Lecture Text

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The Ethics of Professionalism

(*edited for clarity*)

Introduction

To motivate this discussion, let me talk about a bunch of situations and circumstances that various professions have encountered in recent times. None of these is a surprise, but let us go through these real quickly.

Enron: Who was Responsible?

When we talk about professional misconduct, the first event that comes to mind is Enron.

When you look at the Enron disaster, one of the questions people ask is, “Here’s one of the largest firms in the United States collapsing suddenly, billions of dollars of value lost. Who's culpable? Who's responsible?”

One of the first reactions people have is to hold accountable managers and the board of directors. Who comes to mind right away when we think of Enron? Ken Lay. Skilling. Fastow. But you don't stop there. Who else can you look at? Accountants, bankers, lawyers, consultants.

The role of professionals

We should not forget some of the professionals associated with Enron as well.

Accountants

It is now common wisdom that Andersen was culpable. But who else, besides the accountants, was culpable?

Bankers and analysts

Enron’s investment bankers were also commercial bankers, the bankers who were helping them develop the special-purpose entities and then telling others to invest in those entities.

Lawyers

Enron had in-house lawyers and an outside counsel, Vinson & Elkins, which is a very respected law firm.

Why do you think the lawyers were culpable here? They were looking at the documents narrowly. You're not doing anything wrong if you look at the documents narrowly. The lawyers, in fact, were saying, “Show me the document and I'll sign off on this.” Further, sometimes employees were taking positions on the other side of the firm as heads of these special-purpose entities. So if the firm loses, the employee wins. Those executives face a conflict there. Whose job is it to check that conflict? It's the lawyers' job. But the lawyers said, “You, yourself, have to declare that you face a conflict.” In other words, the lawyers defined their duty narrowly rather than broadly.

We also have the analysts. Anybody guess what the peak share value of Enron was? It was about ninety dollars. And in December what was the share value? Less than a dollar. It had gone bankrupt. And throughout this process, from June to December, what were the majority of analysts following Enron saying about the stock? “Buy,” throughout. If you look at the broad range of analyst recommendations, they were saying, “Buy.”

And why are the analysts saying, “Buy”? If they say, “Buy,” what happens? The stock goes up. Why are analysts happy with that? The analysts belong to the same firm to which investment bankers, who have nice relationships with Enron management, belong. And they could say, “If you have anything to underwrite, any imminent transactions, come to us.” The management could say, “Yes, we will, provided your analysts there say how good our firm is.”

<u>Consultants</u>
Do you know who the consultant for Enron was? Where did Skilling come from? McKinsey. One of the biggest clients for McKinsey was Enron. And when Enron collapsed, what does McKinsey say at that point? It said, “We didn't give any advice that led them to this wrong decision. We are not culpable.” Either you are giving strategic advice and then you can take the rewards for good deeds but also the punishment for giving bad advice, or you can say, “Our advice has no impact.” You can't have it both ways. Some of the consultants were management gurus, who said, “Enron is a great company that we should all follow.” My school had case studies on Enron. There were books written on Enron.

Why Was There No Advance Notice of Enron’s Collapse?
There are a number of professionals who are responsible for ferreting out information, for identifying wrongdoing before it occurs, and for letting the public, the shareholders, know. And none of them gave advance notice. The question is, why?

You can have three reasons for that. One is bad luck—the information was totally disguised; nobody was able to identify what was happening. I doubt it. The probability that every professional was taken for a ride is very, very low.

Another possible reason is that the professionals were not doing their jobs well. I doubt that, too. These are the best in their professions! Arthur Andersen was one of the smartest, best audit firms. McKinsey. Vinson & Elkins. Merrill. These firms were really the top of the lot.

A third possible reason is that the professionals were conflicted: Giving wrong advice would give them short-term benefits. In each one of these cases, a plausible story can be told of how the professionals sought short-term benefits by doing long-term wrong by their clients.

Government Solutions
So what were the solutions that the government came up with?

The Demise of Andersen
The first was to make an example out of Andersen, to kill Andersen off.

Here's a quick quiz for you. Who won and who lost with Andersen's demise? The other accounting firms won, because now the Big Five become the Final Four! And if concentration increases, market power of the incumbents increases, margins increase. Soon after Andersen's demise, accounting firms started saying to their clients, “This is a tough business. We have to do a lot of things. There's a lot of regulatory pressure. We need to increase our rates.”

