38, at 101 (noting that instead of being guilty of intentional wrongdoing, Coopers & Lybrand "may have been guilty of the motivational bias of egocentrically interpreting and searching for data in order to maintain the client relationship").

174 *See* Robert Tie, *Concerns Over Auditing Quality Complicate the Future of Accounting,* J. ACCT., Dec. 1999, at 14 (noting AICPA numbers claiming that 99.7% of financial reports are problem-free each year and complaints are raised annually as to only 50 of 15,000 SEC registrants).

of Certified Public Accountants (AICPA) believes that there is "no evidence that audit failure has been caused by a lack of independence,"[175] problems are apparent. In fiscal year 1999, the SEC brought ninety enforcement actions alleging financial fraud and indicating "busted audits."[176] Arthur Levitt recently observed that we find ourselves "witnessing a gradual, but noticeable erosion in

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[175] AICPA, WHITE PAPER, *supra* note 10, at 10. The studies discussed in the remainder of this section provide strong evidence to refute this AICPA conclusion. Nonetheless, the AICPA does validly argue that (a) it is difficult to find specific audit failures that can be traced unequivocally to the provision of additional nonaudit services, (b) insurance companies do not via their premium structure indicate that they believe that the provision of nonaudit services increased the risk of loss, AICPA, WHITE PAPER, *supra* note 10, at 10, and (c) numerous studies of the audit profession done in recent years, not all of them commissioned by the AICPA, *id.* at 12, have failed to find "'conclusive evidence of diminished audit quality or harm to the public interest, or any actual impairment of auditor independence, as a consequence of public accounting firms providing advisory or consulting services to their clients.'" *Id.* at 50 (quoting GENERAL ACCOUNTING OFFICE, THE ACCOUNTING PROFESSION: MAJOR ISSUES: PROGRESS AND CONCERNS 41–42 (Sept. 1996) (Report to the Ranking Minority Member, Committee on Commerce, House of Representatives)).

The AICPA position has flaws. For example, the AICPA emphasizes that few lawsuit complaints against auditors mention whether the auditors receive nonaudit revenue from the clients whose audits they allegedly botched. Because it is perfectly legal to accept nonaudit revenue from those clients, it is not surprising that few complaints would mention it. This is especially true given that courts hold, perhaps erroneously in light of the evidence presented in the studies on auditor self-serving bias, that alleging that auditors intentionally botched audits in order to preserve a client's stream of revenue (whether audit or nonaudit) is irrelevant to establishing the scienter element of a 10b-5 claim. *See generally* Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) (discussing the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (1994 & Supp. IV 1998)).

Moreover, proving the link in any specific case between auditor lapses and their incentives to collect nonaudit revenue is very hard given the difficulty of showing what went on in individual auditors' brains. As the chair of the National Association of State Boards of Accountancy recently noted, the SEC will not find a "smoking gun" so long as most cases are settled or otherwise closed through the work of skilled attorneys, so while "[t]here is not going to be any clear evidence, ... the SEC needs to make policy decisions on the basis of the reality of public perception." John Herzfeld, *Auditor Independence: Meyer, Volcker Lead Off Testimony Supporting SEC Independence Proposal,* BNA SEC. L. DAILY, Sept. 14, 2000, *available in* LEXIS, Nexis, BNA Library, BNASLD File. *See also* Lorie Soares, Note, *The Big Eight: Management Consulting and Independence: Myth or Reality?,* 61 S. CAL. L. REV. 1511, 1529–31 (1988) (exploring numerous explanations for lack of hard evidence between provision of consulting services and independence violations). Nonetheless, as this article is being edited, the SEC has begun a probe that may establish a link between Arthur Andersen's allegedly sloppy auditing of Waste Management and the big consulting fees it was pocketing from the same client. *See* Michael Schroeder, *SEC Probes Andersen for Conflict of Interest,* WALL ST. J., Aug. 25, 2000, at C1 (detailing investigation).

[176] Judith Burns, *SEC Targets Auditors Who Wear Blinkers,* NAT'L POST, Dec. 8, 1999, at C11.

quality of financial reporting."[177] "Earnings management" has reached crisis proportions,[178] causing Levitt to wonder "whether accounting firms have become more concerned with their own financial statements and less so with their clients.'"[179] Not only the Commission is concerned. Louis Lowenstein recently noted: "the SEC has been seeing a vast amount of cheerleading for clients by the very accountants on whose independence we rely. The accountants have come to see their auditing work less as a profit-center guided by professionalism than as a lever for obtaining more lucrative consulting assignments."[180] Numerous observers believe that the accountants' self-serving drive for revenue has overridden legitimate conflict-of-interest concerns.[181]

These concerns have been fueled by several recent audit failures that were striking in their scope.[182] Auditors failed to detect $500 million of fake revenue

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[177] *Audit Committees: Financial Reporting Pressures Affecting Independent Directors, Levitt Says*, BNA SEC. L. DAILY, Apr. 23, 1999, *available in* LEXIS, BNA Library, BNASLD File (quoting SEC Chair Arthur Levitt).

[178] By December of 1999, 53 firms had restated earnings, some more than once. Burns, *supra* note 176, at C11.

[179] *Auditors: 'Earnings Management' May Suffer For Accounting Firms' Profits, Levitt Says*, BNA SEC. L. DAILY, Oct. 12, 1999, *available in* LEXIS, BNA library, BNASLD file.

[180] Lowenstein, *Paparazzi, supra* note 9, at 52. *See also* Sean Somerville, *Pressuring Accountants to Be More Accountable*, BALTIMORE SUN, Mar. 7, 1999, at 1D–2D (noting accounting professor Abraham Briloff's observation that getting tough on an audit client can cost the audit firm not only audit fees but also management consulting fees, which can account for more than 50% of the firm's revenue thus raising the stakes).

[181] *E.g.*, Norman Bowie, *Accountants, Full Disclosure, and Conflicts of Interest*, 5 BUS. & PROF. ETHICS J. 60, 68 (1986) ("It seems obvious that the competition for clients has overshadowed the concerns regarding conflicts of interest."). *See* Jonathan Burton, *When Earnings Bear Closer Scrutiny: What Should CEOs Do to Avoid Embarrassing Blow-Ups over Reported Earnings?*, CHIEF EXECUTIVE, May 1, 1999, at 144 (quoting Warren Buffett as observing that "[t]hough auditors should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay"); LAWLER & RHODE, *supra* note 166, at 132 ("The emphasis in most CPA firms seems to be holding on to all clients even if they compromise the practice."); Robert E. Seiler, *Competition and Independence*, C.P.A. J., Oct. 1987, at 4 ("The stage has been set for commercialism to take the place of professionalism.").

[182] *See, e.g.*, Michael Bologna, *Waste Management Agrees to $220 Million Settlement of Shareholder Class Action Suits*, BNA CORP. COUNSEL DAILY, Dec. 11, 1998, at B2 (noting that Arthur Andersen and Waste Management had agreed to a $220 million settlement after allowing Waste Management to overstate income by $1.32 billion between 1991 and 1997); Lee Gomes, *Informix to Settle Holder Suits for $142 Million*, WALL ST. J., May 27, 1999, at B11 (noting that Ernst & Young had kicked in the biggest part of a $142 million cash settlement following a botched audit of Informix Corp.); Elizabeth MacDonald, *Jackson National Alleges Ernst Botched Audit of Electronics Firm, Causing Loss*, WALL ST. J., Mar. 30, 1999, at B5 (noting botched audit of Kent International Associates allowing the firm to overstate sales by approximately 50%); Dean Starkman, *BDO Seidman Is Sued Over Auditing*

generated by CUC International, Inc. (which became Cendant Corporation) over a three-year period.[183] When Sunbeam restated its 1997 results that had been certified by Arthur Andersen, profits dropped from $123.1 million to $6.8 million; a year later Sunbeam's market capitalization had dropped from $4.3 billion to $567 million.[184] Livent, Inc. perpetrated a criminal fraud so massive that it required specially tailored software to carry out exhaustive manipulations and two sets of books to keep track of the fraud.[185] These cases are but a sampling; of 235 class action securities fraud cases filed in 1998, 65% alleged accounting problems.[186] The chief accountant for the SEC's enforcement division recently decried the "awful" accounting standards being applied in disclosure documents and accused independent auditors of "falling down on the job."[187] He has also noted that "the [SEC] staff is beginning to see . . . instances of clear-cut violations of simple and well-known rules. It is easy to be skeptical about firms' independence safeguards when the most basic rules are not followed."[188]

When surveyed, auditors themselves admit to a startlingly high number of "premature sign-offs," where they sign workpapers indicating that they have performed steps in the audit procedure that they did not in fact perform.[189] The

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of A.R. Baron by Ex-Broker's Trustee, WALL ST. J., Mar. 31, 1998, at B13 (noting claim that auditor had missed millions of dollars in cash bribes as well as payments to prostitutes, and had failed to note an increase in claims by customers from $1.8 million to $80 million in just two years).

183 Emily Nelson & Elizabeth MacDonald, *Cendant Corp. Sues Ernst & Young, Charging Firm Failed to Detect Fraud*, WALL ST. J., Jan. 26, 1999, at B11; Floyd Norris, *Asleep at the Books: A Fraud that Went On and On and On*, N.Y. TIMES, June 16, 2000, at C1 (wondering: "Were the books ever honest at CUC International?").

184 Burton, *supra* note 181, at 144.

185 Richard Melcher, *Is Fraud the Thing?*, BUS. WK., Feb. 15, 1999, at 104, 106.

186 Garrett Glaser, *Large Number of Cases of Improper or Illegal Accounting Practices and the Effect They Have on Companies and Their Stock*, CNBC NEWS TRANSCRIPTS, June 8, 1999, at *1, *available in* LEXIS, NEWS Library, News Group File (reporting on Stanford study).

187 Neil Hare, *Insider Trading: SEC to Issue Insider Trading Proposals by 'End of Year,' Enforcement Chief Says*, BNA SEC. L. DAILY, Nov. 15, 1999, at *1, *available in* LEXIS, BNA Library, BNASLD File.

188 Lynn E. Turner & Joseph H. Godwin, *Auditing, Earnings Management, and International Accounting Issues at the Securities and Exchange Commission*, 13 ACCT. HORIZONS 281, 284 (1999).

189 C. Wayne Alderman & James W. Deitrick, *Auditors' Perceptions of Time Budget Pressures and Premature Sign-Offs: A Replication and Extension*, AUDITING: J. OF PRAC. & THEORY, Winter 1982, at 54, 60 (finding that 31% of auditors surveyed believed that in general some auditors sign-off prematurely); Kelley & Margheim, *supra* note 162, at 22 (concluding from auditors' admissions "that an alarming number of . . . audit quality reduction acts are occurring in practice"). *See generally* JOHN G. RHODE, SURVEY ON THE INFLUENCE OF SELECTED ASPECTS OF THE AUDITOR'S WORK ENVIRONMENT ON PROFESSIONAL PERFORMANCE

premature sign-offs are conscious decisions to violate the norms of good auditing practice. But, again, subconscious factors are likely the more significant. As the psychology literature outlined earlier in the article demonstrates, even when an auditor is trying to be objective, the unconscious effects of the self-serving bias will dramatically affect how that auditor perceives, processes, and remembers information. The strong motivation to please the client in order to keep the client and attendant revenues is bound to color any auditor's judgment.

The rest of this section examines a substantial body of behavioral literature demonstrating the pervasive and corrosive impact of the self-serving bias upon auditors. The discussion is organized by type of research. Virtually every type of study that has been done supports the conclusion that the self-serving bias pervades auditor judgment and performance;[190] only suitable counterincentives seem capable of offsetting these effects.

B. *Nonaudit Laboratory Studies*

Several laboratory studies have been done that study the behavior of accountants outside the audit setting. In these other contexts, such as consulting and tax work, accountants are expected to act with objectivity, though not independence.[191]

OF CERTIFIED PUBLIC ACCOUNTANTS: A STUDY AND REPORT FOR THE COMMISSION ON AUDITORS' RESPONSIBILITIES (1977) (reporting that 60% of respondents admitted to reporting that they had performed certain audit procedures that in fact they had not completed).

[190] This article omits studies based on pure economic modeling for two reasons. First, they assume rather than provide evidence that auditors act in a self-serving capacity. Obviously, in traditional economic analysis, all people are presumed to be rational maximizers of their expected utility. Thomas S. Ulen, *Cognitive Imperfections and the Economic Analysis of Law,* 12 HAMLINE L. REV. 385, 386 (1989) (explaining different assumptions that are made about cognitive abilities when the conventional model is used); William S. Waller, *Decision-Making Research in Managerial Accounting: Return to Behavioral-Economics Foundations, in* JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING 29, 32 (Robert H. Ashton & Alison H. Ashton eds., 1995) ("Individuals are assumed to act *as if* they maximize expected utility."). Second, economic modeling has inherent limitations. *See generally* James R. Boatsman et al., *A Perspective on the Use of Laboratory Market Experimentation in Auditing Research,* 67 ACCT. REV. 148 (1992) (analyzing multiple weaknesses of use of economic models).

