

Public Oversight Board Report

OCT 12 1984

**Scope of
Services by
CPA Firms**

Public Oversight Board

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CPA Firms**

**Public Oversight Board
SEC Practice Section
Division for CPA Firms
American Institute of Certified Public Accountants**

Public Oversight Board

SEC PRACTICE SECTION

American Institute of Certified Public Accountants

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March 9, 1979

Mr. Walter E. Hanson, Chairman
Executive Committee
SEC Practice Section
Division for CPA Firms
American Institute of
Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Hanson:

I am pleased to submit herewith the report of the Public Oversight Board on "Scope of Services by CPA Firms." This report is submitted in response to your request, on behalf of the Executive Committee, that the Board consider and express its views with respect to the proposed amendment to Section IV, 3(i), of the Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms.

This report was made available, in tentative form, to the Executive Committee and to the Chairman and the Chief Accountant of the Securities and Exchange Commission on February 6, 1979. We neither solicited nor received the approval or endorsement of either the Executive Committee or the SEC. While the report reflects in some respects comments received from those sources, it represents solely the views of the Board.

As indicated in the report under the caption "Conclusions and Recommendations," the Board has not viewed favorably the effort of the Executive Committee to engage in a series of determinations on hypothetical situations with respect to which management advisory service (MAS) engagements do, and which do not, involve skills related to accounting or auditing. The Board believes that this approach would involve the Executive Committee in an array of ad hoc judgments which would become, or appear to be, increasingly arbitrary, and that it lends itself to logical extensions beyond the policy purpose sought to be achieved. We believe that it is wiser for the Executive Committee to adhere to the concept of independence and the appearance thereof as the sole governing principle.

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1211 Avenue of the Americas, New York, N.Y. 10036

Second Impression 1979

Published for the Public Oversight Board of the
SEC Practice Section by the
American Institute of Certified Public Accountants

March 9, 1979

The Board has also considered and rejected the more extreme view, expressed in the report of the Senate Subcommittee on Reports, Accounting and Management, that auditors be prohibited from furnishing to audit clients any nonaudit services other than tax services and "certain computer and system analyses...necessary for improving internal control procedures of corporations." Such a draconian measure would not only deprive audit clients of services that they obviously deem valuable but also would cause a substantial reduction in revenues for many CPA firms, especially the smaller ones. We do not believe that otherwise lawful and productive economic activity should be prohibited unless such prohibition is clearly in the public interest and no other measures are available.

These conclusions should not be interpreted to mean that the Board views the matter of scope of services with complacency or believes that possible dangers can be avoided solely with general exhortations to the members to preserve independence. The mere fact that so many persons have expressed concern with the subject, both in and out of the government, over an extended period is reason to conclude that it cannot be dismissed as a chimera. The Board believes that there is possibility of damage to the profession and the users of the profession's services in an uncontrolled expansion of MAS to audit clients. Investors and others need a public accounting profession that performs its primary function of auditing financial statements with both the fact and the appearance of competence and independence. Developments which detract from this will surely damage the professional status of CPA firms and lead to suspicions and doubts that will be detrimental to the continued reliance of the public upon the profession without further and more drastic governmental intrusion. Effective measures must be taken to guard against such a development. Fortunately, in the Board's view, they are at hand.

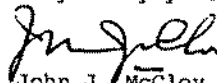
The new proxy statement disclosures occasioned by ASR 250 will largely remove the mystery surrounding the type and magnitude of actual services performed for reporting companies by auditing firms and will have a restraining influence to the degree that some services may be generally perceived as being incompatible with professional stature. The inclusion in peer reviews of an examination of MAS as they may bear on the reviewed firm's independence, including a review of the role performed by the reviewed firm in MAS engagements, will give further assurance of the maintenance of independence. Finally, the new encouragement for audit committees and boards of directors to be aware of the existence of MAS engagements, to approve them, and in so doing to consider the matter of independence, will have a salutary effect. While these new developments may not change existing arrangements, which, of course, they need not, they should do much to allay suspicion.

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The Board has considered whether it should attempt to suggest more specific guidance regarding what factors should be considered by audit committees and boards of directors in reaching judgments on the possible effect of a proposed MAS engagement on independence. In view of the manifold complexity of the total relationship between an accounting firm and an audit client and the infinite variations found in actual practice, the Board has decided that such an effort would be more misleading than helpful. Rather we believe that audit committees and boards of directors should consider all of the factors mentioned in the report as they may apply to a particular circumstance. To this end, member firms may find it useful to make copies of this report available to their clients.

We hope these views commend themselves to your favorable consideration.

Very truly yours,


John J. McCloy
Chairman

JJM/mb

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Introduction

In July 1978, the Public Oversight Board (Board) of the SEC Practice Section of the AICPA's Division for CPA Firms published Notice of Public Hearing 78-1 (Notice) soliciting public comment and announcing oral hearings concerning the general subject of scope of services for member firms of the SEC Practice Section. Conceptually, the term "scope of services" could refer to any type of service performed by accounting firms,¹ including accounting, auditing, tax, and a wide variety of so-called management advisory services, or "MAS." When speaking of MAS in this report the Board is referring to any service other than accounting, auditing, or tax services furnished by independent certified public accountants and firms with which they are associated. It includes such things as executive recruitment, actuarial services, profit planning and budget consulting, marketing analysis, financial planning and control services, data processing services, inventory control systems, plant layout, accounting systems design, and employee benefit plan consulting.

The Notice requested that the written comments and the oral testimony address a number of broad questions as well as a specific proposal of the Executive Committee of the SEC Practice Section (Proposal) to limit the scope of services a member firm may furnish to its audit clients who file audited financial statements with the Securities and Exchange Commission (hereinafter sometimes referred to as the "Commission" or the "SEC").

The oral hearings were held on August 17-18, 1978; 31 witnesses delivered statements and were questioned by members of the Board and its staff. A transcript of those hearings was maintained.² In addition, the Board received written statements from 152 commentators,³ and, as indicated in the Notice, the Board incorporated into its

1. In this report, the terms "accounting firms," "CPA firms," "public accounting firms," "certified public accounting firms," and "auditing firms" are used interchangeably. Similarly, the terms "accountant," "CPA," and "auditor" are used interchangeably.

2. References to that transcript will be cited herein as "POB Hearing Testimony."

3. Comments were received from 89 accounting firms and individual public accountants, 12 consulting firms (including actuarial, data processing, and personnel consultants), 13 members of academia, 33 client companies, and 5 miscellaneous commentators.

record the approximately 400 written comments received by the Securities and Exchange Commission pursuant to its request for comments in Securities Act Release No. 5869 (September 26, 1977). Finally, numerous published articles, studies, and surveys relating to scope of services have served as background material for the Board and have, in part, been relied upon in formulating its conclusions.⁴

This report contains a general discussion of the background giving

4. Subcommittee on Reports, Accounting and Management, Committee on Government Affairs, United States Senate, 95th Cong., 1st Sess., *Improving the Accountability of Publicly Owned Corporations and Their Auditors* (Committee Print 1977) ("Senate Report"); Staff of the Subcommittee on Reports, Accounting and Management, Committee on Government Affairs, United States Senate, 95th Cong., 1st Sess., *The Accounting Establishment: A Staff Study* (1977) ("Senate Staff Report"); Securities and Exchange Commission, 95th Cong., 2nd Sess., *Report to Congress on the Accounting Profession and the Commission's Oversight Role* (Committee Print 1978) ("SEC Report to Congress"); The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations (New York 1978) ("Cohen Commission Report"); Committee on Scope and Structure, *Final Report* (AICPA 1974) ("1974 Final Report"); AICPA Ad Hoc Committee on Independence, "Final Report," *Journal of Accountancy* (December 1969) ("1969 Final Report"); An Opinion Survey of the Public Accounting Profession, sponsored by Deloitte Haskins & Sells and conducted by Reichman Research, Inc. (New York 1978); J. Rhode, "The Independent Auditor's Work Environment: A Survey" (AICPA 1978); *The Balance Sheet: Top Executives Speak Out About CPA Firms*, Wall Street Journal (Dow Jones & Company, Inc. 1978).

For individual commentators, see, e.g., W. Dreher and C. Graese, "The Compatibility of Actuarial Consulting and Auditing Services," *Journal of Accountancy* (July 1978); T. Kelley and D. Roscetti, "Auditor/Actuary Relations Under ERISA: From the Auditor's Standpoint," *Journal of Accountancy* (July 1978); B. Hazlehurst, "Auditor/Actuary Relations Under ERISA: As an Actuary Sees It," *Journal of Accountancy* (July 1978); S. Klion, "MAS Practice: Are The Critics Justified?," *Journal of Accountancy* (June 1978); D. Miller, "The Annual Audit Revisited," *Financial Executive* (March 1978); D. Lavin, "Perceptions of the Independence of the Auditor," *Accounting Review* (January 1976); R. Hartley and T. Ross, "MAS and Audit Independence: An Image Problem," *Journal of Accountancy* (November 1972); G. Hobgood and J. Sciarrino, "Management Looks at Audit Services (Part II)," *Financial Executive* (August 1972); G. Hobgood and J. Sciarrino "Management Looks at Audit Services," *Financial Executive* (April 1972); P. Titard, "Independence and MAS—Opinions of Financial Statement Users," *Journal of Accountancy* (July 1971); A. Briloff, "Old Myths and New Realities in Accountancy," *Accounting Review* (July 1966); J. Carey and W. Doherty, "The Concept of Independence—Review and Restatement," *Journal of Accountancy* (January 1966); A. Schulte, "Compatibility of Management Consulting and Auditing," *Accounting Review* (July 1965).

rise to the scope of services question, the existing and proposed restrictions on scope of services imposed and to be imposed by the SEC Practice Section, and the Board's analyses and conclusions with respect to those restrictions and proposed restrictions as well as the question of limiting scope of services generally.⁵

5. This report is concerned with the performance of MAS by member firms of the SEC Practice Section for clients for whom they serve as independent public accountants rendering opinions on financial reports. For convenience, such clients are referred to as "audit clients."

Conclusions and Recommendations

Preamble

The conclusions and recommendations contained in this section of the report reflect the Board's views with respect to the specific scope of service limitations which are presently a condition of membership in the SEC Practice Section and those scope of service limitations which are embodied in the Proposal. While the Board's general conclusions and recommendations might be viewed in some respects as more permissive than the existing and proposed scope of service limitations, this should not suggest that the Board perceives no problems associated with accounting firms furnishing all forms of MAS to audit clients. The most fundamental departure by the Board from the existing and proposed scope of service limitations appears in the Board's treatment of those forms of MAS which do not impair auditor independence but which involve services not in accounting or financial related areas or which do not require skills related to accounting or auditing—that is, services which may impair the professional image of an accountant but not his independence.

As discussed more fully in the body of this report, the Board is concerned with professional image but does not believe that rule-making is the appropriate way to address the problem. Rather, the Board believes it is preferable to rely on public disclosure, supplemented by the admonition to members of the SEC Practice Section to exercise self-restraint and judgment before venturing into new areas of MAS.

With this in mind, the Board has drawn the following conclusions and makes the following recommendations:

1. There are many potential benefits to be realized by permitting auditors to perform MAS for audit clients that should not be denied to such clients without a strong showing of actual or potential detriment. The profession, therefore, should be careful not to impose unnecessarily broad prophylactic rules with respect to MAS and independence.

2. The Board generally concludes that mandatory limitations on scope of services should be predicated only on the determination that certain services, or the role of the firm performing certain services, will impair a member's independence in rendering an opinion on the fairness of a client's financial statements or present a strong

likelihood of doing so. Independence is generally defined as the ability to operate with integrity and objectivity. Integrity is an element of character, and objectivity relates to the ability of an auditor to maintain impartiality of attitude and avoid conflicts of interest. All conflicts of interest are not avoidable and some conflicts of interest produce countervailing benefits. Such conflicts are accepted, consistent with the concept of independence, because of practical necessity and the realization of important benefits, coupled with the fact that auditor integrity and various legal incentives provide adequate public protection. This helps explain public acceptance of the fact that auditors can be "independent" even though the client selects them and pays their fee. It also helps explain why there has been public acceptance of accounting firms furnishing a variety of tax advisory services to audit clients. Recognizing, therefore, that independence in an absolute sense cannot be achieved, when evaluating whether certain services should be prohibited, it is necessary to consider the potential benefits derived from the service and balance them against the possible or apparent impairment to the auditor's objectivity.

3. At this time no rules should be imposed to prohibit specific services on the grounds that they are or may be incompatible with the profession of public accounting, might impair the image of the profession, or do not involve accounting or auditing related skills.

4. The existing limitations on MAS concerning independence contained in the Professional Standards relating to Management Advisory Services ("MAS Professional Standards"), AICPA, *Professional Standards*, Vol. 1, MS §§ 101 *et seq.* and the Code of Professional Ethics, AICPA, *Professional Standards*, Vol. 2, ET §§ 50 *et seq.*⁶ embrace several provisions that are helpful in ensuring that independence will be maintained. Compliance with those applicable provisions should be made a condition of membership in the SEC Practice Section and peer reviews should be required to test for compliance.

5. Amendments to Regulation 14A (the proxy rules) of the Securities Exchange Act of 1934 and certain publicly available reports required of members of the SEC Practice Section will increase the amount of public disclosure concerning the nature and amount of MAS furnished by an auditor to an audit client and will reveal whether the client's audit committee or board of directors have both approved the MAS and considered its possible effect on independence. To the extent that certain MAS may be perceived publicly as impairing independence, the new disclosure rules, including the role of the audit committee or the board of directors, should either allay suspicion

6. See notes 145 and 159, *infra*, and accompanying text.

or cause clients and auditors to alter their relationships. These disclosure provisions should be given a chance to work, and they should serve to provide a stronger data base for monitoring of this area.

The Board does, however, recommend that SEC Practice Section members be required to include in their annual disclosure statements filed with the SEC Practice Section disclosure of gross fees both for MAS and tax services performed for audit clients expressed as a percentage of aggregate fees charged during the reporting period.

6. In the Board's view an accounting firm's independence is not impaired solely because a person associated with the firm acts as an enrolled actuary for an employee benefit plan of an audit client or as an enrolled actuary for such a plan which is an audit client. The Board, however, believes that an accounting firm should not provide actuarial services for an insurance company audit client unless those services are supplemental to primary actuarial advice furnished by another actuary not associated with the accounting firm.

7. The Board accepts the recent action of the Executive Committee proscribing certain executive recruiting services inasmuch as the services proscribed are perceived by others as having a strong likelihood of impairing independence, are available from other responsible sources, and do not otherwise produce sufficient countervailing benefits. In general, however, the Board is reluctant to support prohibitions against useful services which are based primarily on appearance without an adequate basis in fact.

Background

One of the early public criticisms concerning the breadth of services furnished by public accountants was expressed in a survey and attendant article published by Arthur A. Schulte, Jr. in 1965.⁷ Mr. Schulte's study concluded that the profession should seriously consider whether engaging in management consulting services for audit clients creates a conflict of interest and a concomitant lowering of public confidence in auditors' reports.

In the few years immediately following Mr. Schulte's article, several other interested persons conducted surveys and wrote articles addressing the question of whether auditors can appropriately perform MAS for their audit clients.⁸

In the fall of 1966, the AICPA formed an ad hoc committee to examine the question of scope of services and how those services bear on an auditor's independence. In August 1968, an interim report of this ad hoc committee was exposed for public comment. This was followed by a Final Report published in December 1969.⁹

The 1969 Final Report concluded generally that there was no evidence that performing a wide variety of management advisory services impairs independence in fact. The 1969 Final Report, however, did acknowledge that a significant minority is concerned that rendering management advisory services may impair independence, suggesting that the profession should be sensitive to the possibility that the rendering of such services may affect the appearance of independence.¹⁰ Nevertheless, the 1969 Final Report did not recommend

7. A. Schulte, "Compatibility of Management Consulting and Auditing," *supra* note 4. Mr. Schulte's study was prompted by the publication by the AICPA's Committee on Professional Ethics of Opinion No. 12, in which the Committee stated that "there is no ethical reason why a member or associate may not properly perform . . . management advisory services, and at the same time serve the same client as independent auditor." AICPA, Committee on Professional Ethics, Opinion No. 12, "Independence" (1963). In 1973 the AICPA codified all prior statements and opinions in the AICPA's Code of Professional Ethics. The original Opinion No. 12 can be found, however, in Carey and Doherty, "The Concept of Independence—Review and Restatement," *supra* note 4, at 39-40.

8. *E.g.*, A. Briloff, "Old Myths and New Realities in Accountancy," *supra* note 4; J. Carey and W. Doherty, "The Concept of Independence—Review and Restatement," *supra* note 4.

9. 1969 Final Report, *supra* note 4.

10. The AICPA's Committee on Professional Ethics is reported to have stated

proscribing the rendering of MAS.¹¹ Rather, it concluded that the situations in which the appearance of lack of independence might be involved are countless and that each case should be considered on its own circumstances. Furthermore, the Committee on Management Services of the AICPA had then recently published three statements which attempted to guide the profession in its performance of MAS and better inform the public of the nature of such services.¹² In turn, it was believed that the more informed the public was, the less likely it would be that it would perceive the rendering of such services as impairing independence.¹³

In 1974 the AICPA, through its Committee on Scope and Structure, published another study and analysis of the question of the appropriate scope of services for CPAs to perform.¹⁴ This study generally concluded that the benefits to society, the audit, and the client arising from public accountants furnishing MAS are significant and that the threat that rendering such services may impair independence or the appearance of independence is not sufficiently great to warrant their proscription.

Another major review of this question was conducted by the Cohen Commission.¹⁵ Its examination of the scope of services question en-

that the appearance of the lack of independence might arise from relationships which "might be regarded by a reasonable observer, who had knowledge of all the facts, as those involving conflict of interest which might impair the objectivity of a member in expressing an opinion on the financial statements of an enterprise." 1969 Final Report, *supra* note 4, at 53.

11. The 1969 Final Report did recommend that the profession give serious consideration to whether CPA firms should furnish so-called "peripheral management advisory services" such as plant layout, executive search, and psychological testing. While these services were not thought to affect independence, they were viewed by some as diluting the image of the profession. 1969 Final Report, *supra* note 4, at 55.

12. The three statements were "Tentative Description of the Nature of Management Advisory Services by Independent Accounting Firms," AICPA, *Professional Standards*, Vol. 1, MS § 410; "Competence in Management Advisory Services," AICPA, *Professional Standards*, Vol. 1, MS § 420; and "Role in Management Advisory Services," AICPA, *Professional Standards*, Vol. 1, MS § 430.

13. Cohen Commission Report, *supra* note 4, at 96; P. Titard, "Independence and MAS—Opinions of Financial Statements Users," *supra* note 4. Accounting Series Release No. 250 (June 29, 1978) ("ASR 250") discussed at pp. 42-44, *infra*, is a substantial step toward this end.

14. 1974 Final Report, *supra* note 4.