What's the short-term impact of Andersen's demise on these four firms? They got the clients and they got the professionals at fire-sale prices, as people rushed out of Andersen and joined these firms.

Who was hurt by Andersen's demise? Some of the companies that they were auditing. Suddenly those companies had to scramble to find new auditors. Some auditors went to one firm, some to another; some went to smaller firms. Who else was hurt? Senior partners, whose retirement savings were in Andersen, were hurt. Junior partners, and partners in some country operations that were far from the United States, were able to bid themselves and move away as a team from Andersen and didn't really get hurt. They didn't gain very much but they didn't get hurt.

Anybody else? Had Andersen stayed alive and had there been claims against Andersen, who would have received those claims? Shareholders and creditors of Enron. At the time that Andersen died, its value—it's a private firm, so you make estimates—based on its revenue of about $8 to $10 billion, was approximately $15 billion. When Andersen collapsed, its value fell to $2 to $3 billion. What happened to the remaining $12 to $13 billion? Where did it go? Some of it was destroyed. Some went to competitors. And the claimants on Andersen received very little. Therefore, some of the people who got hurt by Andersen's collapse were the shareholders and creditors of Enron.

It's interesting—this solution. Who did it benefit? Who did it hurt? Especially if you think, "Is it only in Andersen that you have these conflicts? Are the others purer than Andersen?" If they are, then this is a good solution. This was a bad apple among absolutely wonderful firms. On the other hand, if this was an unlucky firm in an entire profession that was riven by conflict, it's not clear that the solution was right.

Sarbanes-Oxley
The other solution that was offered was Sarbanes-Oxley. The act passed through Congress really quickly.

So what is the big thing in Sarbanes-Oxley? It asks the chairman, the CEO, the CFO, to personally sign off on the veracity of documents. So what do they do? They ask all of their division heads to sign off that the results are right. There's more personal signing off. The other aspect is that accountants can't be IT consultants. That may be positive.

The third big thing Sarbanes-Oxley did was it replaced the inside industry oversight by an outside oversight body called the Public Company Accounting Oversight Board (PCAOB). Now there's an outside body that is going to oversee accountants to determine whether audits are right or not. It's an open question as to whether that'll improve or worsen the quality of audits.

The Dot-Com Bubble and the Stock Market Crash
Let's look quickly at the Wall Street settlement following the dot-com bubble. The stock market went through a cycle: rise and collapse. People say that tens of billions of dollars of market value were lost when stock prices crashed in 2001.

Who is culpable for the lost value?
Once this happened, people started saying, "Who's culpable?"

Is it the buy side? Maybe it's the investors who are culpable. They were taken in by the desire to make money really quickly and started investing without looking carefully at the risks of investing without doing due diligence.

The other side of the story says that it's the sell side that is culpable. Analysts can recommend “buy,” “hold,” or “sell” on stocks. What percentage of analysts' recommendations in 2000, do you think, were “buy” recommendations, overall?

__: Eighty-five percent.

PROFESSOR ASHISH NANDA: It's higher than that. Analysts were saying, “Buy.” If all the analysts are saying, “Buy,” who gets hurt? Who's listening to them? Who are the buyers of stocks?

There are two kinds of buyers. One is the institutional investors, and the other is the “mom-and-pop,” small shareholders. What do the institutional investors say when the sell side says, “Buy”? They ignore the buy-sell recommendation. They say, “Let's look at the sell-side research. But we have our own buy-side research folks who will tell us whether to buy or not.” So they take some of the sell-side information and they supplement it with their own research. In fact, many of the buy-side firms will call up the sell-side analysts and say, “Really, tell me seriously what I should do.” And then what do some of the sell-side analysts who have publicly said “Buy” say? “I don't think it's such a good stock.” That is why we saw a number of internal e-mails of analysts saying, “I'm just peddling the stock, which I know is really horrible.”

So who got hurt there? It's the mom-and-pop retail investors, who looked at “buy” ratings and said, “OK, this analyst says, ‘buy.’ This analyst, who appeared on TV, looks really smart. Last time I looked at their compensation it was $1.5 million; they are ranked by the *Institutional Investor* magazine as a star analyst, so they must know what they are saying. Let's go buy the stock, as the analyst recommends.”

