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Work of the Committee on the Nature of Accounting Services, A Talk before Spring Meeting of Council, May 3, 1972

Marvin L. Stone

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THE COMMITTEE ON THE NATURE OF ACCOUNTING SERVICES

A Talk by Marvin L. Stone, Chairman
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The Committee on the nature of Accounting Services was formed to study the proliferation of accounting services offered by nonCPAs. Banks, finance companies, chain retailers, insurance companies, tax return preparers and others now offer many of the services traditionally offered by CPAs. Our committee has been asked to assess the impact of this development on CPAs and to suggest appropriate action for the profession.

Members of the committee come from every specialty -- auditing, taxes and management services -- from firms of every size, and from many parts of the country. While seeking information from people outside the profession, we have tried to avoid a defensive posture but rather have attempted to be interested but unbiased gatherers of fact. We have tried to avoid any implication that we are an "unauthorized practice" committee. Despite our efforts, many of the people we interviewed were obviously quite guarded in their responses.

Some state societies have also been studying facets of this problem. The Illinois Society recently conducted a survey which revealed among other things that preparation of individual income tax returns provides about 15% of the average Illinois CPA's fees. Income from this kind of work increased about 11% in 1970 over the previous year despite the proliferation of new nonprofessional tax return preparers. Those responding to the survey would like to prepare more tax returns. A majority of them would like the Illinois Society to mount an institutional advertising campaign to publicize the CPA's tax knowledge.

To gather data, committee members, assisted by other practitioners and by Institute staff, conducted a number of in-depth interviews in major cities throughout the country. Eight banks, one insurance company, and one retail merchandise chain were visited,and in each case one or more top executives at the policy-making level took part.

We delved into the motivation which led these organizations to offer accounting, bookkeeping, tax and consulting services. We asked about the training and professional qualifications of the personnel providing the services and whether they are employees or independent contractors. We probed for concern about liability and about the compatibility of these new services with each organization's traditional role.

The interviews, coupled with an extensive review of the literature, has provided a comprehensive view of the CPA's competitive environment, present and future. Since we have worked on this assignment for a relatively short time, the committee has not yet sought to arrive at a consensus on the import of its findings. Therefore, the observations which follow are those of the chairman and may not represent the views of the committee as a whole.

General Observations

As most CPAs are well aware, there is already substantial competition for almost every service that we perform. However, the pattern of these services is far from uniform. Banks and other companies are heavily involved in bookkeeping and tax services in some areas -- little in other areas.

By way of justification one banker on the west coast describes banks as purveyors of financial information. In his opinion the bank's original safekeeping function has long been superseded by its role of record keeper. Obviously, almost every kind of financial and advisory service would come under this broad definition.

Computerization will undoubtedly increase the proliferation of competitive services. And I don't mean 10, 15 or 20 years from now -- I believe we will see a very material impact within the next 3 to 5 years. Computer programs are disseminated widely by their developers. Even small banks in small communities can offer sophisticated packages with little investment. Consequently, every part of the country is sure to be affected.

Computerization seems likely to diminish demand for independent verification. Computer programs will incorporate self-policing devices which will reduce the need for audits after-the-fact. Some providers -- notably banks -- will perform such limited verification procedures as they deem necessary.

It does not appear that the risk of liability or concern over incompatibility will deter others from attempting to render the services we do. Those who shy away will do so only because of unprofitability. Few, if any, of the organizations we visited seem to have a long-range plan. Most seemed to be feeling their way, not knowing quite where the trend might lead.

Several interviewees severely criticized the accounting profession for poor technical performance and for breaches of ethical rules. Most interviewees counseled the profession against seeking legal restraints against competition by non-CPAs.

Now for a more detailed look at each area of service.

Tax Return Preparation

In no area is competition so widespread as in the preparation of tax returns. Everyone wants to get into the act. The proliferation is facilitated by the computer, although many organizations prepare tax returns manually.

