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Management Advisory Services—Need for Definition

Questions of Propriety and Auditor Independence

By M. Zafar Iqbal

Revenue derived from management advisory services (MAS) constitutes a significant part of the total income of many public accounting firms. Though some accountants still find management advisory services hard to justify, most view it as a logical extension of their work in the financial field. All of the big auditing firms have committed their resources to provide such services; some more eagerly and wholeheartedly than others. The surrounding controversy nonetheless remains! The questions revolving around propriety of this role assumed by the CPAs have never been resolved, and recently intense and vigorous criticism of MAS has resurfaced. This is typified by the comments made by Mr. Harold M. Williams, Chairman of the Securities and Exchange Commission (SEC), before the AICPA Fifth National Conference on Current SEC Developments held in January 1978.¹ The SEC Chairman singled out independence as one of the key issues facing the accounting profession. Williams noted that the problem of independence "is one of the professional attitude, which cannot be legislated, although legislation will undoubtedly be resorted to if self-discipline fails." He further indicated that the SEC is studying the effect that management advisory services may have on the au-

ditor's independence.

Clearly there is a need to define the concept and scope of MAS.

Auditing and Consulting

Although the term "management advisory services" has been coined recently for usage, this type of service has been rendered by the accountants since the early days of the profession.² The push of the big auditing firms in this area has been accelerated since the postwar years, especially during the last two decades. Although MAS is most emphasized in larger firms, it is also predominant in smaller firms, often in a less formalized fashion. A survey performed by the Roper Organization, sampling practice units of the AICPA, concluded that over ninety percent of the respondents indicated that their practice includes advisory services to the clients.³

Most practitioners have come to recognize and identify MAS as an integral and significant part of their practices. Writers who consider surrounding issues to be still unresolved, generally concede to the fact that from a practical standpoint elimination of MAS is improbable because it has become an interwoven part of CPA's activities.⁴ However cognizance of the reality has not diminished the surrounding controversy, since the questions raised relating to compatibility of

such services with auditing have not subsided. Ethical consideration such as independence, competence and incompatible occupations factors are justifiably considered too important to be ignored solely due to wide-spread practice.

Independence

Rule 101 of the AICPA Code of Professional Ethics prohibits a CPA from expressing an opinion on the financial statements of a company unless he/she and his/her firm are independent with respect to the enterprise.⁵ Some members of the profession claim that independence is not impaired if a CPA performs both auditing and MAS because *advisory services* are not the same as *management services*. This rationalization appears to be based mostly on matters of semantics. For example, if the CPA screens candidates and recommends one of them to fill an executive level opening in a client company, these services are of a managerial nature. The fact that the CPA did not make the final decision is not a relevant factor. It is so because at many levels of an organizational hierarchy the responsibility may be limited to exploring the available alternatives and recommending one of them to higher level executives. The final decision is then made at that level. A corporate personnel director may screen applicants for a vice-presidential position and recommend a well qualified candidate to the president for the final decision. This illustration points out that it really does not matter whether the service provided by the personnel director (on company payroll) is called a "management service" or a "management advisory service". Any attempt to draw a distinction between the two terms will be an exercise in futility.

Essentially the problem boils down to a role conflict. A role conflict takes place when two or more concepts of role overlap to cause a contradiction in the role behavior expected from an individual by various groups.⁶ Even if the CPAs have a clear conception of the distinction between advice to management vs. making decisions for management, the distinction may not be so obvious to the client. Thus there is risk of misunderstanding resulting from different perception of the same situation. Mautz and Sharaf express it quite eloquently:

There tends to come a time in any arrangement for management services

A logical solution to role conflict lies in discriminate limitation of MAS to those areas which fall within the expertise of the CPA.

