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Discussion of "Opportunities for Assurance Services in the 21st Century: A Progress Report of the Special Committee on Assurance Services"

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INTRODUCTION

Conventionally, a discussant's task is to comment on a research paper which typically contains a statement of the research question and its importance, a design for answering that question, a description of methods used and approaches taken, and a presentation and interpretation of results. The progress report which I have been asked to discuss does not fit this pattern; instead of being a research paper, it is a description of an ongoing process or a set of as-yet uncompleted activities. Therefore, a conventional discussion would not be appropriate, and my discussion will take the unorthodox approach of commenting on the processes and preliminary recommendations of the AICPA Special Committee on Assurance Services (the Special Committee) as they are laid out in Richard Lea's paper.

As I interpret the assignment of the Special Committee, it is to provide answers to two questions:

(1) What *new* lines of business should CPA firms enter?

(2) What threats and opportunities are likely to be encountered in doing so?

It is noteworthy that these questions are being addressed at the level of the accounting profession--it is not easy to imagine similar activities occurring in most industries. Would we, for example, expect to see the major U.S. airlines or the major U.S. auto manufacturers jointly sponsoring research into how they could extend their current lines of business? Attempting to carry out this inquiry at the level of the profession (as opposed to the level of the individual firm) clearly has advantages and disadvantages, which are commented on in Professor Lea's report and which I will address in section 3 of this discussion. Sections 1 and 2 contain my comments on the Special Committee's proposals for answering the two questions posed in this paragraph as those proposals are reported in Professor Lea's paper.

WHAT NEW LINES OF BUSINESS SHOULD CPA'S ENTER?

What is the appropriate definition of "assurance services"?

In answer to the first question--what new lines of business should CPA firms enter--it would appear that the Special Committee will recommend that CPA firms become providers of "assurance services." Under the proposed definition provided by Professor Lea in section I of his report, "Assurance services are independent professional services that improve the quality of information or its context for decision-makers." In the text discussion accompanying table 1 in his report, however, Professor Lea broadens this definition to include "any services that assist information users in improving the quality of their decision-making information, including their decision model." Relative to the first definition, the second drops the notion of professionalism/independence and adds the idea of improving users' decision models.

Both definitions of assurance services provided in Professor Lea's report are expansive relative to that provided by a group whose 1993 conference was the impetus for the formation of the

Special Committee;[1] the definition provided by the conference participants is: "An assurance service involves the expression of a written or oral conclusion on the reliability and/or relevance of information and/or information systems" (*The CPA Journal* (1996)). Relative to the definitions in Professor Lea's report, this definition is restrictive in that it confines assurance to opining on information (or an information system), without taking actions to alter either one.

While in all cases the purpose of the definition is to guide CPAs in expanding their professional services beyond the provision of traditional audits, the form of the guidance and the kinds of activities implied differs considerably across the three definitions. The two definitions in Professor Lea's report focus on quality of information; the 1993 conference definition focuses on relevance and reliability of information. Do these have the same implications for the expansion of CPA firms' lines of business?

Professor Lea's report gives relevance and reliability as the two primary characteristics that make information useful for decision making, so it would appear that quality is measured by some combination of these two characteristics. This does not mean, however, that all would agree that these two characteristics exhaustively measure the quality of information, given the implications of other portions of Professor Lea's report. That is, if the assurance services which CPA firms might offer would focus on a variety of financial and nonfinancial information (and it appears from the report that they would), it is by no means clear that quality would be appropriately measured by just these two attributes.

Other quality measures that in my view are implied by Professor Lea's discussion of specific forms assurance services might assume include conformity to rules and procedures; if it is assumed that a system is set up to maximize some objective (which might but need not involve a combination of relevance and reliability) then quality might increase with the degree of conformity to the specifications of that system (for example, ISO9000 guidelines). A second example is fineness; if aggregation destroys information, then quality might be increasing the fineness of the information (as is alleged, for example, in the case of activity-based-costing systems). A third example is timeliness; some of those who believe that accounting information is losing market share in the competition for investors' attention would focus on timeliness--perhaps even if it meant some sacrifice in reliability--as a quality attribute.

