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Ad Hoc Committee on
INDEPENDENCE

INTERIM REPORT

Presented to the Executive Committee
American Institute of Certified Public Accountants

Ad Hoc Committee on Independence Interim Report to Executive Committee

Formation of Committee

Over the last several years a number of articles have been written raising questions as to the propriety of the rendition of management services by CPAs to companies for which they performed the attest function. For the most part the articles have been written by persons in the educational field. Moreover, in an address to the Institute's annual meeting in Boston in October, 1966, Mr. Manuel Cohen, Chairman of the Securities and Exchange Commission, also raised some questions in this area.

In the fall of 1966 the executive committee of the Institute formed this *ad hoc* committee. Its membership was drawn from the three major areas of service by CPAs: accounting and auditing, taxation, and management services; in addition, a representative of the Institute's ethics committee also served.

Outline of Committee's Approach

One ground rule which the committee laid down for itself at the beginning was that it would maintain an open mind in considering the subject, recognizing that this might not be easy, as one's natural reaction when attacked is to rebut those persons critical of existing practice.

At the outset, the committee undertook to read all the various articles it found on the subject.

It was known that at least two of the writers had written articles based on surveys, namely, Messrs. Abraham Briloff and Arthur Schulte, and so the committee arranged to have interviews with them.

Interviews were also held with representatives of various user groups: The American Bankers Association, the Financial Analysts Federation, the Financial Executives Institute, and the Life Insurance Society of America.

The committee also considered two tentative draft statements prepared by the management services committee of the Institute, one dealing with the nature and scope of management services and the other with the matter of competence.

The committee has held seven meetings since its formation in December, 1966.

The chairman participated in a discussion of the subject at the 1967 annual meeting of the Institute.

Interviews with Authors

The purpose of the interviews with Messrs. Briloff and Schulte was to learn firsthand of the concerns which they had expressed in their articles and to engage in dialogue for the purpose of clarifying viewpoints.

One most interesting point was developed in these interviews, namely, that neither of these two gentlemen knew of any situation where independence, in fact, had been impaired. In this connection, Dr. Schulte stated that he had addressed inquiries to all of the state boards of accountancy asking if they had ever had any case in which they had had to take disciplinary action on independence where the rendition of management services was a factor. Dr. Schulte advised that he had heard from 44 of the state boards and that no one of them reported it had ever had such a case. The committee recognizes that this does not prove that no such case has existed but,

on the other hand, it is significant that Dr. Schulte's inquiry disclosed no evidence that audit independence had actually been impaired as a consequence of management services.

Both Messrs. Briloff and Schulte felt that the problem was not one of lack of independence *in fact*, but the *appearance* of lack of independence. Both gentlemen were of the opinion that the problem lies in the role of the CPA. They felt that the closeness to management, which they thought was involved in rendering management services, places the CPA in a position where outside observers would be concerned as to his independence. Both men expressed pleasure that the profession was at last coming to grips with the problem and was studying it.

Interviews with User Groups

The user groups which were interviewed have been indicated earlier in this report. The method of selection was to request the particular organizations represented to nominate a list of persons who they felt would be in a position to contribute to our study of the problem. It was the opinion of the committee that this method of selection would preclude any possibility of bias on our part in the selection process. The number of persons (hereinafter called participants) interviewed in this portion of the committee's work was not large, aggregating some 16 in all.

Our procedure in the first two interviews (there were four in all), after explanation of the reason for formation of the committee, involved a questionnaire that had been used by Mr. Briloff in his survey. This questionnaire was stated to be based on a mimeographed list of management services offered by one of the national accounting firms. Mr. Briloff in his questionnaire had asked two questions of the responders:

1. Are you aware that these management services are being offered, and
2. Do you think they should be offered?

Our committee asked our invited participants to complete

this questionnaire, and told them that after they had finished it we would like to discuss with them any instances in which they felt that the cited services should not be rendered by CPAs.