15. The Cohen Commission was formally titled The Commission on Auditors' Responsibilities. It was an independent commission formed by the AICPA in 1974 and chaired by the late Manuel F. Cohen. The Cohen Commission studied several aspects of the accounting profession and in 1978 published the Cohen Commission Report, *supra* note 4.

compassed a review of the several articles and surveys which had been published, a study of lawsuits and other proceedings against auditors, and extensive discussions with working auditors, financial analysts, technical partners in accounting firms, and representatives in government agencies.¹⁶ After this thorough review of available data, the Cohen Commission was not prepared to recommend proscribing specific services,¹⁷ but it did register concern that rendering MAS continued to appear to impair independence, at least to a significant minority of financial statement users.¹⁸ It suggested, therefore, that the profession increase its educational efforts directed toward users, with emphasis on internal controls utilized by accounting firms to prevent conflicts of interest. Moreover, it recommended that efforts be made to inform users of the nature of MAS rendered to clients and that audit clients be urged to disclose the nature of the various services furnished by the auditors.¹⁹

While the AICPA, in its 1969 Final Report and in its 1974 Final Report, and the Cohen Commission acknowledged concern that various surveys have concluded that rendering MAS to audit clients seemed to impair independence, at least in appearance, both concluded that broad proscriptions were not necessary.

Shortly after the formation of the Cohen Commission, the United States Senate, through its Committee on Governmental Affairs, Subcommittee on Reports, Accounting and Management ("Metcalf Subcommittee"), launched a broad-scale inquiry of the accounting profession which included a review of the nature of services furnished by accounting firms. The resulting Senate Staff Report, based on information obtained from the AICPA and accounting firms, generally concluded that auditors created a conflict of interest if they furnished MAS to audit clients since furnishing MAS "necessarily involves the . . . firms in the business operations of their corporate clients."²⁰ For

16. Cohen Commission Report, *supra* note 4, at 93-94.

17. The Cohen Commission did recommend that accounting firms not engage in recruiting individuals who would be directly involved in questions of auditor selection, with the exception that accountants ought to be permitted to respond informally to requests to identify potential board members. The Cohen Commission, however, did not recommend any restrictions on the ability of individual staff or partners of an accounting firm to seek employment with clients of their firm or from clients to hire personnel from their accounting firm for employment at any level. *Ibid.*, at 101.

18. "Users" generally refers to investors, lenders, financial analysts, investment advisers, and others who rely on financial statements for making investment or credit decisions.

19. Cohen Commission Report, *supra* note 4, at 102-103.

20. Senate Staff Report, *supra* note 4, at 50. The Senate Staff Report actually focused its attention on the so-called "Big Eight" firms and concluded that a

example, the Senate Staff Report concluded that an auditor, furnishing market study services, which an audit client uses in deciding to market a new product, has a professional interest in the success of that product. Similarly, the report noted that an accounting firm has a professional interest in seeing an executive, whom it recruited or helped to recruit, perform well in his new position. Accordingly, the argument goes, the auditor is no longer independent, now having an interest in seeing all or a segment of the client's business succeed.

In April, May, and June of 1977, the Metcalf Subcommittee conducted hearings to address various issues that had been raised in the Senate Staff Report. The Metcalf Subcommittee issued a report in November 1977, based on an analysis of the Senate Staff Report, the record of its hearings, and other documentary materials.²¹ This Senate Report covered a broad spectrum of subjects, including the question of scope of services.

The Senate Report noted that some witnesses testified that the furnishing of certain management advisory services by auditors to audit clients reflected adversely on the stated ideals of the profession and on independence and that accounting firms may be in a position to compete unfairly for business offered by other consultants.²² Expressing concern with this testimony, the Metcalf Subcommittee concluded that accounting firms should perform for audit clients only services related to accounting.²³ This would prohibit the furnishing of such services as "executive recruitment, marketing analysis, plant layout, product analysis, and actuarial services."²⁴ In addition, the Senate Report stated that all placement activities²⁵ should be discon-

conflict would arise if such a firm furnished MAS to audit clients. In determining the existence or nonexistence of conflicts of interest which jeopardize independence, the Board perceives no basis for distinguishing the "Big Eight" from other accounting firms. Indeed, as discussed in note 36, *infra*, the smaller CPA firms seem not to want separate and more permissive treatment based upon their size or the size and nature of their clientele.

21. Senate Report, *supra* note 4.

22. While the Subcommittee generally agreed with the Cohen Commission's Report of Tentative Conclusions issued in March 1977, it registered some disagreement in the area of scope of services. The Board has not thought it appropriate to address the question of unequal competition.

23. Senate Report, *supra* note 4, at 17.

24. *Ibid.*

25. The phrase "placement activities" generally refers to the practice of assisting employees of the accounting firm in locating employment outside the firm, including employment with audit clients of the firm. The motivation, at least for the larger firms, to provide such placement services largely arises from the "leveraged" structure of those firms. Most young CPAs hired by these firms never become partners, and they know this. One reason able graduates accept such a competitive environment is the belief that, whether

continued as well. The Metcalf Subcommittee indicated that the only management advisory services which it believed were appropriate were "providing certain computer and system analyses . . . necessary for improving internal control procedures of corporations."²⁶

In addition to the inquiry by the Metcalf Subcommittee, the Subcommittee on Oversight and Investigation of the House Committee on Interstate and Foreign Commerce (Moss Subcommittee) has conducted hearings related to the role of the Securities and Exchange Commission in establishing accounting principles and overseeing the profession generally.²⁷

The Congressional interest in the profession, as evidenced by the work of the Metcalf Subcommittee and the Moss Subcommittee, prompted the accounting profession to undertake a program of increased self-regulation. At its annual meeting in September 1977, the AICPA approved a comprehensive plan which involved the establishment of a Division for CPA Firms of the AICPA and two sections of that Division—the SEC Practice Section and the Private Companies Practice Section.²⁸ In addition, the Public Oversight Board was established to conduct continuing oversight of all activities of the SEC Practice Section.

The scope of services question under review by the Board arises in the context of the standards for eligibility to become a member of, or retain membership in, the SEC Practice Section. A document entitled "Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms" (Organization Document) sets forth the objectives of the SEC Practice Section, the membership eligibility criteria, structure of various operating committees and governing bodies, the functions of the Public Oversight Board, peer review information, and other matters.

As initially approved by the Executive Committee of the SEC Practice Section, the Organization Document provides that members of that Section should refrain from providing MAS to audit clients who are SEC reporting companies where providing such services would

or not they want to become partners or fail to be invited, they will have attractive alternative career opportunities.

26. Senate Report, *supra* note 4, at 17.

27. Hearings before the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives, 95th Cong., 2d Sess., *Reform and Self-Regulation Efforts of the Accounting Profession* (Committee Print 1978).

28. Members of the AICPA are individuals, not firms. The significance of the new division was to provide a facility for some form of self-regulatory controls over firms. Participation in either section, of course, is voluntary and is achieved by submitting an application and agreeing, among other things, to abide by all of the requirements for section membership.

impair independence or where such services are predominantly commercial in character, inconsistent with the firm's professional status as certified public accountants, and inconsistent with the firm's responsibilities to the public. The Organization Document also states that, in determining which MAS to perform, primary emphasis should be placed on "accounting and financial related areas." Psychological testing, conducting public opinion polls, and merger and acquisition work for a finder's fee are expressly prohibited. Additional prescriptions and guidance are contained in Appendices A and B to the Organization Document. Appendix A addresses two specific services—marketing consulting and plant layout.²⁹ Effective July 26, 1978, the Executive Committee approved adding Appendix B, which embodies limitations on performing executive search services.³⁰ The text of the existing scope limitations contained in the Organization Document appears in Addendum A to this report.

While the scope of services membership criteria remains as described above and as reflected in Addendum A hereto, on May 8, 1978, the Executive Committee of the SEC Practice Section tentatively approved certain changes in those criteria, subject to obtaining the views of the Board on this subject.³¹

As proposed to be revised, the membership eligibility criteria relating to scope of services would prohibit members of the SEC Practice Section from furnishing services to audit clients who are SEC reporting companies when such services (1) impair the firm's independence in expressing an opinion on financial statements of that client or (2) require skills not related to accounting or auditing. The details of these criteria, including a discussion of specific services which do and do not satisfy the criteria, are embodied in proposed Appendix A to the Organization Document. The proposed amendment to that Document and the proposed new Appendix A thereto appear as Addendum B to this report and are discussed in the Notice.

The Securities and Exchange Commission has also expressed views on this subject. In Securities Act Release No. 5869 (September 26, 1977), the Commission solicited public comment on proposals calling for disclosure in proxy statements of audit and other fees incurred by the registrant during the year and also asked for comment on several questions relating to restricting the scope of services accountants can perform for audit clients.

29. See pp. 46-48 *infra*.

30. See pp. 53-54 *infra*.

31. As indicated above, at its meeting on July 26, 1978, the Executive Committee approved that portion of the proposal relating to executive recruiting services.

In June 1978, ASR 250³² was released, announcing amendments to certain rules requiring disclosure in proxy statements of the various services furnished by a registrant's auditor during the year, the percentage relationship the aggregate fee for all nonaudit services bears to the audit fee, and the percentage relationship each nonaudit service (describing the service if more than 3 percent) bears to the audit fee.³³ In ASR 250 the Commission indicated that it had not yet determined to propose rules limiting the scope of services but would await the conclusions and recommendations of the Board. The Board understands that some people react to SEC disclosure requirements as though the matters to be disclosed somehow represent unlawful or improper business practices. Such a reaction may unnecessarily result in a loss of some MAS advice for audit clients.

The Commission again addressed the scope of services question in a Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role, dated July 1, 1978.³⁴ In that report the Commission cited three basic questions to be resolved: (1) whether fees from management advisory services could be so large as to affect the accountant's objectivity in conducting the audit; (2) whether certain services are so unrelated to the normal experience of auditors that it is inconsistent with the concept of being an accounting or auditing professional to perform those services; and (3) whether certain services are so closely linked to the accounting function that performing them will, in the course of an audit, place the auditor in the position of reviewing his own work. The Commission again noted that the Board was reviewing this matter and that it would await the Board's views before deciding to take any action.

32. See note 13, *supra*.

33. The rule changes announced in ASR 250 also require registrants to disclose whether the audit committee or board of directors approved each professional service furnished by the principal accountant and considered the possible effect on independence and whether such approval and consideration was given before or after the service was provided.

In Staff Accounting Bulletin No. 25 (November 2, 1978) the Commission's staff advised that it would be acceptable to state that there was advance approval of services where board of directors or audit committee approves a generic category of services, at least annually, and where such approval includes a limitation regarding the magnitude of the services and a subsequent review to compare the services rendered with such approval.

Of course, an unanticipated occasion for a particular MAS service might arise between meetings of the audit committee or board. There are several reasonable ways to handle such an occurrence, the disclosure of which should cause no embarrassment to the client or the CPA firm.

34. SEC Report to Congress, *supra* note 4.

Discussion of Scope Limitations

Approach to Problem

As is indicated by the extensive record, including the formal record of the Board's proceedings and other documentary material concerning this matter, the limitations on the types of services auditors should furnish to audit clients have been studied intensely. It is apparent that these continuing studies have produced very few conclusions which constitute a consensus. Perhaps the only conclusion everyone, or almost everyone, agrees with is that rendering some management advisory services to audit clients is perceived by some persons as creating a situation in which an auditor's independence could be impaired.³⁵ There also seems to be some consensus, however, that some services are not appropriately performed by certified public accountants because they derogate the professional image which is important to maintain.³⁶ Going from these two broad findings to specific examples of which services should and which should not be prohibited is no easy task.

In the analysis which follows, the Board has avoided discussing specific services, except in certain instances. Rather, the Board has focused its analysis on the general criteria employed by the Executive Committee of the SEC Practice Section in the Organization Document and in the proposed revisions to it.

The Board believes that persons should not be prohibited from engaging in lawful and perhaps beneficial activity unless it is demonstrated that the prohibition serves some necessary purpose and is reasonably necessary to achieve that purpose. Thus, where measures less draconian than outright prohibition are available they should be

35. POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 10; C. Vanatta, Arthur Young & Company, Tr. 34; R. Keating, A. S. Hansen, Inc., Tr. 94; E. Boynton, American Academy of Actuaries, Tr. 104, 111; C. Watson, Conference of Actuaries in Public Practice, Tr. 123-28; R. Cardinal, Lester B. Knight & Associates, Inc., Tr. 139-43; H. Moss, Altschuler, Melvoin and Glasser, Tr. 227; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 243-44; A. B. Frechtman, Robert Half Personnel Agencies, Tr. 340-41.

36. *E.g.*, POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 7, 20-21; W. Mueller, Arthur Andersen & Co., Tr. 12; P. Arnstein, John F. Forbes & Co., Tr. 47-50; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 245-47; J. Korreck, Illinois CPA Society, MAS Committee, Tr. 285-86; J. Burton, Columbia Graduate School of Business, Tr. 313, 317.

employed and resort to prohibitions utilized only after such other measures fail.

The Board also believes it is important to bear in mind that imposing limitations on the scope of services public accountants can permissibly perform will not only affect the large accounting firms, which could probably survive and prosper under whatever rules are adopted, but will also affect management advisory practitioners within those firms and small accounting firms and their clients who rely heavily on a variety of advisory-type services.³⁷

Finally, the Board believes it is important to recognize that MAS is not a recent and subversive corruption of the pristine role of the CPA firm as "pure" auditor. History actually has gone the other way, and modern CPA firms as auditors are perhaps more "pure" than they have ever been. From a historical perspective, accountancy has been professionalized largely through the enactment of statutes encouraging or requiring audits and financial disclosures. For example, the Federal Reserve Board, created by the Federal Reserve Act of 1913, encouraged business entities to supply certified financial statements when seeking to obtain bank notes issued against commercial paper. More importantly, the federal securities legislation enacted in 1933 and 1934 made accountants essential to corporations required to comply with the financial disclosure laws. This federal legislation formalized the accountant's public responsibilities and gave the profession statutory recognition.

Nevertheless, the accounting profession has never been based solely

37. While any proscription emanating from the SEC Practice Section can only be imposed directly against members of that Section, the testimony at the hearings quite clearly demonstrated that virtually all accounting firms would feel constrained to abide by them. This is particularly true if any proscription were founded on the claim that an accounting firm providing such a service to an audit client would not be independent for purposes of expressing an opinion on that client's financial statements.

The importance of maintaining independence is so well grounded in auditing literature and codes of ethics that establishing variations on that theme does not seem to be a reasonable solution. Accordingly, any decision in this area cannot nicely be confined to the so-called "Big Eight," which was the focus of the Senate Report, and other large accounting firms. Spokesmen for smaller accounting firms were especially vehement in opposing the creation of any "second class" membership that looked toward allowing them to be less independent or to appear to be less independent or less "professional" just because they were small. The Board respects this attitude, so strongly felt and stated, even though some of the controversy in this area might be resolved by doing that very thing.

POB Hearing Testimony: J. Mason, Jr., The University of Alabama, Tr. 211; H. Moss, Altschuler, Melvoin and Glasser, Tr. 222-23; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 250; M. Elliott, AICPA, MAS Executive Committee, Tr. 270; S. Hebert, North Carolina Association of CPAs, MAS Committee, Tr. 301-04; H. Bernstein, Bernstein and Bank, Ltd., Tr. 359, 362.

on auditing skills. Those who formed the American Association of Public Accountants in 1887 (renamed the American Institute of Accountants in 1917 and in 1956, after a merger in 1936 with the American Society of Certified Public Accountants, renamed the American Institute of Certified Public Accountants) were rendering a variety of services including bookkeeping and management advice, and were not engaged primarily in auditing.

The first Revenue Act of 1913, authorized by the Sixteenth Amendment, also created a boom for accountants capable of handling the new income tax laws. Most small businessmen suddenly needed expert assistance to install bookkeeping systems, prepare financial statements and tax returns, and handle disputes with revenue agents. Since the first statutes were passed, accountants have been integrally involved in furnishing a wide variety of tax advisory services.

Accountants also have long engaged in giving management advice to clients, and, during the last 30 to 35 years, beginning with the advent of World War II, accountants have enjoyed a rapid growth in new forms of MAS. This growth in part has been the result of general postwar corporate growth and the application of new techniques and systems approaches to problems developed during the war which were well suited to accountants.³⁸

Benefits of MAS

While the rendering of management advisory services has been attacked from many directions, it has also been praised by credible sources. Many persons speaking before and submitting written statements to the Board, along with periodical literature, comments submitted to the SEC, and several predecessors to this task of exploring MAS, have illuminated the many benefits that MAS can provide for audit clients. Even if MAS could arguably be said to taint an auditor's appearance of independence, it cannot be denied that much of value is also produced.

First, from a client's viewpoint, an accounting firm that has conducted an extensive and competent audit is a logical choice when that client needs management advice. Assuming that the accounting firm

38. For detailed discussions of the growth of accountancy and its many components in both America and Great Britain see J. Carey, *The CPA Plans for the Future* (1965); J. Carey, *The Rise of the Accounting Profession* (2 vols. 1969 & 1970); A. Littleton, *Accounting Evolution to 1900* (1933); A. Littleton, *Essays on Accountancy* (1961); S. Zeff, *Forging Accounting Principles in Five Countries: A History and Analysis of Trends* (University of Edinburgh Accounting Lectures (1971)); *Studies in the History of Accounting* (A. Littleton & B. Young, eds. (1956)).

has the competence to render the services needed, its audit clients will naturally want to take advantage of its knowledge, experience, organization, and personnel. Each job may begin more quickly and proceed more efficiently than if the client had to engage a different firm.³⁹ For many smaller businesses, a requirement to retain separate accounting firms or other consultants for MAS and audit services might be cost prohibitive, and might obviously result in a sacrifice of one or the other, or at least a decrease in the quality of services a company could afford. Because all concerned parties advocate improving accounting services for the benefit of businesses and the public, such pressures may be counterproductive. At the very least, the cost savings and quality improvements created by allowing accountants to provide MAS to audit clients are real benefits that must be seriously considered.

Second, many persons appearing before the Board asserted that MAS capabilities within a firm and an audit team enhance audit quality.⁴⁰ Audits are improved, it is argued, because a firm with professionals experienced in MAS has more sophistication in the increasingly complex and intricate inner workings of business enterprises. With that broader base of experience and knowledge of a client's business such a firm can more effectively conduct an in-depth audit through more responsible inquiries and evaluations.⁴¹

39. S. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 76-77; POB Hearing Testimony: C. Vanatta, Arthur Young & Company, Tr. 28; H. Moss, Altschuler, Melvoin and Glasser, Tr. 224; H. Bernstein, Bernstein and Bank, Ltd., Tr. 360. Letters from: Donald E. Schowengerdt, July 28, 1978; and AICPA, MAS Executive Committee, August 7, 1978, in response to the Notice.