The point of these examples is that if CPA firms are to offer assurance services which improve on the quality of financial and nonfinancial information it may be necessary to take an expansive (relative to the conventional accounting view which measures quality in terms of relevance and reliability) view of the attributes which measure quality.[2] Defining quality metrics has implications for choosing which types of assurance services activities would be likely to improve quality. Since it is these activities which will define the new lines of business for CPA firms, the choice of measures of quality will have an important influence on this definition.

Is there any internal inconsistency about which lines of business are appropriate?

This is another way of asking: Can a person who improves information quality also attest to the resulting quality? This question arises because the 1993 conference definition implies the expression of an opinion about information quality while the two definitions in Professor Lea's

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1. In May of 1993 the AICPA sponsored a conference whose participants included representatives of the practicing profession (including small and medium-sized CPA firms), regulators and academic accountants. The purpose of the conference was to consider the future of the attest function. Among other things, the conference participants proposed that the phrase "assurance" be used to describe the collection of activities envisaged for CPA firms in the future.

2. A more expansive attribute list of high quality information is found in Elliott (1994), who lists reliability, relevance, credibility and timeliness. This list is of interest because Robert Elliott is the chairman of the Special Committee.

report imply taking actions which are intended to alter (improve) information quality. (The question can also be viewed as raising the issue of auditor independence, a matter which is not the subject of this discussion.[3])

My objective in raising this question is to comment on the distinction between consulting (which might very often involve the improvement of information quality) and assurance. In making these comments, I am focusing primarily on the first of three distinctions between consulting and assurance drawn by Professor Lea in the Appendix ("Assurance vs. Consulting Services") to his report. In a consulting arrangement, there is a consultant and a recipient of his report (the client)--no other party is involved and there is no assumption of a conflict of interest. In contrast, assurance services are intended to solve or at least mitigate an agency problem--three parties are involved (preparer, user and attestor); because the user perceives that his interests and those of the preparer are not congruent he is concerned about the information provided by the preparer; the attestor reduces this conflict by providing assurances about the information developed by the preparer. If the attestor gathers the information or is substantially involved in improving its quality, then the agency relationship no longer involves three distinct parties; partially or wholly merging the attestor role with the preparer role undermines the ability of the attestation function to solve the agency problem. It appears to me that such a merger is contemplated by the Special Committee; in the text discussion accompanying table 1 of his report, Professor Lea emphasizes that many of the assurance services considered by the Special Committee "would involve adding an assurance component to present consulting services."

The potential for confusion of roles is visible in the presentation of a "first cut" business plan for nonfinancial performance measures in the health care industry; the plan appears in section IV of Professor Lea's report. The definition of assurance services for this business plan notes that the health care provider might accumulate and present the data and the CPA might report on the data *or* the CPA might perform both tasks. This definition does not sharply distinguish the preparer from the attestor role as (I argue) is required to distinguish attestation from consulting--how then can sharp distinctions be expected in practice?

While some may argue that sharp distinctions between preparation (involvement in developing the information) and attestation (opining on some attributes of the information) are unnecessary as a practical matter, I believe those arguments have to rest on a view of the attestation function which differs in fundamental ways from the traditional view, in which attestation exists to solve an agency problem. Absent a full exploration of that alternative view and its implications for the accounting profession, I think it would be premature to dismiss the practical implications of mixing the preparer role with the attestation role.

Are some assurance service lines of business less attractive or less suitable for CPA firms than others?

