

# How the U.S. Accounting Profession Got Where It Is Today: Part I

Stephen A. Zeff

**Synopsis:** Few would deny that the U.S. accounting profession is in a very troubled state. The aim of this two-part article is to explain how and why the profession evolved and changed during the 20th century, with particular emphasis on the last three decades. It is my hope that this article will illuminate the origins and consequences of these changes that collectively brought the profession to its current condition.

This paper reviews, examines, and interprets the events and developments in the evolution of the U.S. accounting profession during the 20th century, so that one can judge "how we got where we are today." While other historical works study the evolution of the U.S. accounting profession,<sup>1</sup> this paper examines two issues: (1) the challenges and crises that faced the accounting profession and the big accounting firms, especially beginning in the mid-1960s, and (2) how the value shifts inside the big firms combined with changes in the earnings pressures on their corporate clients to create a climate in which serious confrontations between auditors and clients were destined to occur. From available evidence, auditors in recent years seem to be more susceptible to accommodation and compromise on questionable accounting practices, when compared with their more stolid posture on such matters in earlier years.

## INTRODUCTION

The paucity of available evidence about actual changes occurring within the big firms, especially from the 1970s onward, poses a major difficulty in conducting this kind of research. Without statistical analysis, the court cases, regulatory investigations, and press reports of alleged audit

---

*Stephen A. Zeff is a Professor at Rice University.*

---

The author expresses his appreciation to several accounting academics and to more than a dozen active and retired senior partners of major accounting firms for their comments on earlier drafts. He also appreciates the suggestions of the anonymous reviewers.

---

**Editor's note:** Professor Zeff agreed to have this lengthy but very important article published in two parts. Splitting an article of this nature is judgmental and unavoidably somewhat arbitrary. We both believe that your appetite will be whetted for Part II, forthcoming in December 2003, beginning as it does with Professor Zeff's discussion of "A Gradual Degeneration of Professional Values." The complete set of references will appear at the end of Part II.

---

<sup>1</sup> Interested readers should consult Previts and Merino (1998), which paints on a much broader canvas than this paper. While their book treats a number of the developments in the evolution of the U.S. profession, it does not provide as extensive a discussion of the subject taken up in this paper. An article that traces the evolution of the Big Eight firms, focusing heavily on published data on their internal growth as well as their growth through mergers, is Wootton and Wolk (1992). Miranti (1990) has also written a valuable work on the development of the profession, but it extends only to 1940.

*Submitted: January 2003*

*Accepted: April 2003*

Corresponding author: Stephen A. Zeff

Email: sazeff@rice.edu

failures can be dismissed by leaders of the profession as isolated instances, not representative of the general way in which the big firms fulfill their professional obligations. Of necessity, I relied on letters from those who do know, on public expressions of concern by leaders of the profession and by regulators, and on the writings by close students of the profession. I formed interpretations and conclusions based on the available evidence, and I welcome comments and reactions from readers.

Three major sections comprise this paper. The first section surveys the evolution of the profession prior to the 1940s, essentially a period of groundbreaking and early development. The second section, covering the 1940s, the 1950s, and the first half of the 1960s, displays the profession at the height of its reputation and influence. The third section, beginning in the mid-1960s, treats the scandals, court cases, the profession's loss of its accounting standard setter and the impact of that loss on the vitality of professional discourse, Congressional criticism, pressures from government to alter the competitive climate of the profession, the burgeoning consulting services, and, in the end, the transformation of the big firms from organizations strongly imbued with professional values to ones that strongly pursue goals associated with commercial and business success. This reshaping of the firms as engines of growth, profitability, and global reach in turn placed added pressure on audit partners, already under pressure to generate fees and to placate clients. Such circumstances exert a severe strain on auditor independence. At the same time, top executives in publicly traded companies found themselves under greatly increased pressure for revenue and earnings performance, which they transmitted first to their accounting staff and eventually to their external auditors. The confluence of these developments inevitably led to the confrontations mentioned above.