*when the mutuality of interest of the consultant and the client becomes so significant that the accountant ceases to be independent in the sense that we feel he should be for auditing purposes. Management requests advice because it expects to use it; the consultant gives it to be used; the consultant knows that as a consultant he will be judged by the ultimate usefulness of his advice in bringing success to management's efforts. He has had a hand in shaping managerial decisions and will be judged by management on the same basis that the management itself will be judged. How then can he claim to be completely independent.*⁷

Independence is of paramount importance for certified public accountant's role as independent auditor:

*The independent audit leads to the expression of a professional opinion as to whether financial information furnished to stockholders, prospective investors, bankers and other credit grantors, is fairly presented. Obviously the extent to which the opinion of a CPA on financial statements will add to their credibility in the eyes of investors or credit grantors will depend on their confidence in his independence of professional judgment, his technical competence and his assumption of an ethical responsibility to the public as well as to his client.*⁸

Some might argue that independence is a frame of mind. This statement is correct but incomplete. Intellectual integrity deals with independence in fact; but the auditor also has to be independent in appearance. In summary, one could argue that to expect a CPA to first make recommendations and later audit the outcome of his/her own recommendations with complete independence is perhaps presumptuous.

Competency

Rule 201 of the AICPA Code of Professional Ethics forbids a member from accepting an engagement for which he/she or his/her firm neither have the competency nor expect to acquire it during the engagement.⁹ Certified public accountants perform some services which have close relationship to their expertise, e.g., financial planning, computer control systems, and setting-up the accounting system for a client; often though their MAS activities are in areas which are tangential or apparently out of their professional realm. Most of the Big Eight CPA firms have extensive staff in their MAS divisions and are eager to provide their clients literally any management services they desire. This may entail assignments, for example, in labor negotiations, personnel selection, executive compensation, new-product planning, factory design and layout, job evaluation, marketing, pricing and promotion strategies, setting-up new pension plans, tax shelter, and helping a client company defend itself against a takeover. Needless to say, this is by no means an all-inclusive listing of the type of services offered.¹⁰

Many individuals question whether CPAs have the credentials to make critical appraisals in areas such as those mentioned above. They wonder whether the public accounting profession has circumvented Rule 201 in approving management advisory services by its members.

Incompatible Occupations

Another applicable rule is Rule 504 of the AICPA Code of Professional Ethics. The rule states that a public accountant is not allowed to concurrently engage in any business or occupation which impairs his/her objectivity in rendering professional services or serves as a feeder to his/her practice.¹¹ Regarding the second criterion i.e., relating to "feeder", it is difficult to envisage a public accounting firm obtaining consulting business from its clients in areas such as marketing analysis, organizational studies, job evaluation and manpower planning, executive search, executive compensation, and a host of other non-accounting activities without first having established the reputation as a CPA firm. Fortunately, it is not the type of situation where one continues moving in circles in an attempt to find the answer whether the chicken came first or the egg. In the case of public

accounting firms, their expertise and reputation as public accountants decidedly influence their clients and result in obtaining consulting work. Thus one may draw the inference that accounting and auditing practice acted as the feeder to MAS work later obtained by the accountants.

Need for Definition

The concept of management advisory services and its scope have never been clearly defined and understood by members of the profession. Consensus does not exist on the reasons why the profession has moved into MAS area. The existing explanations are hypotheses at best, and suffer from absence of systematic analysis.¹² The Commission on Auditors' Responsibilities (Cohen Commission) recently recommended that professional standards should be expanded and the conditions that present the greatest danger to independence should be identified; auditors should decline any engagement that may bias the audit function.¹³ The report further recommended that public accounting firms should not engage in employment recruiting or placement of individuals who would be directly involved in the decision to select or retain auditors.¹⁴

Position Taken by Public Accounting Profession

In 1970 the American Institute of Certified Public Accountants organized its management advisory service activities in a senior technical division. The dual objectives of the division are to assist CPAs in performing MAS services, and to develop guidelines and standards for this area of practice. In December 1973 a study was authorized by the AICPA Board of Directors. The aim of the comprehensive study was to define the MAS body of knowledge for CPA firms and their MAS practitioners. The study, known as the MAS Body of Knowledge and Examination (MASBOKE) Project, was completed by a group of researchers at the University of Texas at Austin in 1976. It identified the following breakdown under the knowledge of organization functions and related disciplines: executive planning; implementation and control; finance and accounting; electronic data processing; operations; human resources; marketing; management science.¹⁵ Unfortunately, the scope of the study did not allow an analysis of the issues concerning propriety of advisory services by

public accountants. Perhaps it was considered unnecessary as the profession has assumed that MAS is here to stay. This hypothesis is substantiated by the fact that the Statements on Management Advisory Services were adopted by the Management Advisory Services Executive Committee in October 1974.