The Wall Street settlement
What was the remedy? The remedy was a $1.4 billion settlement. One, the investment banks will pay a penalty. Two, analysts will no longer report to the investment bankers; they will work separately, and their compensation will not be a function of investment banking revenues. And three, if a firm has to give a recommendation, it must also give the recommendations of two other independent research houses.

Now, if my firm has to give a recommendation, and I can influence which independent research firms to pick, who do you think I will choose for my clients? Really high-quality independent researchers? Or researchers who are really not that good and probably have the same recommendations as my analysts, and who will probably tell me, “Listen, so-and-so investment bank; let's have a strategic alliance and I will be your independent researcher for the next *X* years”?

Research analysts will not be paid directly based on investment banking revenues. How will they be paid? They are employees of an investment bank. Last time I looked, research is being given free. There's no fee charged for research. So how are they paid? Their pay is based on the profitability of the firm. What brings profits to investment banks? Brokerage and underwriting and investment banking. If your brokerage, underwriting, and investment banking fees are going to be high, what will happen to analysts' fees, salaries? They'll be high. So, even though direct links are not there, they are still rife with conflicts.

Who won because of this $1.4 billion assessment? Who were the winners? Lawyers. Anyone else? The attorney general. It's not clear that this settlement will necessarily improve the system.

Other Instances of Professional Irresponsibility
I've just taken two case examples, but you can look at similar events occurring again and again through time.

Anybody recall what happened in 1993? The mystery of the odd eighths in NASDAQ. Two finance professors, Schultz and Christie, were doing some research on stocks on NASDAQ. While they were doing the research they found that market makers, the people who actually put the buyers and sellers together, were not quoting in odd eighths. You can quote in eighths of a dollar: one-eighth, two-eighths, three-eighths, four-eighths, etc. They noticed that whatever the stock—whether Intel, or Microsoft, or a small firm—it was just not being quoted in the odd eighths.

What happens if you don't quote in the odd eighths? What's the minimum spread possible between the buy and ask price? One-quarter. Not one-eighth. They published a paper asking, "Why are the odd eighths missing?" The moment that paper was published, odd eighths started appearing in quotes. An SEC investigation found that anybody who quoted in the odd eighths was pressured by other market makers, who would say, "How can you do that?"

What's happening here? Who gains and who loses by not quoting in the odd eighths? Who is gaining? The fee-takers. The professionals. And who loses? The clients, because they don't get the best prices.

Look at another example. In 2001, this was a big issue. Pharmaceutical firms were looking at what doctors were prescribing and paying them rewards that were a function of the medications that they were prescribing. Or you look at church personnel—a big story in Boston—who abused their power for personal gratification.

All these events lead to a question: Why is it that professionals run afoul of their professional responsibility? It is not specific to the accountants or to the security analysts. It happens across professions. It happens when personal considerations trump client interest.

Societal Reactions to Professional Irresponsibility
Here are some of the solutions to rampant professional misconduct that people are talking about in society.

Increase oversight on institutions
People have said that institutions are fallible. So we need to have oversight on institutions. We need to increase regulation. We need to appoint outside overseers, such as the Public Company Accounting Oversight Board, who will make sure that professionals do the right thing.

Costs of regulation are enormous. And it's not clear that if you regulate people very intensely they'll provide the right quality of professional service. Any example that you know of in the United States where you have tried to increase regulation of a profession, with questionable consequences? Medicine, where people said, “Doctors are basically off doing their own thing; let's put HMOs on top of them. These HMOs will make sure that they do the right thing.” The experiment was attempting to ensure that doctors behave in a way that is consistent with the cost economics of the HMOs. In the first five years of HMOs in the United States, people said, “Yes, cost of service may have declined, but what happened to quality of care? That declined too.”

Maybe we can do that. Maybe we can have an oversight board that keeps looking at every accountant, what they're doing, and gives them bright-line rules. Maybe then the accountants won't do anything wrong. But what's the risk there? They won't do anything of value. As the world becomes more complex and you make bright-line rules and make outsiders sit on top of them, the first thing that gets hurt is professional judgment. You go to analysts and say we are going to check back after the fact on how you made your sell and buy recommendations. They're never going to take a stance and say, “I think that this is going to be a great product or a great discovery. This is my recommendation.” They will all herd together.

So that's one world we can go to, where we have regulators on top of all these professionals, and the professionals are reduced to being low-quality service providers. And there is high overhead and high costs.