#### **PRIOR TO THE 1940s: SETTING THE STAGE**

The U.S. accounting profession emerged during the last quarter of the 19th century, the first major accounting body being the American Association of Public Accountants, the lineal predecessor of the American Institute of Certified Public Accountants, established in 1887.<sup>2</sup> New York State passed the first law, in 1896, to recognize the qualification known as Certified Public Accountant, which, as Carey writes, "marked the beginning of an *accredited* profession of accounting in the United States" (Carey 1969, 44).

Scottish and English Chartered Accountants, who settled in the United States during the last quarter of the 19th century to report on British interests, performed much of the early auditing work. These pioneers from Britain included Edwin Guthrie, Arthur Young, James T. Anyon, John B. Niven, Ernest Reckitt, George Wilkinson, Arthur Lowes Dickinson, and George O. May. Americans who formed important accounting firms in the late 1890s and during the first two decades of the next century included Alwin C. Ernst, Charles Waldo Haskins, Elijah Watt Sells, Robert H. Montgomery, and Arthur E. Andersen.

Prior to the 1930s, no laws or regulations obliged corporations to have their financial statements audited. Quite a few companies had done so, however, for more than a decade, including United States Steel Corporation, E. I. duPont de Nemours & Company, General Motors Corporation, Eastman Kodak Company, and International Business Machines Corporation.

#### **Early Professional Services and Ethical Norms**

In 1913, following approval of the Sixteenth Amendment to the Constitution, Congress passed the first Revenue Act, which, coupled with "[r]ising tax rates, during and after the war, and the increasing complexities of the tax laws and regulations added enormously to the demand for accountants" (Carey 1969, 146, and 67-71, 213-215; also see Sommerfeld and Easton 1987, 169-170). Previously, many companies had never kept adequate accounting records, and, as a result of the

<sup>2</sup> For an extensive treatment of this period, see Miranti (1990), Previts and Morino (1998, Chapters 5 and 6), and Carey (1969).

Revenue Acts of 1913 and 1918, many company executives came to appreciate the importance of recording depreciation, because it was deductible for tax purposes. The Bureau of Internal Revenue's famous Bulletin "F," *Depreciation and Obsolescence*, appeared in 1920 (Grant and Norton 1955, 208–211). Accountants responded eagerly to meet the burgeoning demand for their services. In 1924, the newly instituted Board of Tax Appeals authorized both lawyers and CPAs to practice before it, which represented a strong endorsement of the standing of CPAs to conduct tax practice (Carey 1969, 222–224).

From the earliest days of the profession, accounting firms rendered consulting services. By the 1910s, they included the installation of factory cost systems, studies of organizational efficiency, investigations in connection with possible investments in other businesses, and an array of other services to management, which, as Carey writes, "were often rendered in conjunction with audits" (Carey 1969, 146). But accounting, auditing, and taxation constituted the solid core of the firms' services.

In 1922, the American Institute of Accountants, now known as the American Institute of Certified Public Accountants (AICPA), banned certain forms of self-promotion by accounting firms. The following year, A. C. Ernst and two of his partners in Ernst & Ernst, by then a national firm, were accused of violating the Institute's rules against soliciting and advertising, and all three promptly resigned their Institute membership. Even after his firm no longer engaged in those practices, A. C. Ernst never rejoined the Institute (Carey 1969, 233–234).

Federal agencies sought the advice of the organized accounting profession because of its growing reputation. In 1917, at the request of the Federal Trade Commission (FTC) and the Federal Reserve Board, the Institute supplied a technical memorandum for publication by the Board as a bulletin on auditing procedures. The FTC sought to promote uniform accounting, while the Board wanted to apprise commercial bankers of the importance of securing audited financial statements from their borrowers. Despite the title of the bulletin, "Uniform Accounting," it actually dealt with recommended auditing procedures and the format of the balance sheet and profit and loss statement. This represented the first authoritative guidance on auditing procedures published in the U.S. In 1929, at the request of the Federal Reserve Board, the memorandum was revised by the Institute and published anew (Carey 1969, 129–135, 159–160; Previts and Merino 1998, 229–234, 250–251; Zeff 1972, 113–115, 118–119).