The tax services offered by some banks and by at least one large retailer are provided through concessionaires. Organizations that use their own personnel vary widely in their training programs and in the level of people involved in return preparation.

Banks which prepare tax returns on a computer use the same computer services as are used by CPAs. While many computer service organizations now limit themselves to wholesale business (i.e., for CPA firms, banks, etc.) at least a few are eyeing the retail market. The possibility that present wholesalers might convert to the retail business raises the possibility of still more competition. If these companies should abandon their wholesale business altogether, they would leave CPAs high and dry.

As many of you know, Congress is considering the licensing of tax return preparers. It does not appear that this additional regulation will particularly restrain the nonprofessionals. Licensing might even enhance their stature.

The motives of our competitors vary. To merchandise chains, tax service is just another line to build store traffic. One chain likened tax return preparation to its optometry department. This chain is considering entry into public bookkeeping in an attempt to complement the seasonal nature of tax work.

Finance companies use tax return preparation to attract loan customers; taxpayers who owe additional tax are potential borrowers. Even taxpayers entitled to a refund can become customers -- at least one finance company will lend a taxpayer the amount of his expected refund.

Bankers offer a variety of reasons for entering the tax business. Most felt that tax return preparation is just another of many financial services that a customer should logically expect. One banker felt that his bank had been remiss in failing to offer this and other needed services to its customers sooner, even if the services prove unprofitable. This bank is giving up its tax service after a 3-year trial, however, because of insufficient volume. This banker estimated that a \$300,000 to \$500,000 annual advertising budget would be required to build sufficient tax return volume to yield a profit, and his bank was unwilling to make so large a commitment. But since the volume potential is so great in the tax return field, it is reasonable to expect an ever-increasing number of entrants.

As for tax services other than preparation of individual returns, bank trust departments continue to prepare fiduciary returns as well as some individual returns for wealthy customers. There appears to be increased involvement in estate planning and related business services. Some banks make a tax-planning service available to corporations as a fringe benefit for major executives. This service is also offered to wealthy individuals as part of a money management program. Mutual funds and others in the money management field may feel obliged to offer similar services to prevent the banks from taking away customers. Many banks prepare payroll tax returns as part of a complete payroll service.

Some tax practitioners have jokingly described the increasingly complex tax law as a kind of personal "social security." However, these very complexities can bring about a directly opposite effect because they make computer programs almost indispensable. And once devised, the computer programs permit almost anyone to dabble in complex areas.

Bookkeeping and Financial Statement Preparation

Banks are already heavily involved in bookkeeping and statement preparation. From our interviews, it appears that they will become even more involved. Initially, banks entered the bookkeeping field to use spare computer time. However, that no longer seems to be a prime motive. Banks now seek to build the image of a "full-service" financial institution by offering a complete package to customers. Bookkeeping is an obvious part of such a package.

Since banks already process their customer's cash transactions, bookkeeping is a relatively easy next step. Once checks are coded by the customer, the bank can readily prepare a check register. Coding deposits or the use of a lock box makes it easy to prepare a cash receipts journal. Given access to a customer's retained check copies, the bank can prepare a checking account reconcilement. While preparing payroll checks, a bank can automatically prepare all of the related employee earning records and payroll tax returns. By preparing checks to a customer's suppliers, the bank can prepare a purchase journal. Banks can and do offer complete customer billing services which include the preparation of a sales register, sales analyses, and even receivable aging schedules.

Some of the banks we interviewed limit themselves to systems which relate to cash flow. However, other banks offer all the services enumerated above and then tie them together into a complete general ledger-financial statement package. Many of the banks which now offer only a few of the services listed above plan to offer a complete package within the next two to three years.

Once a customer's data is digested by the bank's computer, they may be manipulated to produce such valuable by-products as budget forecasts and analyses of sales, receivables, inventory turnover, and trends.