In taking this approach the committee almost immediately received questions from the invited participants asking for clarification of the indicated services. The committee refused to answer these questions, feeling that the responders should be placed in the same position in their responses as those persons responding to Mr. Briloff's questionnaire.

After the questionnaires had been completed by the participants we asked each of them to explain why he felt any given management service should not be rendered by CPAs. The answers indicated a lack of understanding of the nature of the management services being offered and the manner in which they were rendered; the answers also indicated that the responders were confusing possible competence of a CPA to render a given service with the question of his independence in the performance of any subsequent attest function. The committee also noted some relationship between a person's knowledge that a given service was actually being rendered by accounting firms with its acceptance in his mind as a proper service. Nonetheless it was clear, after discussion, that there remained some doubts in the minds of some of the participants as to the *appearance* of a CPA's independence in some aspects of management services.

Based upon our experience with the first two groups, our committee concluded that a part of the problem lay in a lack of clarity in the manner in which various management services were described in the questionnaire, and a lack of understanding as to the role played by a CPA in rendering management services. Accordingly, we undertook to revise the questionnaire used by Mr. Briloff in a manner which we thought would better state the nature of the management services involved and the manner in which they were rendered. We also undertook to make it clear that we were focusing our concern on the question of *independence* in the rendition of any subsequent attest function, and not the CPA's *competence* to render a given service.

The revised questionnaire then asked if the rendition of these services, as redefined, could impair independence. Almost immediately, and to our surprise, it was indicated that some of the participants felt such services could impair independence. Then one of the participants stated that if we had used the verb “would” instead of “could” he would have changed his answer. His explanation was that he could conceive of situations in which certain services *might* impair independence (that is, it would be *possible* that independence might be impaired) but that he had no concern that independence “would” be impaired. In essence, this was an expression of confidence in the CPA’s integrity, as well as a recognition of the fact that CPAs have to live with the problem of independence every day in all aspects of their service; in other words, that independence is not an issue related solely to the rendition of management services.

Another significant reaction was the diversity of views expressed by the participants. These ranged all the way from one view that CPAs should render whatever services they wanted and that the market place would decide whether the services were proper, to others indicating concern as to the role played by the CPA, particularly where management services extended to recommendations influencing major business decisions. Not one of the participants, however, thought that all management services should be prohibited.

Observations of Committee

The committee’s study has led it to the observation that there is substantial misunderstanding as to the nature of management services rendered by CPAs and the manner in which such services are rendered — there is a definite need for long-range education.

Another observation of the committee is that there are definite limitations on the value of questionnaires on this subject. These limitations arise not only from lack of understanding as to the nature of management services and how they are rendered, but also from the difficulty of phrasing questions so

as to elicit the desired information, and the responder's difficulty in interpreting the questions. Questionnaires of necessity are essentially "one-way" communication with no opportunity for clarification.

One of the most significant findings of the committee is the lack of substantive evidence that the rendition of management services by CPAs has impaired independence *in fact*.

Reference has already been made to Dr. Schulte's inquiry of state boards of accountancy, resulting in responses from 44 boards, not one of which had ever had a case involving independence of a CPA where management service was a factor. The committee also made inquiries of representatives of the Securities and Exchange Commission and were informed that they knew of no such cases in their experience.

Subsequently the committee addressed similar inquiries to the authors of articles which had raised questions related to independence and management services. With one exception, none of them indicated that he knew of any cases of impairment of independence in fact. The one exception described several cases, but on analysis they did not impress the committee as exemplifying a lack of independence arising from the rendition of management services — rather they showed failure of CPAs to have observed generally accepted auditing standards in performing the attest function.

At yet a later date the committee noted an article in *Forbes Magazine* for November 15, 1967 titled "The Instant Executives," largely based on an interview with Charles P. Bowen, Jr., President of Booz, Allen & Hamilton, a well-known management consulting firm, in which reference was made to management services performed by large accounting firms. One of his complaints, the article said, was alleged conflict of interest. Mr. Bowen was then quoted as saying, "I know of cases where there has been a willful shutting of the eyes to observable facts that affected the destiny of the business, on the ground that some of the executives of the company certified they weren't so."