The economic modeling that has been done is not inconsistent with the other studies discussed in this paper. *See, e.g.,* Ella Mae Matsumura et al., *Strategic Auditor Behavior and Going-Concern Decisions,* 24 J. BUS. FIN. & ACCT. 727, 751 (1997) (reasoning that an incumbent auditor is less likely to issue a going concern opinion if it expects to keep a client); Tucker & Matsumura, *supra* note 168, at 213 (noting that auditors are more likely to maintain independence and reporting integrity when they face large potential liability losses for reporting errors).

[191] AICPA, PROF'L STANDARDS ET § 55, Art. IV (1999) ("A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities.").

For example, Ponemon conducted a laboratory study of the objectivity of accountants' litigation support judgments.[192] He studied accountants with and without litigation support experience, asking them to judge from a realistic factual scenario the dollar amount of inventory loss that an insured had suffered in a fire. Whether they had low or high experience, litigation support accountants acted as the self-serving bias would predict—those assigned the role of plaintiff's expert set a higher amount of loss (overall mean $7,367,715) than those assigned the role of the defendant's expert (overall mean $5,996,894), while those assigned the role of a court-appointed expert set numbers between the other two (overall mean $6,594,394).[193] The study's results for auditors without litigation support experience showed a similar pattern (plaintiff's expert means were greater than court-appointed expert means which were, in turn, greater than defendant's expert means), although the bias effect was not as pronounced.[194] Relatively higher levels of ethical sensitivity and experience had some impact on the results.[195] Ponemon's study indicated "that accountants favor their client's economic interests,"[196] and concluded that "the bias in accounting estimates provided by litigation specialists in this experiment may indicate a tendency for some individuals to subordinate their judgments."[197]

Cuccia, Hackenbrack, and Nelson conducted a similar study in the tax field.[198] They gave some of their subjects, tax managers from then-Big Six firms, incentives to report aggressively and then varied the specificity of the professional standard in order to determine whether reducing the vagueness in such standards would reduce aggressive reporting. They found that when tax professionals were incentivized to report aggressively, they reported more aggressively than their peers who were not so incentivized regardless of the specificity of the standards. If the standards were vague, subjects used the vagueness to justify their aggressive position. If the standards were more specific, they changed their assessments of evidential support to justify aggressive reporting.[199] "Given an aggressive incentive, subjects made aggressive disclosures, regardless of the level and precision of the [professional] standard."[200] Clearly, the self-serving bias was at work here, distorting both judgment and perceptions of factual evidence.

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[192] Ponemon, *supra* note 93, at 467.

[193] *Id.* at 479 (Table 3).

[194] *Id.* at 481 (Table 4).

[195] *Id.* at 484.

[196] *Id.* at 484.

[197] *Id.* at 484–85.

[198] *See generally* Andrew D. Cuccia et al., *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 ACCT. REV. 227 (1995).

[199] *Id.* at 243–44.

[200] *Id.* at 241.

Research has suggested that, in the tax field, "clients expect preparers to assist them in taking the most favorable tax positions on their returns . . . and that preparers understand and attempt to meet this expectation."[201] Johnson found that subjects asked to assess the relevance of cases to their client's issue judged cases supporting their client's position to be more relevant than cases undermining it.[202]

In a similar vein, Cloyd and Spilker studied tax professionals from Big Five firms who were informed of their client's preferred tax position. After studying provided precedents, one-half recommended the client-preferred position, even though a panel of experts concluded that there was only a *14% chance* that the position would be sustained if challenged.[203] Professor Ahlawat performed a similar study of internal and outsource auditors, finding both (especially the former) to be partial to their clients' interests rather than objective.[204]

These various studies are completely consistent with the self-serving bias and not particularly consistent with the objectivity both consultants and tax professionals are supposed to exhibit. Although, the AICPA has accepted that consultants and tax professionals may act as advocates for their clients and need not be independent,[205] nonetheless, they are supposed to be objective and the evidence casts doubt on their ability to remain so.[206]

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201 Linda M. Johnson, *An Empirical Investigation of the Effects of Advocacy on Preparers' Evaluations of Judicial Evidence,* 15 J. AM. TAX ASSOC. 1, 6 (1993) (citation omitted).

202 *Id.* at 18.

203 C. Bryan Cloyd & Brian C. Spilker, *The Influence of Client Preferences on Tax Professionals' Search for Judicial Precedents, Subsequent Judgments and Recommendations,* 74 ACCT. REV. 299, 301 (1999) (noting that their results suggest "that information search biases induced by client preferences can be strong enough to not only result in inaccurate assessments of authoritative support for the client-favored position, which is problematic in and of itself, but also to lead tax professionals to make overly aggressive recommendations"). Cloyd and Spilker attribute much of this effect to the confirmation bias. *Id.*

204 Sunita Ahlawat, *Internal Auditor Objectivity: In-house versus Outsource* (2000) (unpublished Working Paper on file with author).

205 *See* Adrian Harrell et al., *An Examination of Management's Ability to Bias the Professional Objectivity of Internal Auditors,* 14 ACCT., ORGS. & SOC. 259, 267 (1989) (finding that regarding *internal* auditors, study participants who were not members of the Institute of Internal Auditors were biased by knowledge of management's desired outcomes, but members of the Institute resisted management pressure).

206 Tax professionals, for example, are required by both IRS rules and AICPA standards to recommend only tax positions that have a realistic possibility of success. AICPA, PROF'L STANDARDS TX. § 112.02 (1999) ("A CPA should not recommend to a client that a position to be taken with respect to the tax treatment of any item on a return unless the CPA has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged."); Treas. Reg. § 1.6694-2(b)(1) (stating that judgments are to be based on "reasonable and well-informed analysis" which is satisfied when it could be

C. *Audit Laboratory Studies*

Relevant laboratory studies have also targeted auditing activity. For example, Haynes and her colleagues asked ninety six Certified Public Accountants (CPAs) to value inventory in a takeover setting.[207] Those simply told that the buyer was a long-time client tended to value the inventory the same as those told the seller was a long-time client. However, when the auditors were told that the results of the valuation were important to their client's bargaining position in the negotiations surrounding the takeover, they became advocates for their clients even without being told the client's preferred position, and the impact was greater among auditors with more experience.[208] In other words, "with experience, participants' judgments become more consistent with client interests;"[209] thus auditors voluntarily become advocates for their clients rather than watchdogs for the public.

In another study, Farmer and his colleagues examined, among other factors, the impact of economic considerations on audit independence.[210] They asked practicing auditors of varying levels (partner, manager, etc.) to rank attributes thought to affect auditor independence and to perform an audit case evaluation. A primary finding was that "[b]y almost a 2 to 1 ratio, the auditors are more willing to accept the client's proposed treatment in situations where the perceived risk of client loss is high versus a situation in which the perceived risk of client loss was low."[211] Subjects were most likely to accede to the client's wishes when the risk of client loss was high and the risk of litigation was low.[212] One of the most interesting findings of the study was that the lower level auditors valued independence most highly, whereas those accountants at the higher echelons of the firm who were more likely directly affected by loss of a client valued it less.[213] The authors' ultimate conclusion was that "[i]f society expects auditors to be more accountable to third party users, as opposed to advocates of client positions, then it is clear that the economic dependence on clients should continue to be monitored."[214]

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reasonably concluded "that the position has approximately a one in three, or greater, likelihood of being sustained on its merits").

207 *See generally* Haynes et al., *supra* note 165.

208 *Id.* at 100.

209 *Id.* at 98.

210 Timothy A. Farmer et al., *An Investigation of the Impact of Economic and Organizational Factors on Auditor Independence*, 7 AUDITING: J. OF PRAC. & THEORY, Fall 1987, at 1.

211 *Id.* at 8.

212 *Id.*

213 *Id.* at 10.

214 *Id.* at 11.

Salterio and Koonce studied the persuasiveness of audit evidence in a laboratory setting with practicing audit managers and partners from a Canadian Big Six accounting firm.[215] They found that when all available precedents pointed to a given position, the auditors did not heed their client's inconsistent desires. However, when available precedents were mixed, auditors tended to follow their clients' position when it was known, suggesting to the authors "that conflicting precedents provide the basis for the auditor to side with the client which, in turn, may give the appearance of a lack of independence."[216] So, consistent with more general studies reported earlier,[217] when given "wiggle room," the auditors tended to follow their self-interest by giving clients what they wanted.[218]

Hackenbrack and Nelson studied allegations that auditors were allowing their clients to adopt aggressive reporting methods when the auditors had incentive to do so.[219] They presented practicing auditors with an ambiguous accounting

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[215] *See generally* S. Salterio & L. Koonce, *The Persuasiveness of Audit Evidence: The Case of Accounting Policy Decisions,* 22 ACCT., ORGS. & SOC'Y 573 (1997).

[216] *Id.* at 585 (citation omitted). The authors go on to note:

> This result also may have regulatory implications. That is, to the extent the regulators initially do not deny different accounting treatments of a similar transaction as revealed in financial statement disclosures, then they set the stage for auditors (who observe these conflicting precedents) to agree with their clients. Again, while independence in fact may not be compromised (because the client has valid reasons for a choice of accounting treatment), the appearance of a lack of independence may surface in these instances. Given the relatively large number of instances in which conflicting precedents are available (38.5%) this may be of concern to the public accounting profession. Heightening this concern is the increased use of precedents by company management to convince their auditors to disregard national office advice.

Id. (citations omitted).

[217] *See supra* Part III.B.

[218] The Salterio & Koonce study was roughly consistent with an earlier study by Salterio of auditors' tendency to be persuaded by clients. Salterio used both archival data, which suggested an indirect influence, and an experiment, which found no direct influence. However, the experiment's results may well have been accounted for by the fact that overwhelming precedents conflicted with the clients' preferred accounting treatment. *See generally* Steven Salterio, *The Effects of Precedents and Client Position on Auditors' Financial Accounting Policy Judgment,* 21 ACCT., ORGS. & SOC'Y 467 (1996).

Similarly, Trompeter studied client influence and determined that audit judgments were more influenced by client preferences when GAAP was ambiguous than when it offered clear guidance. *See generally* Greg Trompeter, *The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Audit Partner Judgment,* 13 AUDITING: J. OF PRACTICE & THEORY 56 (Fall 1994). To reiterate, the human ability to rationalize is not unlimited, especially in light of potential legal liability, which Trompeter's study found to be a significant variable. *Id.* at 64.

[219] *See generally* Karl Hackenbrack & Mark W. Nelson, *Auditors' Incentives and Their Application of Financial Accounting Standards,* 71 ACCT. REV. 43 (1996).

situation. They found that the auditors acted in a manner consistent with the self-serving bias in that they used aggressive interpretations of accounting standards to allow their clients to take aggressive positions when the auditors' engagement risk (risk of fines, censure, litigation, loss of reputation, etc.) was moderate, but used conservative interpretations of the same standards in order to require conservative positions by their clients when the auditors' engagement risk was high.[220] Thus, "auditors' incentives influenced their reporting decisions," again consistent with the self-serving bias.[221]

Lord studied experienced audit managers in a laboratory setting.[222] His primary purpose was to determine the effect that accountability had on auditors' decisions whether to submit to client pressure for improper accounting treatment. However, his results also indicated that the amount of competition for the client, the provision of non-attest services to the client, and the importance of the client in terms of amount of revenue contributed to the firm were significant variables in determining aggressiveness of reporting.[223] Roberts and Cargile did a similar study of auditor response to self-serving incentives and derived similar results.[224]

Windsor and Ashkanasy used practicing auditors to study the impact on auditor decision-making of the interaction between client economic factors, moral reasoning development, and belief in a just world.[225] Their studies hypothesized that client economic factors, such as size of audit fee and financial condition of the client, would interact with the auditors' moral reasoning development (using Kohlberg's six stages of moral reasoning development)[226] and with their just

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[220] *Id.* at 54.

[221] *Id.* at 45.

[222] Alan T. Lord, *Pressure: A Methodological Consideration for Behavioral Research in Auditing*, 11 AUDITING: J. OF PRAC. & THEORY, Fall 1992, at 89 [hereinafter Lord, *Pressure*].

[223] *Id.* at 97–103.

[224] *See generally* M.L. Roberts & B.R. Cargile, *Impartiality Versus Advocacy: CPA's Responses to Conflict in Auditing and Tax Situations* (unpublished Working Paper, University of Alabama, Tuscaloosa, AL). As reported by Hackenbrack & Nelson:

> They [Roberts and Cargile] required a sample of auditors (mostly from small audit firms) to rate the degree to which they would allow a client to capitalize an (unspecified) expenditure as a betterment rather than expense it as a repair. The strength of the client's operating performance, the risk of client loss, and the potential for detection of aggressive reporting by a third party were manipulated within-subjects, and context (tax, auditing) was manipulated between-subjects. Although subjects were informed that they were to use their professional judgment to make this determination, they were provided no evidence or professional standards on which to base their judgment other than the incentive factors. *All manipulated variables were reported to be significant in interactions.*

Hackenbrack & Nelson, *supra* note 219, at 46 (emphasis added).