40. POB Hearing Testimony: C. Vanatta, Arthur Young & Company, Tr. 28; J. Seitz, Touche Ross & Co., Tr. 198-99; H. Moss, Altschuler, Melvoin and Glasser, Tr. 225-26; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 238-39; M. Elliott, AICPA, MAS Executive Committee, Tr. 268-69; J. Korreck, Illinois CPA Society, MAS Committee, Tr. 284; L. Dowell, McGladrey, Hansen, Dunn & Company, Tr. 290-91; J. Burton, Columbia Graduate School of Business, Tr. 306; H. Bernstein, Bernstein & Bank, Ltd., Tr. 363. Letters in response to the Notice from: Eisner & Lubin, July 18, 1978; McGladrey, Hansen, Dunn & Company, July 31, 1978; and Harris, Kerr, Forster & Company, August 7, 1978. Response to Securities Act Release No. 5869: Coopers & Lybrand; Touche Ross & Co. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 74-76.

41. In a comment letter submitted before the POB Hearing, John C. Burton, Columbia Graduate School of Business, and former Chief Accountant of the SEC, explained some of his own experiences which illustrate the benefits of MAS in the audit process. In his own words he states:

When I was a staff accountant, one of my clients asked our firm to develop a system for translating foreign currency statements in U.S. dollar statements for consolidation purposes. I and a consultant worked on the job and developed an

As appealing as this argument is, there were some differences of opinion at the POB hearings as to how this goal of improved audits is attained. Some testified that persons experienced in MAS are utilized in almost every audit and thus provide a broader knowledge to the audit team.⁴² Others asserted that MAS professionals, although not assigned to each audit team, are frequently consulted and available to auditors.⁴³ Still others explained that members of MAS units and audit divisions often switch from one to another, carrying with them certain expertise that is naturally incorporated into both areas.⁴⁴ Despite this rather hazy picture that was drawn at the hearings regarding the precise mechanics of incorporating MAS capabilities into audits, all witnesses discussing this subject fervently maintained that performing MAS led to an improvement in audit quality.⁴⁵ To foster

understanding in depth of the translation process which would not have occurred otherwise, and in a subsequent audit I was able to point to certain implications of particular changes in exchange rates on the client's statements which required careful audit consideration.

In a second case, I as a professor was consulting with an accounting firm in the area of management services research. One of my areas of interest was credit policy, and the firm was given an engagement to study the credit policy of one of its large mail order clients who wished to develop an improved system of credit control. I worked on the engagement with a consultant from the firm's management services staff and an audit manager. We assisted in the development of a credit policy and a system of credit control, and in so doing achieved an understanding of the variables affecting credit loss for that firm that could never have been achieved through normal auditing techniques. This understanding was of great importance to the audit staff in evaluating the adequacy of the client's allowance for uncollectible accounts. In the year prior to the consulting engagement, the client's allowance was materially understated in the financial statements and its income was materially overstated, even though procedures were performed. In the year following the engagement, the audit staff, assisted by workpapers from the consulting engagement, were able to appraise the adequacy of the allowance with far greater accuracy.

For other examples see Letters in response to the Notice from: Laventhol & Horwath, August 8, 1978; and Coopers & Lybrand, August 10, 1978.

42. *E.g.*, POB Hearing Testimony: S. Klion, AICPA, MAS Executive Committee Chairman, Tr. 275-76. See also Response to Securities Act Release No. 5869: Peat, Marwick, Mitchell & Co., Exhibit II.

43. *E.g.*, POB Hearing Testimony: H. Moss, Altschuler, Melvoin and Glasser, Tr. 230-33; S. Hebert, North Carolina Association of CPAs, MAS Committee, Tr. 302.

The Board urges the Executive Committee to consider what formal procedures, if any, accounting firms should be encouraged or required to institute in order to realize audit benefits from furnishing MAS, taking into account the need to maintain independence. *E.g.*, the comments of S. Burton recited at note 129, *supra*.

44. *E.g.*, POB Hearing Testimony: M. Elliott, AICPA, MAS Executive Committee, Tr. 272-73; S. Klion, AICPA, MAS Executive Committee, Tr. 276.

45. One response to critics who assert that MAS creates the potential for self-review is to isolate the MAS practitioners from the audit staff so that no individual will be reviewing his own work. Carried to its extreme, this sug-

continued improvement the Board believes that accounting firms should apply their MAS expertise to the audit function to the fullest extent possible.

Another benefit of MAS appears to be the quality of young professionals who are attracted to accounting firms because of the opportunity to practice MAS. Time and again the Board heard testimony that the best and brightest students emerging from business schools are most interested in firms that will afford them the opportunity to work in the MAS area.⁴⁶ Whether these students eventually do practice MAS, or do so only for a while, the availability of broader experience beyond that of auditing makes some accounting firms more attractive. Because the audit function is highly important to the SEC Practice Section, given its critical function for reporting companies, the Board is sensitive to the needs of accounting firms that perform audits to strengthen their ranks with the brightest professionals available. Consequently, this benefit of MAS to the accounting profession and to the public, who must rely on the work product of these professional auditors, can also be considered an important one.

There are other advantages to allowing accountants to provide MAS to audit clients in addition to attracting bright students and enhancing audit quality. One is that an auditor who also has some responsibility for advising its client on internal financial controls can facilitate an audit by improving the underlying structure of what is audited.⁴⁷ Auditors are naturally aware of deficiencies in information systems. If they can work with a client to improve a system the result is twofold. First, future audits should be less costly because they will be more easily accomplished. Second, improved controls will in turn make financial statements more accurate and reliable because the system on which they are based is equally so. Thus, a great benefit can be seen in allowing an accounting firm to communicate to a client weaknesses and defects observed in an audit and also to

gestion results in a significant diminution of the benefit MAS may bring to an audit. As long as the MAS personnel abide by the existing standards requiring that they limit their role to that of advisers, the problem of self-review, in large measure, is solved.

46. *E.g.*, POB Hearing Testimony: J. Seitz, Touche Ross & Co., Tr. 195; M. Elliott, AICPA, MAS Executive Committee, Tr. 268-69; J. Burton, Columbia Graduate School of Business, Tr. 306, 310. S. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 76. Letter in response to the Notice from J. Burton, Columbia Graduate School of Business.

47. S. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 75; POB Hearing Testimony: M. Elliott, AICPA, MAS Executive Committee, Tr. 269. Letter in response to the Notice from McGladrey, Hansen, Dunn & Company, July 31, 1978.

be retained to make specific recommendations for improvements through its MAS services.⁴⁸

Finally, there seems to be a general consensus that maintaining a competent accounting firm today does mandate a kind of knowledge broader than in the past.⁴⁹ As the AICPA's Committee on Scope and Structure reported, "a command of more than one field of knowledge is required if the profession is to be fully responsive to the growing public need for better and more extensive services."⁵⁰ The growing complexities within the profession are illustrated not only by the kinds of services that are in demand, but also by newly developing accounting principles and techniques. For example, new concerns with the effects of inflation and certain required disclosures of larger companies have caused accountants to deal with much more "soft" information than in the past. Similarly, the Securities and Exchange Commission recently called for the development and implementation of a method of accounting that provides for recognition in financial statements of proved oil and gas reserves as assets and of changes in proved oil and gas reserves in earnings.⁵¹ Whether this "reserve recognition accounting" is actually feasible remains uncertain, but the future task of working on its development is clearly going to be difficult, as recognized by the Commission, because traditional accounting methods do not adequately provide for recognition of the discovery of oil and gas. The

48. Section 13(b)(2) of the Exchange Act, added to that Act by the Foreign Corrupt Practices Act of 1977, creates an affirmative obligation on each issuer of securities, subject to the reporting requirements of the Exchange Act, to establish and maintain a system of internal controls sufficient to provide reasonable assurances that certain stated standards are met. Accounting firms are already actively engaged in providing advice and assistance to audit clients in meeting these requirements which go well beyond matters of accounting and bookkeeping.

In this vein a partner of a major accounting firm recently made the following observation:

To restrict [MAS] would be particularly shortsighted and unwise at this time because the SEC is virtually certain to demand in the near future that public companies report on the quality of their internal controls.

W. Hanson, "Public Accountancy And The Domino Theory," *Mid-Hudson Business Journal*, Harrison, New York (January 2, 1979).

49. E.g., POB Hearing Testimony: N. Auerbach, Coopers & Lybrand, Tr. 89-90; M. Elliott, AICPA, MAS Executive Committee, Tr. 268-69; J. Korreck, Illinois CPA Society, MAS Committee, Tr. 284; L. Dowell, McGladrey, Hansen, Dunn & Company, Tr. 290-91. Letter in response to the Notice from: AICPA, MAS Executive Committee, August 7, 1978; Touche, Ross & Co., August 17, 1978; Ralph E. Kent, August 7, 1978; and Donald E. Schowengerdt, July 28, 1978.

50. 1974 Final Report, *supra* note 4, at 24.

51. Accounting Series Release No. 253 (August 31, 1978).

inherent imprecision of estimates of proved oil and gas reserves further guarantees that this new accounting for oil and gas production will require skills and expertise that many accountants do not now possess.⁵²

Some or all of the several benefits mentioned above are present in the wide array of MAS being performed today. It is impossible, however, for the Board to measure, in the abstract, the precise benefit accruing from each possible service and concluding whether furnishing that service to audit clients should be permitted. In any event, the Board does not believe it is necessary at this time to engage in such abstract analysis. For one thing, the possible benefit is only one factor to consider. The others include the fact that impairment of independence in fact has not been demonstrated and impairment of the appearance of independence can be cured with greater awareness.

SEC Practice Section—Existing and Proposed Scope Limitations

As indicated above, the Organization Document provides that a member of the SEC Practice Section may not perform services for audit clients that will impair that member's independence and that primary emphasis should be on services which are in accounting and financial related areas. The Proposal embraces the independence criteria and adds to it the requirement that the services require skills related to auditing and accounting. The Board understands that the "accounting and financial related areas" standard and the "auditing and accounting skills" proposed standard both are designed generally to proscribe services which may be incompatible with accounting or which may tarnish the profession's image.

Although notions of compatibility or image have been discussed for many years, until incorporated in the standards for membership in the SEC Practice Section, very few attempts had been made to identify the class of activity which might impinge on them. Independence, on the other hand, has been a concept with which the profession has had to live for many years and which has resulted in numerous interpretations both by the Securities and Exchange Commission and the AICPA. The requirement that accountants be independent of their clients when issuing opinions on financial state-

52. The new demands on the accounting profession have also been recognized by the United States General Accounting Office, in which over 50 percent of the professional staff have basic skills in areas other than accounting. W. Dreher and C. Graese, "The Compatibility of Actuarial Consulting and Auditing Services," *supra* note 4, at 38. See also letter in response to the Notice from Ralph E. Kent, August 7, 1978.

ments is embodied in the AICPA's Code of Professional Ethics,⁵³ and the requirement extends to rendering reports on financial statements to any client of the accountant, whether or not that client is subject to the reporting requirements of the federal securities laws. There is no question, therefore, that an accountant, in deciding whether to perform a particular service for an audit client, must determine whether performing that service will impair his independence with respect to the audit.

The compatibility or image criterion contained in the Organization Document—whether stated as services which are in financial or accounting areas or which require skills related to auditing or accounting—poses a more difficult question for the Board because it remains unresolved by the profession and the SEC. It is necessary to ask whether that criterion serves any necessary or useful purpose and whether it is susceptible of sufficiently definite articulation to make it meaningful. As indicated in the Conclusions and Recommendations section, the Board believes that the compatibility criterion should not be imposed, at least at this time.

Compatibility or Image Criterion

A substantial number of persons testifying at the Board's hearings and submitting written comments in response to the Notice criticized the audit and accounting skill related criterion embodied in the Proposal. Some witnesses argued that the only relevant criterion is independence, urging complete elimination of the skill related criterion or any similar types of criteria, such as accounting and financial related areas presently contained in the Organization Document.⁵⁴ Others urged that some criteria limiting services to areas compatible with accounting or to auditing and accounting related areas be employed as an alternative to skill related criteria.⁵⁵

Witnesses and commentators who favored some compatibility criteria, but not those based on skills, were concerned primarily that the skill criteria would be virtually useless, being susceptible of permitting

53. AICPA, *Professional Standards*, Vol. 2, ET § 50 *et seq.*

54. *E.g.*, POB Hearing Testimony: N. Auerbach, Coopers & Lybrand, Tr. 73; H. Gunders, Price Waterhouse & Co., Tr. 171, 175; J. Mason, Jr., The University of Alabama, Tr. 205; M. Elliott, AICPA, MAS Executive Committee, Tr. 270; J. Korreck, Illinois CPA Society, MAS Committee, Tr. 283; S. Hebert, North Carolina Association of CPAs, MAS Committee, Tr. 296.

55. *E.g.*, POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 6-9, 18-20; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 244-51; J. Burton, Columbia Graduate School of Business, Tr. 313.

nearly any type of service, depending on one's interpretation.⁵⁶ A broad interpretation could effectively reduce the purported limitation to a meaningless obstacle and a poorly veiled subterfuge. Some witnesses, however, suggested that a limitation couched in terms of auditing and accounting related areas, as opposed to skills, would be less susceptible of a broad interpretation and would more effectively limit services to those which are compatible with auditing or accounting.⁵⁷ The desire to achieve compatibility was alternatively expressed as a desire to preserve the accountants' image or dignity as professionals.⁵⁸

Witnesses and commentators opposed to any criteria, save independence, believed that the skill related criterion embodied in the Proposal was illogical and wholly unrelated to the quality of audits.⁵⁹ If the standard is to improve an accountant's image or prevent the deterioration of that image, it will be ineffectual if applied only to services rendered to audit clients who are SEC reporting companies. From the standpoint of image the danger exists that accountants might appear to have converted a professional practice into a commercial enterprise. The appearance of commercialism relates to the types of services performed, not the nature of the person for whom they are performed. This, of course, is in sharp contrast to the concerns related to independence.

In sum, there was significant support for the conclusions that a skill related criterion was unnecessary because it was unrelated to the quality of audits, was unworkable and meaningless because it was susceptible of any convenient interpretation, and was an inappropriate and ineffectual gesture to assuage political critics who would not be satisfied in any event.

The Board agrees with those witnesses who have urged that any limitation on services be predicated only on the requirement that services not be furnished to audit clients if furnishing such services would impair the accountant's independence in rendering an opinion on that client's financial statements. Nevertheless, the Board is sympathetic

56. *E.g.*, POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 7, 18-19; Letter in response to the Notice from A.M. Pullen & Co., August 2, 1978.

57. *E.g.*, POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 7, 20; J. Burton, Columbia Graduate School of Business, Tr. 313.

58. *E.g.*, POB Hearing Testimony: P. Arnstein, John F. Forbes & Company, Tr. 54; R. Mautz, Ernst & Ernst, Tr. 152, 161; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 245.

59. *E.g.*, POB Hearing Testimony: C. Vanatta, Arthur Young & Company, Tr. 28-30; N. Auerbach, Coopers & Lybrand, Tr. 73-74; R. Mautz, Ernst & Ernst, Tr. 153; H. Gunders, Price Waterhouse & Co., Tr. 171, 175; J. Mason, Jr., The University of Alabama, Tr. 205; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 237; S. Hebert, North Carolina Association of CPAs, MAS Committee, Tr. 296.

with those who expressed some concern with respect to image or compatibility. The Board views compatibility as a limitation which would enhance image but not necessarily to the exclusion of other limitations. Accordingly, the Board has chosen to discuss the subject in terms of image.

The early studies and analyses of scope of services recognized a distinction between those services which seemingly impaired the appearance of independence and those services which arguably impaired image.⁶⁰ In fact, services which raise image questions are, as a general matter, so unrelated to what is generally thought to be an accountant's role, that concern for maintaining independence is hardly an issue.⁶¹ The converse is also true. Services most related to accounting and auditing and auditing generally seem to be those services which may impair independence or the appearance of independence.⁶²

60. In its 1969 Final Report, the Ad Hoc Committee made the following observation:

Services which appear unrelated to the accounting function, in its broadest sense, have been singled out for criticism. The committee believes that the critics are not so much concerned about their relation to audit independence . . . as their seeming incongruity with traditional accounting practice.

1969 Final Report, *supra* note 4, at 54. But see Hartley and Ross, "MAS and Audit Independence: An Image Problem," *supra* note 4, whose survey suggests that there is a significant correlation from a perception standpoint between services which could impair independence and those which are incompatible with the image of an accountant.

61. This does not mean that the performance of services wholly unrelated to accounting or auditing could never pose independence problems. Certainly if, on a continuing basis, the magnitude, in terms of revenue of such unrelated services to any one client, became very large in relation to the audit services, serious questions would be raised with respect to independence. The Board is not prepared to speculate as to the point at which the relationship between audit and nonaudit fees poses such a problem. But, based on existing data concerning fee relationships, the Board is satisfied that that point has not been reached on a broad and continuing scale. See note 65, *infra*. More will be known on this subject as 1979 proxy statements containing the information called for by ASR 250 become available.

62. Letter in response to the Notice from J. Burton, Columbia University Graduate School of Business, August 2, 1978.

This is also apparent from two of the three general questions posed by the Securities and Exchange Commission in the SEC Report to Congress. The two questions were stated as follows:

Are there some services which are so unrelated to the normal expertise and experience of auditors that it is inconsistent with the concept of being an auditing professional for auditors to perform those services?

Are there, conversely, some services so closely linked to the accounting function that, for the auditor to perform those services for his client means that, the auditor will, in conducting the audit, be in a position of reviewing his own work?

SEC Report to Congress, *supra* note 4, at 12.

The Board recognizes that professional image is important to maintain since it can bear on the public's confidence in financial statements.⁶³ And, maintaining such confidence is one of the primary reasons for requiring that auditors be independent of their clients.⁶⁴ The Board is concerned that accounting firms may tarnish their image as professional organizations if they appear ready, willing, and able to hawk any service for a profit.

The potential impairment to image, would, in the Board's view, result from a dilution or perceived dilution of an accounting firm's primary service—auditing and accounting. This dilution can manifest itself in terms of the number and types of nonaccounting or nonauditing services which are offered or in the amount of total revenues derived from such other services in relation to revenues from auditing and accounting services.⁶⁵

While the Board is concerned with the possibility that broad-scale expansion by accounting firms into new areas may impair the profession's image, it does not believe that the nature and extent of management advisory services generally furnished in today's environment warrant anything more than sounding an alarm.⁶⁶ If the problem were

63. The concern is not related to competence, as some have apparently believed. An accounting firm can train or hire competent people as well as any other organization or group of people, and, under current Professional Standards relating to MAS, practitioners must have, before undertaking an engagement, "competence in the analytical approach and process, and in the technical subject matter under consideration." AICPA, *Professional Standards*, Vol. 1, MS § 120.

The concern also is not related to independence. If it were, the standard would be redundant since the AICPA's Professional Code of Ethics and the membership criteria relating to independence already have established the required restriction.

