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5-6-1969

CPA's Role in Management Advisory Services, Remarks at AICPA Council Meeting May 6, 1969

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Remarks by Malcolm M. Devore at
AICPA Council Meeting
May 6, 1969

"The CPA's Role in Management Advisory Services"

Ladies and gentlemen: I might make one slight addition to Ralph's opening observation. We also had a representative of the Ethics Committee on our committee, so we had a five-man committee including the chairman.

I would like to segregate my comments into two main segments: First, a little brief background on the formation of the committee and how we proceeded with our work, some of the observations which we included in our interim reports; in other words, down through the interim report.

This will serve two purposes. First, for those of you who have not read the interim report (and I am assuming that is a minority of those here) it will tell you where we have been and give you the conclusions up to the end of the interim report; and secondly, for the majority of us who have read the interim report, this will serve as a refresher, because I am well aware you have had other matters to be concerned with than this matter for the past several months.

As Ralph said, for a number of years we have had some questions raised in various circles as to whether or not the rendition of management services by CPAs, also performing the attest function for a client, might not impair independence. We found this arising in various circles but principally by educators.

I recall a few years ago the California State Society and representatives of the Institute were having some meetings with the

office of the savings and loan commissioner of California and that office raised a question like this: Suppose in connection with the audit of a savings and loan company, you find that the system of internal control is deficient and appropriately recommend it be strengthened in order to get a proper functioning system, and the client requests you to do this, and you do so, and you come back the next year on the audit. How can you possibly be independent in reviewing this system which you yourself put in? Does this not, the question asks, impair your independence?

And then we have the type of questions raised as exemplified by Schulte and Briloff in which they stated that it's not really the subject matter of what you do in management services -- it's the role you play. You are so close to management in the work that you do that maybe you are making de facto management decisions; and if you do, and then come along later in the attest function, aren't you really auditing your own decision?

Dr. Briloff, who is very articulate and given to picturesque language, describes this condition as being cheek to jowl with management. Therefore, if you are this close to the picture (he says), how can you stand off and have the objective view which we need in the attest function?

And then you will recall that at the Institute meeting in Boston in 1966, the then-chairman of the SEC, Manuel Cohen also raised some questions. In effect, he said, I can see the propriety of the work that you do in the conventionally accepted portions of management services, such as financial accounting, management control,

and systems, but when you get into areas like factory layout, market surveys, psychological testing, public opinion polls, and executive recruitment for a fee, then I have questions as to the propriety of this.

So you see, this is the background from which the Institute decided we should have the committee which we now have.

Now, the committee, as its first task, undertook to read all the available writings on the subject, and there was a considerable amount, both within the profession and outside the profession. We thought it appropriate to ask Drs. Briloff and Schulte if they would join us in one of our committee sessions to engage in dialogue to get a clearer expression of their views, and this we did.

Then, recognizing, since our committee is entirely made up of practicing CPAs, and hence vulnerable to the criticism that anything we do is self-serving, we decided we ought to rely rather heavily on interviews with representatives of user groups. We talked in a series of four sessions to representatives of the American Bankers Association, the Financial Analysts Federation, Financial Executives Institute, and the Life Insurance Association of America. You will recognize these groups as having a vital interest in financial statements in view of the reliance they have to place on them.

We engaged in a considerable amount of dialogue with these people, and we found it to be most useful, I should also say that we decided that instead of selecting people from these four associations whom we personally knew, we would be in a better position, a more tenable position, if we asked these four organizations themselves to

nominate people whom we should talk to. So we didn't select them, the organizations did.

What they did was to suggest a number of names as a panel, and we drew from this list sixteen people to whom we then talked in some depth.

Now, in our discussions with Briloff and Schulte, one very interesting thing came out, which is one of the significant findings of our committee. Schulte said in connection with some research he did on the subject, he saw fit to correspond with all of the state boards of accountancy and raised the question with them of whether or not in their entire experience they had ever had a case where they had to take disciplinary action against any member where management services was involved. He heard from 44 of the state boards (which I think is a rather high response) and no one of the 44 boards said that in their experience had they ever had a case where they had taken disciplinary action against a member where management services was a factor. Now, this doesn't necessarily mean that there never were any such cases, but we think it's pretty strong evidence that the system in fact works.

We also raised this question with representatives of the SEC. They said they, too, never had a case of which they were aware. We then undertook to write each of the authors who had written articles on the subject and asked them the same question; and again we got a negative response with the exception of one man who cited three or four cases which he thought indicated that the system had broken down.

We reviewed these, and I think that even if we were to have concluded in the committee that they did represent a breakdown in management services, it would still be a minor part of a very large population. But, nonetheless, on examination we concluded that what was really at fault here was more of a failure of the CPA to have observed generally accepted auditing standards than a breakdown of the system.

As a result of all of these meetings, we then came up with an interim report late last summer or early fall. Copies of the interim report were passed out at the Institute meeting in Washington last fall.

In the interim report, after laying the groundwork which I have attempted to summarize very briefly, we came up with a series of tentative recommendations.

First, we said that so long as a significant minority of users of financial statements have questions as to the propriety of management services, the profession has a problem it cannot ignore.

Secondly, we recommend that the Management Services Committee of our Institute proceed as soon as possible with issuance of three statements which they then had under consideration: the first on the nature of management advisory services, the second on the subject of competence, and the third covering the matter of role.

I might say that the Management Services Committee had been chaffing at the bit to issue these statements for a while and that they had been held by reason of our request that they not release them while we were wrestling with the problem.

Subsequently, the first two of these statements were issued; the third one (on role) is in process, and I think will be out before too long. That was the second of our recommendations.

The third recommendation was that we saw a need to continue to have liaison with our user groups so that we can be sensitive to the problems as they see them.