Consulting Services

One bank in Philadelphia recently formed a management consulting subsidiary. The following letter written by that subsidiary to CPA firms in Philadelphia describes the scope of its operations:

> "Frequently, the medium-size CPA firm finds it difficult to compete with the national CPA organizations since these latter firms maintain large management service and tax departments to support their audit practice. The small firm simply does not have the resources or the need to employ a full-time staff of consulting and tax specialists.
>
> "Consequently, as a client grows and encounters increasingly complex managerial, tax, and accounting problems, he requires more sophisticated support. The tendency is that the client will gravitate toward a national firm that offers the broad-base, technical support. Now, however, the medium-size CPA firm has an interesting alternative available that well may alter his client pattern significantly.
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> " (Our) Bank, through its one-bank holding company, has organized a general management consulting firm....
>
> " (This consulting firm) is staffed to offer a client the same broad range of consulting skills furnished by national accounting firms. In addition, (it) has arranged with a well-known Philadelphia law firm to provide tax work when required by one of its clients, on a sub-contract basis....
>
> " (Thus) the medium-size CPA firm may now offer to clients the multi-services provided by national CPA organizations. This unique business arrangement would furnish smaller CPA firms with the support capability needed to maintain clients over the long run. It would no longer be necessary to refer clients to national firms for special services and, thus, risk the loss of all client business to the larger firms.
>
> "If this program is of interest to you, we would be pleased to hear from you, and arrange for a meeting to discuss the subject in detail."

Banks are not the only organizations entering the management consulting field. Several large management consulting firms have been acquired by publicly held conglomerates.

One large New York bank takes a portable computer terminal to a potential customer's office. In the customer's presence, the bank representative feeds in historical data about the client taken from published statements. Then, by the use of a bank-designed analysis program, the computer terminal spouts forecasts of earnings, financial condition and cash flow. Such a presentation undoubtedly makes a strong impression. This bank sells its programs to any other bank that wants them. Unlike bank bookkeeping services, which normally appeal to the small merchant or professional man, these sophisticated services will appeal to sizable businesses.

Auditing

Even auditing, the very citadel of CPA practice, is affected. A number of banks use internal staff to conduct directors' examinations for themselves <u>and for correspondent banks</u>. Several bankers expressed the opinion that their internal staff was more competent than CPAs to examine banks. None of the bankers expressed any concern whatever over the possible liability which might spring from examinations of other banks, nor did any of them feel that these services are incompatible with a bank's normal role.

It seems but a small step for banks to offer a similar service to customers. Banks already use their own personnel to examine collateral (e.g.,receivables) pledged to secure loans. Banks which offer a customer billing service can and do provide receivable confirmations on request of the customer's CPA. These banks could obviously prepare those same confirmations for their own use. One of the bankers we interviewed categorized receivable confirmation and inventory observation procedures as "non-professional" services not requiring a CPA's expertise. He cited the services offered by some warehouse companies as examples of nonCPA involvement in the area of inventory observation.

Once a bank keeps a customer's books, prepares his payroll, pays his bills, records collections (via a lock box), reconciles his bank account, produces customer billings, and makes financial statements, offering audit services might well appear to be a natural adjunct. Naturally, not every customer will want his bank to know quite so much. However, to a customer who relies heavily on bank credit, a "suggestion" by his loan officer concerning other bank services might prove hard to reject. Those banks which presently offer business services to customers insist that these nonbanking relationships are completely insulated from lending functions. Nevertheless, the availability of a wide variety of business services within the bank invites "tie-in" requirements.

Preparation by banks of financial statements, whether audited or not, raises some other interesting questions. For example, how will a bank treat financial statements which have been prepared by another bank? Those bankers who chose to respond to this question answered, "Just like statements prepared by anyone else." However, some of them were obviously troubled by the implications of such a situation.