[225] Windsor & Ashkanasy, *The Effect*, *supra* note 163, at 701.

[226] *See* Lawrence Kohlberg, *Stage and Sequence: The Cognitive-Development Approach to Socialization*, *in* HANDBOOK OF SOCIALIZATION THEORY AND RESEARCH 347–80 (David

world view[227] to impact their decisions whether to acquiesce to client requests for inappropriate accounting treatment. Only auditors with the highest level of moral reasoning development and a just world view resisted client management power. All auditors without a just world view and auditors not at the highest levels of moral reasoning with a just world view were subject, in various degrees, to client management pressure.[228] Furthermore, the authors allowed that in light of evidence from the real world (lawsuits, scandals, etc.) "the results of this research may underestimate the real extent of auditor acquiescence in practice."[229]

Laboratory studies are numerous,[230] but they only go so far.[231] These results may certainly be questioned because subjects are usually given anonymity. Lord

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Goslin ed., 1969). Windsor and Ashkanasy predicted (and found evidence to support the notion) that auditors with more highly developed moral reasoning would be more resistant to management pressure. *See generally* Windsor & Ashkanasy, *The Effect, supra* note 163.

227 There is substantial evidence that people's actions are significantly affected by whether they believe they live in a just world. If they do, they tend to act as though they have control over their own fate and they are more able to give up immediate benefits in exchange for long-term good. If they do not, they tend to act as if they have little control over life's events, and therefore, they are less likely to take a long-term view. *See generally* M.J. LERNER, THE BELIEF IN A JUST WORLD (1980).

228 Windsor & Ashkanasy, *The Effect, supra* note 163, at 715. Regarding those auditors with the lowest level of moral development and an unjust world view, Windsor and Ashkanasy found:

> It appears that, for auditors in this category, personal beliefs combine with economic considerations to increase any tendency to acquiesce to the wishes of client management. In effect, this group appears to have had neither the philosophical fortitude of the autonomous [highest moral development] group, nor the practical self-interest of the pragmatic [middle moral development] group necessary to withstand client management power.

Id.

229 *Id.* at 716.

230 There are other studies, besides the ones mentioned in the text. For example, one study asked auditors how many hours would be required to do a particular audit. Others were asked the same question, but informed that time pressure was a factor. These auditors generally concluded that less time was needed to do the audit. The authors concluded that "[f]rom the results it can be inferred that auditors were influenced by time pressures to reduce budgeted hours, which may adversely affect quality control and lead to staff morale and turnover problems." George F. Kermis & S. Mahapatra, *An Empirical Study of the Effects of Time Pressure on Audit Time Allocations,* 2 ADVANCES IN ACCT. 261, 272 (1985). Thus, it appears that client pressure to reduce audit budgets induces auditors to conclude that fewer hours are needed to perform an adequate audit. This is arguably a manifestation of the self-serving bias's impact upon human judgment.

231 They are especially limited when subjects are students. *See* Jeffrey W. Schatzberg et al., *Exploratory Experimental Evidence on Independence Impairment Conditions: Aggregate and Individual Results,* 8 BEHAV. RES. IN ACCT. 173, 191 (Supp. 1996) (reporting results of laboratory study involving accounting students that found impaired independence to be strongly associated with the existence of three conditions—differential reporting behavior by auditors,

has found evidence indicating that subjects given anonymity are less likely to issue a qualified opinion than subjects who were held accountable for their decisions.[232] On the other hand, some studies show that imposing accountability produces few changes in result;[233] furthermore, these laboratory studies are consistent with the self-serving behavior accounting firms exhibit in the real world.

D. *Empirical Studies of Actual Auditor Behavior*

As noted earlier, if the self-serving bias affects auditors, one would expect to see auditors more willing to subordinate objectivity and independence in order to resolve accounting conflicts in favor of their clients, less willing to give qualified opinions, including going concern qualifications, and less willing to resign from accounts the more income they derive from that client. On the other hand, a higher risk of litigation exposure should move auditor behavior in the opposite direction. Laboratory experiments discussed earlier have produced results consistent with these effects, and the empirical evidence of actual auditor behavior seems to do the same.

For example, Wright and Wright hypothesized that to maintain an ongoing relationship with a client, auditors who find current period adjustments that they think need to be made to the client's financial statement may waive those adjustments that will disadvantage the client's financial position.[234] One of their hypotheses was that audit adjustments were more likely to be waived as the size of the client, and hence the size of the client's stream of future potential revenue to the auditor, increased. They studied a sample of 186 audits in detail and found a

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existence of future quasi-rents that accrue to an incumbent auditor, and *a net benefit to the auditor for impairing his independence*).

[232] Lord, *Pressure*, *supra* note 222, at 103.

[233] In general studies of heuristics and biases, researchers have tried to improve performance by increasing the accountability of subjects in experiments. They have generally been unsuccessful. *See, e.g.*, Philip E. Tetlock, *Accountability: The Neglected Social Context of Judgment and Choice*, 7 RES. IN ORG. BEHAV. 297, 324 (1985) ("Demands for accountability may sometimes motivate people to 'bolster' previous decisions, to be overconfident in the correctness of those decisions, to 'over-assimilate' new evidence, and to deny difficult value trade-offs, particularly when the trade-offs require acknowledging flaws in past decisions and judgments."); Philip E. Tetlock & Richard Boettger, *Accountability: A Social Magnifier of the Dilution Effect*, 57 J. PERSONALITY & SOC. PSYCHOL. 388, 388 (1989) ("The accountability manipulation motivated subjects to use a wide range of information in making judgments, but did not make them more discriminating judges of the usefulness of that information.").

[234] Arnold Wright & Sally Wright, *An Examination of Factors Affecting the Decision to Waive Audit Adjustments*, 12 J. ACCT., AUDITING & FIN. 15, 20–21 (1997).

substantial percentage of waivers of adjustments.[235] They also found "[a] strong positive association ... between the likelihood an adjustment was waived and client size, a surrogate for audit fees."[236]

Krishnan and Krishnan modeled the decision to render a qualified opinion as a two-stage process.[237] First is the intellectual decision that the client deserves a qualified opinion. Second is the practical decision to actually render the qualified opinion. They created a model that took into account various factors that might affect the second stage of the process, including the relative importance of the client's stream of revenue to the auditor. They then tested their model empirically by using data involving 1,837 public companies. Their findings were quite consistent with the self-serving bias. Given that a client is a potential recipient of a qualified opinion, their study found that an audit firm is more likely to issue a qualified opinion "the higher the litigation risk ... [and] the lower the client's decile position in the auditor's portfolio."[238]

Citron and Taffler suspected that a possible explanation for auditors' reluctance to issue going concern qualifications is "to preserve their future economic interest in the client, unless the likelihood of failure is in fact very great."[239] They did an empirical study covering ten years' worth of going concern qualifications in the United Kingdom and found support for this surmise—only 26% of companies that failed had been issued a going concern qualification prior to their bankruptcy, and those companies tended to be *both* in a very weak financial position and in imminent danger of failing.[240]

The problem is only partly the difficulty of forecasting business failures; models exist that apparently make such forecasts with a reasonable degree of

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[235] *Id.* at 32 ("Of concern was that a number of adjustments greater than planning materiality were subsequently waived (47.5%), suggesting the potential for financial reporting risk.").

[236] *Id.* at 33. However, this finding was mitigated to some extent in that the study did not show a preferential treatment for larger client in terms of higher profits. *Id.* In other words, when one looks at the total income effects of the waivers that were granted, smaller companies did as well as larger companies, roughly speaking. *Id.* at 31.

[237] Jagan Krishnan & Jayanthi Krishnan, *The Role of Economic Trade-Offs in the Audit Opinion Decision: An Empirical Analysis,* 11 J. ACCT., AUDITING & FIN. 565, 565 (1996).

[238] *Id.* at 583. However, because of the limitations inherent in a study such as this, the authors were reluctant to draw explicit conclusions about auditor independence. *Id.*

[239] David B. Citron & Richard J. Taffler, *The Audit Report under Going Concern Uncertainties: An Empirical Analysis,* 22 ACCT. & BUS. RES. 337, 344 (1992).

[240] *Id.* Some numbers in the United States are better. *Id.*. at 340 n.15 (noting another study which found a higher percentage, 48%, of going concern qualifications among a small sample of failed U.S. companies). Yet, 28 of the 30 California savings and loans that cratered in 1985 and 1986 did so under the banner of clean audit opinions issued in their most recent audit. Sternberg, *supra* note 170, at 20.

accuracy.[241] The difficulty of making such forecasts seems to be supplemented substantially by auditor reluctance to blow the whistle on a struggling client. As adverted to earlier, when Campisi and Trotman asked experienced Australian auditors to study case histories, the auditors reached a high degree of consensus on whether a company had going concern problems.[242] The experts agreed that in 36% of the cases they evaluated, qualified opinions were warranted. Yet, in practice *none* of the cases had been qualified, indicating that factors other than the merits drove the auditors' ultimate decisions to qualify or not qualify.[243]

Kida's earlier study found both that auditors could efficiently detect going concern problems,[244] and that they often refrained from issuing qualified opinions when they were warranted.[245] Surmising that the consequences of issuing a qualified opinion might account for this gap,[246] Kida surveyed the auditors he studied and found that those who issued fewer qualified opinions tended to be more worried about deteriorating relations with clients and losing clients altogether, among other factors.[247] Barnes and Huan extended Kida's study with their own involving United Kingdom auditors and again found that auditors have a good sense of when a company's financial statements should be qualified but often do not do so for self-serving reasons.[248] Their finding supported the conclusion "that an auditor's self-interest considerations help explain his

[241] *See, e.g.,* Edward I. Altman & Thomas P. McGough, *Evaluation of a Company as a Going Concern,* J. ACCT., Dec. 1974, at 50, 53 (finding only 44% accuracy in going concern assessments by auditors in the U.S. even though a model produced by one of the authors predicted bankruptcy with 82% accuracy). *See also* Nicholas Dopuch et al., *Predicting Audit Qualifications with Financial and Market Variables,* 62 ACCT. REV. 431, 431 (1987) (proposing a model using firms' financial and stock market variables to judge when opinions should be qualified and what sorts of qualified opinions are appropriate). *But see* W.S. Hopwood et al., *A Reexamination of Auditor Versus Model Accuracy within the Context of the Going-Concern Opinion Decision,* 10 CONTEMP. ACCT. RES. 409, 425–26 (1994) (arguing that neither auditors nor financial distress models are particularly accurate predictors of imminent insolvency).

[242] Campisi & Trotman, *supra* note 15, at 308.

[243] *Id.* at 309.

[244] Kida, *supra* note 93, at 520.

[245] In Kida's study, a qualification or disclaimer was not rendered, on average, 24.6% of the time that problems were indicated. *Id.* at 520.

[246] *Id.* at 506. ("Factors other than the likelihood of problems, such as the perceived consequences of qualifying, may be considered by auditors before a qualified opinion is issued.").

[247] *Id.* at 516.

[248] Paul Barnes & Hooi Den Huan, *The Auditor's Going Concern Decision: Some UK Evidence Concerning Independence and Competence,* 20 J. BUS. FIN. & ACCT. 213, 226 (1993).

decision"[249] to refrain from qualifying a client's financial statements and that "the auditor may be seen as any other economic agent in which his decisions are determined by economic pressures."[250]

McKeown and his colleagues studied the problem that more than half of companies go bankrupt do so under the flag of clean audit opinions.[251] After studying many bankruptcies, they determined that one of the variables that seemed important in whether or not auditors issued going concern opinions was client size, concluding that their finding "raises the issue as to whether auditors' independence is influenced by the size of the client, e.g., that the auditor may be bowing to client pressure or, even in the absence of pressure, that the auditor does not want to face loss of the audit fee."[252]

Relatedly, when the Big Six accounting firms lobbied Congress for protection from lawsuits, ultimately gaining passage of the Private Securities Litigation Reform Act (PSLRA) and Securities Litigation Uniform Standards Act of 1998 (SLUSA),[253] they argued that they were being forced to resign from accounts because of litigation risk. However, a recent study by Scholz found that litigation risk was not correlated with auditor resignations *unless* the client was in relatively poor financial condition. If the client was bringing in a nice stream of revenue and was not in danger of failing, litigation risk did not induce resignation.[254]

Shaub and Lawrence studied 156 auditors in order to examine the interplay of ethics, experience, and professional skepticism, a key to independence.[255] Consistent with other studies, they found that "auditors' professional skepticism was found to be counteracted when the client was important to the audit firm's practice development."[256]

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249 *Id.*

250 *Id.*

251 James C. McKeown et al., *Towards an Explanation of Auditor Failure to Modify the Audit Opinions of Bankrupt Companies,* 10 AUDITING: J. OF PRAC. & THEORY, supp. 1991, at 1, 1.

252 *Id.* at 11.