Punish evildoers
The second argument people give is that professionals have become unethical. We have to go back to punishing the evildoers, making an example of the evildoers and emphasizing the importance of ethics in the education and development of people. People have forgotten that.

Some of that is right. But, as I showed in the example of Enron, if you punish an evildoer, an identified evildoer, sometimes who gains most from that? Others in that group. And who might lose? Those who have suffered at the hands of the evildoers. So when you make examples of folks, you have to be very clear who gains, who loses in the long run.

Succumb to fatalism
Others say, “This is a function of the times. It always happens at the back end of a business cycle.” When there are booms, people will do whatever they want to do. Then when a bust comes, people will take an accounting and punish those who misbehaved during the boom. Nothing can be done about it.”

These are the three themes people talk about when they look at what's been happening in terms of the decline of professionalism.

Shared understanding on what it means to be a professional
One way to think about this issue is to ask the fundamental question, “What does it mean to be a professional?” to understand what a professional is and make sure that people who claim to be professionals behave in accordance with that claim.

What does it mean to be a professional? Does it mean only that you have independence and freedom? Or does it also impose some responsibilities on you? And what are those responsibilities? I think those questions should be asked of our accountants, our investment bankers, our lawyers, and our doctors. Shared understanding of what professionalism implies can lead to an appropriate solution.

Who is a Professional?
Before we go further, let us ask: Who's a professional? Who do you think of when you say, professionals should have an ethical responsibility? When you say "a professional," who comes to mind?

What does being a professional mean? A professional provides a service; a professional is a service provider, but so is a restaurant waiter, and so is a car mechanic. So how is a professional different from a restaurant waiter or a car mechanic?

Code of ethics
Almost all professionals subscribe to a code of ethics. In some professions, you are not considered a professional until you stand up and take a public vow. In medicine it's the Hippocratic Oath. In many religious orders, you take a vow of chastity and poverty. You have vows in the military. In others you are supposed to implicitly sign onto the code of conduct of the profession. That's one distinction. There's a code of ethics that professionals are supposed to hold true to.

Superordinate goal
Any other differences?

__: There's a responsibility to something larger than oneself, to a body of knowledge, to a sense of public safety, to a rightness.

PROFESSOR NANDA: Professionals say that they are not just responsible for their own well-being, but there is some superordinate goal to which they hold themselves responsible. When people ask doctors, "What is the purpose of medicine?" they respond, "The purpose of medicine is health." What is the purpose of law? Justice. People ask, "What is the purpose, the calling of the profession?" Professions have a calling. If you are not able to answer that question, you are not a professional.

Pledge to put client interest foremost
The core element of professional codes of ethics is that professionals take a pledge to place client interest foremost. They say, "Whatever my own interests may be, I will put client interest ahead of that interest." The very core of being a professional is saying, "I am going to manage the conflict of interest between my interests and the client interest always to the client's benefit." A doctor says, "I am going to always take care of the patient." If Richard comes to me as a patient, I am not going to say, "Richard, I am going to keep treating you for three more days because it's really good for my income." I will say to Richard, "Richard, I think you are cured. You're done."

Why is the professional pledge important?
The distinguishing feature of a professional is saying, "I will manage the conflict of interest always to the client's benefit." Why is that so? Because there is no way for a client to judge the quality of service that professionals provide. Unlike if I'm producing a product where the client says, "OK, you produced this car; I can value this," the service provided is so complex that the client doesn't have a way of immediately valuing it. Clients make sure that the provider of the service will provide the right kind of service by either giving them pay for performance or by supervising them. Neither of those approaches works for professionals.

You can't stand on top of an auditor and say, “Auditor, audit all the numbers carefully.” You can't go to the lawyer and say, “Lawyer, did you fight my case to the best of your ability?” You don't have a way of judging that.

Given this situation, if you live in a world of “buyer beware,” what do you think a professional will do? The professional will, like with Richard, take advantage of this information asymmetry. I, the professional, know a lot more about my service than Richard, the client, does. Because of this, Richard will always worry about coming to me for service provision. He will say, “Ashish, tell me what my ailment is, and then I'll go to Jack and find out from Jack what it is, and I will try and compare between you two before I actually come to you for treatment.” Social waste results. To prevent that waste, I tell Richard, “Richard, I am going to take a vow that I will put your interests ahead of my own interests.” That's the professional pledge. Then Richard comes to me and says, “Fine, I'm going to come to you for treatment.” The professional pledge ensures for the client that the professional will always serve in his best interest.