64. AICPA, *Professional Standards*, Vol. 1, MS § 110.03.

65. The SEC has suggested that aggregate MAS fees from an audit client, by their very size relative to the audit fee, may tend to corrupt—presumably the CPA firm will be motivated to be "friendly" in its auditing in order to retain the MAS revenues. See note 62, *supra*. At the Board's hearing, each CPA witness who was asked denied the cogency of this argument, citing the fact that all larger firms, at least, are dominated by audit-oriented CPAs and will continue to be; that aggregate CPA firm revenues from MAS, at least for the larger firms, are significantly less than audit revenues; and that, in any event, the exposure to money damages and worse from poor audits make it folly to compromise an audit to get or buy MAS business, and all members of the SEC Practice Section realize this. The Board tends to agree in theory with the SEC but accepts the practical response of the CPA witnesses, at least in present circumstances. Under present disclosure requirements of the SEC Practice Section and the SEC, if the relative proportions change, that fact will be easily observable.

66. The Board does not believe that the scope and extent of management ad-

susceptible of rulemaking in a manner which was meaningful but which did not impede normal and proper growth in the dynamic area of auditing, the Board might be more inclined to agree with a rulemaking approach, specifying acceptable and unacceptable MAS. For the time being the Board believes the profession should recognize the potential problem and individual firms should exercise self-restraint and not venture into new areas of MAS which may impinge on their professional image. This is perhaps even more true with respect to the larger and medium-sized accounting firms that have a public visibility through their auditing of publicly-held corporations.

The Board is also mindful that the marketplace should serve as a self-correcting device insofar as image is concerned. If furnishing a wide array of services does tarnish a particular firm's professional standing, that should result in audit clients looking elsewhere for their needed auditing services. With the increased disclosure occasioned by ASR 250 and the requirement that members of the SEC Practice Section file annually with the Section a disclosure statement, including disclosure of gross fees for all services—accounting and auditing, tax, and management advisory services⁶⁷—expressed as a percentage of total gross fees, public awareness should play a larger role in shaping the scope of services accounting firms are willing to furnish.

Independence

Stated standards on independence

Independence has traditionally been defined by the profession as the ability to act with integrity and objectivity. Integrity is equivalent to honesty or to trustworthiness and incorruptibility even in the face of strong pressure. Objectivity has been described as the "lack of bias and resistance to any conscious or subconscious influence toward action, inaction, conclusions or statements that are based on anything other than an impartial evaluation of the best available evidence."⁶⁸

visory services performed at present suggests any dilution of accounting firms' primary service. The record indicates that management advisory services represent a small percentage of total revenues. Information submitted by the "Big Eight" firms to the Metcalf Subcommittee on Reports, Accounting and Management, January, 1976, revealed that MAS, both to audit clients and nonaudit clients, generated from 5 to 16 percent of these firms' total revenues. In letters submitted in response to Securities Act Release No. 5869 (September 26, 1977), these same firms reported percentage revenues ranging from 5 to 19 percent, and some smaller firms reported that MAS comprised 3.54 to 11 percent of total revenues. With additional public disclosure, discussed on page 44, this will be an item easy to monitor on an ongoing basis.

67. Organization Document, Section IV, 3, (g)(12). See pp. 43-44, *infra*, for additional disclosure recommended by the Board.

68. S. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 77.

While it is, of course, essential that an auditor preserve his objectivity and integrity from his own viewpoint, commonly called "independence in fact," it is also important that the auditor *appear* independent to all users of the financial information he provides. This latter concept is a key ingredient to the value of the audit function, since users of audit reports must be able to rely on the independent auditor. If they perceive that there is a lack of independence, whether or not such a deficiency exists, much of that value is lost.⁶⁹

As the Auditing Standards Executive Committee of the AICPA has explained:

It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.⁷⁰

To prevent a public perception of a lack of independence, the accounting profession has endeavored to prohibit an accountant from expressing an opinion on financial statements when certain relationships exist between auditor and client. According to the AICPA's *Professional Standards*, an auditor's integrity and objectivity may be, or may appear to be, threatened by the existence of "(1) certain financial relationships with clients and (2) relationships in which a CPA is virtually part of management or an employee under management's control."⁷¹ As a general matter, only the latter relationship is relevant to the scope of services issue.⁷²

69. A. Arens and J. Loebbecke, *Auditing: An Integrated Approach* (Prentice-Hall, 1976).

70. AICPA, *Professional Standards*, Vol. 1, AU § 220.03.

71. AICPA, *Professional Standards*, Vol. 2, ET § 52.10.

72. Both the existing and proposed scope limitations contained, and proposed to be contained, in the Organization Document prohibit engaging in MAS on a contingent fee basis. This is a sound restriction and should be retained. Other-

There are three major rules promulgated by the AICPA that provide the framework for the independence requirement. First, the second general auditing standard states that: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."⁷³ Second, the *Concepts of Professional Ethics* contains the following statement: "A certified public accountant should maintain his integrity and objectivity and, when engaged in the practice of public accounting, be independent of those he serves."⁷⁴ Third, Rule 101 of the *Rules of Conduct* provides specific instances of compromised independence.⁷⁵ The AICPA's Professional Ethics Division and Management Advisory Services Division have also issued pronouncements regarding the relationships between management advisory services and independence.⁷⁶

The AICPA can expel from the organization any member who is found to have violated its Rules of Conduct. Although such a consequence would be a "weighty social and economic sanction," expulsion from the AICPA does not prevent an accountant from practicing his profession.⁷⁷ Each state controls accountants in public practice

wise, the accounting firm would, in the Board's view, have a financial relationship with the client which would impair its independence. A prohibition on contingent fees also is part of the AICPA's Code of Professional Ethics, AICPA, *Professional Standards*, Vol. 2, ET § 302.

73. AICPA, *Professional Standards*, Vol. 1, AU § 220.01. The membership of the AICPA has officially adopted ten broad statements collectively entitled "Generally Accepted Auditing Standards." These auditing standards deal with measures of the quality of the performance of auditing procedures and the objectives to be attained by the use of the procedures undertaken.

74. AICPA, *Professional Standards*, Vol. 2, ET § 52. The *Concepts of Professional Ethics* is a philosophical essay approved by the professional ethics division of the AICPA. The essay suggests behavior which CPAs should strive for beyond the minimum level of acceptable conduct set forth in the *Rules of Conduct*, *infra* note 75, and is not intended to establish enforceable standards.

75. AICPA, *Professional Standards*, Vol. 2, ET § 101.01. The *Rules of Conduct* consists of enforceable ethical standards and requires the approval of the membership of the AICPA before the Rules become effective.

76. Pronouncements of the Management Advisory Services Division are "Management Advisory Services Practice Standard No. 1—Personal Characteristics," AICPA, *Professional Standards*, Vol. 1, MS § 110; "Tentative Description of the Nature of Management Advisory Services by Independent Accounting Firms," AICPA, *Professional Standards*, Vol. 1, MS § 410; and "Role in Management Advisory Services," AICPA, *Professional Standards*, Vol. 1, MS § 430. Pronouncements of the Professional Ethics Division are Interpretation No. 3 of Rule 101 of the AICPA Code of Professional Ethics, AICPA, *Professional Standards*, Vol. 2, ET § 101.04; and various ethics rulings on independence, AICPA, *Professional Standards*, Vol. 2, ET § 191.

77. A. Arens and J. Loebbecke, *Auditing: An Integrated Approach*, *supra* note 4, at 33.

within its borders by a licensing procedure and, thus, only a state board can prevent an accountant from practicing by revoking his license. Because all state boards have rules of conduct substantially similar to the AICPA's, an accountant could be removed from public practice for failure to maintain independence during an audit, although this happens infrequently.⁷⁸

The Securities and Exchange Commission has also addressed the question of independence on sundry occasions over the years. In order to ensure public confidence in the objective reporting of financial information, certain rules, particularly Rule 2-01⁷⁹ of Regulation S-X and Rule 2(e)⁸⁰ of the Commission's Rules of Practice were adopted. Generally, Regulation S-X requires that any audited financial statements filed with the Commission be audited by an accountant who satisfies the independence requirements contained in that Regulation. Under Rule 2(e) the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission to have, among other things, engaged in any violation of the federal securities laws or the rules of the Commission, including its rules relating to independence contained in Regulation S-X.⁸¹

The Commission has consistently held that the question of independence is to be determined in light of all the pertinent circumstances in a particular case.⁸² Rule 2-01(b) of Regulation S-X, however, does set forth certain specific relationships and circumstances which are so likely to impair independence that the Commission will refuse to recognize as independent any accountant having such a relationship with a client. Generally, Rule 2-01(b)(1) provides that an accountant is not independent if he, his firm, or any member of his firm has any direct financial interest or any material indirect financial interest in the client to be audited or any of its af-

78. *Ibid.*

79. 17 C.F.R. 210.2-01.

80. 17 C.F.R. 201.2(e).

81. 17 C.F.R. 201.2(e)(1). The Commission has exercised its power to suspend and censure practitioners many times, with increasing frequency in recent years. The Accounting Series Releases contain more than 30 cases of temporary or permanent suspensions of certified public accountants. The majority of these have occurred within the last 10 years; the SEC has also increasingly accepted resignations of accountants against whom investigative proceedings have been initiated.

The authority of the Commission to discipline those who practice before it was recently reaffirmed in *Touche Ross & Co. v. SEC*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,415 (S.D.N.Y. 1978).

82. See, e.g., Accounting Series Release No. 47 (January 25, 1944); Accounting Series Release No. 81 (December 11, 1958); Accounting Series Release No. 126 (July 5, 1972).

filiates.⁸³ A similar provision is embodied in the AICPA's Rules of Conduct.⁸⁴ Both the Commission and the AICPA have interpreted their rules to prohibit any direct financial interest in a client, no matter how small.⁸⁵

The Commission and the AICPA have also provided that certain specific associations between an accountant and his client will impair independence. For example, Rule 2-01(b)(2) of Regulation S-X⁸⁶ and AICPA Rule of Conduct 101B⁸⁷ generally provide that an accountant will not be independent of any client with which he, his firm, or a member thereof was, during the period to be reported on or at the date of the report, connected as promoter, underwriter, voting trustee, director, officer, or employee.⁸⁸

These two basic rules—no financial interests and no prohibited business relationships or associations—form the foundation for several interpretations concerning independence. Thus, the Commission and the AICPA have issued interpretations and rulings relating to family relationships of auditors and clients,⁸⁹ indemnity agreements between auditors and clients,⁹⁰ financial interests in, or official association with, clients by retired partners of auditors,⁹¹ litigation between and involving auditors and clients,⁹² and auditor performance of bookkeeping services for clients.⁹³

83. 17 C.F.R. 210.2-01(b).

84. AICPA, *Professional Standards*, Vol. 2, ET § 101.01.

85. For the Commission's rulings, see, e.g., Accounting Series Release No. 22 (March 14, 1941); Accounting Series Release No. 81 (December 11, 1958); Accounting Series Release No. 126 (July 5, 1972). For the profession's rulings, see AICPA, *Professional Standards*, Vol. 2, ET § 191, *et seq.*

86. 17 C.F.R. 210.2-01(b)(2).

87. AICPA, *Professional Standards*, Vol. 2, ET § 101.01.

88. See Accounting Series Release No. 126 (July 5, 1972) and Accounting Series Release No. 234 (December 13, 1977) for other business relationships which raise independence questions.

89. E.g., Accounting Series Release No. 234 (December 13, 1977); Accounting Series Release No. 126 (July 5, 1972); AICPA, *Professional Standards*, Vol. 2, ET §§ 101.05, 191.043-.054, and 191.099-.100.

90. Accounting Series Release No. 22 (March 2, 1941).

91. E.g., Accounting Series Release No. 234 (December 13, 1977); AICPA, *Professional Standards*, Vol. 2, ET §§ 101.03, 191.029-.030, and 191.073-.074.

92. E.g., Accounting Series Release No. 251 (July 6, 1978); Accounting Series Release No. 234 (December 13, 1977); AICPA, *Professional Standards*, Vol. 2, ET § 101.07.

93. E.g., Accounting Series Release No. 126 (July 5, 1976); AICPA, *Professional Standards*, Vol. 2, ET § 101.04. For a discussion of this subject, see C. Blough, *Practical Applications of Accounting Standards* 67-69 (AICPA

There have also been specific interpretations and general statements from the Commission and the AICPA concerning the furnishing of MAS by auditors. The profession has stated that the role of an independent accounting firm in performing MAS is to provide advice and technical assistance to a client while providing for participation in the analytical approach and process.⁹⁴ This has been stated to be "the only basis on which the work should be done and it is the only basis on which responsible management should permit it to be done."⁹⁵ Indeed, AICPA Ethics opinions provide that if the auditor makes management decisions on matters affecting the company's financial position or results of operations it could appear that his objectivity as an independent auditor of the company's financial statements might well be impaired.⁹⁶

Rule 101 of the AICPA's Rules of Conduct precludes a member or his firm from expressing an opinion on the financial statements of an enterprise which he or his firm serves in any capacity equivalent to that of a member of management or of an employee. In furnishing MAS to audit clients, auditors must take this into account.

In 1958 the Commission commented on the independence of the accountant who is so closely identified with his client that he makes decisions that should be made by management. The Commission said:

Another reason for finding a lack of independence . . . is the fact that some accountants intending to certify financial statements included in such filings have been interested in serving the client's management, or in some cases large stockholders, in several capacities and in doing so have not taken care to maintain a clear distinction between giving

1957), and J. Carey and W. Doherty, *Ethical Standards of the Accounting Profession* 37-39 (AICPA 1966).

94. AICPA, *Professional Standards*, Vol. 1, MS § 410.01.

95. *Ibid.*

96. AICPA's Committee on Professional Ethics, Opinion No. 12, "Independence," 1963.

Adhering to the role limitation is more difficult with respect to small clients than with large ones, and small CPA firms tend to have a higher portion of small clients among their total clientele. A small company, the extreme of which is the "one-man shop," cannot afford expert staff of its own in many areas. The owner is much more likely to turn to his CPA firm for advice on many matters, because of his own lack of time or capacity, and much more likely to follow the advice given. The testimony of spokesmen for smaller firms heavily engaged with such clients presented a picture of small CPA firms doing much good for small businessmen but also a picture of circumstances in which adherence to role limitations seemed difficult, to say the least. However, these same spokesmen strongly rejected an exception based upon smallness, at least as long as the role limitation is imposed as a condition of independence.

advice to management and serving as personal representatives of management or owners and making business decisions for them.⁹⁷

Occasionally a client will seek to engage its independent accounting firm for a project in which the client wants to be involved only to a limited extent, if at all. According to the AICPA Committee on Management Services, an auditor must be wary of a role in which he assumes exclusive control over the design and implementation of changes. "Only client management is in a position to assume responsibility for all aspects of change (including operations) and, therefore, ultimate success is most likely to be achieved when both consultant and client management recognize this fact and arrange their roles accordingly."⁹⁸

Two ethics rulings analyze the problem of impairment of independence when specific services are involved. First, the AICPA has concluded that an accounting firm's independence would not be impaired if it provided actuarial services to an audit client (the results of which are incorporated in the client's financial statements) where "all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results."⁹⁹

The second ruling concerns executive search activity. Generally, AICPA ethics rulings prohibit a member from hiring for a client a controller or cost accountant since hiring decisions are management decisions which cannot be made by the auditor without impairing independence. The rulings, however, would permit a member to perform services, such as "recommending a position description and candidate specifications, searching for and initially screening candi-

dates, and recommending qualified candidates to the client" for the client's ultimate decision.¹⁰⁰

The AICPA's interpretations regarding actuarial services and executive search reflect the Board view that it has taken on the question of scope of services and its relation to auditor independence. The AICPA's Council, in 1961, stated it to be "an objective of the Institute . . . to encourage all CPAs to perform the entire range of management services consistent with their professional competence, ethical standards, and responsibility."¹⁰¹ In its Opinion No. 12, the AICPA's Committee on Professional Ethics determined that "there is no ethical reason why a member or associate may not properly perform professional services . . . in the [area of] management advisory services, and at the same time serve the same client as independent auditor. . . ."¹⁰²

The Commission and the AICPA have taken a rigid, prophylactic approach in pronouncing that certain audit/client relationships will impair independence. This is most apparent with respect to financial interests in clients and certain formal associations with clients. In the area of MAS relationships, however, a more fluid approach has been embraced. In answering the general question of whether MAS does impair independence, and, if so, whether it should be proscribed in any respect, the Board believes that this same fluid approach should prevail.

The effect of MAS on independence

Actual Impairment. From the voluminous record before the Board, it is apparent that documented evidence of MAS abuses or impairment of independence through the use of MAS is virtually nonexistent.¹⁰³ Many concerned persons point to a feeling that "it doesn't

97. Securities and Exchange Commission, *23rd Annual Report for Fiscal Year Ended June 30, 1957*, at 184 (U.S. Government Printing Office, 1958).

98. AICPA, *Professional Standards*, Vol. 1, MS § 430.19. The Committee on Management Services promulgated the following criteria for accepting an engagement which includes implementation:

1. The client understands the nature and implications of the recommended course of action.
2. Client management has made a firm decision to proceed with implementation based on this understanding and consideration of alternatives.
3. Client management accepts overall responsibility for implementation of the chosen course of action.
4. Sufficient expertise will be available in the client organization to fully comprehend the significance of the changes being made during implementation.
5. When the changes have been fully implemented, client personnel have the knowledge and ability to adequately maintain and operate such systems as may be involved.

AICPA, *Professional Standards*, Vol. 1, MS § 430.22.

99. AICPA, *Professional Standards*, Vol. 2, ET § 191.107-108.

100. *Ibid.*, at § 191.111-112. But see Appendix B to the Organization Document (Addendum A of this Report) which prohibits members of the SEC Practice Section from engaging in certain executive search services for audit clients whose securities are registered with the Securities and Exchange Commission. This is discussed at pp. 82-84, *infra*.

101. AICPA, *Professional Standards*, Vol. 1, MS § 410.03.

102. See note 7, *supra*.

103. The lack of incriminating evidence was mentioned repeatedly at the POB Hearing. POB Hearing Testimony: C. Vanatta, Arthur Young & Company, Tr. 28; D. Noonan, Harris, Kerr, Forster & Company, Tr. 62; N. Auerbach, Coopers & Lybrand, Tr. 70; H. Gunders, Price Waterhouse & Co., Tr. 170, 177; J. Mason, Jr., The University of Alabama, Tr. 207, 216-17; S. Klion, Peat, Marwick, Mitchell & Co., 239; M. Elliott, AICPA, MAS Executive Committee, Tr. 283-84; S. Hebert, North Carolina Association of CPAs, MAS Committee, Tr. 299; J. Burton, Columbia Graduate School of Business, Tr. 305; R. Leisner, CPA, Tr. 355-56; H. Bernstein, Bernstein & Bank, Ltd., Tr. 363. It is also a

look right" or a speculation that some services "might" or "could" impair independence,¹⁰⁴ but no one can counter the demonstrated benefits of MAS with some proof that specific practices lead to actual impairment. Although charges against MAS are serious and conceptually tenable, abolishing services that are deleterious in speculation but are beneficial by wide acclaim would be unwise.¹⁰⁵

The several surveys conducted over the years have suggested that a minority of financial statement users believe that an accountant's independence could be impaired by his furnishing MAS to audit clients—indicating that furnishing such services may impair the appearance of independence. Evidence of actual impairment resulting from MAS, however, has been difficult to find. One commentator from the accounting profession has strongly urged that none in fact exists:

Despite more than fifteen years of research—much of which conducted by persons, however sincere their motives, with an apparent preconception about the impropriety of MAS—the record of MAS practice as it relates to audit independence is unblemished: *Not a single compromising instance has been presented.* Both equity and reason would seem to suggest that the question has been answered adequately.¹⁰⁶

The two special committees established by the AICPA¹⁰⁷ to study this problem failed to find any evidence of actual impairment of independence after years of performance of MAS for audit clients. The Ad Hoc Committee on Independence interviewed Dr. Arthur Schulte (author of an article which surveyed the opinion of users of financial statements regarding the impairment of independence of accountants) when preparing its own report, and he 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 to take disciplinary action on independence where the rendition of management services was a factor.

recurrent theme in professional studies on the subject, but the Board is puzzled as to what weight it should be given. Specific evidence of loss of independence through MAS, a so-called smoking gun, is not likely to be available even if there is such a loss. On the other hand, the assumption by congressional staff and other studies that MAS must corrupt lacks persuasion because of its *a priori* foundation without empirical verification.