253 *Securities Litigation Uniform Standards Act of* 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (1998). SLUSA mandates that most securities fraud class action suits be filed in federal court so that plaintiffs' attorneys cannot escape the limitations that the Public Securities Litigation Reform Act (PSLRA) placed on securities fraud suits by filing such suits in state court. *See also* PSLRA, 109 Stat. 737 (current version with additions and amendments at 15 U.S.C. §§ 77–78 and 18 U.S.C. § 1964 (Supp. I 1995)).

254 Susan Scholz, *Auditor Litigation Risk and Auditor Resignations: Some Empirical Evidence* (1997) (unpublished Doctoral Dissertation on file with author).

255 Michael K. Shaub & Janice E. Lawrence, *Ethics, Experience and Professional Skepticism,* 8 BEHAV. RES. IN ACCT. 124, 155 (Supp. 1996).

256 *Id.*

Carcello and his colleagues surveyed senior managers and partners of CPA firms.[257] Most claimed never to have witnessed the inappropriate behaviors that Carcello et al. inquired about, however, 25% did admit that they had observed inadequate workpaper review, and large client size was one of the key factors strongly associated with this General Accounting and Auditing Standards (GAAS) violation.[258]

Such violations are not terribly surprising because the self-serving bias allows auditors to rationalize and conclude that they can maintain independence in many situations where third-party observers believe that they cannot and also believe that breaches of independence are not as serious as third-parties think they are.[259]

Not all empirical studies of actual auditor activity produce results so consistent with the self-serving bias. For example, Louwers recently reported that auditors' going-concern opinions are primarily a function of client financial condition.[260] Although he admitted that some of his proxies for variables that he tested were crude and that he found some evidence that larger prospective audit fees mitigated the tendency to issue a going-concern opinion, Louwers found little evidence that audit firm-specific factors, such as recent litigation or recent loss of clients, affected decisions.[261]

Still, the greater weight of evidence clearly indicates that auditors act in a self-serving manner.[262] Due to the fact that, in auditing, the *appearance* of independence is arguably as important as the fact of independence,[263] perceptions of others cannot be overlooked. Most knowledgeable observers seem to believe what the studies suggest—that auditor independence and objectivity are affected by auditors' self-interest in that, for example, the more revenue coming from a

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[257] *See generally* Joseph V. Carcello et al., *Inappropriate Audit Partner Behavior: Views of Partners and Senior Managers,* 8 BEHAV. RES. IN ACCT. 244 (Supp. 1996).

[258] *Id.* at 266.

[259] Michael Firth, *Perceptions of Auditor Independence and Official Ethical Guidelines,* 55 ACCT. REV. 451, 462 (1980) (reporting results of extensive survey in the United Kingdom).

[260] Timothy J. Louwers, *The Relation between Going-Concern Opinions and the Auditor's Loss Function,* 36 J. ACCT. RES. 143, 154 (1998).

[261] *Id.* at 152.

[262] Studies show that, unsurprisingly, even auditors' lobbying efforts are self-serving. Marsha Puro, *Audit Firm Lobbying before the Financial Accounting Standards Board: An Empirical Study,* 22 J. ACCT. RES. 624, 645 (1984) (finding auditors' lobbying activity before FASB consistent with their own self-interest). *See also* John W. Hill & Robert W. Ingram, *Selection of GAAP or RAP in the Savings and Loan Industry,* 64 ACCT. REV. 667, 678 (1989) (concluding that auditors' willingness to allow their S&L clients to adopt the alternative RAP accounting method was "influenced by their perceptions of [RAP's] key role in maintaining the continued existence of their S&L clients").

[263] Article IV of the AICPA Code of Ethics provides that "[a] member in public practice should be independent in fact *and appearance* when providing auditing and other attestation services." AICPA CODE OF ETHICS art. IV (1988) (emphasis added).

client, the more likely auditors are to give in to client pressure for improper accounting treatment.[264]

[264] Professor Gul studied bankers in New Zealand, finding that the bankers perceived that the size of the audit fee and, to a lesser extent, the size of consulting fees, affected auditors' ability to resist management pressures for improper accounting treatment. Ferdinand A. Gul, *Size of Audit Fees and Perceptions of Auditors' Ability to Resist Management Pressure in Audit Conflict Situations*, 27 ABACUS 162, 167 (1991).

Knapp surveyed senior loan officers in the United States and found that they believed a client in good financial condition is more likely to obtain its preferred audit outcome in an audit conflict situation than is a client in poor financial condition, especially where the conflict issue is not dealt with in precise terms by the technical standards. Michael C. Knapp, *Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure*, 60 ACCT. REV. 202, 208 (1985). His study also found that competitive conditions in the audit market and provision of consulting services increased perceptions of audit conflicts being resolved in favor of the client. *Id.* However, the effect was not nearly as strong as that found in Shockley's study. *Compare with* Randolph A. Shockley, *Perceptions of Auditors' Independence: An Empirical Analysis*, 56 ACCT. REV. 785, 798 (1981). Shockley set up an experimental task, using as subjects auditors from big and medium-sized firms and financial statement users, such as commercial loan officers and financial analysts, learning that they perceived a higher risk of loss of independence when the auditor (a) operated in a competitive environment, (b) offered consulting as well as auditing services, and (c) was a smaller firm. *Id.*

Numerous other studies addressing the perception issue have been reported, yielding contradictory results. *See* Ronald V. Hartley & Timothy L. Ross, *MAS and Audit Independence: An Image Problem*, J. ACCT., Nov. 1972, at 42, 44 (reporting that sizable percentages of both CPAs and financial analysts expressed concern over the conflict created by performing both consulting and auditing services for the same client); D. Jordan Lowe & Kurt Pany, *CPA Performance of Consulting Engagements with Audit Clients: Effects on Financial Statement Users' Perceptions and Decisions*, AUDITING: J. OF PRAC. & THEORY, Fall 1995, at 35, 49–50 (finding that if enough safeguards are imposed, the appearance of independence may not be impaired); Sue McKinley et al., *An Examination of the Influence of CPA Firm Type, Size, and MAS Provision on Loan Officer Decisions and Perceptions*, 23 J. ACCT. RES. 887, 887 (1985) (reporting study finding that provision of MAS services did *not* impair loan officers' perceptions of independence and noting that the finding was "contrary to all available research of which we are aware"); Kurt Pany & Philip M. J. Reckers, *MAS, Auditing and Your Orientation*, CPA J., Feb. 1988, at 70, 72 (surveying financial analysts and finding that they tended to feel, at least under extreme conditions, that performance of MAS services could impair independence); Kurt Pany & Philip M. J. Reckers, *Within- Vs. Between-Subjects Experimental Designs: A Study of Demand Effects*, AUDITING: J. OF PRAC. & THEORY, Fall 1987, at 39, 39 (finding that in within-subjects experimental design, subjects expressed concern that MAS performance impairs independence but did not in between-subjects experiment design); Kurt Pany & M. J. Reckers, *Auditor Independence and Nonaudit Services: Director Views and Their Policy Implications*, 2 J. ACCT. & PUB. POL. 43, 60 (1983) (finding that directors perceived independence problems with the simultaneous provision of audit and consulting services and that those problems were perceived to be more serious as the size of nonaudit services grew).

E. *Studies of Individual Auditor Self-Interest*

Most of the studies and results adverted to have assumed that if it were in the accounting firm's self-interest to keep a client, it would also be in the best interest of the individual auditors making the decisions. While there is probably a substantial identity of interest between auditors and their firms, if agency theory counts for anything, some analysis of auditors as individuals is warranted. If individual auditors are self-serving, this phenomenon should also influence audit outcomes.

Individual auditors should generally wish to please their superiors and thereby improve their chances of continued employment, pay raises, promotions, and even partnership. The self-serving bias would not predict that auditors would blatantly flout the law, court disciplinary actions and lawsuits, and engage in other potentially self-destructive behavior in order to please superiors. In ambiguous cases, however, the tendency to please should be there, and studies show that it is.

Trompeter studied auditor compensation schemes and learned that if auditors' compensation were tied closely to client retention, they would be less likely to require clients to downwardly adjust their clients' claimed income than auditors whose compensation was not based on incentives.[265] Unsurprisingly, the tendency was greater the more ambiguous the relevant General Accounting and Auditing Procedures (GAAP) provision appeared to be.[266]

DeZoort and Lord studied obedience pressure in a laboratory setting and found that "[a]uditors who received inappropriate instructions from either a manager or partner were significantly more likely to violate professional norms or standards than auditors under no pressure."[267] Overall, as the authors noted, their results indicate "that auditors may have a tendency to compromise their professionalism when faced with inappropriate instructions."[268]

In a laboratory study of compliant behavior of subordinate auditors, Tan and her colleagues found that the risk assessments of superior auditors significantly influenced the risk assessments of their subordinates and the amount of cognitive

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[265] Trompeter, *supra* note 218, at 63–64.

[266] *Id.* at 66.

[267] F. Todd DeZoort & Alan T. Lord, *An Investigation of Obedience Pressure Effects on Auditors' Judgments*, 6 BEHAV. RES. IN ACCT. 11, 11 (Supp. 1994).

[268] *Id.* Because attitudes toward authority did not have a significant impact on the authors' findings, *id.*, a self-serving desire seems to be playing a greater role in this phenomenon than the blind obedience to authority that is often observed in psychology studies. *See generally* Stanley Milgram, *Behavioral Study of Obedience*, 67 J. ABNORMAL & SOC. PSYCHOL. 371 (1963) (famous study demonstrating subjects' willingness to inflict apparently serious electric shocks when asked to do so by authority figures).

effort exerted by the subordinates.[269] In other words, once subordinate auditors learn the preferences of their superiors, they tend to quickly align their views with those of their superiors and to not waste too much cognitive effort in an attempt to learn whether those views are accurate.[270] Several other studies have found evidence of this "acceptability heuristic"—the aligning of subordinate auditors' preferences to match those of the superiors to whom they are accountable.[271] Such actions are generally consistent with the self-serving bias,[272] but often not with concepts of objective and independent auditing.

Just as people need to think well of themselves, they want others to think well of them and therefore "[t]here is tendency—underscored in the research on anticipatory regret in decisionmaking—to make choices in a way that bolsters both one's *external* and self-image."[273] People spend a lot of effort being their own public relations agents in what is called "impression management."[274]

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[269] Christine E.L. Tan et al., *Auditor Judgments: The Effects of the Partner's Views on Decision Outcomes and Cognitive Effort*, 9 BEHAV. RES. IN ACCT. 157, 169–70 (Supp. 1997).

[270] *Id.* at 170.

[271] *See* Thomas A. Buchman et al., *Accountability and Auditors' Judgments about Contingent Events*, 23 J. BUS. FIN. & ACCT. 379, 394 (1996) (finding no significant differences in choice of disclosure of litigation, but finding that experienced auditors accountable to clients chose unqualified opinions while those accountable to partners chose qualified opinions in laboratory test case); Michael Gibbins & James D. Newton, *An Empirical Exploration of Complex Accountability in Public Accounting*, 32 J. ACCT. RES. 165, 183 (1994) (reporting results of survey in which accountants reported feeling "strong accountability pressure" to do what their superiors or clients wished); Mark E. Peecher, *The Influence of Auditors' Justification Processes on Their Decisions: A Cognitive Model and Experimental Evidence*, 34 J. ACCT. RES. 125, 136–39 (1996) (finding that knowing justified preferences affected auditors' acceptance of client explanations and decision to search for other alternatives when the client was perceived as higher-integrity, but had little effect when the client was lower-integrity).

[272] It is certainly not the case that auditors are unique in this regard. Several studies find this phenomenon generally. *See, e.g.*, Philip E. Tetlock et al., *Social and Cognitive Strategies for Coping with Accountability: Conformity, Complexity, and Bolstering*, 57 J. PERSONALITY & SOC. PSYCHOL. 632, 638 (1989) (finding that "subjects who knew the views of the audience coped by shifting their public attitudes toward those of the anticipated audience").

[273] Langevoort & Rasmussen, *supra* note 63, at 429 (citation omitted) (emphasis added).

[274] "Impression management" includes "those behaviors individuals employ to protect their self-images, influence the way they are perceived by significant others, or both." Sandy J. Wayne & Robert C. Liden, *Effects of Impression Management on Performance Ratings: A Longitudinal Study*, 38 ACAD. MGMT. J. 232, 232 (1995).

Impression management is used, often successfully, in a variety of circumstances. *See* David F. Caldwell & Charles A. O'Reilly III, *Responses to Failure: The Effects of Choice and Responsibility on Impression Management*, 25 ACAD. MGMT. J. 121, 134 (1982) (reporting that "when confronted with failure, decision makers may attempt to justify their position through impression management"); Wayne & Liden, *supra*, at 250 (finding that "a subordinate's use of impression management early in the relationship with a supervisor induces liking and perceptions of similarity, which in turn influence performance ratings made later."); David B.

