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The Ethical Importance of Conflicts of Interest: Accounting and Finance Examples

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I. Conflicts of Interest in Accounting and Finance

The general area of business and professional ethics is full of vexing and confusing problems. For example, questions concerning the importance of ethical standards, whether ethics is unnecessary given appropriate legal enforcement, whether it is imperative to teach ethical behavior in professional education, and similar questions are all controversial. The specific ethical problems to be found in the areas of accounting and finance are at least as difficult as those in other areas. However, there is one kind of ethical problem which is unusually prominent in finance and accounting, which deserves to be recognized more widely in ethics as a significant kind of issue. This is the problem of conflicts of interest.

Examples of such conflicts of interest include the following. Many conflicts are concerned with possible undue or unfair personal financial gain by experts while providing professional services. Notorious and highly publicised cases include various 'insider trading' scandals, while the need for government bail-outs of failed savings-and-loan institutions raises questions about the adequacy and objectivity of public audits of those institutions. But there are plenty of less sensational but just as theoretically interesting cases, some of which will be discussed here.

In the field of accounting, an important concept closely related to that of conflict of interest is that of independence. Generally speaking, independence is maximized by minimizing actual or possible conflicts of interest. An accountant or auditor is expected to maintain total independence from the client at all times, and any conflicts of interest would tend to undermine his or her professional independence. The AICPA (American Institute of Certified Public Accountants) in its Code of Ethics gives a central place to the concept of independence.[1] Other significant concepts related to that of conflict of interest include those of integrity and objectivity, which also feature prominently in the AICPA ethics code.[2]

For example, an auditor is allowed to be an advocate for a client in dealing with taxation matters, such as by resolving doubtful matters in favor of the client, and thus to that extent giving up her independence as an auditor. But an auditor may only do this if there is reasonable, objective support for such actions.

Also, the auditor is generally expected to maintain her integrity and objectivity in such situations, such as by not automatically agreeing with the client on every issue or demand. Any failures of integrity and objectivity would almost inevitably involve conflicts of interest, such as between an auditor's desire to keep a client and the professional responsibility to be fair and objective.

II. Conflicts of Interest in Ethics Generally

I have already illustrated the centrality of issues of conflict of interest in accounting and finance. However, in neither ethical theory nor applied ethics has the concept received much attention. Let me offer a likely explanation, or series of related explanations, for this, and also show why they are short-sighted.

Common cases of potential conflict of interest involve matters where a professional is exposed to moral temptation, where she might gain more by following her personal rather than her professional interests, for example. However, in terms of standard moral theories and concepts, such cases could easily be assumed to deserve no special attention because it is always one's moral duty not to give in to immoral temptations. Any professional in any work situation at all will have both personal and professional interests, which could be viewed as always being at least in potential conflict with each other. Hence the topic of conflicts of interest could easily be dismissed as being too over-general or vacuous.

Secondly, the serious and difficult accounting and financial issues involving conflicts of interest already mentioned could also be viewed as essentially no different from the vacuous cases because no matter how serious the conflict, morally upright and determined persons arguably could and should make sure that it would not affect their professional judgement and conduct. Behaving properly under difficult circumstances is something we all have to learn to do, so again conflicts of interest seem to present no special moral problems, whether in theory or in practice.

A third likely response from standard ethical theory to conflicts of interest would be as follows. To the extent that such issues are serious and legitimate matters of social concern, they are so not because they present moral problems as such, but because they raise problems about how best to enforce morality. The problems, it might be said, are those of how to ensure compliance with standard morality, including criminal sanctions if necessary. In this view, the problems call for legal or other regulative action rather than changes in moral theory or education. People already know what is morally right or wrong, it is assumed, so solutions must be found in punishing offenders more, or in legislation which attempts to prevent professionals from ever getting into situations in which they might be tempted to decide in favor of merely personal interests.

III. Reply to the Conventional Views

My reply to these three conventional views about the morality of conflicts of interest is as follows. The last item reviewed, concerning legal enforcement of morality, is certainly an important issue in its own right. There would be general agreement that many aspects of business and professional conduct need the backing of the law. However, it is also commonly recognized that there are significant aspects of morality which it is impractical or undesirable to enforce by legislation. This is one basic reason why many professions have codes of ethics at all, which censure various forms of conduct as unethical whether or not they are also illegal. And, as we have already seen, in the areas of accounting and finance, issues concerning conflicts of interest, independence etc. are very prominent in the relevant professional codes of ethics. Since only a few of the provisions of these ethical codes are legally enforcible, it is unrealistic to expect the law to handle all aspects of conflict of interest problems.