104. E.g., POB Hearing Testimony: E. Boynton, American Academy of Actuaries, Tr. 106-07; C. Watson, Conference of Actuaries in Public Practice, Tr. 124-26; R. Cardinal, Lester B. Knight & Associates, Inc., Tr. 138-39.

105. Support for MAS has been widespread among accounting firms that practice MAS, academics, and client companies. See the discussion of MAS benefits at pp. 16-21, *supra*.

106. S. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 78.

107. Ad Hoc Committee on Independence, 1969 Final Report, *supra* note 4; Committee on Scope and Structure, 1974 Final Report, *supra* note 4.

He advised the Committee that he had heard from 44 of the state boards and that not one of them reported it had ever had such a case.

Finally, one mechanism which potentially could reveal whether the independence of auditors has actually been impaired is our legal system. Research conducted by the Cohen Commission, however, produced only one case that could arguably have involved an actual impairment of independence on the part of auditors.¹⁰⁸ One commentator cited a few other cases¹⁰⁹ which were considered by the Cohen Commission before reaching its conclusion, but, otherwise, there have been no instances of litigation concerning this issue.¹¹⁰

While the available empirical evidence does not reveal any actual instances where the furnishing of MAS has impaired independence, the Board recognizes that the nonexistence of such evidence does not necessarily mean that there have not been instances where independence may have been impaired. Not all situations where an auditor's objectivity is compromised will result in a lawsuit. Accordingly, the absence of any known cases, while comforting, does not serve to prove conclusively that independence has not been, or will not be, impaired due to the furnishing of MAS to audit clients.¹¹¹

108. Cohen Commission Report, *supra* note 4, at 102. In the *Westec* case, auditors advised on the accounting effect of prospective merger transactions and were involved in the company's merger and acquisition program. Research conducted at the University of Texas at Austin yielded similar results. Researchers searched U.S. Supreme Court decisions from 1938 to March 1977, U.S. Court of Appeals decisions from 1945 to April 1977, and U.S. District Court decisions from 1960 to March 1977 and judicial decisions in courts of eleven states. Few cases were found which were relevant and none where the actions of the auditors were determined to be improperly influenced by the furnishing of MAS to audit clients. G. Grudnitski and J. Robertson, "Additional Evidence on Auditor Independence When Management Services Are Performed," College of Business Administration, The University of Texas at Austin. Received with letter in response to the Notice from Associate Professor J. Robertson.

109. A. Briloff, *More Debits Than Credits* (Harper & Row, 1976), 283.

110. The Cohen Commission's analysis of legal cases did not disclose any other examples besides those cited by Professor Briloff, and their survey of audit staff members failed to indicate any significant relationship between the provision of MAS and substandard audits.

In three of the four cases cited by Professor Briloff, the accountants performing MAS learned of information that reflected unfavorably on the audit and on unaudited financial statements. As the Cohen Commission Report notes, the fault was not the result of a conflict when the audit was performed, but was the failure to act when learning of adverse facts during the MAS engagement. The cases suggest that MAS can add strength to the audit process by giving the auditors access to more information. The fourth case was the *Westec* case referred to in note 108, *supra*. Cohen Commission Report, *supra* note 4, at 97.

111. See note 103, *supra*.

Appearance of Impairment. The problem of impairment of independence when an accounting firm furnishes MAS to an audit client is not so much lack of independence in fact as the appearance of lack of independence. Closeness to management, which many persons view as a by-product of providing MAS, places the auditor in a position where outside observers become concerned as to his independence.

Surveys of users of financial statements, however, have been inconclusive regarding the effect of MAS on auditor independence. These surveys have severally concluded: (i) that there is a problem with the accountant's appearance of independence;¹¹² (ii) there is no problem in this area;¹¹³ or (iii) the evidence is conflicting and no conclusions may be drawn.¹¹⁴ This division in the literature illustrates the difficulties inherent in measuring such an intangible quality as the appearance of independence.

The surveys have shown, however, that those people most familiar with the MAS provided by auditors are far less concerned about a possible impairment of independence than those who are less familiar with the situation.¹¹⁵ The difference in perception of a possible impairment of independence is related to a knowledge of the scope of MAS furnished by auditors. This has given rise to the assertion that an auditor must not only appear to be independent to a reasonable person in possession of all the facts, but also to an "unreasonable" person who has no knowledge of this area. Lack of such knowledge could produce a "psychological" uncertainty as to whether the services would impair independence.¹¹⁶

112. A. Briloff, "Old Myths and New Realities in Accountancy," *supra* note 4, at 484-95; A. Schulte, "Compatibility of Management Consulting and Auditing," *supra* note 4, at 587-93.

113. P. Titard, "Independence and MAS—Opinions of Financial Statement Users," *supra* note 4, at 47-52.

114. R. Hartley and T. Ross, "MAS and Audit Independence: An Image Problem," *supra* note 4, at 42-51; D. Lavin, "Perceptions of the Independence of the Auditor," *supra* note 4, at 41-51; G. Hobgood and J. Sciarrino, "Management Looks at Audit Services," *supra* note 4, at 26-32; G. Hobgood and J. Sciarrino, "Management Looks at Audit Services (Part II)," *supra* note 4, at 24-25; D. Miller, "The Annual Audit Revisited," *supra* note 4, at 38-44.

115. P. Titard, "Independence and MAS," *supra* note 4.

116. Query whether the appearance to a *reasonable* observer is an adequate standard. While, on the one hand, it seems unreasonable to ask the profession to curtail useful, profitable, and harmless activities to cater to the suspicions of unreasonable observers, if enough observers were to perceive MAS in general or some types of service in particular as seriously impairing independence, the profession would be in trouble and should do something about it, even though the perception was unreasonable and not founded in fact. These considerations help explain and support the recent ban on executive recruiting services. In other cases the appropriate professional response might be to use disclosure and

One commentator has argued that many of the researchers who questioned the independence of an auditor who performs MAS have started with the hypothesis that auditing and MAS are somehow incompatible. Using questionnaires, information was compiled on the attitudes of informed users of financial statements toward this hypothesis. "[N]one of these studies developed research findings, rationale or any specific instance which would justify curtailment of MAS as currently performed by auditing firms."¹¹⁷

Since some of the surveys discussed above seem to indicate that the concern of users about the potential conflict between MAS and the audit function "decreases as their familiarity with the nature of services offered by public accounting firms increases,"¹¹⁸ a solution to the appearance issue would seem to be the education of these "concerned users" through disclosure. It is possible that there may be a lack of understanding as to the specific role the auditor plays in rendering MAS.

The AICPA, through its Management Advisory Services Executive Committee, has been successful in informing the CPA of his expected role in MAS. It may be advisable for the AICPA to increase its efforts to provide similar information to members of the financial community in order to inform them as to what the accounting profession expects of auditors who render MAS. This would give users of financial statements a better basis upon which to form judgments about MAS and independence. In this connection, the AICPA should place special emphasis on those specific services perceived to be closely related to management. It still remains the responsibility of the auditor to take all necessary precautions to safeguard independence and to avoid acts which may appear to justify the fears expressed about MAS.

The idea of disclosure and education, however, is not a novel one. In 1966 the AICPA prepared a document which attempted to educate the general business community regarding the nature of management advisory services as performed by independent public accounting firms.¹¹⁹ The 1969 Ad Hoc Committee on Independence recommended that in any discussion of MAS with user groups, emphasis should be placed on the role played by the auditor.¹²⁰ These past efforts indicate that any future program of disclosure must be com-

audit committee or board of directors surveillance to change the public perception.

117. S. Klion, "MAS Practice: Are the Critics Justified?," *supra* note 4, at 77-78.

118. Cohen Commission Report, *supra* note 4, at 96.

119. AICPA, *Professional Standards*, Vol 1, MS § 410.03.

120. 1969 Final Report, *supra* note 4.

prehensive and specifically designed to ease the appearance problem with MAS. Nothing less will suffice.

Independence as an absolute

The existing studies, although generally supportive of the conclusion that performing MAS does not impair independence in fact, are quite inconclusive concerning whether any particular management advisory services impair the appearance of independence. Even conceding, for the sake of argument, that furnishing a wide variety of such services to audit clients does impair the appearance of independence and assuming that additional public awareness of the true nature of accountants' advisory activity will not allay the suspicions of all observers, the inquiry cannot end there. Independence is not and never has been a status which public accountants achieve or have achieved in any absolute sense. Thus, before jumping from a conclusion that furnishing certain services to audit clients could result in the impairment of independence in appearance (or even in fact) to a conclusion that public accountants be barred from furnishing such services to their audit clients, it is judicious to look at what other relationships presently exist between accountants and clients which raise similar independence questions but which have been accepted by the profession and the public.

As indicated above, independence has traditionally been defined by the profession as the ability to act with integrity and objectivity—integrity being an element of character, and objectivity being an accountant's ability to maintain an impartial attitude on all matters which come under his view. It is this second element of independence—objectivity—which precludes the attainment of independence in any absolute sense. A significant conflict of interest exists in every auditor/client relationship by virtue of the fact that the client selects the auditor and pays the fee.¹²¹ Acceptance of this conflict is, in part, based on practical necessity. In addition, a good deal of reliance is placed on the first element of independence—integrity—in recognizing that objectivity can be compromised to some extent without unduly impairing independence.¹²²

Similarly, accountants have been performing tax advisory services

121. The existence of this significant conflict was recited on several occasions during the course of the Board's hearings. POB Hearing Testimony: P. Arnstein, John F. Forbes & Company, Tr. 46-47; R. Mautz, Ernst & Ernst, Tr. 152; H. Gunders, Price Waterhouse & Co., Tr. 176; H. Moss, Altschuler, Melvoin and Glasser, Tr. 240; J. Burton, Columbia Graduate School of Business, Tr. 306; H. Bernstein, Bernstein & Bank, Ltd., Tr. 373.

122. Other pressures to act properly, in accordance with professional standards, cannot be overlooked. These include legal liability, professional discipline and loss of reputation. See AICPA, *Professional Standards*, Vol. 2, ET § 52.08.

for years. Indeed, one of the more significant factors responsible for the growth of the accounting profession was the adoption of the 16th Amendment to the U.S. Constitution in 1913 providing for federal income tax.¹²³ The public, and certainly the SEC, have been acutely aware that independent accountants perform a wide array of tax reporting and advisory services. It is not uncommon for an accounting firm to be closely involved in assisting management in determining the provision for taxes appearing on the income statement and the accrual appearing on the balance sheet even though that same firm will review the appropriateness of those provisions in rendering its opinion on the fairness of the financial statements. Notwithstanding this fact, the public has accepted the audits conducted by the same accounting firm without undue concern that somehow independence has been impaired.

Some persons might propose that tax advisory services are distinguishable from MAS because a third party—the U.S. Government—conducts its own audit, serving as an additional check on the accountant's performance.¹²⁴ Others may argue that tax services are entitled to some sort of *de facto* grandfathering in this area, since they have been performed for so many years.

The Board does not believe the foregoing arguments represent the primary justification for permitting independent accountants to perform tax advisory services. The Internal Revenue Service audit, for example, is not conducted until some years after financial statements are published—hardly adequate protection for shareholders. While the argument that tax advisory services simply be accepted under some theory of grandfathering has some appeal, the Board believes there are other reasons for accepting tax advisory services which are more substantive and which bear on the larger question whether accountants should be permitted to furnish MAS to audit clients.

Accountants historically have assisted management in calculating the net income of the corporation. Accordingly, accountants were a natural profession to turn to for assistance in determining taxes which in large measure are based on net income and other financial bases requiring utilization of accounting concepts. Financial reporting and rendering opinions on the fairness of financial statements require a review and understanding of the appropriateness of the provisions for taxes appearing on the income statement and the related accruals appearing on the balance sheet. If tax services could not be performed by the same accounting firm engaged to conduct an audit, a significant amount of work would have to be

123. See text accompanying note 38, *supra*.

124. *E.g.*, POB Hearing Testimony: D. Gustafson, American Academy of Actuaries, Tr. 115.

duplicated without any appreciable public benefit.¹²⁵ Indeed, the Board believes that in some cases the result of separating those functions could produce significant economic waste, and in some cases would deny clients the best tax advice reasonably available to them. In addition to these benefits realized by the clients, and hence shareholders, furnishing tax advice may result in benefits to the audit generally due to a more direct awareness of the client's tax posture and other factors.¹²⁶

These practical considerations, coupled with the integrity of the accounting profession and other external forces which come into play¹²⁷ lead the Board to conclude generally that accountants should not be made to curtail the furnishing of MAS to audit clients; they also lend further substance to the argument that independence in an absolute sense has not been achieved historically and probably would not be desirable to attain even if possible.

Those who have criticized accountants for furnishing MAS to audit clients have pointed to the potential for self-review, the possibility of engaging in management decisions, and the possible incentive for misrepresenting audit results because of a desire to continue furnishing MAS.¹²⁸ These criteria cannot be ignored, but they suggest an

125. Letters in response to the Notice from: McGladrey, Hansen, Dunn & Company, July 31, 1978; A.M. Pullen & Company, August 2, 1978; John F. Forbes & Company, August 8, 1978.

126. Letters in response to the Notice from: A. M. Pullen & Company, August 2, 1978; Coopers & Lybrand, August 1978; Touche Ross & Co., August 17, 1978; Hurdman & Cranstoun, August 15, 1978. Responses to Securities Act Release No. 5869: Peat, Marwick, Mitchell & Co. at 8-9; Touche Ross & Co. at 7.

127. See note 122, *supra*.

128. The profession, of course, has faced the question of the potential conflict of interest in performing MAS. The following excerpts from the *Concepts of Professional Ethics* reflect this problem:

CPAs continually provide advice to their clients, and they expect that this advice will usually be followed. Decisions based on such advice may have a significant effect on a client's financial condition or operating results. This is the case not only in tax engagements and management advisory services but in the audit function as well. . . . It must be noted that when a CPA expresses an opinion on financial statements, the judgments involved pertain to whether the results of operating decisions of the client are fairly presented in the statements and not on the underlying wisdom of such decisions. It is highly unlikely therefore that being a factor in the client's decision-making process would impair the CPA's objectivity in judging the fairness of presentation. The more important question is whether a CPA would deliberately compromise his integrity by expressing an unqualified opinion on financial statements which were prepared in such a way as to cover up a poor business decision by the client and on which the CPA has rendered advice.

AICPA, *Professional Standards*, Vol. 2, ET § 52.14-17. See notes 61 and 65 *supra*, for a discussion of a potential conflict which may result due to a continual disproportionate amount of fees attributable to MAS.

analysis of independence which disregards the fact that some relationships between auditors and clients, even though posing potential conflicts, are accepted because of practical necessity or because they produce countervailing benefits. Especially when such other relationships are questioned because they impair independence in appearance, rather than independence in fact, it would be contrary to the public interest to impose artificial restrictions which will deny the realization of possible countervailing benefits.

Where there is no countervailing benefit from permitting certain relationships to exist and where there is not otherwise a practical necessity for the relationship, more prophylactic measures are entirely appropriate. This is most apparent with respect to the proscription of financial relationships. While it may be entirely reasonable to expect that an independently wealthy accountant has not lost his independence by owning \$100 worth of a client's stock, the AICPA's Code of Professional Ethics and the Securities and Exchange Commission rules would not permit such ownership under pronouncements relating to independence. This approach is justifiable on the ground that it is easy not to own client stock and owning such stock does nothing which appears to improve the accountant's ability to conduct an audit or otherwise serve any public interest.

Existing Safeguards

The public has accepted the notion that independence in an absolute sense does not exist, and several factors, some recently created, constitute substantial procedural safeguards that can further protect against the impairment of independence of auditors.

Client Awareness and Public Exposure

Due to new disclosure requirements imposed on issuers by the proxy rules and imposed on members of the SEC Practice Section by membership criteria of that Section, shareholders and other interested members of the public will be aware of the extent of MAS furnished by members of the Section generally and the amount furnished to individual clients relative to audit services furnished to those clients. Long a basic premise underlying the federal securities laws, disclosure operates to "clear the air" and to reduce suspicion. Most importantly, disclosure serves to conform conduct to public expectations and demands.¹²⁹

129. Reliance on disclosure—as opposed to proscribing special services—was also part of a program which Professor John C. Burton, former Chief Accountant of the SEC, urged the Board to endorse. POB Hearing Testimony: Tr. 305-306. Professor Burton generally urged that the SEC Practice Section

ASR 250,¹³⁰ released this year, announces new regulations requiring companies to disclose in proxy materials all nonaudit engagements and the fees therefrom as a percentage of the audit fee.¹³¹ It further requires disclosure of whether the company's audit committee or board of directors approved such engagements and whether the approval was granted before or after commencement of the engagement. In the future, therefore, these disclosures will inform shareholders of the magnitude of nonaudit fees compared to audit fees and whether the amount of nonaudit services disclosed appears appropriate.¹³² They also reveal whether a company's audit committee or board of directors gave appropriate consideration to the possible effect on the auditor's independence, and ultimately should decrease concern by shareholders about nonaudit engagements.¹³³

should not adopt scope of services limitations beyond those presently contained in the AICPA's Code of Professional Ethics. He did, however, suggest three positive steps to improve the appearance of independence problem. Professor Burton urged that (1) the SEC Practice Section peer review include a review of the reviewed firm's entire practice, rather than limiting the review to its accounting and auditing activities; (2) auditing standards be changed to require consultation between the audit staff and the MAS staff and to require the audit staff to review MAS work papers; and (3) reports filed with the SEC Practice Section by members should require disclosure of total fees paid by each client, identifying the clients and breaking down the components of the total fee between auditing services, tax services, and MAS.

130. ASR 250, *supra* note 4. The concept of disclosure was discussed at the POB Hearing Testimony: H. Gunders, Price Waterhouse & Co., Tr. 172-73; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 252-54; J. Burton, Columbia Graduate School of Business, Tr. 307-08, 318-21, 327-28. Disclosure was also discussed in most responses to Securities Act Release 5869. The majority of accounting firms oppose such disclosure.