The Role of the Professional Association
Then the question becomes, how do you make sure that people will hold true to this professional pledge?

__: True professionals have an obligation to judge the practice of their fellow professionals and have an obligation to expose their practices to these fellows.

PROFESSOR NANDA: Absolutely. It is the other professionals who can judge your quality of service. It is not the client. It is the other professionals. The professionals say, “As a group, we are going to evaluate each other and make sure we hold true to our pledge.” That is the central role of an association, to make sure that professionals hold true to their pledge. That's the role of the AMA (American Medical Association); that's the role of the AICPA (American Institute of Certified Public Accountants); that's the role of the ABA (American Bar Association): to make sure that their member professionals are holding true to their pledge.

Powers of associations
Because they promise that they will monitor their members, society gives them two very big powers. One is the power of certification. Professional associations have a tremendous say in certifying whether somebody will practice the profession or not. The Bar Association has a tremendous input in saying whether somebody can practice the law or not. And the second power is self-monitoring; you are given the right to evaluate whether your members are doing the right thing or not.

Internal Threat to Professional Associations
If an association does the right thing, public goodwill develops for that association. But the more public goodwill develops, the more that profession becomes susceptible to what I call "rent seekers.” Let me give you an example.

“Rent seekers”
Let's say that there is a profession, medicine, which the patients think is a great profession; they feel, “Doctors really care for us.” Harris says, “This is a great profession for me to enter and maximize my own interest, because clients have a lot of trust in doctors, so I can do pretty much what I want. I can ask them to go through treatments that they don't need.

I can charge them huge fees. There is a risk I may get caught, but the benefit from taking advantage of this trust is very high."

So Harris will go into the profession, attracted by the amount of public goodwill for the profession. The more goodwill there is, the more important it becomes for the profession to ensure that people like Harris do not infect the profession, that the rent seekers do not become the major part of the profession.

But what is an association? An association is composed of the people who practice the profession. So, in fact, as the reputation of a profession becomes bigger and bigger, more and more people start saying, "How can I take advantage of this reputation for my personal gain?" What they think about is personal benefit versus personal cost. What they don't think about is "If I am found to have taken advantage of clients, how will the other professionals suffer from that?"

This is what we call "the tragedy of the commons." There's a shared commons and you have somebody going in with their cattle and saying, "Should I overgraze or not?" They say, "Let me overgraze the commons because my cattle will be well fed. Why leave it for the next person?" So every herdsperson who goes in overgrazes the commons and the commons loses all its grass.

That is the problem. The individual practitioners don't think about what happens to the entire profession's reputation if they are caught being unprofessional. The more a profession becomes recognized and respected, the more it becomes susceptible to rent seekers. But then the more the rent seekers are a part of that association, the less well the association is able to monitor and protect against them. You will find that associations gain a lot of public credibility, but then they start behaving like rent-seeking guilds.

Any examples that you know of, of associations of professionals that forgot that their primary purpose was to evaluate their current practitioners? And their purpose became, "How do I maximize the returns of my member practitioners?" One example I have is the AMA. In the mid-sixties, they did not want universal healthcare and they fought against Medicare. What was the key reason? It was going to hurt the doctor's compensation.

The other example I have is the AICPA. When SEC Chairman Arthur Levitt came to them in 1998 and 1999 and said, "Look into how you are doing audits. Your consulting is actually hurting your independence in audits," what did the AICPA say? The AICPA said, "We don't think so. The whole profession is doing just right, and we have this excellent internal regulatory arm, the SEC Practice Section (SECPS), which makes sure that we do good audits, and we check how the audit quality is." That internal arm, over a period of more than a decade, found zero problems. They never found any faulty audits.

Consequences of rent-seeking behavior by professional associations

If you have associations that forget that their primary goal is to make sure that your professionals stand true to their pledge, and they become rent seekers, what will happen? After a period of time, their credibility goes down. What does society do then? It says, "We are going to take away from you the rights that we have given to you: the rights of certification and self-regulation. We are going to put other institutions representing clients on top of you. We are going to put the PCAOB on top of you. We are going to have HMOs that will oversee you."