Audit work developed apace in the 1920s, as an increasing number of listed companies issued audited financial statements. By 1926, more than 90 percent of industrial companies listed on the New York Exchange were audited (May 1926, 322), even though the Exchange did not require audited statements by newly listed companies until 1933 (Rappaport 1963, 39–40). Yet the Exchange had informally encouraged companies to publish audited financial statements "for some years" before then (Staub 1942, 14–15).<sup>3</sup>

### **Initial Accounting Principles and Auditing Procedures, and the SEC**

In 1930, following on the heels of the 1929 stock market crash, the New York Stock Exchange sought out the Institute for advice on the policies it should adopt with respect to the financial statements of its listed corporations. After three years of deliberations, a blue ribbon committee of the Institute provided the Exchange with a philosophy and a framework for dealing with the accounts of listed companies. The committee proposed a set of "five broad principles" of accounting that it regarded "as so generally accepted that they should be followed by all listed companies" (Carey 1969, 177). These, together with a sixth, were officially approved in 1934 by a vote of the Institute's membership. The committee also recommended a standard form of the auditor's report. The

<sup>3</sup> The great increase in the frequency of appearance of audit reports occurred between 1920 and 1928 (Hawkins 1962, 364).

committee's work quickly established the Institute as a body of stature in the field of corporate financial reporting. The leader of the Institute's committee was George O. May, the senior partner of Price, Waterhouse & Co. (Carey 1969, 174–180).

In June 1932, *Fortune* magazine, the trumpet of American capitalism, acknowledged the growing importance of the accounting profession by devoting a major article to a profile of the largest firms (Certified Public Accountants, 1932).

Early in his first term, President Franklin D. Roosevelt signed into law two major pieces of reform legislation, the Securities Act of 1933 and the Securities Exchange Act of 1934, the second of which created the Securities and Exchange Commission. These Acts, as implemented by the SEC, required all new and continuing registrants to have their financial statements audited by independent CPAs, thus highlighting the importance of the accounting profession and generating an increased demand for its services. A government takeover of the auditing of publicly traded companies was averted, as Col. Arthur H. Carter, the senior partner of Haskins & Sells and the president of the New York State Society of Certified Public Accountants, succeeded in persuading the Senate Committee on Banking and Currency, during the hearings on the proposed Securities Act, not to assign the external audit function to a government agency, but instead to allow it to be done by firms in the private sector (Carey 1969, 186–187; Wiesen 1978).

In 1935, the SEC appointed a chief accountant, Carman G. Blough, who promptly began to work closely with the Institute and the American Accounting Association (the organization of academic accountants), and other accounting experts, to identify the norms of proper accounting and auditing practice. In 1937–38, Blough succeeded in persuading the Institute to empower the Institute's Committee on Accounting Procedure to approve and publish bulletins constituting "substantial authoritative support" for accounting principles, known as Accounting Research Bulletins (Zeff 1972, 132–138; Seligman 1982, 197–201).

In 1939, the Institute established a similar standing committee to promulgate a series of bulletins on auditing procedures, a step precipitated by the gigantic McKesson & Robbins auditing scandal, which led to a widely reported SEC investigation, greatly embarrassing the profession (Carey 1970, 22–38). The editor of the Institute's *Journal of Accountancy* wrote in February 1939, "Like a torrent of cold water the wave of publicity raised by the McKesson & Robbins case has shocked the accountancy profession into breathlessness" (The McKesson & Robbins Case 1939, 65).<sup>4</sup> McKesson & Robbins had grossly inflated its receivables and merchandise inventory, and its auditor, Price, Waterhouse & Co., had neither confirmed the receivables nor verified the existence of the inventory. Neither of these tests was a required auditing practice at the time. In response, a special committee formed by the Institute promptly issued a bulletin requiring that both of these tests become standard auditing procedures.