Auditors, like others, use impression management techniques in a way that impedes objectivity. Applying persuasion literature, Rich and his colleagues noted that audit report "[p]reparers . . . are likely to view each audit engagement as an opportunity to manage their reputation in the reviewer's mind because a preparer's standing within the firm, as well as promotions and pay raises, will be strongly related to performance evaluations made by the reviewer."[275] The authors noted:

> [P]reparers may fail to report material evidence, sign off on an audit program step without actually performing that step, fabricate supporting evidence or otherwise falsify results in extreme cases of perceived pressure to support the client's position. While it is hoped and expected that deceptive behaviors (e.g., signing off on procedures not performed) would be relatively uncommon, they are not unheard of and they have obvious and potentially severe implications for audit effectiveness.[276]

It is not surprising that auditors do try to please their superiors.[277] Other authors have observed that "auditors who know that their supervisors favor 'ready acceptance' of clients' nonerror explanations for account balance fluctuations likely embrace such explanations with little circumspection—perhaps without considering a *single* error or fraud as an alternative explanation."[278] Although it clearly overstates the case, some researchers have characterized auditing as an exercise in "CYA,"[279] in "marshalling evidence to justify or defend a choice that

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Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581, 1594–96 (1998) (finding that associates in law firms often either inflate or deflate the hours they bill for working on projects, depending on whether they wish to look as if they are working very hard or working very efficiently).

[275] Jay S. Rich et al., *The Audit Review Process: A Characterization from the Persuasion Perspective*, 22 ACCT., ORGS. & SOC'Y 481, 491–92 (1997).

[276] *Id.* at 492.

[277] Rich, et al., note:

> [S]ome reviewers may be known by [work paper] preparers to have a preference for supporting the client's position in low audit-risk situations. When faced with such a reviewer in a low-risk situation, the preparer may shift to an evidence-marshalling mode. Such a shift would be consistent with the accountability literature's notion of a "social politician." Importantly, although this strategy may enhance the preparer's reputation as perceived by the reviewer, audit effectiveness may be negatively affected by the preparer's orientation toward merely giving the reviewer what the preparer perceives the reviewer to want.

Id. at 494 (citation omitted).

[278] Peecher, *supra* note 271, at 127 (citing Eric Hirst & Lisa Koonce, *Audit Analytical Procedures: A Field Investigation* (1995) (Working Paper, University of Texas)).

[279] Michael Gibbins, *Propositions About the Psychology of Professional Judgment in Public Accounting*, 22 J. ACCT. RES. 103, 117 (1984) [hereinafter Gibbins, *Propositions*]

is preferred by the auditee or by some other party to whom the auditor is accountable,"[280] such as a supervisor.

Loewenstein has provided a slightly amplified explanation of the difficulties that individual auditors face:

> First, the people who will be hurt by any misrepresentation of information are statistical [in that the auditor does not know them personally—they are merely numbers on a list of investors]. Many of them might lose a small amount of money; it isn't clear who will do so; and there is some chance that no one will be adversely affected by a minor misrepresentation. In contrast, the auditor is likely to be intimately acquainted with those who would be hurt by a negative ("qualified") opinion on an audit. Second, the negative consequences of a qualified opinion are likely to be immediate—loss of the client's friendship, likely loss of the contract, and possible unemployment—whereas the effects of a false negative (an unqualified report where qualification is merited) are likely to be delayed in time. Third, auditors form an ongoing working relationship with the organizations they audit, and any deterioration in the audited company is likely to unfold gradually. Auditors may unknowingly adapt to small changes year after year in the company's financial practices. Fourth, financial records are inherently ambiguous, so it is very easy for an auditor to rationalize arriving at a judgment that is consistent with self-interest rather than with the actual financial figures. *In sum, if one wanted to create a business setting that would virtually guarantee unethical behavior, it would be difficult to improve on the existing case of independent auditing.*[281]

IV. APPROPRIATE SEC RESPONSES TO THE SELF-SERVING BIAS

Although the self-serving bias is pervasive, persistent, and influential, it is not omnipresent and omnipotent. Every day people pass on many opportunities to act in self-serving ways that would be dishonest or injurious to others. The reasons

("Public accounting has been described as having a 'negative sanction' environment, where the penalties for error are stronger motivators than are the rewards for positive results.").

280 Ira Solomon & Michael D. Shields, *Judgment and Decision-Making Research in Auditing*, *in* JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING 137, 168 (Robert H. Ashton & Alison H. Ashton eds., 1995). *See also* Gibbins, *Propositions*, *supra* note 279, at 118 ("Because of the importance of justification and the presence of retrospective rationalization, public accountants' explanations of their own judgments will be biased toward their perceptions of acceptable ways of making judgments."); Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 96 (1998) ("Psychologists have also shown that people's reaction to being held accountable can be as much as anything to engage in window-dressing—anticipating the reaction of the audience and seeking plausible justifications for the otherwise desired course of action.").

281 Loewenstein, *Skewed Tradeoffs*, *supra* note 22, at 226 (emphasis added). *See also* Max H. Bazerman et al., *The Impossibility of Auditor Independence*, 38 SLOAN MGMT. REV. 89, 90–91 (Summer 1997) (expressing similar sentiments).

for their restraint range from fear of legal consequences to ethical and religious principles.

The specific evidence adduced in Part III indicated that the self-serving bias currently creates for auditors the potential for significant objectivity and independence problems. What factors restrain auditors from violating professional rules with reckless abandon every time the opportunity presents itself? After all, despite the significant problems with earnings management and audit failures referred to earlier, the audit profession is generally quite honest and strives for efficiency and accuracy.

The challenge is either to produce an audit profession that is willing to sacrifice its best interests for the investing public's (unlikely) or to align these two interests (difficult, but possible). This section looks at the various candidates for achieving those goals.

A. *Ethical Constraints*

Some hope that ethical constraints will sufficiently serve to minimize inappropriate auditor behavior motivated by the self-serving bias.[282] However, as noted earlier in the article, while ethical principles do constrain human behavior, their impact is often weak and uneven. Studies of auditors find that they are all too human in this regard. For example, as noted earlier, Shaub and Lawrence's study of ethics, experience, and professional skepticism found that the skepticism auditors need to do their jobs properly is counteracted when the client is an important source of referrals to the audit firm's practice development.[283]

Falk and colleagues recently studied the interplay of ethics and audit practices.[284] They found, fortunately, that "amoral, self-interested profit-maximizing behavior [did] not generally characterize the subjects in their experiment."[285] However, they also found substantial evidence consistent with

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[282] One who does so hope is Dr. W. Warner Burke. He prepared an appendix to the AICPA White Paper on independence and argued that internalization by practitioners of values such as integrity and objectivity provide the best assurance of true independence. *See* W. Warner Burke, *Auditor Independence: An Organizational Psychology Perspective*, AICPA, WHITE PAPER, *supra* note 10, app. C at 3. *See also generally* Barry E. Cushing, *Economic Analysis of Accountants' Ethical Standards: The Case of Audit Opinion Shopping*, 18 J. ACCT. & PUB. POL'Y 339 (1999) (using economic modeling to suggest a laissez-faire approach, substituting ethical training for legal regulation).

[283] Shaub & Lawrence, *supra* note 255, at 155. This is one of the reasons that some ethicists believe that deriving other income from an audit client creates an inherent conflict of interest. *See, e.g.*, Bowie, *supra* note 181, at 64 (calling this a "classic conflict of interest situation").

[284] *See generally* Haim Falk et al., *Auditor Independence, Self-Interested Behavior and Ethics: Some Experimental Evidence*, 18 J. ACCT. & PUB. POL'Y 395 (1999).

[285] *Id.* at 395.

the self-serving bias, including that "[a]s the probability of losing a client by disagreeing with the client's decision increases, the frequency of independence violations increases."[286] When the probability of losing a client was great, even monitoring and penalizing auditor behavior did not reduce the independence violations.[287] Furthermore, consistent with studies noted earlier, the larger the potential economic loss, the more likely were auditors to violate independence rules to avoid it.[288]

Despite these findings, Falk and colleagues were optimistic about the role that ethical development could play in improving audit behavior, suggesting that heightening auditors' awareness of ethical issues might enhance their independence.[289] Improved ethics training is likely to improve auditor performance, and therefore, that avenue should be pursued vigorously.[290] But, current studies of auditor ethics indicate that primary reliance on auditor ethics as a means of ensuring independence and objectivity is a long way away. One recent study found a *negative* association between level of moral development and employee advancement within audit firms.[291] Most other studies of auditor moral development are no more comforting.[292] Therefore, McNair is probably correct in suggesting that "given the limited observability of auditor behavior and professional judgment, the sole reliance on professional ethics to ensure desirable behavior is a questionable resource for audit management."[293]

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[286] *Id.* at 397.

[287] *Id.*

[288] *Id.* at 423.

[289] *Id.* at 424.

[290] *See* Tsui & Gul, *supra* note 161, at 47 (finding that both levels of ethical reasoning and personality type affected auditor responsiveness to client pressure for improper accounting treatment).

[291] Lawrence A. Ponemon, *Ethical Judgments in Accounting: A Cognitive Development Perspective,* 1 CRITICAL PERSP. IN ACCT. 191, 206–08 (1990).

[292] *See, e.g.,* Richard A. Bernardi & Donald F. Arnold, Sr., *An Examination of Moral Development within Public Accounting by Gender, Staff Level, and Firm,* 14 CONTEMP. ACCT. RES. 652, 663 (1997) (finding that the average moral development scores for male managers of the Big Five fell between those expected for senior high school and college students, although, fortunately, female accountants scored somewhat higher); Cohen et al., *Exploratory Examination, supra* note 93, at 57 (finding in a cross-cultural study that American auditors were much more likely to perform questionable acts than Latin American or Japanese auditors *if* the action would either maintain or expand their client base).

These findings make Dr. Burke's general statements about the significance of firm culture and the positive impact it can have on auditor behavior sound more hopeful than realistic. *See* Burke, *supra* note 282, at 17–18 (noting that organizational norms can have an influence on the actions of members).

[293] C.J. McNair, *Proper Compromises: The Management Control Dilemma in Public Accounting and Its Impact on Auditor Behavior,* 16 ACCT., ORGS. & SOC'Y 635, 638 (1991).

B. *Reputational Constraints*

If auditors cannot be expected to be selfless, then perhaps it might be in their own interests to act with objectivity and independence. Moizer, for example, believes that auditors have a self-interest in being objective and independent because they can sell their reputations for honesty and objectivity.[294] According to this view, it would be irrational for auditors to be anything other than objective and independent because clients would then pay them less or not hire them at all. The literature on reputational intermediaries is well established,[295] and there is no doubt that the Big Five CPA firms have substantial investments in their reputations.[296]

Professor Kinney notes that he often asks members of his CPA audiences whether their firms' internal independence guidelines are more specific and more restrictive than the AICPA's or the SEC's. He notes that the answer is invariably "yes."[297] From that he concludes, again based on the reputational constraint, that the particular CPA firms have more to lose than anyone from sloppy auditing.[298]

Although there is no doubt that the reputational constraint affects auditor behavior, there is reason to doubt its absolute strength. For example, it is not surprising that, once the SEC sets a floor for independence standards, individual firms' embodiments of those standards exceed the floor on occasion. But to assume that once the floor is taken away the standards will remain at that high level is Pollyannaish.[299] Reputation is often not a sufficient motivation for auditors to preserve their own objectivity and independence.[300]

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[294] Moizer, *supra* note 17, at 35–43.

[295] Auditors act as reputational intermediaries in many settings. *See* Ronald J. Balvers et al., *Underpricing of New Issues and the Choice of Auditor as a Signal of Investment Banker Reputation,* 63 ACCT. REV. 605, 605 (1988) (finding that reputations of both auditor and underwriter affect underpricing of IPOs); Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing,* 94 YALE L.J. 239, 290 (1984) (noting reputational capital that both law firms and accounting firms sell); Karl S. Okamoto, *Reputation and the Value of Lawyers,* 74 OR. L. REV. 15, 24 (1995) (noting that auditors sell their reputations).

[296] In 1996, four members of the Big Five made a total investment of over $170 million in audit technology and methodology. LECG, *supra* note 11, at 17. The LECG also argues that the Big Five make $6 billion a year in audit revenue (almost as much as they make through consulting) and that they would not risk that stream of revenue by doing anything dishonest. *Id.* at 16. However, as shall be explained, it is not at all clear that, when an audit firm is faced with a client willing to pull its lucrative audit account, the economically prudent thing to do is to stand up to the client and lose the account.

[297] William R. Kinney, Jr., *Auditor Independence: A Burdensome Constraint or Core Value?,* ACCT. HORIZONS, Mar. 1999, at 69, 72–73.

[298] *Id.* at 73.

[299] If a group of college football coaches were asked if they observed rules more stringent than the NCAA's, many of them would likely say that they did. If the NCAA-mandated

For instance, the rewards that can be gained through audit revenues, and more importantly through attendant consulting revenues, can outweigh the damage to reputation. After all, a very high percentage of Big Five income now derives from consulting revenue,[301] and these firms often use audit engagements as "loss leaders" to acquire consulting business.[302] Given these other fees, it can be rational for self-serving auditors to risk their reputations to gain lucrative nonaudit fees.[303] Just as coaches of sports teams are more likely to bend the rules for their star players,[304] auditors are naturally more willing to bend the rules for their star clients. As noted earlier, several studies have noted that the higher the stream of revenue from a client, the less independent auditors seem to act.[305]

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minimums were taken away, it is equally likely that S.M.U.'s football program of the 1980s, that earned the only NCAA death penalty thus far prescribed, would soon be a commonly emulated model.