What does that do to the profession? It deprofessionalizes the profession. If your service is not a function of judgment, if there are outsiders who are evaluating the quality of work you are doing, there's very little distinction between a service provider and a professional.

Conflict of Interest

I want to talk a little bit about conflict of interest. Some of my friends and colleagues say that there are too many conflicts of interest in today's world. If we make sure that nobody faces conflicts of interest, the problem will be solved. That is not a good world to be in, because the moment you say that you will not have conflict of interest, what are you taking away from that person? Judgment. Conflict of interest is inextricably tied in with judgment.

Conflict of interest is when you say that your stated primary goal conflicts with your secondary goal. Very often the secondary goal is my own self-interest.

Also, we should be clear what conflict of interest is not. Conflict of interest is not an ethical dilemma. An ethical dilemma is when you have somebody saying, "Should I go for justice or should I care about happiness?" Both of these are good goals to have, but they are incommensurate. Conflict of interest is very clear. "Should I, as a doctor, take care of my patient, or should I take care of myself at the patient's cost?" There is one right answer there, given your professional pledge. So it's not an ethical dilemma.

It's not an agency problem either. An agency problem is when Al has some interests and Ron has some interests. Al is the owner, and Al says, "What is the right compensation system or contract I can enter into with Ron to make sure that Ron behaves in a way that satisfies my interests?" In a conflict of interest situation there is no way to enter into a contract. A contract has to be a function of either effort or output. And, as I just mentioned, a professional's output and effort are both not observable. How can Al say to Ron, "Ron, I am going to make your reward a function of the quality of your treatment to me," when he is unable to judge the quality of that treatment?

Long-Lived Professions

Can you think of some professions that are very long-lived? Some people say religious organizations; for example, the Catholic Church is a long-lived profession. Professoriat is a long-lived profession. Let us look at what makes some of these professions long-lived.

First, the superordinate goal is the primary goal of an association. The goal is not maximizing the well-being of your professionals. If you are in the Church, for example, it's clear why you are there. It's not to increase your well-being. It's made very clear very often, for instance in the case of professoriat, that this profession will not maximize your wealth. In fact, very often norms develop in which you curtail personal well-being. What is the model of a good professor? Somewhat tattered coat and somewhat beat-up car. If you come in a very nice set of clothes and in a good car, other professors will look down their noses at you. In the profession of the Church, they take a vow of poverty.

The other interesting aspect is that, if you have populist elections for leaders, totally democratic elections where anybody can stand, if you have a majority of rent seekers in a profession, the association will fall under the control of the rent seekers. Long-lived professions don't just have democratic elections. They have a nomination system where people who represent their clients nominate people who they think have a sense of stewardship of the profession. You don't have the Catholic priests just voting amongst themselves and saying who's going to be the head. They have a nomination system. You look at universities and the presidents of universities. The faculty does not directly vote for the president. The visiting committee comes up with the nomination.

The more lush the commons becomes, of public goodwill for the profession, the more that profession becomes attractive to rent seekers. The better the reputation, the greater the risk is that you will have a higher percentage of rent seekers in a profession. If you have a group of rent seekers who can combine and vote one of their leaders to a leadership position, the whole profession gets captured by them.

Some people claim that this is what happened in AICPA. There were at that time eight big firms, which were able to organize and put their people in leadership positions in the AICPA. It was clear that the primary goals of those people were maximizing the welfare of those large firms.

Professional Service Firms
If you don't have a strong professional association, then you will start seeing firms develop that will offer exactly the same kind of services that these associations do. So, for example, management consulting does not have a strong association. But then management consulting has firms that offer exactly the same promise, which is, "Trust us. We will have socialization and monitoring to make sure that our professionals will serve client interest foremost." This is literally what McKinsey offers. It says, "We will be professional; we will offer what's best for clients."

If associations are weak, firms will offer to maintain client interest first. You don't see that promise in many law firms, because the law profession has a strong association.

How Associations Should Respond to Public Criticism:
Lessons from AICPA's Interactions with the SEC
What happens if an association, faced with a challenge, closes rank and says, "There's no problem with us"? The case study of the AICPA offers interesting insights. In 1998, the SEC told them, "You have a problem." They closed ranks and said, "There's no problem." Between 1998 and 2000, they fought the SEC tooth and nail. The SEC said, "Your audits are not independent." They said, "There's no smoking gun here. Not once have you shown us an audit that was wrong." The SEC responded, "No, but you are doing consulting also. You are too close to your clients. This is not right; you should have stronger independence rules. We will work with you to do this." When the body that the SEC developed to work with them started doing research on audit quality, the AICPA cut its funding.