The organized profession consolidated into one national body in 1936, as the Institute merged with its rival, the American Society of Certified Public Accountants. Thus, for the first time since 1921, when the Society was formed, the organized accounting profession became united (Carey 1969, Chapter 19).

The decade of the 1930s ended with the organized profession, represented by the Institute, poised to be the principal source of authoritative pronouncements on both accounting and auditing that the SEC would require for use by SEC registrants and their auditors. The professional and academic literature thus became the place where improvements in accounting and auditing norms could be discussed and debated.

The end of the 1930s marked the close of a major chapter in the profession's history. In a similar vein, John L. Carey, in his landmark history of the Institute from 1896 to 1969, identified 1936/37 as

<sup>4</sup> For more on the McKesson & Robbins scandal, see McCarten (1939), Shaplen (1955), and Kcats (1964).

the turning point between his two volumes, subtitled "From Technician to Professional" (1969) and "To Responsibility and Authority" (1970).

### 1940s TO THE MID-1960s: THE PROFESSION AT ITS PEAK

From the 1940s to the mid-1960s, accounting, auditing, and the accounting profession in the United States reached the height of their standing and reputation. Throughout this period, the SEC relied on committees of the Institute for "generally accepted accounting principles" (GAAP) and the auditing procedures that accounting firms were to adopt in their engagements. Nowhere else in the world did the organized accounting profession possess such a large degree of influence in setting the norms of professional practice.

Moreover, in 1947, the Institute's Committee on Auditing Procedure recommended a set of "generally accepted auditing standards," which the Institute's membership approved at an annual meeting in September 1948. These standards, as distinct from procedures, dealt with the auditor's professional qualities and the exercise of judgment in the conduct of the audit engagement (Carey 1970, 147-150). Once again, the organized profession set the terms governing the performance of its flagship service, the external audit.

At the top of its form, the Institute held well-attended annual meetings, which addressed both policy and technical issues in plenary sessions and roundtables, and distributed the papers widely in volumes of proceedings.

By 1950, all of the states and territories had enacted CPA laws, with all jurisdictions but one adopting the Institute's Uniform CPA Examination. Accounting courses were offered in nearly all major universities, and a large American literature on accounting and auditing had come into existence (Accounting at the Half-Century Mark 1951).

In 1940, the American Accounting Association published *An Introduction to Corporate Accounting Standards*, by Professors W. A. Paton and A. C. Littleton, which both the Association and the Institute distributed as a dividend to its members (Zeff 1966, 57). This monograph, which provided an elegant rationale for the conventional accounting model, profoundly influenced accounting thought, education, and practice for decades thereafter. (See Sterling 1967, 340-343; Ijiri 1980, 620-622.)

In 1943, George O. May, the doyen of the accounting profession, wrote an important treatise, *Financial Accounting: A Distillation of Experience*, and from 1947 to 1952 he directed a major study sponsored by the Institute and the Rockefeller Foundation on the appropriateness of different concepts of business income during periods of substantial change in price levels, a subject of great importance during the postwar inflation (Study Group on Business Income 1952).

### CPAs Emerge as Prominent Public Figures

From the late 1930s through the 1960s, CPAs served in important government positions, gave testimony before Congressional committees, and served as expert witnesses in court cases, in rate regulation hearings, and before federal wage tribunals. From 1938 to 1941, Eric L. Kohler was comptroller of the Tennessee Valley Authority; from 1948 to 1951, he served as controller of the post-World War II Economic Cooperation Administration, known as the Marshall Plan. In 1942, Norris Poulson became the first CPA elected to Congress; his election in 1953 as mayor of Los Angeles made him the first CPA to head a major city.<sup>5</sup> In 1948 and again in 1954, former President Herbert C. Hoover tapped Paul Grady, a Price Waterhouse audit partner, to chair a task force to study government lending agencies under the auspices of the first and second Commissions on Reorganization of the Executive Branch of Government, known as the Hoover Commissions. In

<sup>5</sup> Abraham Beame became comptroller of New York City in 1969 and mayor in 1973.