300 *See* Prentice, *Irrational Auditor, supra* note 160, at 210–17.

301 *See Competitive Pressure,* IOMA: PARTNERS REPORT FOR LAW FIRM OWNERS, May 1999, at 3, *available in* LEXIS, NEWS Library, ALLNWS File (noting that 36% of Big Five revenue is now derived from consulting).

302 McNair, *supra* note 293, at 637. A recent survey found that 85% of more than 200 companies surveyed bought consulting services from their auditors. Robert Tie, *SEC Renews Push for More Oversight of Auditors,* J. ACCT., July 2000, at 16, 17 (reporting results of survey by the Financial Executives Institute, but noting that company executives felt they were selective about which consulting services they purchased).

303 *See* Steve Bailey & Steven Syre, *Coopers & Lybrand Takes Heat for Failing to See Trouble Sooner,* BOSTON GLOBE, Feb. 28, 1997, at C1 (noting that former SEC chief accountant Walter Schuetze has described auditors as often just cheerleaders for management when they are also courting lucrative consulting contracts); Abraham J. Briloff, *Old Myths and New Realities in Accounting,* 41 ACCT. REV. 484, 490–92 (1966) (criticizing auditors for not recognizing conflicts of interest in providing both consulting and auditing services simultaneously); Simon Caulkin, *Calling Our Auditors to Order: Conflicts of Interest Raise Searching Questions,* THE OBSERVER, Jan. 16, 2000, Business Pages, at 9 ("[A]n auditing team is unlikely to rock the boat if, on the back of the audit, its sister divisions are about to sell the client some much more lucrative consultancy or corporate finance services."); Arthur A. Schulte, Jr., *Compatibility of Management Consulting and Auditing,* 40 ACCT. REV. 587, 592 (1965) (concluding that serious independence problems exist when auditors provide Management Advisory Services (MAS)).

304 *See* Geoff Calkins, *Sugar Bowl Notebook,* COM. APPEAL (Memphis), Jan. 3, 2000, at D8 (quoting eventual national champion Florida State's coach, Bobby Bowden as admitting that it looked to him as though he was showing favoritism in stretching team rules to allow star player Peter Warrick to play in the Sugar Bowl after criminal charges had been brought against him).

305 *See, e.g.,* Carcello et al., *supra* note 257, at 266 (reporting survey results that large client size was a key factor strongly associated with inadequate workpaper review); Falk et al., *supra* note 284, at 423 (finding that "[t]he larger the economic impact of client loss, the more likely the independent auditors are to compromise their independent assessment of the situation"); Krishnan & Krishnan, *supra* note 237, at 583 (finding in empirical study that an auditor is more likely to give a qualified opinion if, among other factors, the client's fees are a

The decision to risk reputation in favor of nonaudit fees may well be a rational one in light of the fact that (a) unless the client gets into financial trouble, the auditor will probably not get caught,[306] (b) if an audit firm does get caught, it can often preserve its reputation by firing and scape-goating an individual auditor or two,[307] (c) reputational damage will be particularly mild in situations where

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smaller percentage of the auditor's client portfolio and the client's growth potential is limited); Lord, *Pressure, supra* note 222, at 97–103 (finding that importance of the client in terms of amount of revenue contributed to the firm was a significant variable in determining aggressiveness of reporting); Thomas Lys & Ross L. Watts, *Lawsuits against Auditors,* 32 J. ACCT. RES. 65, 85 (Supp. 1994) (finding the proportion of revenues generated by the client to be significantly higher for the litigation sample, consistent with the argument that auditor independence decreases as the proportion of the audit firm's revenue generated from the client increases); Shaub & Lawrence, *supra* note 255, at 155 (finding that "auditors' professional skepticism was found to be counteracted when the client was important to the audit firm's practice development"); Wright & Wright, *supra* note 234, at 33 (reporting that "[a] strong association was found between the likelihood an adjustment was waived [by the auditor] and client size, a surrogate for audit fees," although the authors note that other factors than the auditors' stream of income could account for the correlation). *But see* James D. Stice, *Using Financial and Market Information to Identify Pre-Engagement Factors Associated with Lawsuits against Auditors,* 66 ACCT. REV. 516, 516–17 (1991) (not finding proportion of audit fees of the client to be a statistically significant variable in a litigation study).

306 It is exceedingly cost-ineffective for either clients or third-party users of audit statements to effectively monitor an audit firm's work. *See* Larry R. Davis & Daniel T. Simon, *The Impact of SEC Disciplinary Actions on Audit Fees,* AUDITING: J. OF PRAC. & THEORY, Spring 1992, at 58, 59 n.1 (stating that "neither [an external user nor an audit client] is likely to possess the information required to accurately assess audit quality"); Linda E. DeAngelo, *Auditor Size and Audit Quality,* 3 J. ACCT. & ECON. 183, 186 (1981) (noting that consumers of audit reports do not directly observe audit procedures and have little information about the auditor's incentives); Thomas E. Wilson, Jr. & Richard A. Grimlund, *An Examination of the Importance of an Auditor's Reputation,* AUDITING: J. OF PRAC. & THEORY, Spring 1990, at 43, 44 ("Unlike consumers of most other goods and services, consumers of audited financial statements find it difficult to directly assess the quality of the product."). Unless the client goes into bankruptcy or falters in some other significant way, it is unlikely that the auditor's errors will ever be detected or lead to meaningful consequences. *See* Gary Klott, *Auditors Feel the Heat of a New Scrutiny,* N.Y. TIMES, May 13, 1984, § 3, at 1 (quoting Professor Knapp as observing that there are probably "thousands of problem audits out there but you don't see them until the company goes belly up or until a massive fraud is uncovered").

Even if the SEC does detect sufficient errors to bring an enforcement action against auditors, many times the "ultimate sanction" of private civil litigation will not occur. *See* Sarah E. Bonner et al., *Fraud Type and Auditor Litigation: An Analysis of SEC Accounting and Enforcement Releases,* 73 ACCT. REV. 503, 527 (1998) (reporting results that over 40% of companies in a research sample had no litigation despite SEC enforcement action).

307 Scapegoating a single employee and suggesting that he or she was a "rogue" and that his or her error was an "aberration" is common by organizations. *See, e.g.,* George M. Cohen, *When Law and Economics Met Professional Responsibility,* 67 FORDHAM L. REV. 273, 289 (1998) (noting that such actions are easier for larger firms); James Denn, *Conquest, Controversy on Wall Street,* TIMES UNION (Albany), May 30, 1999, at B1 (noting such actions

accounting standards are ambiguous,[308] and (d) empirical evidence demonstrates that economic consequences of damage to reputation often are minimal, even if the audit firm does get caught and cannot successfully scapegoat.[309] Indeed, Big Five firms have so much reputational capital in the bank that they have significant, although not complete, immunity to reputational damage. This is especially so because any client wishing to dump an auditor because of reputation-damaging litigation against it will quickly find that virtually all the auditor's competitors have recently suffered similar litigation.[310] As a British

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by an investment banking firm). Accounting firms have also used this ploy. *See* Dan Atkinson, *Accountants Pay $2.5m Settlement,* GUARDIAN (Manchester), Jan. 15, 1999, at 23 (noting PricewaterhouseCoopers's statement that it "regretted and abhorred" the independence rule violations of certain "rogue individuals" within the firm). Later, it was established that 1,885 PricewaterhouseCoopers's employees had committed a total of 8,064 violations. Elizabeth MacDonald, *Accountant Faces Salvo From SEC,* WALL ST. J., Feb. 28, 2000, at A3.

308 In a recent study using experimental economic markets methodology, Mayhew and his colleagues surmised that an accounting firm's reputation would be damaged relatively more if it flouted relatively certain accounting standards (giving the Sunbeam Corporation's problems with the SEC as an example) and relatively less in cases involving uncertain application of accounting standards (giving an America On-Line accounting controversy as an example). Their study resulted in a conclusion that "auditors facing uncertainty frequently impaired their independence even though such reporting behavior generated sub-optimal returns for market participants. This suggests that auditor reputation concerns alone do not deter independence impairment under conditions of uncertainty." Brian W. Mayhew et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Independence* (2000) (Working Paper on file with author).

309 *See* Davis & Simon, *supra* note 306, at 66 (finding that after SEC disciplinary actions, auditors' fees dipped slightly, but only for one year); Michael Firth, *Auditor Reputation: The Impact of Critical Reports Issued by Government Inspectors,* 21 RAND J. ECON. 374, 386 (1990) (finding that audit firms disciplined in England continued to gain clients, although they lost a little bit of market share compared with rivals); Mary S. Schroeder et al., *Audit Quality: The Perceptions of Audit-Committee Chairpersons and Audit Partners,* AUDITING: J. OF PRAC. & THEORY, Spring 1986, at 86, 91–92 (1986) (finding that client audit committee chairs who are intimately involved in selecting auditors give no significant weight to litigation involvement when rating audit quality); Wilson & Grimlund, *supra* note 306, at 58 (finding only weak evidence that an auditor's ability to attract new clients is hurt by SEC disciplinary actions taken against it).

310 In a discussion of reputational damage to law firms from securities suits being filed, one author recently observed:

> Reputational capital is important to accountants as well as to lawyers, but there is a difference. The accounting profession is dominated by the Big Six [now Five] accounting firms, all of which have been sued for substantial sums in connection with securities fraud claims, making differentiation by reputation difficult. The difference between Coopers and Lybrand, which disclosed $145 million in settlements in 1992, and KPMG Peat Marwick, which disclosed $4.5 million in the same year, is discernable but also debatable, particularly in view of the fact that, in the following year (1993) Coopers and Lybrand disclosed $25.90 million in settlements whereas KPMG Peat Marwick disclosed $55.32 million.... [F]or a large accounting firm a securities suit is simply one more suit to be settled or litigated

editorialist recently noted, "when the reputation of a firm is attacked most [accountants] admit, privately, that clients do not care. What happens is simply that the general reputation of all auditors drops another inch. That is hardly a sanction when the statutory audit is just that—a legal requirement."[311]

C. *AICPA Self-Regulation*

Although the reputational constraint by itself is likely inadequate to well align auditors' interests with those of the investing public, the self-regulation that the AICPA performs under the watchful eye of the SEC helps to keep accountants on the straight and narrow. There can be no doubt that, to a substantial extent, it is to the profession's best interest to generate effective self-disciplinary rules and to follow them. However, the evidence presented earlier in this article shows rather clearly that auditors often tend to breach rules when it appears to them to be in their interests to do so. Furthermore, professional standards are viewed by sociologists as involving a huge coincidence of norms and self-interest.[312]

Indeed, AICPA independence standards remain less stringent than the SEC's,[313] and those standards are largely a product of actions taken to ward off more drastic government regulation. For example, following 1977 Congressional hearings and SEC expressions of concern, the audit profession adopted its peer review process that was clearly instituted in "response to the various recommendations for self-initiated reform made by the Congress, the Commission, and others."[314] When the audit profession did little to respond to the "opinion shopping" problems of the 1980s, the SEC stepped into the breach with its own proposed rules.[315] This prompted the profession to begin its own initiatives and to urge the SEC to refrain from promulgating final rules until after

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Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation,* 50 S.M.U. L. REV. 225, 239 (1996).

[311] *Maxwell's Legacy: The Fate of Coopers & Lybrand Suggests New Penalties Are Needed,* FIN. TIMES (London), Feb. 4, 1999, at 11.

[312] *See* MAGALI S. LARSON, THE RISE OF PROFESSIONALISM: A SOCIOLOGICAL ANALYSIS 71–72 (1977); Langevoort & Rasmussen, *supra* note 63, at 414–15 n.76.

[313] AICPA, WHITE PAPER, *supra* note 10, at 37. *See also* § 210.2-01(b) of Regulation S-X, 17 CFR § 210.2-01(b) (2000) (showing the SEC's independence rules); SEC CODIFICATION OF FINANCIAL REPORTING POLICIES §§ 601–602 (1999) (same); AICPA PROF'L STANDARDS ET § 101 (1997) (setting out the AICPA's independence rules).

[314] Independent Accountants—Mandatory Peer Review, 52 Fed. Reg. 11,665, 11,667 (proposed Apr. 10, 1987) (citing SEC REPORT TO CONGRESS ON THE ACCOUNTING PROFESSION AND THE COMMISSION'S OVERSIGHT ROLE, 94th Cong. (2d Sess. 1978)).

