“How to Audit (and Do All the Other Stuff) with Integrity”

June 10, 2020
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I am grateful to have the opportunity to speak to you.
My interest is in **behavioral ethics**, the study of how and why people make the ethical (and unethical) decisions that they do.

- Behavioral psychology
- Brain science
- Evolutionary biology
- Primatology
- Etc.

Accountants generally know the rules. They don’t go to jail because they can’t figure out that insider trading is wrong, that lying is wrong, that manipulation is wrong.

And yet, auditors and other accountants sometimes screw up.
“U.S. Accuses Accountants of Trying to Game Reviews of KPMG Audits”

Do we think KPMG didn’t know this was wrong?

“Ex-KPMG Partner London Gets 14 Months for Insider Trading”

Do we think Scott London didn’t know insider trading was wrong?
“Arthur Andersen Indicted in Enron Case”

Do we think Arthur Andersen didn’t know that financial fraud and evidence destruction were wrong?

“Managing Partner of Accounting Firm Pleads Guilty to False US Department of Labor Filings”

(Aug. 2, 2018)

Do we think CPA/CFE Sal Armao didn’t know that filing false documents to cover up a $100,000 embezzlement scheme was wrong?
“Another Accountant Exposed in Panama Papers Pleads Guilty to Criminal Activity”
(March 10, 2020)

Do we think CPA Richard Gaffey didn’t think tax evasion and money laundering were wrong?

“Prison Sentence for $2M Westchester Fraud Marks Former Stamford CPA’s Fall from Grace”
(Feb. 15, 2020)

Do we think CPA Steven Henning didn’t think defrauding investors was wrong?
“Local Accountant Charged with $100K Theft”
(June 11, 2019)

Do we think CPA Rhonda McClendon didn’t know it was wrong to steal from a client?

Other Recent Headlines

- “Accountant bought and sold $4m in iPads and iPhones on Company Credit Card” (4/8/19)
- “Missoula couple, accountant face federal tax fraud charges” (4/6/19)
- “Former CFO at Public Traded Transport Co. Charged with $245 Million Securities Fraud Scheme” (4/3/19)
- “’A pattern of theft’: How a Pa. Tax Preparer Scammed 18 Clients” (4/2/19)
- “Accountant Embezzled Over $1 million from Port Huron Charity” (4/1/19)
Headlines Involving Gov’t Auditors

- “MC Auditor Candidate Was Put on Probation After Stalking Charge” (2/28/20)
- “Charges Against Marion Auditor-Elect Stems from a ‘Clear Violation’” (11/7/19)
- “Ex-Monroe County Auditor Gets 8 Year Prison Sentence for Child Porn Possession” (7/17/19)
- “State Auditor Defends Controversial Facebook Post Targeting Female Senator’s Attire” (1/29/19)

Headlines Involving Gov’t Auditors

- “Former Cuyahoga County Auditor Frank Russo Gets Eight Years Shaved Off Prison Sentence” (2/21/19)
- “Former Washington State Auditor Sentenced to a Year in Prison” (6/30/18)
- “State Auditor Says He Regrets Actions, Issues Apology” (9/14/18)
Humility
Most ethics training assumes:

Want to do the right thing
+ Know what the right thing is
= Do the right thing

Behavioral Ethics assumes:

Intention
+ Knowledge ≠ Action
Behavioral Ethics assumes:

Intention + Knowledge

Action

The Grand Canyon

Illusions: Auditory
The McGurk Effect
Optical Illusions
Shepherd's Table Illusion

Shepherd’s Table Illusion
There are even tactile illusions...

So, the fact is that your brain can fool:
- Your auditory sense
- Your optical sense
- Your tactile sense, and even:
- Your *moral sense*
If there is one overwhelming finding in behavioral ethics research over the past decade, it is this:

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- Yet, most people frequently act unethically, usually in minor ways
- Our accomplice:
BEHAVIORAL ETHICS categorizes roadblocks to ethical action:

Social & Organizational Pressures
Cognitive Biases and Heuristics
Situational Factors

Social and Organizational Pressures
Social and Organizational Pressures

- Obedience to Authority
- Obedience to Authority
  --Milgram study

- Obedience to Authority
  --Watergate’s Egil “Bud” Krogh
- Obedience to Authority
  --CEOs & CFOs

- Auditor who are pressured.
- Auditors who know what the boss wants
David Myers, Controller of WorldCom, explained in an interview that he first signed off on numbers he should have known were wrong, because his boss, CFO Scott Sullivan convinced him that he was wrong even though his people had run the numbers three times. He said that when this became overwhelmingly clear two quarters later, he “fell off a mountain and didn’t even now he was on a mountain.”