1949, Donald C. Cook, also a lawyer, became the first CPA to be named to the SEC; he served as chairman of the Commission in 1952–53. Three days after Cook joined the Commission, Edward T. McCormick, another CPA, became a Commissioner.<sup>6</sup> McCormick left the SEC in 1951 to become chairman of the New York Curb Exchange, renamed the American Stock Exchange two years later. In 1953, T. Coleman Andrews became the first CPA to serve as Commissioner of Internal Revenue, and in 1954 Joseph Campbell became Comptroller General of the U.S., the first CPA to head the General Accounting Office.

In 1959, when Christopher Del Sesto won election as governor of Rhode Island, he became the first CPA to serve as governor of a state. Two leading accounting practitioners, Percival F. Brundage and Maurice H. Stans, became successive directors of the Bureau of the Budget, appointed by President Dwight D. Eisenhower, and in 1969 President Richard M. Nixon named Stans as his Secretary of Commerce. Members of the accounting profession were coming to the fore in public affairs because of the increasing respect accorded to the profession (see Carey 1970, 382–384).

### **Movement into Information-Based Services**

Following the Second World War, the major accounting firms began to develop capabilities in new information-based services, gradually expanding beyond their traditional services of accounting, auditing, taxation, and systems design and installation. They chose to describe this new line as “management services,” “management advisory services,” or “administrative services.” It began with punched card and punched tape systems, followed by the introduction in the mid-1950s of electronic computers for business applications, which in turn led to the development of computerized information systems and computer modeling. Operations research and electronic data processing were among the early pillars of this broadened scope of activity. Some firms, such as Arthur Andersen & Co., Peat, Marwick, Mitchell & Co. and Touche, Niven, Bailey & Smart, invested heavily in these new services (Glickauf 1971; Wise 1982, 48–49; Swanson 1972, 39–40).

In the mid-1950s, Arthur Andersen & Co. designed and installed the first business application of a computer, a payroll system at General Electric Company’s Appliance Park facility in Kentucky. As the firm wrote, “This was a milestone event in the development of computers for business use as well as in the development of our administrative services practice, and it marked the beginning of a dramatic firm-wide growth in our practice” (*The First Sixty Years 1913–1973* 1974, 67). (Also see *A Vision of Grandeur* 1988, 95–98.) From the inception of Andersen’s administrative services division in 1942, its staff grew to 400 in 1965, and nearly tripled to 1,150 by January 1970 (Glickauf 1971, 113, 175). By 1969, the division’s gross fees accounted for “roughly one-fourth of the firm’s business” (Williams 1971, vi).

In 1965, after 30 years of controversy and a protracted battle with the legal profession, CPAs secured Congressional recognition of their status to represent tax clients before the Treasury Department (Carey 1970, Chapter 9). The position of CPAs in tax practice was now secure.

### **Accounting Principles Become Controversial**

Also in the mid-1950s, Leonard Spacek, the outspoken managing partner of Arthur Andersen & Co., began publicly criticizing the probity of the Institute’s committee that issued pronouncements on GAAP. The Institute sensibly channeled Spacek’s criticisms toward constructive change by appointing him to a blue ribbon committee to recommend a better approach (see Zeff 2001). The committee proposed a new body, the Accounting Principles Board, and charged it to undertake basic and applied research as well as issue pronouncements on GAAP. The Institute promptly accepted and implemented the committee’s recommendation in 1959, and during the 1960s, especially in

<sup>6</sup> Both Cook and McCormick had been SEC staff members before being named to the Commission. In 1969, James J. Needham became the first CPA firm partner to be appointed to the Commission.

1966–67, the APB earned some credit for narrowing the areas of difference in a number of controversial areas of GAAP.