[315] Martin, *supra* note 10, at 429 ("Unfortunately, the profession has not done a good job of discouraging [opinion shopping, so] . . . the SEC has stepped into the field.").

the private measures had had an opportunity to work.[316] As another example, only after the SEC took action against auditors who borrowed money from clients during the S&L fiasco of the 1980s, did the AICPA amend its rules to prohibit almost all types of loans from financial institutions that are audit clients.[317] Similarly, in the mid-1990s, the Independence Standards Board (ISB) was created to mollify SEC concern about the conflicts between the audit function and the many other services accounting firms were beginning to offer audit clients.[318]

The audit profession has put in place an impressive set of mechanisms and procedures to help maintain independence and the appearance thereof. From extensive codes of ethics with arcane rules regarding independence to elaborate peer review programs, a system is in place that works to preserve independence most of the time. The system plays an important role in maintaining the high quality of audits in the U.S. The audit profession justly takes pride in these developments and consumers of financial statements can take substantial comfort in their existence. It is only a drumbeat of SEC pressure over the past two decades, however, that is responsible for the existence of these standards and procedures. History teaches that counting on the AICPA to rein in auditor misconduct, in the absence of substantial SEC prodding and oversight, is a manifestation of the overoptimism bias.[319]

D. *The Litigation Constraint*

Individual ethical standards, accounting firm investment in reputational capital, and the guidelines established by the AICPA are all very important to the current system's regulatory regime. However, the discussion in the preceding three sections has indicated that alone, and together, they are insufficient to protect the objectivity and independence of the audit profession. Therefore,

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316 *See* Daniel L. Goelzer, *The SEC and Opinion Shopping: A Case Study in the Changing Regulation of the Accounting Profession,* 52 BROOK. L. REV. 1057, 1067 (1987) (noting that commentators on SEC proposed rule changes urged the Commission to wait until the profession's own response to opinion shopping could be formulated); Smolevitz, *supra* note 170, at 1122 n.196 (quoting comment letters from accounting firms to the SEC). *See also* Rietberg, *supra* note 18, at 227–231 (indicating that proposed SEC rule changes for the profession prompted it to institute peer review and second-partner review, to rotate audit partners every seven years, and to conduct annual quality-control reviews).

317 *Ernst & Young Settles SEC Case Alleging Lack of Auditor Independence,* BNA SECURITIES LAW DAILY, Mar. 17, 1995, *available in* LEXIS, BNA Library, BNASLD File.

318 J. Gregory Jenkins, *A Declaration of Independence,* J. ACCT., May 1999, at 31 ("The system needed fixing, and the SEC required a solution.").

319 It has been suggested that "the [accounting] profession [in Great Britain] is less concerned with developing, promulgating and enforcing effective accounting standards in the public interest than with giving the appearance of so doing." David Lyall & Robert Perks, *Create a State Auditing Board?—Yes. . .,* ACCT., June 1976, at 34, 35.

despite the common sense appeal of a columnist's recent argument that "[c]reating hostages to litigation is a lousy way of incentivizing proper behavior,"[320] there has long been anecdotal evidence that the potential for civil and criminal litigation is the best, and perhaps, only method of inducing auditors to do their jobs properly.[321] The self-serving bias literature would predict that increased likelihood of litigation and increased penalties stemming from detection would tend to improve auditor performance by aligning their interests more directly with the interests of those who benefit from accurate financial reporting. Many of the empirical studies noted earlier in this article for other propositions reached just this conclusion. Indeed, substantial empirical evidence indicates that greater litigation risk (higher chance of detection or higher penalties or both) has many beneficial effects on auditor conduct.[322]

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320 Holman W. Jenkins Jr., *Abused Accountants Say 'Take This Job and...,'* WALL ST. J., Jan. 19, 2000, at A23.

321 Bernard Black has noted that "[e]xperience teaches that at least some legal liability is an important buttress for the accounting firm's concern for reputation," noting:

> The needed liability risk doesn't have to be great. I make no claim that aggressive, American style class action litigation against accounting firms is necessary or even desirable.... But if there is no liability risk, the temptation for even the largest accounting firms to squander reputation to gain a client will always be present and will sometimes be accepted.

Bernard S. Black, *The Legal and Institutional Preconditions for Strong Stock Markets: The Nontriviality of Securities Law* (Sept. 1999) (Stanford Law School John M. Olin Program in Law and Economics, Working Paper No. 179). *See also* Ellen Benoit, *A Gentleman's Game,* FIN. WORLD, Sept. 22, 1987, at 18, 29 (noting that litigation may be "the only thing that can really force auditors to be tough"); Abraham Briloff, *Accountants' Bottom Line: Home Free,* NEWSDAY, Jan. 19, 1993, at 83 ("There is nothing like a conviction to concentrate the mind. That is the only kind of penalty which cannot be transferred [by an auditor] to an insurance company, to the tax collector, to clients, or to society."); Dan L. Goldwasser, *State of the Accounting Profession 1994, in* ACCOUNTANTS' LIABILITY 9, 11 (PLI 1994) (noting that mounting liability claims have "been the prime moving force behind enhancements [in] professional standards, changes in the level of accounting education and on-the-job training"); C. W. Nobes, *Summary and Highlights of Chapters Four to Seven, in* ACCOUNTANTS' LIABILITY IN THE 1980S: AN INTERNATIONAL VIEW 31, 37 (E.P. Minnis & C.W. Nobes eds., 1985) ("One response to increasing litigation has been a growing emphasis on quality."); E.P. Minnis, *Professional Liability After* Hedley Byrne, *in* ACCOUNTANTS' LIABILITY IN THE 1980S: AN INTERNATIONAL VIEW, *supra,* at 13, 26 (noting that British expert Paul Rutteman "sees the improvement in [audit] quality ... in recent years as a direct by-product of the legal problems [of accountants]").

322 Concomitantly, the self-serving bias would assume that less litigation pressure would mean less motivation for auditors to adhere tightly to proper procedures. Observers of the audit industry believe this to be the case. Knapp hypothesized that "[a]n audit firm that realizes it has little risk of legal exposure, due to the client's excellent financial condition, may be less motivated to resist management pressure." Knapp, *supra* note 264, at 204. His study determined that senior loan officers who often used audit reports believed this to be true. *Id.* at 208.

The audit profession itself admits that "exposure to legal liability provides a powerful deterrent to compromising independence."[323] Studies have indicated that higher litigation risk induces auditors to exert greater effort[324] and to plan more thorough audits.[325] Litigation risk also affects the audit standards auditors choose for their clients. Hill and Ingram empirically studied selection of standards and its interaction with auditor choice in the savings and loan industry.[326] In the early 1980s, S&Ls were given the option to switch from GAAP accounting to RAP (regulatory accounting principle) accounting. RAP accounting is much more aggressive than GAAP accounting, and because the S&L industry was already in shaky financial shape, auditors had incentive to oppose adoption of RAP by their clients. Hill and Ingram found, however, that they generally did not do so. They suggest that the auditors' worries about litigation were more than counterbalanced "by their perceptions of [RAP accounting's] key role in maintaining the continued existence of their savings and loan clients."[327] One suspects that had accounting firms possessed keener insight into the litigation risk they truly faced because of their S&L work, they would have behaved much differently.

Litigation risk affects application of audit standards, as well as their choice. Other studies indicate that if the threat of litigation is high, auditors tend to require conservative reporting and justify that requirement with conservative interpretations of accounting standards, but that if the threat of litigation is only moderate, auditors tend to permit aggressive reporting and justify their stance with aggressive interpretations of the same standards.[328] As Farmer and his

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[323] AICPA, WHITE PAPER, *supra* note 10, at 4.

[324] Julianne Nelson et al., *Legal Services and the Market for Auditing Services,* 3 J. ACCT., AUDITING & FIN. 255, 277 (1988) (concluding, based on mathematical modeling of the auditor-client relationship, that "increases in auditor liability lead to increases in both auditor effort and fees").

[325] Judith C. Walo, *The Effects of Client Characteristics on Audit Scope,* AUDITING: J. OF PRAC. & THEORY, Spring 1995, at 115, 123 (finding evidence "that auditors do impound business risk assessments [i.e., threat of suit] into their scope [of audit] judgments").

[326] Hill & Ingram, *supra* note 262, at 667.

[327] *Id.* at 678 (noting also that it is an "open question as to whether auditor decisions are independent of their clients' preferences and/or financial welfare").

Other direct support for the existence of a self-serving bias, and indirect support for the impact it has on auditors, comes from empirical studies showing that management-controlled companies select different accounting methods (that favor managers) than owner-controlled companies. *See* Dan S. Dhaliwal et al., *The Effect of Owner Versus Management Control on the Choice of Accounting Methods,* 4 J. ACCT. & ECON. 41, 52 (1982).

[328] *See* DeZoort & Lord, *supra* note 267, at 54 (citing two working papers by Lord finding that auditors are more likely to accept the aggressive financial reporting practices of a client in strong financial shape than one in weak financial shape whose bankruptcy would likely spark litigation); Hackenbrack & Nelson, *supra* note 219, at 52 ("We found that auditors tend to make the reporting decisions favored by their incentives and apply the vague language in

colleagues found, "the threat of litigation is a demonstrated important factor that appears to affect auditors' willingness to take stands opposing a client's proposed accounting treatments."[329]

Detecting fraud or other problems with the client's financial statements is only step one. The subsequent issue is: will the auditor report them? "The qualification decision involves economic tradeoffs because auditors who qualify too frequently risk losing clients and those who seldom qualify are exposed to lawsuits and loss of reputation."[330] Krishnan and Krishnan found that the more likely an auditor would be sued for false reporting, the more often a qualified opinion would be issued where one was warranted.[331] Other studies indicate that with a higher litigation risk, auditors are more likely to resign or refuse accounts where the risk of misrepresentation of the client's financial status is high. Menon and Williams studied retention/disengagement decisions from 1990 to 1996 in the United States and concluded that "auditors' decisions to resign or to decline reappointment are a function of the audit error cost, which reflects the expected losses to the auditor when the probability of misrepresentation is high."[332] Whereas the accounting industry has been successfully lobbying Congress for legislation to protect its members from litigation by claiming that the auditors have been forced to refuse to audit certain litigation-prone industries, thus endangering their financial viability, Menon and Williams found that "the decision to resign or decline reappointment seems to be driven by the likelihood

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financial accounting standards in a manner consistent with the reporting position they selected.").

It is interesting that accountants make reporting decisions favored by their clients when they act as tax professionals. *See, e.g.*, C. Brian Cloyd, *The Effects of Financial Accounting Conformity and Client Risk Attitude on Recommendations of Tax Preparers* (1993) (University of Texas Working Paper, on file with author); Cuccia et al., *supra* note 198, at 243–44 (finding that replacing vague standards with precise standards does not mitigate aggressive reporting when tax accountants are incentivized to aggressively report); Johnson, *supra* note 201, at 1.

Not surprisingly, a higher litigation risk induces tax accountants to be more conservative in their approach to client requests to make aggressive tax claims. *See, e.g.*, Kathryn Kadous & Anne M. Magro, *The Effects of Exposure to Practice Risk on Tax Professionals' Judgments and Recommendations* (Dec. 1999) (unpublished Working Paper on file with author).

329 Farmer et al., *supra* note 210, at 10.

Analogously, Matsumura and Tucker reported that the results of their economic experiment indicated that "increasing the auditor's penalty . . . increased fraud detection" by auditors. Ella Mae Matsumura & Robert R. Tucker, *Fraud Detection: A Theoretical Foundation*, 67 ACCT. REV. 753, 754 (1992).

330 Dopuch et al., *supra* note 241, at 432–33.

331 Krishnan & Krishnan, *supra* note 237, at 577, 583.

332 Krishnagopal Menon & David D. Williams, *Error Cost and Auditors' Termination Decisions*, 12 J. AUDITING, ACCT. & FIN. 95, 121 (1999).

that the client's financial statements will contain misrepresentations that are likely to subsequently be detected, rather than by the client's industry."[333]

All in all, it has been concluded that "[a]lthough [litigation risk] is a pressure toward conservative behavior, it is also a pressure toward high-quality audits."[334] It is no surprise then that Nichols and Price argued a long time ago that of the possible alternatives to improving auditor performance, the one holding the most promise is reducing the auditor's and/or client's flexibility of action by increasing the cost of inappropriate actions.[335]

It is worth noting that auditor litigation risk has been significantly reduced recently due to a string of pro-defendant federal court decisions in securities cases[336] and successful lobbying by the accounting and high tech firms to induce passage of favorable federal legislation.[337] This is not necessarily a bad thing, for accounting industry claims of a "liability crisis" in the early 1990s were quite plausible, and litigation is a blunt instrument for achieving policy goals.[338] SEC enforcement is a scalpel preferable to private class action securities' suits relative

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333 *Id.*

334 LAWLER & RHODE, *supra* note 166, at 187. *See also* Farmer et al., *supra* note 210, at 10–11 (noting that threat of liability serves to provide countervailing pressure in favor of observation of independence standards).

335 Nichols & Price, *supra* note 166, at 345.

336 There are several favorable court decisions relevant to federal securities. *See generally, e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (drastically reducing the coverage of § 12(2) of the Securities Act of 1933); Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) (eliminating aiding and abetting cause of action under § 10(b)); Reves v. Ernst & Young, 507 U.S. 170 (1993) (largely eliminating auditor liability under the Racketeer Influenced and Corrupt Organizations Act); Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (dramatically reducing the length of the statute of limitations under § 10(b)); Pinter v. Dahl, 486 U.S. 622 (1988) (reducing the liability of auditors under § 12 of the Securities Act of 1933 by giving narrow definition to the term "seller").