There are numerous forms of assurance services and the definitions provided in Professor Lea's report do not provide guidance as to which are most suitable for CPA firms. I believe there is some possibility that the Special Committee has not in fact been able to distinguish assurance services where CPAs have a comparative advantage from certain other types of assurance services. Specifically, table 4 of Professor Lea's report lists "Promising Consumer Needs" for assurance services which include better information about business risk, information about product quality, and information about quality of processes and controls (among other things). To provide some idea of how existing service providers--who are usually not CPAs-- meet these customer needs, in a way that fits the expanded definition of assurance services given in Professor Lea's report, I will provide four examples.

3. For two quite different perspectives on auditor independence, se:Sutton (forthcoming) andWallman (1996).

Example 1 is bond rating agencies, whose objective is to provide independent judgments about one component of bond valuation models, namely, default risk. Example 2 is sell-side equity analysts, whose objectives include (among other things) providing information about the business risk of public companies. Example 3 is accreditation services (e.g., the AACSB) whose objectives include attesting to the extent to which accredited institutions meet specific benchmarks which are intended to capture product quality. Example 4 is consumer rating agencies which provide direct assessments of product quality (e.g., Consumers Union, Bests Insurance Ratings). In all these cases, external parties take actions to improve the quality of information on which resource allocation decisions are based; thus, they are providing assurance services.

The point of these examples is *not* to argue whether CPAs should or should not offer certain types of assurance services. The point is to note that since there are already providers of some assurance-like services, it is essential to consider very carefully what are the opportunities in a given line of business, what is the comparative advantage of the CPA relative to other service providers in this line of business, and what are the threats to entry (of which existing service providers is just one example).

WHAT THREATS AND OPPORTUNITIES ARE CPA'S LIKELY TO FACE?

In a 1994 article in the *Journal of Accountancy*, Robert Elliott, the chairman of the Special Committee, provided a short sketch of his vision of the future for assurance services. In speaking of the desirability of extending lines of business, Elliott pointed to the notion that dealing with all kinds of information is the CPA's natural domain: "CPA's have a natural advantage in helping business decision makers navigate these seas of data [created by on-line information sources] and gather what will best support their decision needs" (Elliott (1994), p. 78). The question arises as to what precisely are the determinants of this natural advantage, relative to existing providers of services that increase information quality, such as investment bankers and consultants? Absent a full consideration of just where the CPA's competitive advantage lies, it is not clear that entry into certain assurance lines of business would be successful.

In my view, the most important advantage of the CPA in extending into assurance services is not expertise; it is the existence of substantial amounts of "brand capital" associated with the CPA certification--integrity, objectivity, high professional standards of conduct. I argue that a substantial portion of this brand capital arises from the existence and enforcement of tight regulations (e.g., licensing requirements, CPE requirements, GAAS). Some might argue that a portion of the capital also arises from a careful demarcation between preparing financial statements and attesting to them, with CPA brand capital supported by the ability of CPAs to demonstrate the independence of their attestation activities from preparation; I do not consider this source of brand capital in these comments, except insofar as independence from preparation is caused by regulation.

The question arises: does it make sense to extend the notion of regulation--which gives rise to brand capital--to the provision of assurance services that may already exist in some wholly or largely unregulated form? The answer is not clear. It may be that regulation will only hamper CPAs in competing with less-regulated providers of assurances (e.g., analysts, investment bankers, consultants). It may also be that the value of the CPA's brand capital could be damaged by combining regulated and unregulated assurance activities in the same firm; the severity of whatever damage could ensue is of course an empirical question.[4] The question facing the profession as it considers expansion into assurance services is whether and how the brand capital developed in large part from the provision of mandatory audits of financial statements--viewed by some as a low-growth, price-sensitive business--can be extended profitably into assurance services without

4. This again raises the notion of auditor independence; operational measures of auditor independence have been debated for years in the context of CPA firms providing management advisory (consulting) services separate from their audit services.

destroying the capital.[5]

THE AICPA'S ROLE IN DEVELOPING NEW ASSURANCE SERVICES

Professor Lea's report contains a proposal that new product development should occur at the level of the profession (i.e., it should be undertaken by the AICPA). This proposal raises three questions. First, will the largest firms (those with the internal capability of generating new products) participate? Second, given the AICPA's role as a *professional* association, is it useful and appropriate to add to this role a set of activities which are in some sense directly in conflict with the Institute's traditional core activities? In other words, would it be more useful to have the AICPA develop standards for products developed by individual firms? Third, does the fact that financial statements are standardized and regulated at the level of the profession imply that product development should take place at the same level?