The fourth recommendation went back to a comment by Mr. Cohen in Boston where he raised the question as to certain peripheral services, such as factory layout and market surveys, and we recommended that anyone should consider carefully whether he ought to get into this type of service.

It was pretty clear in the work of the committee that these peripheral services are very minor in relation to the total practice that we have, and they could very easily be dispensed with without any detriment to our profession or to our clients. We didn't see fit to go ahead and proscribe the services, however, because we couldn't find a rationale to justify it a proscription; we did express a word of caution though as I have noted.

The fifth recommendation we made was that the greater the economic significance of the management advisory service which is being performed, the greater the care that must be exercised in making sure that the CPA adheres to all rules of ethics and does not impinge on management's decision-making responsibility.

The sixth recommendation relates to an earlier action by the Executive Committee recommending the formation of Audit Committees; the recommendation of our committee was to the effect that if you

are asked by a client to render some management advisory services, you first have the obligation of deciding whether or not that service or the role you are asked to play, is one that you think you can undertake, not only from the standpoint of competence, but from the standpoint of continuing to maintain your independence. If you decide that you can, but there is still a question as to the problem of appearance of independence (as distinguished from actual lack of independence), then we suggest that it might be appropriate to confer with the Audit Committee. They are, as you know, generally drawn from outside directors, representatives of the stockholders; compliance with our suggestion would insure that they agree with your observation before you actually get involved in the work.

Then as a conclusion, we commented on the reputation which the profession has for integrity and independence and made the obvious comment that this is not something that has been granted to us in perpetuity, but is something we have to continue to justify and earn, and that we should conduct ourselves accordingly.

That ends the first segment of the two segments that I want to speak of. This will reflect a summarization of what is in the interim report because what I have said is all there, so for those of you who have not read it, you are up to date.

Subsequent to the issuance of the interim report, we then agreed to have it released primarily to our membership, so some seven hundred to eight hundred copies were sent to all members of the Council, all members of the Executive Committee, and to both Institute and state committees on management services, auditing, and ethics; also

State Society presidents and executive secretaries. Publication of a notice of the interim report was included in the Journal of Accountancy which generated requests for about an additional 400 copies. We did of course, send copies of the invited representatives, to Schulte and Briloff, the sixteen members from the four trade organizations, Mr. Barr of the SEC.

Speaking first of responses from those in the profession, I must say we were disappointed in the volume of such response. Actually we received fifty plus responses only. I suppose in one sense you might say we should take considerable solace from this as indicating almost by acquiescence or silence general acceptance of the report. Nonetheless we had hoped for more responses.

I should say, however, that the responses undoubtedly represented more than fifty people because some of the letters were responding on behalf of committees.

Now, as you might expect on a subject like this you have some wide extremes in views. One or two members wrote back and said, the best thing you can do with the report is to bury it and never let it see the light of day. Essentially the position being taken here is that we are solidly entrenched in management services and doing all right, and don't need any help from the Institute on the subject.

The one comment which was most frequently noted, however, and it amassed a grand total of six responses, was that we ought not to render service in peripheral areas, that we should confine ourselves to the accepted financial, accounting management services type of work.

I think we have to conclude that under any interpretation the profession very markedly approved the interim report.

Now, we were very interested in getting responses from the sixteen guests who had spent some time with us, and we received responses from fifteen of the sixteen. I would like to share with you just three letters, or portions of three letters, which indicate, I think, the three extremes in views which we had.

The first is from a gentleman who takes the position that we should do anything we want in management services. I will read one paragraph:

"It seems to me that the conclusions which you have drawn are quite proper and appropriate and represent an extremely careful and considered approach to the subject. As I indicated in an earlier discussion, I don't believe the Institute should be unduly concerned about rumors or implied criticism coming from various and sundry sources, but should concentrate on the competence of its members and on what might be termed a self-policing of its own activities. In the last analysis if the members of the Institute prove competent to perform the services which they perform and do in fact demonstrate their competence, they have little to fear from any serious interference or criticism from any *****"

Now, at the other extreme was a very vocal member of the Financial Executives Institute who had had a considerable amount of experience in the total area of conflicts of interest and the like,

and he made it quite clear in the meetings we had that he felt there should be definite limitations placed on management services work where you are also performing the attest function. Nonetheless, he says:

"I have no real objections to the report in its present form. It reflects the findings of your committee as I understand them."

After some interim background on the basis of his previously expressed position, he says,

"You will, of course, recognize I made these observations when your committee met with the FEI. I must admit none of my associates share my views, nor did anyone particularly seek to dissuade me from such. Thus, my observations constitute a minority viewpoint."

In substance he says the report is all right, but he hasn't personally changed his mind too much.

These represent the two extremes. Then the last of the three letters I want to share with you represents what I think is the middle of the road and pretty much sets the tone that we tried to express in our interim report. This is from a man who was chairman of the Robert Morris Associates:

"One year ago I researched the subject rather thoroughly among the New York banks, and it was my conclusion that most senior credit officers felt that the management services performed by independent accounting firms was a highly desirable adjunct to the

traditional attest function. In view of internal controls among corporations today, and particularly in view of the expanding volume of paper work and the growth of conglomerates, management services work in some cases should enable the auditor to do a better job in the attest area. Your report mentioned the concern expressed by some that management services might compromise the position of independent accounting firms. No doubt this might be the case in a few instances, but it was the feeling of most bankers that the Institute could police its own members by setting forth professional standards of conduct."

Now among the fifteen of the sixteen who responded, we had a very clear expression of approval of the interim report.

We have a few things yet to be done in our committee, but I might say that based upon the work we have done and the observations we have had made to us, our committee is of the opinion that we should render a final report, and that its form and content will very closely track the interim report because nothing has come to our attention yet to make us believe we should take any different position.

Thank you very much.