Social and Organizational Pressures

- Conformity Bias
Conformity Bias

--Asch Study

Solomon Asch
- Conformity Bias
  --Cheating Study

- Conformity Bias
  --Petrified Forest Sign: “Your heritage is being stolen. Fourteen tons of rock a year are disappearing, mostly by visitors pilfering of small amounts.”

Effect:
--Petrified Forest Sign: “Your heritage is being stolen. Fourteen tons of rock a year are disappearing, mostly by visitors pilfering of small amounts.”

Effect: Pilfering tripled

- Conformity Bias: Accountants
  --Accountant Betty Vinson of WorldCom
Conformity Bias: Accountants

“The desire to fit in with those around us helps explain how lower-level employees, such as lawyers and accountants, become fatally implicated in corporate wrongdoing. In large organizations, decisions get parceled out among many people, and every piece of work is the product of many hands.” –Dr. David Luban

KPMG: “You’re either on the team, or you’re off the team.”
A CPA jailed for fraud said:
“The justification in my mind was that it was more or less aggressive accounting, creative accounting, and had been going on before my time and those involved were praised and rewarded. They were considered true, pushing the envelope, you were expected to do so, um, it was the culture. You expect...you were expected to do it.”

Studies show that auditors who have previously worked on a team with auditors who are sanctioned for bad behavior are more likely to issue lenient opinions and have their numbers restated. Bad behavior is contagious!
Cognitive Heuristics and Biases

- Overconfidence Bias
- The Overconfidence Bias

- Overconfidence Bias
  -- Divorce
Overconfidence Bias
--Driving/Auditing/Teaching

“The human mind is an overconfidence machine.”

David Brooks

Overconfidence Bias
--Morals, too.

1. 80% say they are more ethical than their peers, competitors, co-workers, etc.

2. 92% are satisfied with their moral character

3. More people think that they will get to heaven than that Mother Teresa did.
Overconfidence Bias
--Milgram Study

Fig. 4. Diagram of control panel.

Overconfidence Bias: Accountants

“Studies show that overconfidence in one’s ability to perform an accurate audit can lead an auditor to take short-cuts that might look unethical in retrospect.”
Overconfidence: Accountants

“‘Ultimately, I capitulated,’ sighed [Mark] Watson. ‘I did so because I really did not want to believe that my partners at a Big Four accounting firm would get into something that would be illegal.’”

Cognitive Heuristics and Biases

- Framing
Framing.

- Framing

Space Shuttle Challenger
Framing

--Space shuttle Challenger: “Take off your engineers’ hats and ... put on your management hats.”
Framing.
---Enron: How did Enron frame its goals?

Framing: Accountants
---Arthur Andersen: How did this accounting firm frame its job?
1920s – 1980s

“Think Straight, Talk Straight”

“There’s not enough money in the City of Chicago to get me to sign off on accounts containing flawed accounting.”

Framing: 1990s

“Let us be your business partners.”
KPMG employee on tax shelter scandal: Our culture was “focused on revenue growth.”

E-mails between KPMG partners urged the marketing of bogus tax shelters with full knowledge of their dubious validity and “without making any reference to ethics, professional standards or reputational risk.”

Cognitive Heuristics and Biases

- Role Morality
Role Morality:

“Executives’ identification with their organizational role, the desire to be successful or help the company succeed, and even pride served to induce the executives to engage in accounting fraud in order to meet corporate financial targets.”
Role Morality:

In an article entitled “Role Morality in the Accounting Profession,” Prof. Radtke wrote that professionals like accountants “may believe that they have an obligation to act on behalf of their clients in ways that would be wrong if done on their own behalves.”

Cognitive Heuristics and Biases

- Incrementalism.
III. Incrementalism

Incrementalism.