Subsequently representatives of our committee conferred with Mr. Bowen on the foregoing. He explained that the cases referred to (three in all) did *not* relate to the rendition of man-

agement services by CPAs, but to audit services; on the facts stated the committee's representatives concluded that these were simply instances of substandard auditing, which from time to time, unfortunately, do happen. Mr. Bowen also stated unequivocally that he had never intended to suggest that the performance of management services had an adverse effect on audit independence. On the contrary, he suggested, the fact that an accounting firm served as independent auditors of a company was more likely to impair its objectivity in the performance of management services for the same client — presumably because the partners of the accounting firm would hesitate to jeopardize their relationship with the client as auditors by confronting the client with disagreeable conclusions as a result of management services engagements.

In short, the committee has found no substantive evidence that the rendition of management services has impaired the independence of CPAs *in fact*. Recognizing that CPAs have rendered management services for decades, this one finding might well lead to a conclusion that the profession really has no problem.

However, as indicated earlier, there is some evidence that some users believe there is an *appearance* of lack of independence. It seems clear to the committee that whatever problem exists is in this area.

There are some, albeit a minority, who would question the propriety of the rendition of *any* management services by CPAs to their audit clients, whereas others limit their questions to only certain areas. For example, Mr. Cohen's speech, referred to earlier, contains the following:

A recent book by Eric Kohler, an accountant well known to all of you, notes that "A public accountant's established services to management have also come to be of the first order of importance. These include the preparation of income-tax returns, or aid in their preparation or review; and forward planning on such diversified matters as budgetary procedures, costing methods, inventory controls, incentive plans, and pension schemes." These services may, in Mr. Kohler's words, be "natural consequences of the auditor's developed skills," and may "contribute to a better background for succeeding audits, as well as to better management." So long as they are

directed towards those ends, they do not appear to pose a serious threat to the accountant's independent status.

However, a word of caution is in order with respect to what one of your prominent members describes as "consulting services which cannot be related logically either to the financial process or to broadly defined information and control systems, (such as) market surveys, factory layout, psychological testing, or public opinion polls." And, I am disposed to add, executive recruitment for a fee. An accountant who directs or assists in programs of this kind raises serious questions concerning his independence when it comes time to render to creditors, to investors and to the public his opinion on the results of the programs. Public accountants should carefully reconsider their participation in these activities lest their continuation and extension undermine the main function of the independent accountant — auditing and the rendering of opinions on financial statements.

It seems clear that the consideration of this entire subject is complicated by semantical problems. Neither "independence" nor "management services" in the present context is precisely defined. CPAs use the word independence in the sense of not being subordinate, not subordinating their judgment to that of clients or others. If a CPA were not independent in fact, he would be more likely to subordinate his judgment to avoid losing a valued client than because he performed services such as factory layout or executive recruiting.

There are many pressures on the independence of CPAs, from many quarters, but there are also strong countervailing forces, which may not be generally recognized. These forces do in fact sustain independence, despite the pressures, throughout the profession: they are (1) personal integrity and professional pride, (2) possible legal liability, (3) possible professional discipline, including loss of CPA certificate, (4) possible loss of reputation and consequent loss of clientele.

Fortunately, there are few challenges to the independence of CPAs *in fact*.

The *appearance* of lack of independence, which is the principal question here, is more difficult to deal with. The Institute's committee on ethics says that it may arise from relationships which "might be regarded by a reasonable observer, who

had knowledge of all the facts, as those involving conflicts of interest which might impair the objectivity of a member in expressing an opinion on the financial statements of an enterprise." Such relationships might occur in any area of public accounting practice, not only in management services. In each instance it would require knowledge of all the facts in the specific situation to reach an informed judgment. The definition of a "reasonable observer" depends on the circumstances — the nature of the situation. What relationships "might" impair objectivity must be a purely subjective determination.