I proceed now to the second part of my reply to the three conventional views about the morality of conflicts of interest described earlier. It will be recalled that the remaining two conventional views, not already dealt with, are as follows. First, conflicts of interest might be thought ethically uninteresting because they are just a variety of ethical temptation, which is omnipresent in professional life and indeed life generally. And second, even serious conflicts of interest might seem to be just more of the same, i.e., strong temptations which also should be resisted.

In each case the standard prescription would be that one's moral duty is clear in such situations, and that one should carry it out in total disregard of any conflicting interests. A professional should always properly carry out services requested by a client, for example, no matter what conflicting opportunities for personal or corporate gain present themselves, and no matter how tempting they are.

However, though I would accept that these conventional views are broadly correct as an initial view or first approximation, they do not give the whole picture. They miss out on a deeper structural aspect of conflicts of interest, which affords us a significant opportunity to better understand particular cases, as well as to deepen our understanding of ethics in general. These deeper aspects relate to the ways in which ethics itself is fundamentally about the regulation of interests and conflicts between them.

Try to imagine a society in which the interests of its members were never in conflict with each other, in which everyone was free to do anything they liked without this in any way adversely affecting the interests of others. Such a society would have no need for ethics or codes of ethics, nor probably for legal institutions either. Of course the world we actually live in is not like this, but the thought-experiment does show that issues about conflicting interests must be important in some way to ethics.

One familiar ethical concept, that of justice or fairness, is about impartially deciding between conflicting claims or interests of various parties in a dispute, and so is clearly, in a broad sense, about how best to handle conflicting interests. Thus laws against professional fraud, deception, contractual non-performance etc., also can be viewed as about how to deal with conflicting interests in this broader sense, as can codes of ethics which also deal with these topics.

My main reason for introducing these wider concerns about conflicting interests is as follows. In the case of issues of justice or fairness, for example, there is no initial presumption that one side of a dispute is right and the other wrong, or that one is morally correct whereas the other is merely self-interested. Such decisions would be arrived at, if at all, only after close examination of the opposed interests and the specific ways in which they conflict. In general, an attempt would be made to arrive at an optimum balance or adjustment of the interests in question. My suggestion is that the narrower, more standard issues of conflicts of interest with which we are concerned should be approached along similar lines.

In more theoretical terms, my suggestion is that conflicts of interest should not be regarded as peripheral or minor cases, capable of straightforward handling by standard morality or moral theories, but that instead it should be acknowledged that they often raise significant issues and require methods of resolution not provided at all by standard ethical concepts and theories. Here are some specific examples of such cases.

IV. Examples of Conflicts of Interests

Consider an example such as that of a public accounting firm which offers external auditing services to its clients, but which also provides management advisory services, which go so far as to include making available to clients computer hardware and software to implement a financial control and decision system. On the face of it, this sets up a significant conflict of interest, in that the firm is both claiming to provide an impartial analysis of the financial structure and soundness of a client, while at the same time it is providing the means to implement each and every significant aspect of that structure.

In conventional terms, the firm could be regarded as having a conflict of interest because it has a material financial interest in a client it is auditing, which would conflict with the public interest in an impartial audit. The success of the auditing firm's computerized financial system depends upon its adequacy in handling business financial matters, but it is those very matters the adequacy of which the firm would be certifying in its audit of the client. Conventional morality would see this as a simple case of public duty versus private interest, and judge accordingly.

However, a closer examination of the interests involved could lead one to a different conclusion. Surely some private interests are more legitimate or acceptable than others. If an auditing firm owned stock in a business they were auditing, that would clearly be an illegimate private interest, because it could easily prejudice the impartiality of the audit.

Yet in the case in question, the private interest in the computer system is arguably a legitimate one, because it is (presumably) deliberately designed to implement the best judgement of the firm as to how financial transactions should be structured and validated. If this is so, it would not have the same questionable tendency to prejudice the impartiality of the audit, and hence it need not be judged to result in a significant conflict of interest. In such a case public and private interests could work well together with little or no conflict.