The accounting profession has won important state law victories as well. Auditor third party liability has been dramatically reduced by court decisions, *see, e.g.*, Bily v. Arthur Young & Co., 834 P.2d 745, 774 (1992) (replacing "reasonable foreseeability" scope of negligence liability with more restrictive "Restatement" approach), and legislative action. *See, e.g.*, ARK. CODE ANN. § 16-114-302 (Michie Supp. 1999) (adopting an even narrower "privity" approach).

337 The two most important such acts are: the Public Securities Litigation Reform Act (PSLRA), 109 Stat. 737 (current version with additions and amendments at 15 U.S.C. §§ 77–78 and 18 U.S.C. § 1964 (Supp. I 1995)), which erected numerous barriers to a § 10b-5 class action plaintiff's recovery, and the Securities Litigation Uniform Standards Act of 1998 (SLUSA), codified at 15 U.S.C. §§ 77(p), 78bb(f) (Supp. 1996) (reinforcing PSLRA reforms by largely eliminating option of plaintiffs' attorneys to file class action securities fraud suits in state courts).

338 *See generally* Adam C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999) (highlighting weaknesses and disadvantages of litigation and suggesting alternative methods of discouraging fraud).

meat ax. Still, the bottom line is that more than ethical constraints, reputational capital, or self-regulation, the threat of SEC sanctions and of civil money judgments accounts for the relatively sterling record of the audit profession.

E. *Governmentalizing the Audit Function*

It is plausible to conclude that auditor interests can never be properly aligned with audit report consumer interests so long as the auditees are paying the auditor's bill.[339] Therefore, over the years, people have occasionally suggested that the audit function should become a governmental service.[340] Given that some have lamented that "auditing is no longer considered to be a value-added activity for much of the profession,"[341] perhaps it is time to revisit this suggestion.

However, in an economic world where privatization is the dominant economic trend, this tide-resisting change is likely too great, especially because the benefits of making audit a public function are too dubious. Government takeover of the audit profession is too great a change and too inconsistent with America's free enterprise system to seriously contemplate at this time.[342]

F. *Separating the Audit Function*

A more limited approach to the conflict of interest and its damage to objectivity and independence created by the provision of consulting services to audit clients has been the separation of functions. Hence, in 1990, accounting firm Arthur Andersen spun off Andersen Consulting to create a demarcation between the audit and consulting functions.[343] PricewaterhouseCoopers has announced

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[339] *See* Elizabeth MacDonald, *How a Ballpark Tip Evolved into a Burden for One of the Big Five*, WALL ST. J., Feb. 18, 2000, at A1 (quoting a Big Five partner as saying "[t]he real conflict is that we get paid by the companies we're auditing").

[340] *See, e.g.*, Lyall & Perks, *supra* note 319, at 34 (suggesting nationalization of the British audit profession).

[341] Robert G. Ruland, *Commentary on Inappropriate Audit Partner Behavior: Views of Audit Partners and Senior Managers*, 8 BEHAV. RES. IN ACCT. 269, 269 (1996) (also noting that today "there is an emphasis on [good] client service that is alien to the skepticism and diligence required of a good auditor").

[342] Harvey Hendrickson & Reza Espahbodi, *Second Opinion, Opinion Shopping and Independence*, CPA J., Mar. 1991, at 26.

[343] *See* Arthur Andersen & Co., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79, 484, at 77, 457 (Jul. 25, 1990). Of course, there was so much money to be made in consulting that tension between the less profitable Arthur Andersen and the more profitable Andersen Consulting has been substantial, leading Arthur Andersen to go back into consulting in competition with its related branch. *See* Roger O. Crockett, *Next Stop, Splitsville*, BUS. WK., Jan. 18, 1999, at 100 (discussing attempts by Andersen Consulting and Arthur Andersen to settle their competitive differences).

plans to separate its consulting business from its audit and tax business,[344] and so has KPMG.[345] Ernst & Young has announced a plan to sell its consulting business to Cap Gemini Group.[346] All three separations were the result of heavy SEC pressure, and the resulting trend is a sensible one.

Today, only a small minority of accountants do audit work.[347] As noted earlier, the audit aspect of the profession has become disrespected to some degree. It is a less desirable career track. The SEC-mandated "annual audit is a federal gravy train that hardly pays its way anymore."[348] Accounting firms use it as a loss leader to generate profits from related activities and jettison it when it stands in the way of more lucrative consulting work.[349]

Perhaps now it is time for all accounting firms to seriously consider spinning off their audit functions into separate entities. Most of the nonaudit functions do not require independence. Attest-related activities, such as Webtrust and ElderCare, could perhaps be spun off along with traditional financial statement auditing, but firms could segregate attest work from knowledge translation work, such as tax, accounting, consulting, and other work. Audit work might become more expensive as the new firms would have to put it on a profitable basis rather than using it as a loss leader, but it would be worth the cost for auditing to regain the respectability that the function deserves. Absent SEC pressure, the accounting profession would prefer not to make such changes, arguing, among other things, that (a) offering nonaudit services increases the auditor's knowledge of the client's business and its general business skills and can enhance the overall sophistication of the firm, and (b) forcing firms doing audits to give up other forms of revenue makes them more, not less, dependent on fees from individual audit clients.[350] The former argument is plausible, but thus far is mainly supported by merely anecdotal evidence. It assumes an identity of or

The problems created by this competition were recently settled in a bitter arbitration dispute that split the two entities that had uneasily co-existed under parent Andersen Worldwide. *See* Geanne Rosenberg, *Andersen Legal's Strategy Unbowed by Andersen Split*, NAT'L L.J., Aug. 21, 2000, at B8 (describing results of arbitration).

344 Elizabeth MacDonald, *PricewaterhouseCoopers Will Divide into Two or More Parts, Under Pressure*, WALL ST. J., Feb. 18, 2000, at B8. The announced plan would separate PricewaterhouseCoopers's audit, business-advisory, and tax businesses from its management-consulting practice. *Id.*

345 *See* Carole Gould, *KPMG Consulting Arm Looks Ready to Fly Solo*, N.Y. TIMES, Aug. 13, 2000, § 3, at 8 (describing KPMG's plan to have an initial public offering for its consulting branch).

346 Kevin J. Delaney & Elizabeth MacDonald, *Ernst & Young to Sell Business to Cap Gemini*, WALL ST. J., Feb. 29, 2000, at C14.

347 Peter D. Fleming, *Steering a Course for the Future*, J. ACCT., Nov. 1999, at 35, 37.

348 Jenkins Jr., *supra* note 320, at A23.

349 *Id.*

350 *See* AICPA, WHITE PAPER, *supra* note 10, at 58.

interrelationship between audit personnel and consulting personnel that probably does not exist and that would create major independence problems if it did.[351] The latter argument ignores the fact that when a firm's main source of revenue is audit work, the reputational constraint will become much more effective than it is today when audit work is just a minor profit center in the firm.

After this article was accepted for publication, the SEC proposed new rules that are generally consistent with the suggestions put forth here.[352] While easing restrictions on picayune matters of stock ownership, the proposal would require auditing firms to more strictly limit their nonaudit services to clients, such as designing information systems, internal auditing, appraising client assets, and acting as a broker-dealer.

CONCLUSION

Behavioral literature is increasingly informing legal analysis.[353] In this setting, it indicates that the self-serving bias, although a bounded phenomenon, is

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[351] One of the arguments that audit firms traditionally made when independence issues were raised in conjunction with provision of both audit and consulting services is that the staffs were completely separate. If so, it is not easy to see from where the synergy of knowledge comes. If it is important for auditors to learn how complex financial systems operate, "they should get that experience while serving non-audit clients." John H. Biggs, *Auditors and Consultants Shouldn't Be Too Close*, WALL ST. J., July 13, 2000, at A26.

[352] Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 43, 148 (July 12, 2000). The proposal drew some support from within the Big Five firms. *See* Scott Hartz, *Audit and Advice Should Split*, WALL ST. J., Aug. 15, 2000, at A26 (Hartz is global managing partner for management consulting services at PricewaterhouseCoopers); Louis Lavelle, *Cozying Up to the Ref*, BUS. WK., July 31, 2000, at 85 (noting that Ernst & Young generally supported the proposals). For the most part, however, the Big Five was quite hostile to the proposals. *See* Nanette Byrnes & Mike McNamee, *The SEC v. CPAs: Suddenly, It's Hardball*, BUS. WK., May 22, 2000, at 49 (quoting AICPA chair Robert Elliott as saying "we cannot permit the SEC to bomb the profession back into the Stone Age").

[353] *See, e.g.*, Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in the Hindsight Bias*, 73 OR. L. REV. 587, 621–30 (1994) (analyzing the impact of the hindsight bias on the contrasting rules for judicial review of decisions of doctors and directors); John C. Coffee Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1132–56 (1977) (applying behavioral psychology and organizational behavior research to the corporate setting); Ward Edwards & Detlof von Winterfeldt, *Cognitive Illusions and Their Implications for the Law*, 59 S. CAL. L. REV. 225, 227–76 (1986) (exploring a broad range of literature on human decision-making and applying its lessons to various legal matters); Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 213–59 (1995) (noting how psychological constraints on cognition explain many aspects of contract law); Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI-KENT L. REV. 23, 35–54 (1989) (offering a broad look at the fields of psychology and sociology regarding how insights about human behavior

inescapable in human behavior.[354] Both the general literature and the audit-specific literature bear this out. Auditors, like others, tend to act according to its dictates. They are more likely to falsify the numbers or simply "look the other way" when it suits their purposes (e.g., allowing them to keep a lucrative client). They are more likely to resist client requests to fudge the numbers when that course of action serves their best interests (e.g., preventing unacceptable litigation risk). Whether decisions to audit recklessly are conscious or (more often) subconscious, they are products of the self-serving bias.

Evidence regarding the self-serving bias's impact on auditors should preclude SEC sanguinity on the MDP issue. Should MDP come to be, it is unlikely that it would directly generate any huge audit failures. Auditors generally follow the rules. MDP would provide just one additional source of revenue that likely would never match the huge stream of computer consulting revenue that already exists. But although implementation of MDP would not likely cause a sea change in audit reliability, another step in an unsettling direction would occur.[355] There are already grounds for concern (e.g., widespread earnings management, shocking audit failures, etc.). Numerous studies have demonstrated that an important variable in inducing improper auditor performance is a greater stream of revenue from the particular audit client. Thus, there is reason to believe that an increased stream of revenue from MDP would exacerbate existing objectivity and independence problems.[356]

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can improve economic analysis of law); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics,* 88 CAL. L. REV. 1051, 1060–74 (2000) (noting significant flaws in law and economics theory's core behavioral assumption that people act rationally and suggesting a more nuanced approach); Cass R. Sunstein et al., *Assessing Punitive Damages (With Notes on Cognition and Valuation in Law),* 107 YALE L.J. 2071, 2094–2142 (1998) (attempting to explain punitive damages with behavioral insights); *see generally* Cass R. Sunstein, *Behavioral Law and Economics: A Progress Report,* 1 AM. L. & ECON. REV. 115 (2000) (surveying broadly the implications of behavioral research for the legal system).

354 Even trained scientists are subject to the self-serving bias. It often affects physicists' interpretations of their experimental results and for that reason physicists are starting to use double-blind testing to minimize the effects of the bias. *See* James Glanz, *New Tactics in Physics: Hiding the Answer,* N.Y. TIMES, Aug. 4, 2000, at D1 ("The problem is, physicists' natural eagerness to find new effects may lead them, in all innocence, to parse the data or make the comparisons in slightly biased fashion if they can see the answer as they work.").

355 Although lawyers are not this article's focus, opponents of MDP have noted that the self-serving bias means that MDP may have a "multiplier effect" on conflicts-of-interest and impose severe pressure on attorneys. Naturally, it will be harder for an attorney, who should advise a client against an action that the client desperately wishes to take, to do so when the client is not just a legal client, but an audit and/or consulting client as well. *See generally Submission of Patrick F. McCartan to the American Bar Association's Commission on Multidisciplinary Practice* (Apr. 1, 1999), *at* http://www.abanet.org/cpr/mccartan.html (on file with The Ohio State Law Journal).

356 *See supra* note 356. As Bazerman and his colleagues have noted:

As the impact of ethical constraints upon the self-serving bias is uncertain and uneven, other forces are needed to align auditors' self-interest with the investing public's best interests. Firm reputational capital and industry (AICPA) standards are very significant in this regard, but without constant SEC pressure are unlikely to be adequate. Structural separation of auditing from non-attest tasks and continued litigation risk are the two most promising avenues for SEC action. The SEC should not underestimate the influence of the self-serving bias and the adverse effect upon independence and objectivity in the audit realm that the advent of MDP could cause.

> [T]he 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 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.

Bazerman et al., *supra* note 281, at 93.