131. Item 8(g) of Schedule 14A, 2 Fed. Sec. L. Rep. (CCH) ¶ 24,039 (effective after September 30, 1978). The SEC has recently issued interpretations of the requirements to guide issuers on how to disclose relationships with independent public accountants in proxy statements. Staff Accounting Bulletin No. 25 (Nov. 2, 1978).

132. The Commission has recognized that the ratification of accountants by shareholder vote is a desirable action to strengthen the accountant's independence. Accounting Series Release No. 126 (July 5, 1972). Ratification by more informed shareholders lends additional support to that position.

133. ASR 250 has received criticism from CPA firms and from business executives on several grounds, and the Board understands that some effort may be made to persuade the Commission to withdraw or substantially modify the rule changes announced in that Release. In this report, the Board accepts ASR 250 as a fact and relies in part on the public information that it will produce and the corporate board or committee procedures that the new disclosures are stimulating. If these fundamental aspects of ASR 250 are removed, the Board will have to reconsider its views and consider whether there are other devices that it can recommend to achieve the same results.

Management's close relationship with auditors whose firms also provide MAS might suggest to some a situation in which the auditor and management would be too closely identified with each other. Appropriate disclosures, however, should allow the marketplace to work by revealing to shareholders and directors the auditor's relationship with management to promote the auditor's independence not only in fact, but also in appearance. Whatever can be gleaned from such disclosure, such as extraordinary management advisory services or the absence of audit committee or board approval, will serve as impetus for the board of directors to decide initially whether its auditor is and will remain independent and to avoid engagements that could endanger independence or could be so perceived. Such disclosure, therefore, creates a self-imposed pressure on management to consider carefully whether any particular services offered by its auditors might impair independence or be perceived as impairing independence.

Additional information will also be produced by virtue of membership in the SEC Practice Section. As a condition of membership in the Section, SEC audit clients must receive reports from members disclosing the total fees received from the client for MAS furnished during the year under audit and a description of the types of services rendered.¹³⁴ A client's board of directors or audit committee, therefore, receives a mandatory report on MAS provided by the company's auditor and can satisfy itself as to the auditor's independence. Coupled with the disclosures required under ASR 250, which should create subtle pressures to scrutinize carefully all MAS engagements, this membership requirement should also stimulate audit committees and boards of directors to utilize these reports in evaluating MAS and its effect on auditors' independence.

Membership in the SEC Practice Section will also obligate members to file annually with the Section gross fees for accounting and auditing, tax, and MAS expressed as a percentage of total gross fees. Such information is open to public inspection.¹³⁵ With these figures, shareholders and the general investing public can review the relative amount of nonaudit work individual auditing firms perform and assess whether their primary service of auditing financial statements is being diluted. If the public or boards of directors are concerned with any such trend, they can respond by engaging audit firms that have not chosen that course.

While the annual filing will provide additional data on the relative importance, in terms of fees, for MAS, tax, and auditing and accounting services, it will not reveal the relative importance of MAS to ac-

134. Organization Document, Section IV, 3(g)(12).

135. Organization Document, Section IV, 3(j).

counting and auditing as furnished only to audit clients. The Board believes that such data could be helpful to observers concerned with this question and to the Board in any future examination of this question. Accordingly, the Board recommends adding to the Organization Document a requirement that members' annual disclosure statements under Section IV, 3(g) of that document include disclosure of gross fees for both MAS and tax services performed for audit clients, expressed as a percentage of aggregate fees charged.

The Board believes that reliance on disclosure with enhanced audit committee or board of directors surveillance is a far better approach than imposing prophylactic proscriptions, since individual factors and special situations can be considered in each case. Users of financial statements, including boards of directors and audit committees, should be given time to evaluate the importance of the new disclosure rules in assessing auditor independence.

Incentives for Independence

Another factor that ensures the maintenance of auditor independence is grounded in the professional ethics of accountants. Acceptance of responsibility to the public is one of the distinguishing features of a profession; accountants have accepted the responsibilities placed on them by the government, the business community, and the public at large, all of whom rely on accountants for fair financial reporting and professional advice on business problems. The independence of auditors is a characteristic imposed by accountants on themselves not only as a matter of personal professional integrity, but also as a response to their responsibilities to their various publics. As indicated earlier,¹³⁶ the AICPA's Code of Professional Ethics and MAS Professional Standards require that members be independent of their clients by maintaining their integrity and objectivity when expressing opinions on financial statements.¹³⁷ Failure to maintain independence is enforceable by a Trial Board that may, after a hearing, admonish, suspend, or expel a member from the AICPA.

In addition to professional discipline, accountants may be subject to SEC sanction, pursuant to Rule 2(e) of the SEC's Rules of Practice, if they fail to maintain an independent status.¹³⁸ An auditor has further incentives to retain his honesty and integrity when dealing with a client, since he is faced with substantial liabilities at common law and under the general antifraud provisions of the federal securi-

ties laws. Potential damages from individual and class actions provide incentive to auditors to preserve carefully their independence and to cooperate with the new disclosure provisions discussed earlier to create adequate safeguards for the investing public.

AICPA Peer Review Process

Mandatory peer reviews conducted within the AICPA structure provide another check on the independence of auditors. The SEC Practice Section requires its members to undergo peer review at least every three years.¹³⁹ The program, administered by the Peer Review Committee of the SEC Practice Section, has several objectives, including determining whether member firms maintain and apply quality controls in accordance with standards established by the AICPA Quality Control Standards Committee and whether such firms meet membership requirements.¹⁴⁰ As the reviews are structured now, emphasis is on the quality control system of a firm's accounting and auditing practice which, of necessity, includes review of the procedures for maintaining independence with respect to audit clients.

The Board does believe, however, that the process should be expanded to require a more careful review of MAS engagements performed for audit clients. While the Board does not believe that the peer review process should include a review of the quality control procedures applied to an MAS engagement itself, it does believe that MAS engagements should be reviewed to determine whether they impaired the auditor's independence in rendering an opinion on the fairness of the client's financial statements.¹⁴¹ The efficacy of such an inquiry depends on developing some agreed upon formulation of attributes relative to MAS and relevant to independence. At the present, these attributes seem generally to center on the auditor's role in connection with furnishing MAS. That is, the auditor must be limited to serving in an advisory capacity and refrain from making management decisions or participating in the conduct of operations.¹⁴² By in-

139. Organization Document, Section IV, 3(c).

140. *Ibid.*, Section VIII, 3.

141. A more careful review of MAS engagements was generally supported by witnesses at the POB Hearing. *E.g.*, POB Hearing Testimony: C. Vanatta, Arthur Young & Company, Tr. 30-31; N. Auerbach, Coopers & Lybrand, Tr. 92; J. Mason, Jr., The University of Alabama, Tr. 213-14; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 243, 258-59; M. Elliott, AICPA, MAS Executive Committee, Tr. 280; J. Burton, Columbia Graduate School of Business, Tr. 307.

142. This proposition is embodied in the present standards and has been supported by many witnesses before the Board. *E.g.*, POB Hearing Testimony: D. Noonan, Harris, Kerr, Forster & Company, Tr. 67-68; N. Auerbach, Coopers & Lybrand, Tr. 92; T. Testman, Ernst & Ernst, Tr. 166-68; H. Moss, Altschuler,

136. See pp. 26-30, *supra*.

137. AICPA, *Professional Standards*, Vol. 1, MS § 101; Vol. 2, ET § 51.01.

138. See p. 29, *supra*.

investigating these facets of MAS, peer reviewers not only may better meet the objectives of the process, but they may also generate some data on the interplay of MAS and independence that will enable the Board to consider this matter at a later date with a stronger factual basis.

Specific Services Mentioned in the Organization Document and Proposal

As indicated above, the Board generally believes that, when possible, questions relating to scope of services should be answered in general terms rather than by attempting to analyze specific services and drawing hard, sometimes crude, lines around permissible and impermissible MAS. Nonetheless, some discussion of the specific services mentioned in the Organization Document and the Proposal is warranted.

Marketing Consulting, Plant Layout and Design, Product Design and Analysis, and Employee Benefit Consulting

The Proposal contains a discussion of the following: (1) executive recruiting services; (2) marketing consulting services; (3) plant layout and design services; (4) product design and analysis; (5) insurance actuarial services; and (6) employee benefit consulting services.

Appendices A and B of the Organization Document and Appendix A of the Proposal discuss certain types of services under the general rubric of marketing consulting, plant layout and design, and product design and analysis, which are or would be permissible and certain types which are or would be proscribed. The existing and proposed proscriptions are predicated on the conclusion that the skills required for performing the proscribed services are nonfinancial in nature or are not related to accounting or auditing. Inasmuch as the Board recommends that the skill related criterion not be imposed, it would recommend that the specific proscriptions concerning those services contained in the Organization Document and the Proposal be deleted. This does not mean that the Board believes accountants should perform architectural or engineering services, act as a general contractor in constructing a building, or develop a new product. But, the Board is not aware that those services and others specified under the general subject matter under discussion are furnished by accounting firms in any event. If such services and other similar

services are being furnished, as a result of ASR 250, that fact will be revealed in the client's proxy statement. If it then appears that accountants are engaged in services which are likely to impair their image, further consideration of this question may be necessary.

The Board also does not believe, as a general matter, that furnishing marketing consulting, plant layout, and product design and analysis services will impair an accountant's independence if performed in a manner consistent with existing MAS Professional Standards and the Code of Professional Ethics relating to independence.¹⁴³ Notwithstanding the above, the Board recognizes that this is a very broad area, and it is possible that under some circumstances independence could be impaired. To attempt to identify in the abstract what those circumstances might be, however, would be an exercise in futility. The Board, therefore, subscribes to the Commission's early advice that "the question of independence is one of fact, to be determined in the light of all the pertinent circumstances in a particular case."¹⁴⁴

The question of independence is raised in the Proposal with respect to employee benefit consulting, and general guidelines are established which are largely duplicative of existing MAS Professional Standards and the Code of Professional Ethics.¹⁴⁵

As with the services discussed above, the Board does not believe

143. See notes and 145 and 159, *infra*.

144. Accounting Series Release No. 47 (January 25, 1944). This leaves open the question of who is to do the determining. Obviously the auditor has the duty to make the initial determination. So do the client's management and its board of directors or audit committee—a duty which will be more apparent and no doubt be taken more seriously as a result of the disclosure occasioned by ASR 250. The SEC no doubt will continue to do the determining on cases brought to its attention. If the recommendations in this report are adopted, the determination will also be made in the course of peer reviews.

145. For example, paragraph (1) under the discussion of Employee Benefit Consulting in the Proposal (see Addendum B hereto) would provide that the member not assume managerial functions or the client's responsibility for judgments in several areas. See AICPA, *Professional Standards*, Vol. 1, MS §§ 110.04, 410.02, and 430 for the same limitation.

Paragraph (2) provides that, while services may be on a recurring or periodic basis, they should not require continuous involvement and therefore become an engagement to perform a management function. This limitation is related to the prior one and is probably covered by the MAS Practice Standards cited above. In addition the Code of Ethics prohibits members who audit clients from developing any relationship with the client in which the member is virtually a part of management. AICPA, *Professional Standards*, Vol. 2, ET § 52.10.

Paragraph (3) requires that the member take precautions to assume that the client understands the recommendation so that it makes informed judgments. This requirement naturally follows from the others. If the client is expected to make all significant decisions based on the accountant's advice, the accountant

Melvin and Glasser, Tr. 227; S. Klion, Peat, Marwick, Mitchell & Co., Tr. 237; M. Elliott, AICPA, MAS Executive Committee, Tr. 271; L. Dowell, McGladrey, Hansen, Dunn & Company, Tr. 290.

that furnishing employee benefit consulting services, as a general rule, would impair an accountant's independence.¹⁴⁶ Again, it is necessary to look at the facts and circumstances of each case and a broad injunction or permissive conclusion is inappropriate.

Actuarial Services

The furnishing of actuarial services, either to insurance companies or employee benefit plans, raises special questions which have been addressed by both sides, perhaps more completely than any other particular service.¹⁴⁷ The Board believes that the only serious question is whether an accounting firm can furnish actuarial services to an audit client or regarding an audit client's employee benefit plan without impairing its independence to render an opinion on the financial statements of the client or the client's employee benefit plan. Accordingly, the Board is satisfied that there are no problems associated with an accounting firm furnishing actuarial services to a nonaudit client. The question narrows down to whether an accounting firm should audit the financial statements of (1) an insurance company for which it also furnished actuarial services; (2) a client for which it acted as the enrolled actuary of the client's employee

must be satisfied that his advice is not *de facto* decision making. See also, AICPA, *Professional Standards*, Vol. 1, MS § 430.22.

Paragraph (4) sets forth seven specific matters which would otherwise be prohibited because (1) they would associate the accountant too closely with management (maintenance of original records, custodian of securities, claim administration, and negotiating plan terms); (2) they would require making final decisions rather than rendering advice and might otherwise be prohibited by ERISA's prohibited transaction sections (acting as investment advisor or some other fiduciary capacity); (3) are already expressly prohibited by the Code of Ethics, AICPA, *Professional Standards*, Vol. 2, ET § 302.01 (contingent fees).

146. Actuarial services furnished to employee plans are discussed separately below.

147. See POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 10; R. Keating, A. S. Hansen, Inc., Tr. 94; E. Boynton, American Academy of Actuaries, Tr. 104; C. Watson, Conference of Actuaries in Public Practice, Tr. 125-28, 134. Letters in response to the Notice from: American Academy of Actuaries, August 14, 1978; A.S. Hansen, August 1, 1978, incorporating statement to SEC, November 30, 1977; Conference of Actuaries in Public Practice, August 11, 1978; Coopers & Lybrand, August 10, 1978. Response to Securities Act Release No. 5869: A.S. Hansen, Inc.; American Academy of Actuaries; Coopers & Lybrand; Peat, Marwick, Mitchell & Co.; George B. Buck, Consulting Actuaries, Inc.

See also W. Dreher & C. Graese, "The Compatibility of Actuarial Consulting and Auditing Services," *supra* note 4; B. Hazlehurst, "Auditor/Actuary Relations Under ERISA: As an Actuary Sees It," *supra* note 4; T. Kelley and D. Roscetti, "Auditor/Actuary Relations Under ERISA: From the Auditor's Standpoint," *supra* note 4.

benefit plan; or (3) an employee benefit plan for which it also acted as the enrolled actuary.

Before discussing the foregoing question, the Board notes that it believes accounting firms should not be discouraged in developing their understanding of the actuarial science. A better understanding would seem to lead to more reliable audits where actuarial determinations are an important part of a client's financial statements.¹⁴⁸ Moreover, the Board is concerned that restricting the type of actuarial services an accounting firm can furnish to audit clients may restrict the overall level of actuarial activity of the firms and therefore limit the breadth of its skills. Among other things, the more restricted the actuarial practice of the firm, the less likely it will be able to attract the most qualified actuarial personnel to its professional ranks.¹⁴⁹

Two separate but related arguments are advanced to support the notion that an accounting firm would not be independent to render an opinion on a client's financial statements if it also served as an actuary for that client or for an employee benefit plan sponsored by that client. These arguments relate to the possibility that (1) the dual services will result in self-review;¹⁵⁰ and (2) the actuary will not limit his role to providing advice and technical assistance. Since one of the purposes to be achieved by the role limitation is the avoidance of self-review, these arguments are related. Another purpose for a role limitation is to avoid appearing essentially as part of management's team.

The question of self-review is sometimes addressed in the context of Statement of Auditing Standards No. 11 ("SAS 11"). SAS 11 generally provides that an auditor obtain an understanding of the methods and assumptions used by a specialist, and need not perform comprehensive audit procedures or challenge the specialist's methods or assumptions, unless his limited review procedures lead him to believe that the findings are unreasonable under the circumstances.¹⁵¹ In the context of using the work of an actuary, an accountant, relying on SAS 11, must satisfy himself as to the professional qualifications and reputation of the actuary, understand the actuary's methods and assumptions, and test the data supplied by management to the actuary;

148. POB Hearing Testimony: N. Auerbach, Coopers & Lybrand, Tr. 82; J. Seitz, Touche Ross & Co., Tr. 197-99.

149. POB Hearing Testimony: J. Seitz, Touche Ross & Co., Tr. 195; J. Burton, Columbia Graduate School of Business, Tr. 306, 310.

150. See, e.g., POB Hearing Testimony: G. Catlett, Arthur Andersen & Co., Tr. 10; R. Keating, A. S. Hansen, Inc., Tr. 94-102; E. Boynton, American Academy of Actuaries, Tr. 104-07.

151. AICPA, *Professional Standards*, Vol. 1, AU § 336.08.

the accountant performing the audit does not duplicate the actuary's work.

Insofar as an auditor must satisfy himself on the professional qualifications and reputation of the actuary, that judgment has obviously been made at the time the auditing firm agreed to hire its actuarial personnel and in all likelihood after much greater analysis and review of both objective and subjective criteria relating to the actuarial personnel than would be the case when evaluating third-party actuaries. It is unrealistic, therefore, to suggest that such a judgment can be better made by a stranger than an associate, partner, or employee of the auditor.¹⁵² Similarly, the Board does not believe it is objectionable that an auditor tests the validity of client supplied data relied upon by the actuarial personnel of his firm. The Board understands that actuaries ordinarily do not test the validity of data supplied by management, at least not in any audit sense. Accordingly, the testing of that data often is done for the first time by the auditing firm, whether or not the actuarial work is performed by an actuary associated with the auditing firm. In any event, even if the actuarial personnel tested such information, the Board believes that the auditing personnel would not be relieved from performing audit procedures to the same extent they would be performed if the actuary were not associated with the auditing firm. If this is not clear from existing auditing standards, SAS 11 should be clarified to so provide. Inasmuch as SAS 11 requires an auditor to understand an actuary's methods and assumptions and to believe that the actuary's conclusions are not unreasonable, there may be some credence to the argument that acting both as actuary and auditor for the same client can result in some self-review. This does not mean, however, that the limited self-review involved impairs the auditor's independence or otherwise is harmful to the public or investors. First of all, it must be remem-

152. Critics, of course, may argue that once the initial hiring decision is made subsequent evaluation of the qualifications of a fellow employee or partner cannot be performed objectively. This is a problem not only with respect to MAS personnel but with respect to all personnel, including those on the audit staff. Accounting firms generally have overcome this by installing quality control procedures which require, among other things, periodic evaluation of hiring and promotion practices and compliance with the firms' own continuing professional education requirements. The professional staff (including MAS personnel) of member firms of the SEC Practice Section are now required to adhere to prescribed continuing professional education standards and the mandatory peer review must check for compliance. The Board believes that these safeguards overcome any serious concern that an accounting firm can not fairly evaluate the qualifications of its own employees. Additional safeguards would exist if the peer review were expanded to cover hiring practices with respect to MAS professional staff, but the Board is not prepared to suggest that this is essential.

bered that the review is quite limited and is not duplicative of the work performed by an actuary.