It seems clear that the ethics committee intended to sound a warning to members to proceed at their own risk, rather than to define situations in advance which were to be prohibited. This was wise, in our opinion. Questions involved in possible *appearance* of lack of independence are potentially countless in number. Each case must be considered in the light of all the circumstances. A common law approach, rather than a statutory approach, is indicated.

Again, the imprecision of the term "management services" adds to the difficulty of discussing this subject. By far the greater part of the work done by management services divisions of CPA firms is of the same type which these firms performed before the term "management services" was invented. Smaller firms today render services in conjunction with regular audit work which other firms describe as management services. In short, CPAs have always offered consulting services in the financial, controls and systems areas, as well as technical assistance in providing bases for management decisions — such as projections of costs of proposed actions. The demand for such services has increased rapidly in the past twenty years, and the techniques have become much more sophisticated (e.g. the use of computers and of mathematical devices). Otherwise there is nothing new in the bulk of CPAs' management services.

Confusion also prevails as to just what CPAs do—their role—in various management services. Some critics apparently believe that they participate in management decision-making, or advocate actions which materially affect the financial statements which they later audit. But those whom this committee

consulted had no objection to the CPA's advisory role with respect to any phase of management's functions if that role were confined to structure, plan, system, method or procedure by which management can achieve the desired results. In addition, it seems to be accepted that CPAs can properly gather data, analyze data and point out the advantages or disadvantages of alternative courses of action.

Services which appear unrelated to the accounting function, in its broadest sense, have been singled out for criticism. Whether the critics are more concerned about their relation to audit independence, or about the competence of CPAs to perform them, or only about what may seem their incongruity with traditional accounting practice, is not entirely clear. In any event, criticism of such services by our critics is a cause of concern.

The question remains what, if anything, the Institute should do about criticism.

Those who question the propriety of the rendition of any and all management services by a CPA to his audit clients should give consideration to the social consequence of such a proscription. There seems little doubt that the rendition of the usual management services by CPAs has made a significant contribution to the financial health of organizations served, and has strengthened procedures and controls. Such services have unquestionably redounded to the benefit of creditors, stockholders, and our national economy.

However, such services as psychological testing, public opinion polls, or executive recruiting pose a different problem. Such services are rendered by relatively few firms, and represent only a very minor part of the management services rendered even by them. At first blush it would seem that such services could be proscribed without any great harm to the profession or its clients. As a matter of fact, the committee gave some consideration to this as a possible recommendation, but felt that in order to proscribe any given service it would be necessary to develop a sound rationale justifying the proscription. It seemed to the committee that in order to proscribe any particular service it would be necessary to make clear in what way the rendered service would impair independence; also that ques-

tions of competence should not be confused with independence. In other words, a proscription of any particular service requires more than a vague, visceral feeling that a particular service by a CPA “just does not look right.” The committee has been unable to find any sound rationale for proscribing any of the services mentioned, assuming competence and appropriate role on the part of the firm concerned.

The committee questions if it is possible to exclude any total area of management services, inasmuch as the role which the CPA plays is of paramount importance. For example, an audit client of a CPA may wish to acquire another company (by purchase or merger) and request the assistance of his CPA in connection with the acquisition. If the acquisition is consummated the CPA would be expected in the future to perform the attest function for the acquired company as well as for his existing client. It would seem clear that the CPA in assisting his existing client with reference to the prospective acquisition can appropriately assist in a review of the past financial performance of the company sought to be acquired, review its accounting principles and procedures, and develop any historical data which his existing client may wish. He may give advice, based on his analysis, as to possible courses of action and he must accept responsibility for this advice. However, it seems clear that the CPA should not negotiate the price to be paid for the acquisition or place himself in a position where he accepts responsibility for the ultimate decision whether or not to acquire.

Summary of Observations and Tentative Recommendations of Committee

1. The committee believes that so long as a significant minority of users of financial statements have a concern that the rendition of some management services may pose a serious

threat to an auditor's independence, the profession has a problem and cannot ignore it.