--Gino & Bazerman: “boiling frog syndrome”: “much unethical behavior occurs when people unconsciously lower the bar over time through small changes in ethicality”
Incrementalism

--Hitler’s doctors

“In the beginning it was impossible. Afterward it became almost routine. That’s the only way to put it.”
- Incrementalism
  --Abu Ghraib:
“But after four or five nights of running the M.I. block of the Abu Ghraib hard site, Davis said, “I just wanted to go home.” He felt that what he did and saw there was wrong. “But it was reaffirmed and reassured through the leadership: We’re at war. This is Military Intelligence. This is what they do. And it’s just a job,” he said. “So, over time, you become numb to it, and it’s nothing. It just became the norm. You see it—that sucks. It sucks to be him. And that’s it. You move on.”
“In the beginning,” [Sabrina Harman] said, “you see somebody naked and you see underwear on their head an you’re like, ‘Oh, that’s pretty bad—I can’t believe I just saw that.’ and then you go to bed and you come back the next day and you see something worse. Well, it seems like the day before wasn’t so bad.”

- Incrementalism: Accountants  
  --Enron CAO Rick Causey, a UT graduate, needed to do a deal to disguise a delay in recording losses. An executive balked.
Causey: “Is it possible the deal is still alive?”
Exec: “No.”
Causey: “So there’s no chance of it coming back?”
Exec: “No”
Causey: “Is there even a little bit of a chance of it coming back?”
Finally, the exec took the hint and the deal was declared “undead”.

The exec later said:

“You did it once, it smelled bad. You did it again, it didn’t smell bad.”
Incrementalism

--Simon Platt, founder of Stoneturn Group, a forensic accounting firm, has told of a case where an auditor argued against a restatement because earnings were off by **only 25%**, and in another case one of his clients had been off by even more than that and he didn’t require a restatement. That’s incrementalism!

Simon Platt

Incrementalism

--A CPA who went to jail for fraud said:

“I call it increment...incrementalization, whether that’s even a word. You...you get to here so it must be okay to go to here. And if you’re here, it surely is okay to go here. It’s really fuzzy where you cross the line [...] At what point do you cross the line where the act becomes illegal? I don’t know. I don’t know.”
Incrementalism

“Perhaps the fatal false step was Enron’s use of an SPE in the early 1990s to move the liability of its Houston headquarters off-balance sheet. This arrangement had some color of justification then, but a conservative application of the principles of SPEs would have decided against it. ... When Enron [later] desperately needed to hide its mounting debt, Andersen could not argue consistently against the device... At every later step, it became more difficult and more costly to reverse course.”

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- Incrementalism

--A recent study found: Financial professionals judge ethical issues like insider trading: *as less intense than do others.*
Incrementalism

- There is a biological basis for the slippery slope
- *the amygdala’s sensitivity to lying lessens with repetition*
The Self-Serving Bias

A. Affects how we collect, process, and even remember information.
1. Collect

“The speeches I drafted ... were composed of facts filtered from the stacks of reports and intelligence that daily hit my desk. As I read these reports, facts and judgments that contradicted the British version of events would almost literally fade into nothingness. Facts that reinforced our narrative would stand out to me almost as if highlighted, to be later deployed by me, my ambassador and my ministers like hand grenades in the diplomatic trench warfare.”
2. Process
   a. Capital punishment

b. Team credit
2. Process
   a. Capital punishment
   b. Team credit
   c. Westen’s study: *the brain lights up*

Drew Westen
Emory Univ.

3. Remember
B. People respond to incentives, even if unconsciously.

1. The more at stake; the more people respond.

2. Earnings Management
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1. The more at stake; the more people respond.

2. Earnings Management

3. Doctors and CAT scans

C. We are often unaware of how we are impacted [by the self-serving bias].
1. In 2000, a top AICPA official testified before the SEC, saying:

“We are professionals that practice by the highest moral standards. We would never be influenced by our own personal financial well being.”

D. Studies have found that the self-serving bias affects the judgments of:

- Physicians
- Attorneys
- Auditors *
- Investment Bankers
- Securities Analysts
- Scientists
- Expert Witnesses
- Judges
- Stockbrokers
Loss Aversion
Loss Aversion

B. Dave Bliss
C. Nick Leeson.

--“I was ashamed of myself and what I’d become. It started off so small, but had rapidly seized hold of me and now was all across me like a cancer. If I was to keep this job, I had to hide the losses. I’d then do my best to get out of them, but I couldn’t admit them to anyone. To make any inroads into my losses—which now towered over 200 million pounds—I had to double up. I was drowning like an insect stuck in resin, clawing hopelessly but unable to pull myself out.”
D. Roomy Khan

“As I reflect back I am horrified by the choices I made... Over time, the shame of losing my house and status in this society became more important than the unlawfulness of insider trading.”
ROOMY KHAN