Perhaps more important from the public's standpoint is not the potential for self-review but the objectivity of the person performing actuarial services in the first place. The Board understands that it is not uncommon for insurance companies to rely exclusively on their own staff for actuarial expertise. While an auditor auditing financial statements of such a client would, under SAS 11, be required to employ more thorough procedures with respect to the actuary's methods, assumptions, or findings (or engage an outside specialist for that purpose) than if the actuary were independent of management, he would not be required to duplicate the actuarial work performed.¹⁵³ In the Board's view, the use of a nonmanagement or nonemployee actuary in the first instance provides at least as much protection. In light of the very limited review an auditor is required to perform with respect to the findings of an actuary who is not related to management, little, if anything, is gained by requiring the actuary to be independent of the auditor. Because the Board perceives some potential benefit to the quality of audits by allowing auditors to have in-house actuarial expertise, it does not believe the Executive Committee should adopt scope of services limitations which would discourage that result by prohibiting the firm from furnishing actuarial services to audit clients.

Some persons have argued that an actuary cannot satisfy the requirement imposed by the AICPA's MAS Professional Standards that, in performing MAS, an accountant must limit his role to advisor and not make management decisions.¹⁵⁴ Since the role limitation relates to independence¹⁵⁵ and the Board recommends that compliance with those portions of the MAS Practice Standards and the AICPA's Professional Code of Ethics relating to independence be made a condition of membership in the SEC Practice Section, this argument must be addressed.

The ability of an actuary to appropriately limit his role was most vigorously challenged with respect to acting as an enrolled actuary of an employee benefit plan. These challenges are prompted by Subsections 103(a) and (d) of ERISA, which require that an actuarial statement be filed as part of a pension plan's annual report and that the actuarial statement include an opinion of an "enrolled actuary," as defined. Specifically, Section 103(a)(4)(B) provides as follows:

(B) The enrolled actuary shall utilize such assumptions and techniques

153. AICPA, *Professional Standards*, Vol. 1, AU § 336.08.

154. AICPA, *Professional Standards*, Vol. 1, MS §§ 110.04, 410.01, 430.

155. *Ibid.*, MS §410.01.

as are necessary to enable *him* to form an opinion as to whether the contents of the matters reported . . .

- (i) are in the aggregate reasonably related to the experience of the plan and to reasonable expectations; and
- (ii) represent *his* best estimate of anticipated experience under the plan.¹⁵⁶

Inasmuch as Subsection 103(a)(4)(B) requires the enrolled actuary to formulate his own best estimate of anticipated experience under the plan, it is difficult to maintain that an actuary acting in that capacity is simply giving advice. On the other hand, it is equally difficult to conclude that the actuary has usurped management's role and is making management decisions. Rather, it appears to the Board that, in the context of an employee benefit plan, the enrolled actuary is simply performing an independent professional service outside of management's traditional area of operation and expertise. It is not, therefore, making management decisions and should not be viewed as being part of management's team. Accordingly, the Board does not believe that an accounting firm exceeds the role limitation mentioned above or otherwise impairs its independence as an auditor simply because it serves as enrolled actuary of an employee benefit plan and audits that plan or that plan's sponsor.¹⁵⁷

156. Employee Retirement Income Security Act of 1974, § 103(a)(4)(B) [emphasis added]. See also Section 412(c)(3) of the Internal Revenue Code which, in pertinent part, provides:

(3) For purposes of this section [determination of funding policy], all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the *actuary's* best estimate of anticipated experience under the plan [emphasis added].

157. This is consistent with the conclusion reached by the Department of Labor in an interpretive bulletin addressing the question of independence in the context of Section 103(a)(3)(A) of ERISA. That section requires that the accountant rendering an opinion on the Plan's financial statements to be contained in the annual report be independent. In pertinent part, the interpretation provides as follows:

An independent qualified public accountant may permissably engage in or have members of his or her firm engage in certain activities which will not have the effect of removing recognition of his or her independence. For example, . . . the rendering of services by an actuary associated with an accountant or accounting firm shall not impair the accountant's or the accounting firm's independence.

Department of Labor Interpretive Bulletin 75-1, 29 CFR § 2509-75-9.

Notwithstanding the foregoing interpretation, some commentators dispute that it is intended to permit an accounting firm to perform original actuarial services unless it expressly relies on the actuarial determinations when issuing its opinion on the financial statements. See, *e.g.*, Response to Securities Act Release No. 5869 from American Academy of Actuaries, dated April 11, 1978.

In examining the role limitation as applied to an insurance company actuary, more traditional analysis should be employed. Actuarial considerations for an insurance company are integrally related to the role and responsibility of management. Thus, if an accounting firm furnishes actuarial services to management of an insurance company audit client, care must be taken to satisfy the role requirements contained in the AICPA's MAS Professional Standards. This means generally that the actuary must only furnish advice to management and render assistance and that management must make the final decision. To do this, the accountant must be satisfied that the client has the expertise to understand the significance of his recommendations so that all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results.¹⁵⁸ The Board does not believe that this standard can reasonably be met if an auditing firm is doing more than rendering supplementary actuarial advice.

On balance, therefore, the Board does not believe that an accounting firm should be prohibited from serving both as auditor and enrolled actuary for an employee benefit plan or from serving as auditor for a client and as enrolled actuary for that client's employee benefit plans. When furnishing actuarial services to insurance company audit clients, care must be taken to limit those services to advice and technical assistance. To avoid the appearance of exceeding the limits of such an advisory role, accounting firms should not furnish actuarial services to insurance companies unless such services are supplemental to primary actuarial advice furnished by another actuary not associated with the accounting firm.

Executive Recruitment

The final area of discussion relates to executive recruiting services. The Executive Committee has added an Appendix B to the Organization Document to prohibit members of the SEC Practice Section from searching for prospective candidates for managerial, executive, or director positions with its audit clients. The limitation, however, does not prohibit an accountant from giving a client the name of prospective candidates (including employees of the accounting firm) and it does not prohibit an accountant, on the request of a client, from interviewing candidates for financial, accounting, administrative, or control positions and advising the client on the candidates' competence in those areas.

158. See note 99, *supra*.

In addition to the foregoing, the amendment prohibits an accounting firm from engaging in psychological testing or other formal evaluation programs or from undertaking reference checks for candidates for executive or director positions on behalf of a client. Finally, accountants are forbidden to act as negotiators on an audit client's behalf in determining such things as title, compensation, and other conditions of employment.

The Board accepts the Executive Committee's decision in this area. At a minimum, engaging in active recruiting services creates an appearance of an independence problem. And, there appear to be little, if any, audit benefits derived from furnishing such services. The one benefit the Board does see is the interjection in the interview and evaluation process of an accountant's expertise in accounting and financial controls. It would, in the Board's view, be a mistake to deny management the views of its independent accountants concerning the competency of a candidate for accounting or other financial positions. This benefit is preserved in the amendment and permits members of the SEC Practice Section to interview candidates and evaluate their competence in financial, accounting, administrative, or control positions.

The Board also believes it is important to note that recruiting services, as such, are available from other sources. Thus, the restriction will not result in depriving audit clients of valuable and necessary services. Because the restricted services would, if furnished, create an appearance of impairment of independence, and because prohibiting such services will neither deny the public any audit benefits nor deprive the client of a necessary service unavailable from other responsible sources, the Board concurs in the Executive Committee's decision.

Summation

In general, the Board has concluded that maintenance of independence should be the only limitation on scope of services and that independence be assessed after giving consideration to potential benefits derived from furnishing various services and recognizing that integrity and risk of civil liability and administrative sanctions can offset some loss of objectivity. To implement this general conclusion the Board recommends reliance on existing programs and procedures and suggests that adherence to the portions of the existing MAS Professional Standards and the Code of Professional Ethics dealing with independence be made a condition of membership in the SEC Practice Section.¹⁵⁹ As indicated in the body of this report, however, the Board believes the Executive Committee decision of July 26, 1978, to restrict certain executive recruiting services can be supported and should not now be disturbed.

In formulating its conclusions and recommendations the Board has considered the various conflicting views and the arguments pressed in their support. It is evident that there is no formula to accommodate all the views and interests involved, and the Board recognizes that those whose views are contrary to the conclusions reached here are not likely to be convinced.

However, the Board believes that its conclusions are sound and that the Executive Committee in its Proposals was starting down a road that could lead only to an administrative quagmire. A program of making authoritative *ad hoc* determinations, on either hypothetical or actual cases, of which services do and which do not involve auditing and accounting skills can only lead to confusion, frustration, and inequity. On the other hand, such radical surgery as the Senate Report suggests, that is to say banning all MAS, save tax and internal control advice and assistance, while clear and simple, seems far more

159. Aside from the general admonition appearing throughout the MAS Professional Standards and the Code of Professional Ethics concerning independence, other pronouncements impose the following limitations: (1) members must avoid assuming the role of management and limit their role generally to that of providing technical assistance and advice (MS §§ 110.04, 410.01, and 430 and ET §§ 191.109-.110); (2) members must not become involved in any relationship with management that causes them to become virtually a part of management or under management's control (MS § 410.09 and ET § 52.10); and (3) members may not charge contingent fees for their services (ET § 302.01).

draconian than the record justifies. Nevertheless, there is enough concern about the scope of services in responsible quarters so that the question cannot be dismissed as a "nonproblem." The Board believes that there is potential danger to the public interest and to the profession in the unlimited expansion of MAS to audit clients, and some moderating principles and procedures are needed.

These principles lie in the established axiom that auditors must maintain independence, plus the corollary that the role of auditors in providing MAS, if beyond advice and technical assistance, may destroy independence or appear to do so to a significant degree. The appropriate procedure lies in the peer review process and the disclosures occasioned by ASR 250 and the SEC Practice Section, all of which are new, and in reliance on audit committee or Board of Director surveillance. The Board has therefore concluded that the SEC Practice Section should reassert the principles of independence and of role as an advisor as they relate to MAS, revise the peer review procedures to search for adherence to these principles, and observe the effects of the new disclosures and the information they will provide.

ADDENDUM A

Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms*

Section IV. Membership

3. Requirements of Members

Member firms shall be obligated to abide by the following:

- (a) Ensure that a majority of members of the firm are CPAs, that the firm can legally engage in the practice of public accounting, and that each proprietor, shareholder, or partner of the firm resident in the United States and eligible for the AICPA membership is a member of the AICPA.
- (b) Adhere to quality control standards established by the AICPA Quality Control Standards Committee.
- (c) Submit to peer reviews of the firm's accounting and audit practice every three years or at such additional times as designated by the executive committee, the reviews to be conducted in accordance with review standards established by the section's peer review committee.
- (d) Ensure that all professionals in the firm resident in the United States, including CPAs and non-CPAs, participate in at least one hundred twenty hours of continuing professional education over three years, but in not less than twenty hours in any given year.
- (e) Assign a new audit partner to be in charge of each SEC engagement which has had another audit partner-in-charge for a period of five consecutive years and prohibit such incumbent partner from returning to in-charge status on the engagement for a minimum of two years except as follows:
 - (1) This requirement shall not become effective until two years after a firm becomes a member.
 - (2) In unusual circumstances, the chief executive partner of a firm or his designee may grant no more than one two-year extension so long as there is an in-depth supplemental review by another partner, or
 - (3) An application for relief is granted by the peer review committee on the basis of unusual hardships.
- (f) Ensure that a concurring review of the audit report by a partner other than the audit partner in charge of an SEC engagement is required before issuance of an audit report on the financial state-

* This excerpt is reprinted from AICPA, Division for CPA Firms SEC Practice Section, *Peer Review Manual* (1978).

ments of an SEC registrant. The peer review committee may authorize alternative procedures where this requirement cannot be met because of the size of the member firm.

(g) File with the section for each fiscal year of the United States firm (covering offices maintained in the United States and its territories) the following information to be open to public inspection:

- (1) Form of business entity (e.g., partnership or corporation) and identification of domestic affiliates rendering services to clients.
- (2) Description or chart of internal organizational structure and international organization (including the nature of relationships maintained in each geographic region).
- (3) Number and location of offices.
- (4) Total number of partners and non-CPAs with parallel status within the firm's organizational structure.
- (5) Total number of CPAs (including partners).
- (6) Total number of professional staff (including partners).
- (7) Total number of personnel (including item 6, above).
- (8) Number and names of SEC clients for which the firm is principal auditor-of-record and any changes of such clients.
- (9) Number of SEC audit clients each of whose total domestic fees exceed 5 percent of total domestic firm fees and the percentage which each of these clients' fees represent to total domestic firm fees.
- (10) A statement indicating that the firm has complied with AICPA and SEC independence requirements.
- (11) Disclosure regarding pending litigation as required under generally accepted accounting principles and indicating whether such pending litigation is expected to have a material effect on the firm's financial condition or its ability to serve clients.
- (12) Gross fees for accounting and auditing, tax, and MAS expressed as a percentage of total gross fees.

(h) Maintain such minimum amounts and types of accountants' liability insurance as shall be prescribed from time to time by the executive committee.

(i) When determining its scope of management advisory services, place primary emphasis on accounting and financial related areas*

* These areas would include the design and installation of systems (such as computer-based systems and procedures) and the performance of studies related to the accounting, general record-keeping, and control. This process relates to recording, compiling, analyzing, and communicating financial and economic information, expressed in money or other qualities. This process involves and provides support to the essential organizational functions, such as (1) sales and distribution of products or services; (2) protection and custody of assets; (3) procurement and use of raw materials, capital, and human resources; and (4) production of products or services. These complex functions are closely interrelated in an integrated system. The specific elements of the overall system interact with each other in many ways and at many levels of the organization. The process also embraces systems for planning and budgeting, including comparisons between planned results and actual results.

and refrain from performing management advisory services engagements for audit clients whose securities are registered with the SEC that—

- (1) Would create a loss of the firm's independence for the purpose of expressing opinions on financial statements of such clients.
- (2) Are predominantly commercial in character and inconsistent with the firm's professional status as certified public accountants.
- (3) Are inconsistent with the firm's responsibilities to the public.
- (4) Consist of the following types of services:
 - (i) Psychological testing
 - (ii) Public opinion polls
 - (iii) Merger and acquisition assistance for a finder's fee
- (5) Will be proscribed by the executive committee after further study and which comprise portions of what is included under the broad classifications of marketing consulting and plant layout as tentatively outlined in Appendix A.
- (6) May be proscribed by the executive committee from time to time after further study based on the concepts described above in Appendix A. (See resolution of executive committee, Appendix B.)
 - (j) Report annually to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client on the total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered.
 - (k) Report to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client on the nature of disagreements with the management of the client on financial accounting and reporting matters and auditing procedures which, if not satisfactorily resolved, would have caused the issuance of a qualified opinion on the client's financial statements.
 - (l) Pay dues as established by the executive committee and comply with the rules and regulations of the section as established from time to time by the executive committee and with the decisions of the executive committee in respect to matters within its competence; cooperate with the peer review committee in connection with its duties, including disciplinary proceedings; and comply with any sanction which may be imposed by the executive committee.

Appendix A—SEC Practice Section Organization

The impact on the audit independence of CPA firms of performing management advisory services for audit clients has been carefully studied many times in the past, most recently by the Commission on Auditors' Responsibilities. In no case have the studies identified instances where the auditor's independence was in fact impaired by the performance of management advisory services.

Nevertheless, concerns continue to be expressed by lay observers of the profession. It may be that the perception of these observers would be altered if they had a better understanding of the role of CPAs in providing management advisory services. However, it is virtually impossible to communicate this understanding to the public at large, and it is expected that there will be a continuing belief by lay observers that auditors should refrain from performing certain types of consulting services for audit clients.

Because the image and perception of CPAs as being independent of their audit clients is vital to public reliance on their opinions on financial statements, it is intended that the executive committee of the SEC practice section of the AICPA Division for CPA Firms may from time to time proscribe certain types of management advisory services based upon further studies and experience. As a general guideline, services which are related to accounting and financial matters will not be proscribed. Those which do not fall within this broad definition or are only remotely related will be the subject of continuing consideration for prohibition.

Examples of two types of services to be initially considered and the portions which may be proscribed are as follows:

Marketing Consulting

Marketing consulting services rendered to audit clients are limited to those which are significantly financial or internal control oriented in nature and respond to their needs for objective external insight, study, and evaluation. These are engagements that CPAs as a professional group are best qualified to perform.

Engagements of this type fall into two broad classes: (1) those where marketing activities are but one segment of a broader study, such as—

1. Operations or management audits of one or more business units or multiple functions of them.
2. Profitability studies of business units.
3. Review and reporting on prospective (forecast) results and the conduct of financial feasibility studies.
4. Services to improve existing business management systems, procedures, and practices (e.g., the development of management information/control systems).

and (2) those where only marketing activities are under review, such as—

1. The study of financial and administrative controls applied to marketing activities, the operating consequences that result therefrom, and the cost-benefits that could accrue from modification of either.
2. Analysis of the internal and external marketing factors (e.g., price-cost relationships, product mix, competitive factors, industry and customer demand experience and outlook, and business constraints) in evaluating the potential change in profitability from various operating alternatives available for an existing product/service, business unit, or select elements thereof.

3. Services similar to the foregoing with respect to an expanded or new product line, service, or facility (such as an addition to a hospital).
4. Services to improve existing marketing management systems, procedures, and practices to improve financial or administrative control and competitive posture (marketing information systems).

The CPA should not render those types of marketing consulting services which are essentially nonfinancial in nature and where financial or internal control implications are remote or only indirectly involved. These potential services are multiple and include such activities as—

1. Purely subjective evaluations of any type, including the development and evaluations of attitude surveys of user/consumer/influence groups.
2. Development and conduct of market test activities.
3. Product design, engineering, and development of physical specifications.
4. Product quality control policy, specifications, and testing programs.
5. Development of advertising copy, media strategy, and time/space buying plans.
6. Development/evaluation of sales literature, aids, presentations, contracts, and so forth, to be utilized in the selling situation.
7. Package design and engineering.
8. Technical evaluation of physical/usage characteristics of competing products.
9. Development or evaluation of product safety policy, standards, and so forth.

Plant Layout

In the broadest sense, plant layout includes the total design of a manufacturing or processing facility.

Such services as product design, site selection, and actual design and construction of productive facilities of manufacturing companies should not be performed by CPAs.

To the extent that the activity involves such areas as (1) determining the selection, control, and flow of costs of production (i.e., material labor), (2) the financial feasibility of new, expanded, or modified product manufacture, (3) the optimum controls and positioning of raw material, in-process, and finished goods inventory, and (4) clerical layout and staffing, the performance of professional service falls within the financial and accounting expertise of CPAs.

Other Services

Other services may be proscribed from time to time by the executive committee after further study of such types of services as executive search and actuarial evaluation based upon concepts described herein and in the accompanying document.