2. The profession, through the management services committee of the AICPA, should proceed as soon as practicable to issue, for exposure comment, tentative position papers as to the nature of management services as rendered by CPAs, the appropriate role of CPAs in rendering such services, and requirements as to competence. These statements should stress the caveats implicit in our code of ethics to the effect that a CPA is prohibited from making management decisions or taking positions that might impair his objectivity as an independent auditor. In the exposure process readers should be encouraged to feed back their observations and such observations should be used to assist the profession in further developing its position as to rendition of management services.

3. The profession should continue to confer with representatives of user groups in order to clarify positions. For example, seminars might be held with representatives of user groups following the receipt of reactions to the exposure drafts referred to in the preceding paragraph. If as a result of these and other appropriate actions to increase the user groups' understanding of the CPA in management services, a substantial concern for the CPA's appearance of independence persists among a significant proportion of important users, the profession should be prepared to take whatever action then seems appropriate — including possible proscription of some services (via the code of ethics) and/or restriction of the CPA's role, should such severe remedies be required and suitable criteria become apparent.

4. For the present, CPAs should recognize that peripheral management services — i.e., those not “related logically either to the financial process or to broadly defined information and control systems” (see reference to Mr. Cohen's speech on page 7), as well as executive recruitment for a fee — are raising questions with some users of financial statements and they should consider *most seriously* whether or not they should render, or continue to render, such services; if they do, they should

be *particularly* on guard to observe the injunctions of our code of ethics as to avoidance of management decisions or taking positions that might impair their objectivity as independent auditors.

5. As a generalization it may be stated also that in any area of management service the greater the economic significance of the service the greater the caution that should be exercised to avoid making management decisions or taking positions that might impair objectivity as independent auditors. For example, assistance to a client in a possible acquisition could have a significant economic impact and therefore would be a sensitive area. Accordingly, the CPA should confine himself to a review of accounting and financial aspects of the proposed acquisition — past operations, accounting methods used, accounting principles followed, and so forth — and to advice based on his analysis; the CPA should not negotiate price or place himself in a position where he accepts responsibility for the ultimate decision whether or not to acquire.

6. The committee endorses the action of the executive committee of the Institute in recommending audit committees composed of outside directors. Where a CPA is requested to render a management service, he has an obligation of deciding whether he believes the given service, or more particularly the role he is asked to play, might pose a serious question as to his independence; if he so decides, then he should decline either to render such service or the audit service. If the CPA believes that providing such service causes no problems of independence in fact, yet might cause a serious question to be raised due to an appearance of lack of independence, he should confer with the audit committee (or if there be no such committee, then with the full board of directors) to make certain that the audit committee, as representatives of the board of directors and hence of the stockholders, concurs as to the propriety of the rendition of the given service. The committee also believes it would be appropriate for the independent CPA on some periodic basis, possibly annually, to report to the audit committee on the nature of all important services being rendered to that client.

Conclusion

As a result of its studies and particularly its exposure to representatives of user groups, the committee is of the opinion that the profession is fortunate in having achieved a remarkable reputation for integrity and independence. This is a valuable asset but it has not been granted the profession in perpetuity. The profession must continue to justify its reputation and, accordingly, has the obligation in all areas of its service, and particularly in the management services area, to observe its self-imposed ethical restraints. Furthermore, it must be sensitive to public opinion, and respond to criticism in a constructive, rather than a defensive, manner. This suggests careful consideration by each member of the nature of the services he chooses to offer, his appropriate role in performing such services, and the manner in which he describes them—all in the light of possible public reaction.

This is an interim report. It is intended to elicit the views of those who receive it. Readers are urgently requested to express their opinions on the committee's observations and tentative recommendations, and also on any additional steps they believe should be taken.

Respectfully submitted,
Malcolm M. Devore, *Chairman*
William T. Barnes
Charles C. Crumley
Samuel L. Ready
Joseph L. Roth

August 1, 1968