Of course, the public still has to take it on trust that the firm is carrying out its audit with integrity and objectivity, but that assumption has to be made in any case.

Let us return to the example of an illegimate private interest, that of an auditing firm which owned stock in a business they were auditing. As noted, such ownership could prejudice the impartiality of an audit, for reasons such as that the firm might be tempted to suppress any evidence of financial instability in the company being audited so as to protect its own financial investment in the company. Here the private interest is in direct conflict with a public interest in an objective audit.

Note that the situation would be unethical because of the conflict itself, not simply because the accounting firm had both public and private interests in the company being audited.

This point can be reinforced by consideration of a related financial example. Consider the situation of a financial-services house which offers stockbroking services to clients for a fee. These services include giving advice to clients on which stocks to buy or sell. Now initially one might think this example to be a more inclusive form of the auditing example, in that a broker recommending that clients buy a stock is in effect vouching not only for the financial integrity of a company, but also for its health and future growth prospects. Therefore one might expect that it would be unethical for such a broker to personally own stock in the company in question.

However, in reality the situation is more complicated. Under some conditions there could be grounds for concern, such as if a broker purchases stock prior to recommending it, and then profits from the increases in price following upon her recommendations being acted on by clients. But in other cases clients could have legitimate grounds for suspicion or complaint if brokers or advisers did not own stock in at least some of the companies being recommended by them.

These cases are those where, in the familiar phrase, an adviser should "put their money where their mouth is," or be willing to personally invest in and risk their own funds in what they are recommending. In such cases, the personal interest would reinforce the public evidence of sincerity and integrity on the part of the adviser in her recommendations.

A couple of examples of where such self-interested commitment is generally thought to be desirable by the financial community are as follows. First, the ownership of stock by prominent company officials (and other insiders) in their own company is closely tracked by financial publications, and greater personal investments are taken as a good sign that the company in question is healthy, i.e., that the officers are also fulfilling their public duty as agents for owners of the company (the stockholders).

An example closer to that of an investment adviser is provided by the roles of officers of a mutual fund. A mutual fund purchases shares in a wide variety of companies, and in effect the manager and other officers are recommending that the public purchase shares in their fund as a good way to invest in stocks generally. In this case too, evidence that top management is willing to make substantial personal investments in their own fund is taken as a positive sign that they are also fulfilling their public duties to their shareholders.

Returning to cases specifically concerning the profession of accountancy, another simpler example is as follows. Rule 302 of the

AICPA code of ethics prohibits providing professional services for a fee which is contingent on some outcome of an audit, such as the success of a subsequent stock offering. Clearly there would be a temptation to paint a rosy picture of a company's prospects in order to secure such a contingency fee, and it would be generally agreed that such an arrangement would be unethical. However, probably virtually no one would see anything ethically problematic about charging a non-contingent fee for an audit.

Nevertheless, in this case too there are both public and private interests involved; the difference of course is that in this case we have no reason to think that the different interests are in any significant conflict with each other. Thus here too, as before, we have to look closely at the seriousness or triviality of the ways in which interests actually conflict, in order to make adequate ethical judgements about conflicts of interest in accounting, or in the professions and ethics generally.

V. Broader Perspectives

In this concluding section I shall try to advance in a broader context the range of issues being considered, concerning the importance of conflicts of interests to professions such as accounting, how such conflicts should be resolved, and why the conflicts are often ignored or trivialized.

To start, it is worthwhile to ask at this stage why it is that (as noted initially) problems regarding conflicts of interest are unusually prominent and pervasive in accounting and finance contexts. I shall provide, through the examination of some test cases, several inter-connected reasons as to why this is so. It will be useful to introduce these reasons through a demonstration of yet another weakness in conventional ethical assumptions (as illustrated earlier) regarding conflicts of interest.

The weakness in question concerns the narrow, individualist focus of the conventional assumptions. It is assumed that problems of conflicts of interest arise as problems for individuals about how their own interests (personal, professional, etc.) conflict with each other. Quite apart from the simplistic labeling of interests as either morally good or bad, independent of the specific details of particular conflicts (as previously criticized), this individualist picture ignores two significant kinds of possibility.