During the 1960s, as the APB became active in addressing controversial areas, leading partners of the Big Eight firms—each of whom had a vote on the APB—began to speak at public forums and write articles and even books on the major accounting principles issues of the day. From the 1930s to the 1970s, *The Journal of Accountancy* regularly contained articles dealing with accounting and auditing issues of interest to the profession, as did *The Accounting Review* from the 1930s to the 1960s. Journals published by a number of state CPA societies also carried the dialogue, and several universities, including Ohio State, Tulsa, and the City University of New York, held annual conferences or sponsored lecture series to air controversial professional issues.

Beginning in the mid-1950s, Arthur Andersen & Co. prepared reprints of partners' speeches and booklets expressing the firm's views on accounting principles, and distributed them to a wide audience of academics, practitioners, and companies. From 1962 to 1967, the investment banking house of Hayden Stone sponsored an annual Accounting Forum, featuring major accounting practitioners speaking on accounting principles at well-attended one-day programs held at New York University. And starting in 1968, the Institute co-sponsored a series of Seaview Symposia, at which representatives of the preparers, auditors, and users of financial statements debated major issues of the day. The decade of the 1960s was marked by a vibrant dialogue on accounting principles, with active participation both by partners in the big firms and by accounting academics (see Zeff 1986).

This was a time when audit partners were, except in rare instances of substandard performance, assured of tenure until they retired, and they expected their firm to back them with its full resources when they stood up to their clients over questionable accounting practices. Partnership in one of the big accounting firms was seen as the pinnacle of one's career, it being almost unknown for partners to leave their firms to take positions in industry. The idea of a "marketing" campaign for new clients did not exist. If a partner secured a new client, he was praised, but the rewards doled out to partners recognized the quality of audit service to one's clients.

The corporate merger movement of the 1960s that led to the formation of conglomerates and multinationals focused attention on a sensitive accounting issue, segment reporting, and called forth a demand for the international comparability of financial statements. Numerous high-profile mergers heightened the pressure on top corporate executives to deliver improved earnings performance—either to defend against takeovers or to engineer takeovers—thus prompting the corporate sector to begin opposing constraints on their freedom of choice of accounting methods, especially any limits on the use of "pooling of interests" accounting for business combinations.

Early in the 1960s, the business press took notice of the much higher profile of the accounting profession. While comparatively little had been written in the press about accounting and the profession in previous decades, this coverage mushroomed in the 1960s, especially when the APB moved into controversial territory—accounting for the investment tax credit, leases, pensions, income tax allocation, convertible debt, extraordinary items, and business combinations and goodwill. The decade began with a major, two-part article in the November and December 1960 issues of *Fortune*, "The Auditors Have Arrived." Written by T. A. Wise, the article began as follows:

It is a curious and noteworthy fact that the tremendous growth of the U.S. accounting profession in the postwar years has taken place almost unnoticed by most Americans.

This was the article that coined, or at least popularized, the term, "the Big Eight," referring to the eight largest public accounting firms. Special interest magazines such as *Business Week*<sup>7</sup> and *Forbes*, and even the more general *Time* and *Newsweek*, as well as *The Wall Street Journal*, *The New York Times*, and newspapers across the country, began covering accounting principles issues, as they

<sup>7</sup> A good example is "A Matter of Principle Splits CPAs" (1963).

became news of interest to more than accountants. During the 1968–70 debate over “pooling of interests” and goodwill, the Financial Executives Institute flooded the nation’s press with criticisms of the APB’s draft pronouncements. Articles on accounting principles also began appearing in the likes of the *Harvard Business Review* and *California Management Review*.