Appendix B—Resolution

WHEREAS, section IV 3(i)(6) of the "Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for Firms" (organizational document) authorizes the executive committee to proscribe certain services which may be performed by member firms of this section for audit clients whose securities are registered with the SEC; and

WHEREAS, the executive committee, after further study and advice, believes that the action to be taken herein is consistent with the concepts expressed in section IV 3(i), as presently in effect, and with Appendix A of the organizational document;

IT IS HEREBY RESOLVED, as follows:

Executive Recruiting Services

The hiring of persons for managerial, executive, or director positions is a function which is properly the client's* responsibility. Accordingly, the role of the CPA firm in this function should be limited. The CPA firm should not—

1. Accept an engagement to search for, or seek out, prospective candidates for managerial, executive, or director positions with its audit clients. This would not preclude giving an audit client the name of a prospective candidate previously known to someone in the CPA firm.
2. Engage in psychological testing, other formal testing or evaluation programs, or undertake reference checks of prospective candidates for an executive or director position on behalf of an audit client.
3. Act as a negotiator on the audit client's behalf, for example, in determining position status or title, compensation, fringe benefits, or other conditions of employment.
4. Recommend, or advise an audit client to hire, a specific candidate for a specific job. However, a CPA firm may, upon request by the audit client, interview candidates and advise the client on the candidate's competence for financial, accounting, administrative or control positions.

When an audit client seeks to fill a position within its organization which is related to its system of accounting, financial, or administrative controls, the client will frequently approach employees of the CPA firm directly as candidates or seek referral of the CPA firm's employees who may be considering employment outside of the profession. Such employment from time to time is an inevitable consequence of the training and experience which the public accounting profession provides to its staff, is beneficial to all concerned, including society in general, and therefore is not proscribed.

* The term "client" refers to a company whose securities are registered with the SEC.

ADDENDUM B

Proposed Amendments

Proposed Amendment to Section IV, 3(i) of the Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for Firms

(To Replace Previous Section IV, 3(i))

(i) When determining the scope of its services, not undertake an engagement for its audit clients registered with the SEC where—

- (1) The circumstances of that engagement impair the firm's independence for the purpose of expressing an opinion on the financial statements of such clients; or
- (2) The skills required are not related to accounting or auditing.

From time to time, the Executive Committee of the SEC Practice Section may issue interpretations to assist firms in applying these two criteria to their practice. The committee's current interpretations are detailed in the appendix.

Proposed Amendment to Appendix of the Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for Firms

(To Replace Previous Appendix)

All professionals acknowledge that they have a dual responsibility for their work—a direct obligation to their clients as well as broader public responsibilities. In 1967, Roy and MacNeill, in their study, *Horizons for a Profession*, observed that the public accounting profession could be distinguished from the other professions by the degree to which it has recognized its responsibilities to the public. The events of the last ten years have accentuated the public accounting profession's unique public responsibilities.

CPA firms have an obligation to conduct their practice in such a way as to maintain the public's confidence in the public accounting profession. The firms which join the SEC Practice Section agree to perform only those services which are compatible with their responsibilities to the public. To achieve this objective, when determining the scope of its services, a member CPA firm will not undertake any engagement for its audit clients registered with the SEC where—

- (1) The circumstances of that engagement impair the firm's independence for the purpose of expressing an opinion on the financial statements of such clients; or
- (2) The skills required are not related to accounting or auditing.

This appendix has been prepared to help the firms apply these two criteria to specific situations in their practice. The following section defines the key phrases used in the criteria. The next section provides some suggestions a firm might follow in implementing these criteria in its practice. The final section illustrates how these criteria might be applied to some selected services.

Definition of Key Phrases

Firms and Clients

Throughout this appendix the terms "firm" and "client" are used. In each instance "firm" refers to a CPA firm which is a member of the AICPA Division for Firms, SEC Practice Section. "Client" refers to a company whose securities are registered with the SEC and which is an audit client of the member firm in question.

Independence

Independence is the cornerstone of the public accounting profession. It is the principal characteristic which distinguishes the public accountant from his peers in industry or the other professions. That critical distinction is vital to the public's acceptance of the public accountant's opinion. The public acknowledges the value of the CPA's opinion, not only because of his tested skills but also because of his independence.

Independence is the ability to act with integrity and objectivity. Integrity is a quality of character. Objectivity is an attitude of mind. Because of the nature of these traits and the difficulty of establishing their existence in a tangible way, the appearance of independence as well as independence in fact becomes important, particularly as it relates to the audit of publicly held companies.

For this reason the AICPA Code of Professional Ethics prohibits the expression of an opinion when relationships exist which pose a threat to a CPA's independence, either in fact or in appearance. These relationships fall into two categories:

- (1) certain financial relationships with audit clients
- (2) where the CPA is virtually part of management or an employee under management's control.

In determining which relationships pose a threat to a CPA's independence, in fact or in appearance, the profession uses the criterion of whether reasonable men, having knowledge of all the facts and taking into consideration normal strength of character and normal behavior under the circumstances, would conclude that a specified relationship between a CPA and a client poses an unacceptable threat to the CPA's integrity or objectivity.

Generally, a CPA firm's services do not create financial interests in clients other than through compensation for services rendered. However, the amount of such fees should not be contingent upon the outcome or results of the service. More often, any question concerning the possible loss

of independence as a result of professional services relates to the role or degree of involvement of the firm in the client's affairs. The CPA firm must avoid any engagement where it assumes management's responsibilities for decisions or operations of the client, either directly or through becoming so extensively involved in assisting management that it appears to be a part of the client's management team.

Because of their special interest in publicly held companies, the CPA firms which join the SEC Practice Section have a special responsibility to maintain the appearance as well as the fact of independence in their relationships with these clients.

Skills Related to Accounting

Accounting is a discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of any organization.

The information which accounting provides is essential for—

- (1) effective planning, control and decision making by management
- (2) discharging the accountability of organizations to investors, creditors, government agencies, taxing authorities, association members, contributors to welfare institutions, and others.

Accounting includes the development and analysis of data, the testing of their validity and relevance, and the interpretation and communication of the resulting information to intended users. The data may be expressed in monetary or other quantitative terms, or in symbolic or verbal forms.

Some of the data with which accounting is concerned are not precisely measurable, but necessarily involve assumptions and estimates as to the present effect of future events and other uncertainties. Accordingly, accounting requires not only technical knowledge and skill, but even more importantly, disciplined judgment, perception and objectivity.

Accounting deals with the information needs of all organizational functions of a company including, for example, the—

- (1) procurement and use of raw materials, capital and human resources,
- (2) production of products or services, and
- (3) sales and distribution of products or services.

It serves as the common language for management as they carry out both their custodial and managerial responsibilities.

To evaluate the accounting for economic transactions, the CPA firm must understand the systems which provide the economic data, the essential functions of an organization as well as the essential processes of general management. Consequently the "skills and disciplines related to accounting" go beyond a knowledge of elementary accounting techniques. The pressures to supplement basic accounting skills with varied disciplines are a natural outgrowth of the desire to make the accounting process more effective in an economy which involves intricate business transactions, highly developed capital raising techniques, elaborate entity structures, the use of sophisticated management science techniques and computer capabili-

ties, and extensive government regulation. In short, the CPA firm cannot evaluate the accounting for an economic transaction if it does not understand it.

Skills Related to Auditing

The skills related to auditing are those which assist the auditor to evaluate a client's reported accountabilities and transactions, as well as those which assist the auditor to evaluate the effective functioning of the underlying systems of internal control. Put another way, the effectiveness of the attest function of a CPA firm depends on the availability of the skills needed to ascertain the facts and to assess the measurement and reporting judgments involved.

Basic audit competence requires an understanding of the client's business—its purpose, organization and systems, the inherent risks in the industry and in the particular company, and how all these factors interact. The complexity of business has been increasing in all aspects. At the same time, the public has been demanding that the auditing profession continually improve its ability to evaluate management's representations and to detect errors, omissions, and improprieties. Auditors are also being urged to broaden the scope of their involvement, e.g., by becoming associated with unaudited financial data and "soft" information such as forecasts and current value estimates. All of these factors require that auditors continue to broaden as well as sharpen their skills. Participation by auditors in advisory services helps achieve this objective.

In order to make competent judgments in auditing, the auditor may require the assistance of those whose knowledge and experience is in disciplines beyond the technical training of the skilled accountant. Some CPA firms fill this need through the use of outside specialists. Other firms find it more satisfactory to hire such specialists on a full time basis. In either event the work of the specialist is an important element in fulfilling the audit function.

Implementation of the Scope of Services Criteria in a Firm's Practice

(1) An Independence Policy

A CPA firm is expected to maintain its independence from its clients, giving careful consideration to all factors which might impinge on its independence. A firm will consider, for example, the impact of financial interests, personal relationships and performance of non-audit services. Each firm has an obligation to establish appropriate policies and to maintain an internal control system which evaluates the engagements to be sure that the firm's independence is not compromised. The Peer Review, conducted under the auspices of the SEC Practice Section, will evaluate the firm's policy statement, and the effectiveness of its internal review mechanism.

(2) Board of Directors or Audit Committee Involvement

The CPA firm has the primary responsibility for maintaining an independent client relationship. Nonetheless, the client's board of directors or its audit committee shares in that responsibility. In fact, the oversight provided by the board or an effective audit committee will help to reinforce the effectiveness of a CPA firm's independence policies, and thereby strengthen public confidence in the relationship. In addition to providing the board or audit committee with an annual analysis of the services provided to that client during the year, as required under IV, 3(j), each CPA firm should periodically discuss with its client's board or audit committee the scope of services it offers, describing how it applies the SEC Practice Section criteria to its practice.

(3) Management's Role

A CPA firm should not render services to its clients where those services take the place of management decision making.

- a. The CPA firm must assure that the proper relationship is maintained in all engagements with SEC audit clients. Each engagement must be carefully structured so that management is adequately involved in the project and makes managerial decisions that may be required along the way.
- b. A CPA firm should not undertake an engagement unless it believes that management has sufficient understanding of the work to be done in order to properly carry out its management role and make informed decisions.
- c. A CPA firm should not undertake an engagement which, because of the CPA firm's continuous involvement, becomes an engagement to perform a management or operating function. This interpretation would preclude, for example, an engagement to manage a computer facility over a period of time. More generally, this interpretation requires that advisory engagements include provisions for management implementation and operation on an ongoing basis.

(4) Contingent Fees

A CPA firm should not undertake an engagement where its fees are contingent on the outcome of the project. This interpretation would, for example, preclude performing merger and acquisition studies on a contingent fee basis. Similarly, a firm should not undertake an engagement promising a specific profit improvement. This interpretation draws on Rule 302, of the AICPA Code of Ethics, and related Rulings 8 through 13.

Application of Criteria to Selected Services

The two criteria of "independence" and "related skills" are applied in this section of the appendix to the following areas of services:

- Executive Recruiting
- Marketing Consulting
- Plant Layout and Design
- Product Design and Analysis
- Insurance Actuarial
- Employee Benefit Consulting

As the need arises the Executive Committee of the AICPA SEC Practice Section will apply the criteria to additional services and publish the results to all members of the SEC Practice Section.

Executive Recruiting Services

The hiring of persons for managerial, executive, or director positions is a function which is properly the client's responsibility. Accordingly, the role of the CPA firm in this function should be limited. The CPA firm should not—

- (1) Accept an engagement to search for, or seek out, prospective candidates for managerial, executive, or director positions with its audit clients. This would not preclude giving an audit client the name of a prospective candidate previously known to someone in the CPA firm.
- (2) Engage in psychological testing, other formal testing or evaluation programs, or undertake reference checks of prospective candidates for an executive or director position on behalf of an audit client.
- (3) Act as a negotiator on the audit client's behalf, for example, in determining position status or title, compensation, fringe benefits or other conditions of employment.
- (4) Recommend, or advise an audit client to hire, a specific candidate for a specific job. However, a CPA firm may, upon request by the audit client, interview candidates and advise the client on the candidate's competence for financial, accounting, administrative or control positions.

When an audit client seeks to fill a position within its organization which is related to its system of accounting, financial or administrative controls, the client will frequently approach employees of the CPA firm directly as candidates or seek referral of the CPA firm's employees who may be considering employment outside of the profession. Such employment from time to time is an inevitable consequence of the training and experience which the public accounting profession provides to its staff, is beneficial to all concerned, including society in general, and therefore is not proscribed.

Marketing Consulting Services

The CPA firm should not render advisory services related to the marketing function which require skills that are not related to accounting or auditing. These precluded services include such activities as—

- (1) Purely subjective evaluations of any type, including the development or evaluation of consumer attitude surveys.
- (2) Development or conduct of market test activities.
- (3) Development or evaluation of advertising copy, media strategy and time/space buying plans.
- (4) Development or evaluation of sales literature, aids presentations, contracts, etc., to be utilized in the selling situation.

Certain advisory services relating to the marketing function, however, are oriented significantly toward accounting, financial, control or administrative function. Such services are appropriate because they require skills related to accounting or auditing. Engagements of this type are not proscribed and fall into two broad classes:

- (1) Those where marketing is but one segment of a broader study such as—
 - a. Operations or management audits.
 - b. Profitability studies of a business unit.
 - c. Reviews of forecasts and the conduct of financial feasibility studies.
 - d. Studies to strengthen business management systems.
- (2) Those where only marketing activities are under review such as—
 - a. Studies of the effectiveness of financial and administrative controls applied to marketing activities.
 - b. Analysis of quantitative market factors which affect demand for a new or existing product.
 - c. Studies to improve the client's market information systems.

Plant Layout and Design Services

In the broadest sense, plant layout includes the total design of a plant facility. The CPA firm should not render such services which require skills that are not accounting or auditing related. More specifically, services precluded include such activities as—

1. Evaluating the geological and engineering characteristics involved in site selection.
2. Architectural and engineering designing of production facilities and processes, or equipment to be utilized in such facilities and processes.
3. Assuming the general contractor role related to the building, installation or modification of facilities, processes or equipment.
4. Performance testing or other services related to the acceptance of facilities, processes and equipment.

Some services which are related to plant layout and design may properly fall within the scope of a CPA firm's services because they require accounting or auditing related skills. Examples of such services are those where the CPA firm assists its audit client to—

1. Improve the control and efficiency of operations.

2. Determine the financial feasibility of new, expanded, or modified production facilities or processes.
3. Enhance the control and positioning of raw material, in process, and finished goods inventory.
4. Determine the clerical layout and staffing levels.

Product Design and Analysis

Services related to product design and analysis which involve the analysis, research, design, modification, production and testing of physical properties or results should not be rendered by CPA firms because they require skills that are not accounting or auditing related. More specifically, CPA firms should not undertake engagements involving—

- (1) Product design, engineering and development of physical specifications.
- (2) Development of technical policy or specifications of quality control programs.
- (3) Development or evaluation of product safety policy, standards, etc.
- (4) Technical evaluation of physical or usage characteristics of competitive products.
- (5) Package design and engineering.

There are, however, certain aspects of product design and analysis which involve the analysis and estimation of the cost and profit aspects of product design and production, or the financial and administrative controls required to manage the product design and production activities. Because such advisory services require skills which are accounting or auditing related, they are a proper part of the CPA firm's overall scope of services.

Insurance Actuarial Services

Actuarial skills are both accounting and auditing related. The bodies of knowledge supporting the actuarial and accounting professions have a substantial degree of overlap. Both professions involve the analysis of various factors of time, probability and economics, and the quantification of the analysis in financial terms. The results of their work are significantly interrelated. Their professions are logical extensions of each other; indeed, they have practiced jointly for many years and even shared the same professional society in Scotland prior to their becoming established in the United States.

The work of actuarial specialists generally is necessary to obtain satisfaction in support of insurance policy and loss reserves. To assist in meeting their audit responsibilities, a number of CPA firms have employed qualified actuaries of their own.

The actuarial function is basic to the operation and management of an insurance company. Management's responsibility for this function can be assumed by the CPA firm without jeopardizing its independence. Because of the special significance of a CPA firm's appearance of independence when auditing publicly held insurance companies:

ular facts and circumstances. Although most accountants have some training in and understanding of such skills, including the use of computers, CPA firms which render such services frequently employ individuals specifically trained and qualified as actuaries. Certain compliance and valuation reports required by ERISA, for example, must be signed by client personnel or independent consultants who have been qualified by the government as enrolled actuaries.

Since the scope and nature of employee benefit advisory services, including actuarial services, require skills and disciplines related to accounting and auditing, such services properly fit within the general scope of services for a CPA firm. Indeed the concurrent provision of employee benefit and accounting services by CPA firms has existed for many years. In rendering such services, however, the CPA firm must be satisfied that such involvement will not compromise its professional independence or objectivity as an auditor. Accordingly, the role of the CPA firm in rendering such services should be limited as follows:

- (1) The CPA firm should limit its role to that of technical assistance and advice, and not assume the client's managerial functions or the client's responsibility for any significant judgments or assumptions implicit in plan design, in plan administration, or in the related actuarial computations.
- (2) Although various services may be updated or rendered on a recurring or periodic basis, the CPA firm should not render employee benefit consulting services which require the firm's continuous involvement and therefore become an engagement to perform a management function.
- (3) The CPA firm must satisfy itself that the client has sufficient understanding of the implications of the technical factors involved in a benefit plan and the alternatives considered in a benefit plan study, so that the client can make its decisions based on an informed business judgment and assume responsibility for its actions.
- (4) The CPA firm should not render employee benefit consulting services which involve—
 - a. maintaining original records of employee or plan investment data,
 - b. retaining custody of securities or other benefit plan assets,
 - c. acting as investment advisor or making investment decisions,
 - d. deciding claim administration or benefit eligibility,
 - e. negotiating plan provisions with employee representatives or otherwise representing employers in bargaining sessions,
 - f. assuming a fiduciary role as defined under ERISA or other applicable statutes or regulations, and
 - g. accepting commissions or other contingent fees.

Subject to the above limitations, the CPA firm may properly render various employee benefit advisory services to its audit clients such as the following:

(1) *Plan Design*

- a. Help management develop estimates of cost, and possible tax and accounting consequences of alternative benefit formulae.
- b. Help management analyze the advantages and disadvantages of alternatives for eligibility and vesting requirements, the methods of distributing benefits, various funding policies and vehicles, and other pertinent plan features.
- c. Assist the client's legal counsel in drafting the plan.
- d. Assist management in connection with filing the plan with the Internal Revenue Service for the purpose of obtaining a determination as to the plan's "qualification" under the applicable provisions of the Internal Revenue Code and ERISA.
- e. Assist the sponsor with filing and other requirements of regulatory agencies, such as the Department of Labor and the Pension Benefit Guaranty Corporation.

(2) *Periodic Financial Analysis of Plan Obligations and Cost (Actuarial Valuations)*

- a. Assist management in the periodic estimation of benefit obligations of ongoing pension plans and the determination of costs for minimum funding requirements and allowable income tax deductions.
- b. Help management analyze and estimate the impact of proposed changes in benefit plans or funding policies.

(3) *Plan Administration*

- a. Assist management in the preparation or review of administrative manuals and procedures governing the plan's operation.
- b. Assist management in the preparation of filings required by the regulatory agencies.
- c. Assist management in the preparation or review of communication materials describing the benefit programs available to employees.