Eleven jurisdictions, including such large states as Pennsylvania and New Jersey, still have "permissive" accountancy laws. In those jurisdictions, it is legal for anyone -- including a bank -- to perform an audit and render an opinion. Even in the other jurisdictions which have "regulatory" laws, banks may perform an audit so long as no opinion is rendered. Where a bank is the customer's major creditor, it is quite possible that neither the customer nor the bank will see any need for an independent opinion. If, as is often the case, financial statements are audited only because of a bank's insistence, might not the independent audit be dispensed with if the bank performs its own examination?

Future Trends

The huge investment in computers -- one bank has invested $40 million -- would seem to foster expansion of banks' business service divisions.

Not all the bankers we interviewed agreed with this; a few felt that banks' interest in peripheral services will disappear when they prove to be unprofitable. However, the majority of the banks interviewed seem headed toward increased involvement. The impetus appears to come more from a desire to meet or beat competition than from expectation of profits.

Not all ventures into nontraditional fields have proved successful. One large midwestern bank abandoned its "family financial planning centers" when it found that the centers attracted loan customers instead of depositors. As mentioned earlier, one large bank left the tax return business even though it felt it was performing a public service. New entrants in the business service area will have the benefit of others' experience, however, and can be expected to be more selective in the services they undertake.

Many banks offer business services through a subsidiary or affiliate. Where this is the case, the subsidiary or affiliate normally solicits customers on its own in addition to following up leads from bank officers. One such bank group splits its business service offerings between the bank and a subsidiary. The bank offers a few generalized accounting services (e.g., payroll) while the subsidiary offers customer EDP services. This subsidiary specializes in "facilities management" (i.e., management of a customer's computer division). The subsidiary even stands ready to buy a customer's computer in order to secure a contract to manage the customer's EDP facilities. This bank also designs customer EDP systems for industry groups (e.g., a membership dues package for unions).

While banks seem to be the CPA's principal source of competition, there are others. A large diversified insurance and finance company offers a variety of consulting services, primarily to its own subsidiary companies. At a recent board meeting, a director suggested that the company consider the possibility of acquiring a public accounting firm.

In summary, the days ahead are murky for CPAs. We will face a great deal of new competition. These competitors will be unhindered by ethical restraints against solicitation, advertising, competitive bidding, organizational structure and non-professional associates. By offering a package which includes loans, record-keeping, consulting services, and perhaps tax services as well, banks will enjoy a special edge over competitors.

Banks and other organizations that can sell stock to the public have a means to raise capital for computer installations and working capital that is not open to CPA firms.

Accounting services might even be used as loss-leaders to attract customers. Several savings and loan associations already offer to prepare an individual's tax return free as an inducement to open a savings account. This service might prove to be a better premium than a set of dishes!

But, enough of the good news!

How do we cope?

Coping with this tough environment may require reorientation of our thinking. For example, shouldn't we be looking at our practice both as a profession and as a business? One might say that the CPA's unique function -- attesting to financial statements -- is the practice of a profession, while on the other hand, the offering of all other services is the conduct of a business, notwithstanding that such services are performed in a "professional" manner.

In "business" areas, our professional rules require us to compete with nonCPAs with one hand tied behind our backs. Even in the professional area, CPAs are hampered by structural limitations, largely self-imposed.

The AICPA has traditionally concerned itself almost entirely with facets of professional practice. To be responsive to member needs and to remain a viable organization, the Institute must reorganize to take cognizance of members' business activities -- activities which provide a substantial part of the profession's income. To some extent, state societies must effect a similar transition.

Thoughts on how the accounting profession might accommmodate to this new environment fall in four broad categories:

1. Diminish competition by legislation, government regulation, or persuasion.
2. Review ethical codes which limit a CPA's capacity to compete with nonCPAs.

3. Recognize and encourage the trend toward specialization in the accounting profession.

4. Use professional organizations to improve the CPA's ability to serve clients by providing new services that few, if any firms could provide for themselves.

The suggestions which follow are offered as examples to stimulate thinking and discussion throughout the profession. The ideas are not recommendations of our committee or of its chairman. Most of them are not original. Only after these ideas are fully exposed, along with many additional thoughts which will undoubtedly spring from the membership, will our profession be ready to decide on a course of action.