In 1963, after issuing its second Opinion, the APB suffered a stunning reversal. In its Opinion, the board narrowly voted to require that the investment tax credit be deferred for accounting purposes rather than be taken immediately into income. Immediately afterward, pressure from several major accounting firms, whose partners voted against the Opinion, and from an important segment of industry, as well as from the Department of the Treasury (behind the scenes), led the SEC to reject the APB’s single permissible treatment. Instead, the SEC allowed registrants either to defer the credit or to take it immediately into income. This rebuff by the SEC forced the APB to concede the acceptability of both treatments in Opinion No. 4, issued two years later. In 1967, the board once more tried to gain acceptance for its preferred treatment of the credit, but it was again defeated by the Treasury, this time in the open. Political lobbying by powerful interest groups against objectionable draft standards began afflicting the APB in the early and mid-1960s. (See Zeff 1972, 178–180, 201–202; Moonitz 1966; Zeff 1978.)

### **MID-1960s TO THE PRESENT—THE PROFESSION BEGINS A DESCENT UNDER STRESS**

All was not rosy as the three decades from the 1940s through the 1960s came to a close. Threatening clouds began to form over the accounting profession in the middle and latter 1960s. Financial scandals burst on the scene, raising questions about the performance of auditors. Trailing in the wake of the scandals, auditors found themselves as defendants in a number of highly publicized lawsuits. And the accounting profession lost its prized authority to pronounce on “generally accepted accounting principles” (GAAP) to an independent body, with unfortunate ramifications for the vitality of professional discourse.

#### **Scandals, Lawsuits, and Criticism of the Profession**

The collapse of Westec (1965) and National Student Marketing (1969), which were notorious practitioners of what Abraham J. Briloff, an acerbic critic of unprincipled accounting, called “dirty pooling” (Briloff 1967, 1970), as well as the bankruptcies of Penn Central and Four Seasons Nursing Centers (both in 1970), visited huge losses on investors and raised questions about the performance of their auditors. The Westec case eventually animated a serious concern that its auditor’s independence was compromised by rendering certain consulting services to the audit client.<sup>8</sup>

During the second half of the 1960s, criticism of the accounting profession was on the rise. John L. Carey, the Institute’s administrative vice president, said in 1967 that “the accounting profession is going through a most unusual and difficult period. On some days it seems as though we were being attacked from all sides.” He was concerned over “a feeling that CPAs are not quite the stalwart protectors of investors and creditors that the public had assumed they were” (Carey 1967, 15). It was, he said, a time of rising expectations of auditors (Carey 1967, 18). Carey’s colleague at the Institute, Leonard M. Savoie, a former research and education partner in Price Waterhouse (PW) and, since 1967, the Institute’s executive vice-president, bluntly criticized the “opinion shopping” that was beginning to pit firm against firm:

competition to obtain a client for the lowest fee or to obtain or retain a client at the expense of technical standards is debilitating. It will weaken and, if unchecked, destroy the profession. Competition for a client based on accounting principles must be stopped. (Savoie 1968, 112)

<sup>8</sup> This charge was made both by Briloff (1972, 292–293) and by the Commission on Auditors’ Responsibilities (1978, 102).



The second half of the 1960s witnessed a series of important federal court decisions: *Fischer v. Kletz* (1967), also known as the Yale Express case; *Escott v. BarChris* (1968); and *United States v. Simon* (1969), also known as the Continental Vending case (see Isbell 1970), triggered a "litigation explosion" against auditors in the 1970s (Jaenicke 1977, 1). After decades of comparative calm, the profession was coming under attack by the plaintiff's bar. "By the mid-1970s," Jaenicke (1977, 1) wrote, "hundreds of suits were filed against auditors."

In a speech given in 1970, John C. (Sandy) Burton, an accounting and finance professor at Columbia Business School, took a dim view of developments in the profession:

In recent years, there is little evidence that the "public" in public accounting has been emphasized. In its zeal to protect itself from liability, the profession has given every impression of attempting to avoid responsibility. In the professional literature pains have been taken to assert what the auditor does *not* do, and to indicate that auditors attest only to the general acceptability, rather than the desirability, of management's choice of accounting principles.