The first possibility is that some of these interests (in particular, professional interests such as those of the accounting profession) may themselves have significant internal structures involving potential or actual conflicts of interest. An important accounting example will be given below.

The second related possibility is that such internal structures may at least partly be explicable only in non-individualist terms involving fundamentally social concepts. For instance, it seems likely that in some cases the interests of many people considered as a group may require to be taken into account in understanding how conflicts of interest affecting the accounting profession (among others) should be resolved. Thus in this way also the inadequacy of a conventional individualist approach, with its strong tendency to trivialize conflicts of interest, can be demonstrated. The examples to be given will demonstrate this non-individualist feature also.

My first example draws upon a point forcefully made by Robert Baum,[3] namely that the current AICPA code of ethics grows out of a tradition in which the primary duty of a professional is taken to be to her client, who traditionally has also been the person paying any fees due to the professional. But the AICPA code also requires accountants to serve the public interest,[4] which includes the interests of non-paying non-clients (the general public).

As a result, since conflicts of interest between the interests of clients and of the general public can all too easily arise, the accounting profession seems to be saddled with inevitable and pervasive conflicts of interest as an inherent part of carrying out their duties as defined by the AICPA code. The situation is make even more problematic by the fact that the code also requires members of the profession to be free of conflicts of interest in discharging professional responsibilities.[5]

The situation to which Baum draws our attention in terms of a basic internal conflict in the AICPA ethics code also has been widely recognized in broader social contexts, particularly since the Savings and Loan scandals of recent years. There is a general concern that accountants are very unlikely to bite the hand that feeds them (their corporate clients) even when such hand (or bullet) biting is clearly required. Public accountants are supposed to provide as part of their duties accurate and informative audits which serve the public interest, whether or not these would reflect badly on a corporate client. But the concern is that few accounting firms would be willing to risk losing valuable clients by revealing any significant negative aspects of the financial status of those clients.

This one fundamental kind of conflict is arguably enough by itself to explain why conflicts of interest are so significant an ethical issue, and so pervasive, in public accounting contexts. However, my concern in this paper has also been initially to explore some ways in which ethical concerns about conflicts could be minimized or resolved in specific ways. Here are a few pertinent observations on this issue.

Fortunately, the AICPA code itself provides at least one method for minimizing the ethical impact of conflicts of interest. Though, as previously noted, the code prohibits the acceptance of work where a professional has such conflicts, it nevertheless provides that if the basis for a conflict of interest (such as a significant relationship to another party which might impair objectivity) is properly disclosed, and if consent to proceed is obtained from any affected parties, then the conflict need not prevent the relevant professional services from being rendered.[6]

It is easy to see how disclosure and consent could often be critical in making conflicts of interest morally acceptable. For example, given a conflict situation in which those whose interests are most at risk are in fact willing to proceed, in spite of full knowledge of the risks to which their interests are exposed, surely then they may be taken to have fully and voluntarily accepted those risks, and hence to have annulled or minimized any grounds for moral concern. Generally, potential injury to a person's interests is morally problematic only if it is unknown by her, outside her control, or not something to which she is willing to agree.

However, it is important to note that disclosure alone is not in general sufficient to morally defuse interest conflicts: consent to proceed is also critical. In the case of the AICPA code, this is sufficient to reinstate the morally problematic features of the fundamental conflict discussed above (between the interests of a client and of the public). For in general, even full disclosure of conflicts by accountants would not enable the general public to give any adequate or meaningful consent to proceed in such cases.

Some more radical solution would be required to the moral problems in those cases, such as appointing 'watchdog' government-paid accountants who would oversee every detail of potentially problematic audits, or (even more radically) reorganizing public accountancy so that the general public (through taxes, etc.) becomes the paying client to whom the accountant is primarily responsible.

However, in other cases such as that of the computerized management advisory services discussed earlier, disclosure and consent generally should be sufficient for at least conditional moral approval of the practice. As previously argued, such computerized systems (when properly implemented) do not by themselves add any additional audit risk to the public interest. Provided the client fully understands and agrees to the specifics of such a system, the public will be no worse off than if no such system had been used.[7]

I have just illustrated how the simplistic picture of private versus professional interests (and the resultant moral trivializing of conflicts of interest) breaks down in one important area. Clearly the 'professional interests' of a public accountant are significantly complicated by the presence of internal conflicts of interest endemic to the profession and its responsibilities. Admittedly, techniques are available for mitigating or even eliminating the moral undesirability of the conflicts, in ways such as those I have suggested, but the moral problems raised by these conflicts remain characteristic and significant, problems which should not be trivialized or assimilated to some more familiar moral category.