There are stories of the AICPA having gone to the lawmakers asking them to send letters to the SEC, saying, "You are doing the wrong thing by putting too much pressure on accountants. Back off." A lot of pressure was put on the SEC. Finally the SEC and the AICPA arrived at an agreement—in a way it was a retreat by the SEC— where they basically said, "Fine, accountants can do what they want, but companies have to publicly declare how much nonaudit and audit work their accounting firms are doing for them."

The head of the SEC resigned. And the Democratic president was replaced by a more business-friendly Republican president. In January 2001, accountants were cheering and thinking that they had beaten back a huge attack on them.

Meanwhile, the SEC kept saying, "We have to look for a smoking gun." They found a smoking gun called Waste Management, where the auditor, Arthur Andersen, was also the consultant, and they had basically okayed questionable audits. A few months after that they found another smoking gun. Guess what the name of that was? Enron.

The whole situation has come around to, now, the AICPA saying, “Please allow us to have some voice in regulating the profession.” The SEC came back to them and said, “Sorry, that's not your job. That is the PCAOB’s job.”

You can fight external criticism by saying we'll close ranks and we'll silence the criticism, but then the entire profession risks getting degraded.

Conflict Between Clients

I have focused in this talk on only one kind of conflict of interest, which is conflict of interest between the provider and the client. There are other kinds of conflicts of interest. One is between clients. Ron has been my client in the past. Now Tom comes to me and says, “Ashish, will you take me as a client?” And Ron and Tom are competitors. In some professions, I will say no, as in law. In other professions I will say, sure, as in consulting or accounting. When is it right to take competitors as clients and when is it wrong?

Narrow versus broad conflict rules

There's one simple rule of thumb: If the service you're offering is strategic, then you should have narrow conflict rules; if the service you're offering is generic (best practice), then you should have broad conflict rules. With narrow conflict rules clients are sure that their confidence will be with you and your interest is aligned with the client; broad conflict rules bring economies of service—you get the best service and you have large enough scale.

Will the client want narrow or broad conflict rules? When the client wants to engage you, what will the client want? Broad conflict rules: “Bring me everything that you know.” As soon as your service is over, what will the client want? Narrow conflict rules: “Don't tell anybody what I've told you!” You cannot use the clients to tell you whether to have narrow or broad conflict rules. But you have to have a sense of what kind of service the profession is offering.

Management consulting firms say they are offering strategic advice. If they were truly offering strategic advice, what kind of conflict rules should they have? Narrow. But they have broad conflict rules. They say, “You want to do strategic planning, come to us. We've done this with everybody.” Clearly the service they're offering is actually not strategic; it is best practice.

Look at marketing services. For example, look at WPP. Part of what WPP offers is advertising, and part of what it offers is market research. Advertising has narrow conflict rules because in advertising you are working with a client to determine their identity and you're trying to distinguish it from competitors. Market research has broad conflict rules because you're looking outside at the market.

What does WPP do? Whenever it acquires firms, it keeps the advertising departments separate. Ogilvy and Mather is separate from J. Walter Thompson. And it puts market research together. Why? Three advertising firms can now have three clients in the automobile industry, whereas market research can benefit from economies of scale. Therefore, the structure of organizations becomes a function of conflict rules.

You also have competition between the professions, like law and accounting. There's been a lot of competition over jurisdiction on some activities in Europe between law firms and accounting firms. That competition hinges on what the appropriate conflict rules should be. What's the argument that law firms give against accountants? They say they don't have narrow rules, so client confidence will not remain with these firms. What's the argument accounting firms give against law firms? They are inefficient and uneconomical. The argument of narrow versus broad conflict rules on the one hand is economy of service, and on the other hand is loyalty to client.

Summary

The core point I want to emphasize is that managing conflicts of interest is central to being a professional. There has to be a shared understanding of putting client interest ahead of personal interest, and what that entails. If you are prepared to do that, call yourself a professional. If you are not prepared to do that, there's a risk you will degrade the service that you're offering by calling yourself a professional.

Thank you for your attention and your participation. I enjoyed it.