Conclusions

The public accounting profession has expanded its role in management advisory services. Quite often the activities in this segment of the practice appear to fall outside the boundaries of accounting and auditing. Many questions, especially those relating to independence, competence, and incompatible occupations, remain unanswered despite a long history of debate. Skeptics include even those who are well known as friends of the profession. For example, U.S. Senator Charles Percy recently noted:

There may be conflict between some of these services and auditing. I think particularly in personnel placement there is conflict of interest. This is a big enough business, and an important enough profession, to this country that you don't have to go into a lot of unrelated activities.¹⁶

The cynics might say that the profession tends to respond more quickly to critics rather than persuasion by friends like Senator Percy. Such an allegation could be rejected on the basis of good reasons. However for self-preservation and freedom from possible future governmental control it is critical that the profession make a concerted effort to define the concept and scope of management advisory services, once and for all, in the immediate future.

The above analysis indicates that it is necessary to remove any role conflict with the *raison d'etre* of the public accounting profession, i.e., auditing services. The most logical solution lies in discriminate limitation of MAS to those areas which fall within the expertise of the CPA, and can be identified as direct, natural extensions and adjuncts of auditing. Some of those activities include setting-up the accounting system, financial planning, computer control systems, internal controls in general, and tax planning. By focusing on planning and control aspects of self-defined areas related to the financial field the CPA can continue to be of valuable service to the

clients without violating, in appearance or in fact, the ethical rules relating to independence, competence and incompatible occupations. □

FOOTNOTES

¹News Report, *The Journal of Accountancy*, February 1978, pp. 24-26.

²John P. Sullivan, "The Accountant as Consultant: A Historical Review," *The Journal of Accountancy*, November 1974, p. 92.

³Edward L. Summers and Kenneth E. Knight, "The AICPA Studies MAS in CPA Firms", *The Journal of Accountancy*, March 1975, p. 56.

⁴For example see William G. Shenkir and Robert H. Strawser, "Auditing and Management Advisory Services: A Conflict of Roles?", *Abacus*, June 1972, p. 19, and Benzion Barlev and Arieh Goldman, "Management Advisory Services and Accounting", *Abacus*, June 1974, p. 82.

⁵AICPA, *Code of Professional Ethics*, March 1975, p. 17.

⁶Billy J. Hodge and Herbert J. Johnson, *Management and Organizational Behavior: A Multidimensional Approach*, John Wiley & Sons, New York, 1970, p. 223.

⁷R.K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing*, American Accounting Association, 1961, p. 222.

⁸John L. Carey and William O. Doherty, *Ethical Standards of the Accounting Profession*, American Institute of Certified Public Accountants, 1966, p. 62.

⁹Code of Professional Ethics, op. cit., p. 18.

¹⁰For an extensive listing of Management Advisory Services See Pierre L. Titard, "Independence and MAS - Opinions of Financial Statement Users", *Journal of Accountancy*, July 1971, p. 50.

¹¹Code of Professional Ethics, op. cit., p. 21.

¹²For a discussion of possible reasons see Barlev and Goldman, op. cit., pp. 74-82.

¹³Conclusions and Recommendations of the Commission on Auditors' Responsibilities, AICPA, New York, 1978, p. 100.

¹⁴*Ibid.*, p. 101.

¹⁵"The MAS Body of Knowledge", *Journal of Accountancy*, April 1976, p. 81.

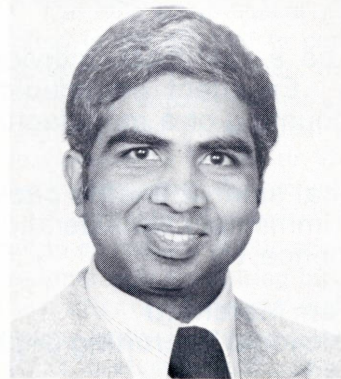
¹⁶"A Senator Speaks", *The Week in Review*, Haskins & Sells, Washington, D.C., March 10, 1978, p. 2.

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