The other related way I mentioned in which the simplistic individualist approach to conflicts of interest breaks down, it will be recalled, is that professional and social situations involving such conflicts may involve non-individualist, fundamentally social concepts, such as that of the interests of many people considered as a group. Here again the accounting profession provides some significant (and perhaps surprising) examples.

One such class of examples is as follows. As is well known, there are many internal, technical standards of good accounting practice, some established directly by professional organizations such as the AICPA, and others by regulatory boards such as the Finanancial Accounting Standards Board (FASB). It might be thought that such technical standards have little to do with broader issues of community moral standards and values.

However, questions about matters such as what information should be disclosed on financial balance-sheets, in what time-period should costs be listed as incurred, and other technical matters have some vital links to issues concerning the public interest, and concerning morally significant conflicts of interests between businesses and population groups. Not only are the connections morally relevant, but they are significant enough so that arguably the moral issues involving the interests of groups should guide the future evolution of accounting standards as well.

In the remainder of this paper I can do no more than initially defend this claim with the help of two kinds of example. The first concerns accounting and reporting standards for mutual funds. The Securities and Exchange Commission (SEC), which regulates mutual funds, proposed in 1989 (but has not yet required) that mutual funds in their prospectus should provide the annual percentage total return on investments in a fund.[8]

This piece of information would be very valuable to investors (or potential investors) since it would enable them to directly compare the profitability of different funds and therefore to make wise investment decisions. However, the interests of investors as a group conflict with the interests of most mutual funds, which (unless they have outstanding returns) would tend to lose investors to better-performing funds if this information were revealed in their prospectuses.

Once this conflict is recognized as the specifically moral issue of whose interests ought to prevail in the situation, it would not be difficult to make the case that the interests of the vast group of investors or potential investors (which, after all, could include the general public at large, given the increasing popularity of mutual funds) should take precedence over those of mutual funds. Then in turn this would dictate that reporting standards should require the inclusion of total-return information in prospectuses, and hence that accounting standards should also change to mandate investigation of the presence and accuracy of this information during auditing.

In the example just given, members of the accounting profession would not themselves be involved in potential conflicts of interest, but nevertheless their professional standards for auditing would directly depend on a morally acceptable resolution of conflicts between the interests of some financial institutions and of the public at large.

A more interesting and complex kind of case would be one involving some larger issue about accounting standards, which is of ongoing concern in debates among accountants, regulators, and the public. The example given below is chosen because it also involves conflicts of interest involving more than two groups or organizations.

The case concerns business costs which arguably are incurred in the present, but which are not actually paid out until some time in the future. A standard instance is that of pension benefits. The benefits are paid only after an employee has retired, but the current FASB regulation governing pensions[9] requires that the costs of these benefits should be treated for accounting purposes as incurred during the period when the employee is actually working. There are also similar FASB regulations covering other post-retirement benefits such as health insurance.

Such regulations initially may seem to have little or no ethical relevance. However, the general issues in this area have become a matter of public attention in recent years, when a number of large corporations such as GM have taken substantial one-time charges against a current year's earnings in order to fund a significant proportion of some post-retirement benefits for their employees. Cases such as this help to highlight the usually-hidden way in which accounting standards can play an essential role in mediating conflicts of interest between various social groups and organizations.

In the case in question, there are at least three, and possibly four or more, significant categories of interests which need to be considered. First, current and potential retirees have an interest in actually receiving in full the benefits which they were promised. For them, the present accounting standards (when properly enforced) are the best way to satisfy their interests, because they guarantee that funds to cover retirement costs will be deducted from earnings each year, and be available to retirees as needed. Without those accounting standards, retirees might suffer catastrophic losses of benefits if their employer should ever get into financial difficulties.