E. Martha Stewart, Frank Quattrone, Arthur Andersen...
F. U.S. v. Simon (2d Cir. 1969)

The Tangible and the Abstract
The Tangible and the Abstract

Goldman Sachs whistleblower:

Noreen Harrington
Noreen Harrington explained why she blew the whistle on late trading and market timing, saying that “prior to blowing the whistle on these practices, she viewed them as part of ‘a nameless, faceless business...in this business this is how you look at it. You don’t look at it with a face.’ That view changed, she said, when her older sister asked her for advice on her 401(k) Account. Her sister, whom Harrington characterized as one of the hardest workers she knew, was worried that the losses she saw in her retirement account would prevent her from retiring. Suddenly, Harrington ‘thought about this from a different vantage point,’ she explains. ‘I saw one face—my sister’s face—and then I saw the faces of everyone whose only asset was a 401(k). At that point I felt the need to try and make the regulators look into [these] abuses.”

The Tangible and the Abstract

**Auditors** easily identify with their clients, studies show, and may unduly discount potential injury to temporally distant victims.
Moral Equilibrium
Moral Equilibrium

A. Moral Compensation.

B. Moral License

Moral Compensation + Moral License = Moral Equilibrium

Studies.

1. Sachedeva study on ethical priming and charitable giving
2. Dutton & Lake study on moral compensation and panhandling

3. Organic Food Study
We don’t realize how our past decisions affect current decision making...

Situational Factors
Situational Factors

- Time Pressure

--Seminary Study
Seminary students on the way to give a talk about the parable of the Good Samaritan came upon a person lying by the sidewalk in apparent distress.

If not in a hurry:
Seminary students on the way to give a talk about the parable of the Good Samaritan came upon a person lying by the sidewalk in apparent distress.

If not in a hurry: 63% stopped to help

If running a little late:
Seminary students on the way to give a talk about the parable of the Good Samaritan came upon a person lying by the sidewalk in apparent distress.

If not in a hurry: 63% stopped to help

If running a little late: only 45% stopped

If urged to hurry:
Seminary students on the way to give a talk about the parable of the Good Samaritan came upon a person lying by the sidewalk in apparent distress.

If not in a hurry: **63%** stopped to help

If running a little late: only **45%** stopped

If urged to hurry: only **10%** stopped

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Time Pressure & Auditors:

Some studies show that in the presence of time pressure, **auditors**, especially creative ones, “engage in less professional skepticism as a result of a more creative moral justification process.”
Situational Factors

- Self-Control Regulation

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My Super Power:

{SELF
CONTROL}
One study indicated that auditors experience a significant accumulation of self-control depletion during an extended stressful period.

Situational Factors

- Transparency
- Transparency

- Transparency
 Transparency

• Transparency
Situational Factors

- Money

--A factor that’s particularly relevant to auditors
Money

Theory: Morality is rooted in social relationships and emphasis on money often leads people to ignore those relationships.

Kouchaki, et al. (2013)

Subjects in one group were primed to think about money. Subjects in the other were not. Then all subjects were asked how likely it was that they would do something unethical like filch a ream of paper from work when they had run out at home.
Result:

- A significantly higher percentage of money-primed subjects:
  - Indicated that they would do the unethical acts
- Other money-primed subjects also:
  - Lied more often to other subjects in a deception game where they could profit by lying
  - Lied more often to the experimenters to gain money rewards
  - Were more likely to say that they would hire a candidate who promised that if hired he would bring a competitor’s confidential information to the job
Another study found that people primed to think about money:

- Were less helpful when others asked for assistance
- Were more reluctant to ask for assistance themselves
- Donated less to charity
- Maintained greater social distance when meeting someone new
- Chose more often to work alone rather than with a peer

Conclusion:

Priming subjects to think of money caused them to evaluate their decision in a business frame, which freed them to ignore the consequences of their decisions for others.
Remember the **Fundamental Attribution Error**
Remember the **Fundamental Attribution Error**

The situational vs. the dispositional

The social psychology of this century reveals a major lesson: often it is not so much the kind of person a man is as the kind of situation in which he finds himself that determines how he will act.

*(Stanley Milgram)*
Behavioral Ethics

A. Good character is essential to ethical behavior.

B. But, social and organizational pressures, psychological heuristics and biases, and situational factors can cause us to screw up unless we are really careful.
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