In answer to the first question, it is no secret to anyone familiar with the activities of Big 6 accounting firms that they are already extending their lines of business. In some instances, the activity is described as "re-engineering the audit" or "adding value to the audit"; a common element, however, is the introduction of activities that are close to if not completely within the scope of the definition of assurance services provided in Professor Lea's report.[6] Given their own within-firm activities, it then becomes an economic decision within each large CPA firm whether to devote resources (in the form of financial support, ideas and expertise) to the AICPA's efforts *as well.* Clearly, there is an economic incentive for large-firm defections from any profession-wide new product development process, and it is not clear that the AICPA can develop a practicable organizational structure for developing new products that would neutralize this incentive.[7]

The second question concerns the perils and advantages of combining professional association activities with new product development activities. I believe that table 3 of Professor Lea's report lays out the conflict clearly. In particular, professional associations with self-regulatory functions must be characterized by consensus development, open processes, and multiple review and approval processes if they are to develop effective standards. These three features in particular are in direct conflict with the desired specifications (also in table 3) of a new product development process. While Professor Lea's report seems to be quite firm on the suggestion that the AICPA modify itself as necessary to accommodate the new product development process, the report does not seem to me to make a compelling case that the accounting profession as a whole is sure to be better off in the long run if some aspects of the self-regulatory function were sacrificed to put a new product development process in place. In the discussion of this issue in Professor Lea's report, I found insufficient weight placed on the role of the self-regulatory function in developing CPA brand capital and relatively too much weight placed on the value of having new product development occur within a professional association; others might have different views, but the point is that making this choice will have profound effects on the future of the profession.

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5. The point that providing mandatory audits is a low-growth, price-sensitive line of business has been made in many places; for one such example, see Elliott (1995).

6. For a summary of selected activities among Big 6 firms, see *Emerson's Professional Services Review* (May-June, 1996), "Coopers &Lybrand: Creating a "Whole New Ball Game" for Business Assurance Services." While the focus of the article is on Coopers &Lybrand, certain activities of Arthur Andersen, Price Waterhouse, Deloitte & Touche, and KPMG PeatMarwick are also touched upon.

7. Section III of Professor Lea's report ("Overview of a 'New Lines' Development Process") lays out the basis for the committee's recommendation that the AICPA undertake new product development for the profession, discusses certain strengths and weaknesses of the AICPA in this role, and notes that the AICPA must change some of its approaches and structures if the development efforts are to succeed.

The third question draws an analogy between financial statements (an "industry-level" product) and new assurance services--if the former is regulated at the industry level then new product developments should occur there too. This analogy appears in Robert Elliott's comments at *The CPA Journal* Symposium on the Future of Assurance Services (*The CPA Journal* (1996)):

> The accounting profession and typical market-driven business activity are different. Our product design takes place at the industry level. For example, my firm cannot design its own financial statement presentation using its own GAAP....We have a standardized product...and our research and development takes place at the industry level, not the company one.

In my view, this analogy depends on the assumption that whatever new assurance services are provided by CPA firms will be regulated and standardized along the same lines as financial reports. It is not clear to me, given the diverse ways that Big 6 firms have begun to extend into business assurances, whether such standardization and regulation are currently in place. However, the extensions so far have been relatively modest compared to those apparently envisaged by the Special Committee and the possibility remains that the most appropriate approach might be to fold assurance services into the same type of regulatory framework that is currently provided by GAAS.

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