Diminish Competition by Government Regulation

Federal Reserve Board regulations, as recently amended, give banks a virtually free hand to offer data processing services to customers. Reversal of this policy would probably require proof that the public is suffering some damage (e.g., because "tie-in" sales of service diminish competition and restrain trade).

Government agencies might also restrict banks' nonbanking activities if potential liability endangers depositors. Interviewees exhibited little concern over potential liability. Moreover, the use of separate subsidiaries or affiliates, already somewhat common, could answer this threat to depositors.

In an area served by only one bank, government regulations might well be expected to prevent that bank from driving out competition unfairly. However, there seems to be little chance for a meaningful limitation of competition by government regulation of finance companies, retailers, etc. The Internal Revenue Service is anxious to encourage more, not less, tax return preparers. Licensing may well be required in the near future (by legislation not regulation, however). But even licensing is not likely to diminish competition to any great extent.

Diminish Competition Via Legislation

The accounting profession could seek legislation which defines accounting services and restricts their performance to CPAs. Such a move would appear to stand little chance of success. Any such legislation would be diametrically opposite to present trends in American thought. Reducing competition is definitely not in keeping with the trend toward greater consumer protection. Several attempts have been made in recent years to legislate banks out of the data processing business. These attempts have been neither initiated nor supported by the Institute -- wisely, in my judgment.

Several of the bankers we interviewed cautioned CPAs against seeking restrictive legislation. They warned that any such efforts would necessarily appear self-serving. Each reminded us that only the attest function is exclusively ours. There seems to be no logical basis for expansion of this exclusive right, nor would expansion appear to serve the public interest.

CPAs should seek enactment of regulatory accountancy laws in the eleven jurisdictions which now have only permissive legislation. Such a move would at least solidify our exclusive legal claim to the attest function.

Diminish Competition Via Persuasion

Heavy losses may convince some banks to abandon some nonbank services, but there is little chance that CPAs' persuasion can increase the abandonment trend. A few bankers indicated that most of the business and tax services are money-losers and that continuing losses will convince banks to return to banking. However, the majority speak and act as though banks will continue to broaden their areas of offered service.

CPAs might argue that continued competition by banks will eventually serve to deprive those very banks of the benefits of independent customer audits. Again, our interviews gave little hope that support for any such concern can be generated. Most of the bankers we interviewed seemed to feel that most of our work can be done better or cheaper by bank personnel or eliminated entirely by the use of bank computers.

One banker suggested that CPAs worried by bank competition should counter that competition by opening their own bank.

Revise Ethical Codes

At present, our rules of professional conduct limit a CPA's ability to compete with nonCPAs. For example, in many states, nonCPAs are awarded consulting engagements because CPAs are unable to submit competitive bids.

Application of the rules against solicitation and advertising to non-audit work puts the CPA at a competitive disadvantage vis-a-vis nonCPAs. Since many kinds of work require sizable volume to be profitable, advertising is virtually a necessity.

The requirement that any activity in which a CPA is engaged must be conducted in accordance with our rules of professional conduct effectively prevents CPAs from forming separate firms to perform non-audit work. A separate-firm approach might provide a means to improve the CPA's competitive position. However, this approach would accomplish little if such separate firms were bound by the same rules as apply to a CPA's professional practice.

With the current expansion of CPA activities into many disciplines, the rule against partnerships with non-CPAs inhibits a CPA firm's growth and limits its direction. Many firms faced with this problem have developed awkward substitutes for partnerships to attract nonCPA specialists. Since these financial arrangements are virtually indistinguishable from partnerships, this rule is honored more in the breach than in fact.

Formation of a separate firm to carry on non-audit work is also inhibited by the ethical rule which requires that any such business must be "compatible" with the practice of public accounting. CPA activities range over such a wide spectrum that the import of this rule is difficult to assess. However, its operation places some limitation on the manner in which a CPA conducts his "business" as opposed to "professional" activities.