Second and third, a company and its shareholders have an interest in the company maximizing its current earnings in a given year, which means more profit for the company and more dividends or capital appreciation on shares for shareholders. For these organizations or groups, the accounting standards have a somewhat negative (but not highly negative) effect on their interests, since their interests would be maximized by keeping current costs to a minimum by excluding any pension costs until they actually need to be paid out to retirees.

One might also include a fourth category of interests, that of consumers and the general public, who have an interest in lower prices for products. Prices tend to fall if overhead costs can be reduced, such as by excluding pension benefits from current costs. So the interests of consumers on this issue line up with those of corporations and shareholders, and against those of retirees.

However, I think that the wisdom of the current accounting regulations is shown by the fact that, once we focus on the interests involved in the situation, clearly a very strong case can be made that the interests of retirees greatly outweigh those of the other three groups. Retirees stand to suffer catastrophic losses without the regulations; at worst, the other groups may suffer minor ongoing (or somewhat greater one-time) losses in profits or decrease in expenses because of the regulations.

Thus morally speaking, there is really no contest, particularly when one considers that any losses suffered by shareholders and consumers are likely to be more than offset by the gains they will realize when they themselves become retirees. Even companies, it could be argued, will have compensating gains to offset any current higher costs they incur under the regulations, becuase for example they will find it easier to attract a higher-quality, loyal workforce drawn by the increased security of their pension benefits.

In introducing this example, I mentioned that the accounting standards in question are a matter of ongoing debate among accountants and others. Another paper included in this issue, by Weidman, Welsh, and Bonino,[10] provides an excellent illustration of this. The authors convincingly argue that environmental clean-up costs should be handled in a manner similar to that of post-retirement benefits, that is, charged as current expenses of doing business rather than remaining unrecognized until actual clean-up efforts begin.

Here too, it seems to me, insofar as this is specifically an issue of accounting ethics rather than just part of a more limited technical discussion, the critical issues are those concerning the relative weights which should be attached to the various categories of competing interests. In this case it is the interests of the general public in an unpolluted or remediated environment which are analogous to the interests of retirees, and which are in conflict with the interests of consumers, companies and shareholders. But the very real risks of catastrophic or irreversible environmental degradation virtually force us (it seems to me) to morally rule in favor of early accounting recognition of clean-up costs.

This moral ruling could guide accounting standards in more technical ways as well. For example, potential clean-up costs are likely to be uncertain or unreliable in different ways than are estimates of costs of retirement benefits.[11] Hence they may be hard to recognize or substantiate by current cost-estimating methods tailored to retiree benefits and the like. However, here too the moral importance of supporting public interests in an unpolluted environment will require accountants to modify their cost-estimating methods, and other technical measures, as best they can to cope with the new category of environmental costs.

In conclusion, it would be hard to find a better example than this of how ethical demands–based on a resolution of conflicts of interests–could, and arguably should, motivate structural changes at a variety of levels in the standards and practices of a profession.[12]

Notes

1. AICPA code, Section 55, Article IV.
2. AICPA code, Sections 54, 55.
3. Robert Baum, "Defining Accountant's Responsibilities: Some Philosophical Observations on the Evolution of the AICPA Code

of Ethics," *Accounting Ethics Conference* (Rochester Institute of Technology, May 1993).

4. AICPA code, Section 53, Article II.

5. AICPA code, Section 55, Article IV.

6. AICPA code, Section 102-2 (Interpretation). In discussion following the Rochester presentation of (an earlier version of) this paper, Baum noted the often morally beneficial effect of disclosure of conflicts of interest.

7. Section 101-3 of the AICPA code provides various guidelines for provision of automated bookkeeping and related services.

8. See, e.g., Jane Bryant Quinn, *Making the Most of Your Money* (New York, 1991), pp. 517-519.

9. FASB Statement Number 87, "Employers' Accounting for Pensions," (December 1985).

10. Stephanie M. Weidman, Carol N. Welsh, and Lawrence N. Bonino, "Accounting for Environmental Remediation Costs," *Business and Professional Ethics Journal*, Vol. 13, Nos. 1 & 2, pp. 145-161. My thanks to the authors for a stimulating paper, which helped me to appreciate more fully the significance of these kinds of accounting standards for the issues of conflicts of interest with which I am concerned.

11. See ibid.

12. My thanks to Robert Baum, Wade Robison, and others who provided helpful comments on versions of this paper.