Capital required to finance both audit and non-audit work is sometimes difficult to amass without public financing. Even though the Institute recently lifted its ban against incorporation, raising capital from the public is still prohibited. Since capital requirements are likely to increase materially (e.g., for computer installations), this prohibition might well prove a serious barrier to the growth of a CPA firm.

Our committee received several examples of advertising in which nonCPA organizations capitalize on the presence of a CPA-employee. Ethical rules should be strengthened to prevent CPAs from allowing a nonCPA organization to exploit the CPA's professional attainments.

I am in no way suggesting that the proposed restatement of the Institute's code of professional conduct be postponed. The code restatement is a result of many years of hard work. To postpone its adoption would, in my opinion, be a tragic mistake. The revisions suggested above should be considered only after the restated code has been adopted.

Recognize and Encourage Specialization

Our present rules of professional conduct and the structure of our professional organizations are based on the assumption that every CPA is a generalist. Since that assumption is fallacious, the rules are unrealistic and our organizations fail to meet our present needs. Specialization is a fact of life and will increase. Pretending it's not there serves no useful purpose.

Much consulting work goes to nonCPA firms partly because CPAs may not let their speciality be known. Even other CPAs have no way of knowing where to turn for specialized help. Unless a CPA has accidentally read a paper or heard a speech by a colleague, he has no way of determining that colleague's area of expertise.

The medical profession takes a much more realistic approach. If I need brain surgery, I need not blindly choose a physician from the yellow pages, risking the possibilty that I might inadvertently engage an obstetrician who might take a devious route to my brain. Physicians who have taken special training are permitted to inform the public of their specialty. It's high time that CPAs should be afforded the same privilege.

Even the legal profession is taking tentative steps toward the recognition of specialties. Bar journals are filled with proposals for accreditation and specialization.

At least one Bar Association is exploring means by which lawyers may become accredited and may then notify the public of their respective specialties.

The AICPA or an affiliate could accredit specialists, for without some accreditation mechanism, specialists would be self-designated. Once a mechanism has been established for objective accreditation, ethical rules should be amended to permit CPAs to disclose their specialties.

In addition, in order to better serve its members, the Institute should be restructured by adoption of the "sections" proposal or something similar. This would enable members to identify with other members having a professional interest in a specialized area.

Improve CPA's Competitive Position

Professional organizations such as the Institute can greatly improve the CPA's competitive position by providing services which members might not be able to provide for themselves. For example, the Institute could form a non-profit entity to provide data processing and retrieval services to Institute members. The entity could even enter the tax return preparation field to guard against the possibility that "wholesalers" might abandon CPAs in favor of "retail" business. A data processing service within the profession would provide assured integrity of information and probably the advantage of lower cost.

The Institute could also provide its members with specialized consulting services via a paid staff or through referrals to other members engaged for a fee. Obviously, the latter arrangement would work only if there is some means to identify specialists within the membership. Availability of such specialized consulting services would permit smaller firms to compete more effectively with nonCPAs. Such a service would assist members in the retention of clients and would certainly improve AICPA membership relations. By making available specialized services in a relatively risk-free atmosphere, CPAs would probably feel less reluctant to seek specialized help. This trend would undoubtedly reduce marginal and substandard work.

Our professional organizations, national and local, might also conduct institutional advertising campaigns to sell CPA services to the public. A majority of the CPAs responding to a recent Illinois survey favored such a program and indicated a willingness to pay the costs.

Conclusion

I repeat that the possible courses of action which I have discussed are not recommendations. In fact, some of the suggestions may even be inconsistent with one another. I have expressed these ideas only to stimulate thinking and discussion.

Several years ago John Lawler introduced his report to Council with a quotation from the Koran: "If you don't know where you are going, any road will take you there." Our future is too important to be left to chance. We must decide where we wish to go and map out the road most likely to take us there.

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