It is not at all surprising that articles critical of the accounting profession are beginning to appear more and more frequently in the business press. (Burton 1971, 49)

### **Tribulations of the Accounting Principles Board**

In the mid-1960s, under pressure from the SEC and from the Big Eight firms and at a time when the accelerated pace of corporate merger activity focused increased attention on the earnings measure, the APB began to issue longer and more prescriptive Opinions. Several of these pronouncements attracted significant numbers of dissenting votes from board members. In two instances (on interperiod tax allocation in 1967 and on business combinations/goodwill in 1970), a board member from a Big Eight firm infuriated his colleagues in the majority by rescinding his vote on a contentious Opinion after the board had, in a final vote, approved a position that had secured a bare two-thirds majority. In 1967, the reversal occurred after the Opinion in 1967 was printed and ready for distribution. In both instances, the board met in emergency session to rescue the pronouncement. Thus was the intensity of pressure on board members, probably brought, directly or indirectly, by a firm's important clients.

Burton alluded to complicity by audit firms in helping their clients escape the adverse effects of the APB's pronouncements: "By writing precise rules, ... [the APB] has made it possible for people to observe the letter and avoid the spirit, with the blessing (and often the assistance) of their auditors" (Burton 1971, 50), a state of affairs that continues today.

Although the APB received praise from some quarters for "narrowing the areas of difference" on such contested subjects as pensions and interperiod tax allocation, other Opinions, especially Opinion No. 15 issued in 1969 on earnings per share, were criticized by leading accounting professionals for being laden with detailed rules. Ernest L. Hicks (1969, 60), a technical partner in Arthur Young & Company, complained that "much of the difficulty the Board has experienced resulted when it yielded to pressure to move too fast, with less than an adequate exposure of the issues." No less an exalted figure than Professor *Emeritus* William A. Paton, who served for 11 years on the old Committee on Accounting Procedure, reviled Opinion No. 15 as an illustration of "obscurity and unnecessary detail." He also criticized the board for its "dictatorial tendencies" in recent Opinions (Paton 1971, 42), a view echoed by retired PW senior technical partner Paul Grady, who had served as the Institute's director of accounting research in 1963-64 (Grady 1971, 24). PW executive office partner A. Carl Tietjen derided the APB for issuing "cookbooks" (Tietjen 1970, 10), as Hicks (1969, 60) did earlier. George R. Catlett, senior technical partner of Arthur Andersen & Co. and a longtime APB member, contended that the APB, like its predecessor, "has been so busy 'putting out fires' and dealing with a large and ever-increasing backlog of current problems that it has never established an adequate basis upon which to build" (Catlett 1969, 62).

Also, the ferocity with which Corporate America lobbied against APB proposals that limited companies' flexibility in matters of accounting choice, most notably between 1968 and 1970 on business combinations and goodwill as the conglomerate merger craze was losing steam, led to a widespread loss of confidence in the board's effectiveness after the board issued a highly compromised Opinion No. 16, with six dissenting votes. The press followed every step in the board's tortured deliberations with relish (Zeff 1972, 212–216; Olson 1982, 3).<sup>9</sup> Critics from both inside and outside the profession inveighed against the organized profession's body charged with establishing the norms of proper accounting practice.

In August 1970, the APB finally issued its two hotly contested Opinions, Nos. 16 and 17, on accounting for business combinations and goodwill; the two Opinions were regarded more as the result of intense lobbying by industry than the product of sound thinking and analysis. The Big Eight accounting firms themselves differed profoundly and even emotionally over the best solution, partly fueled by their clients' preponderant views. So strong were the firms' reactions to the pressurized process in which these two Opinions were developed that three of the Big Eight notified the Institute in November 1970 that they had lost confidence in the APB.<sup>10</sup> The three firms recoiled at the powerful intrusion of self-interested lobbying and lamented the board's lack of agreement on the objectives of financial statements.

In August 1970, the American Accounting Association (AAA) became involved by appointing a special committee to inquire into the formulation of accounting principles. Acting swiftly, the committee urged the Institute and other interested bodies to cooperate with the AAA to convene a Commission of Inquiry to develop a better alternative to the APB. The Association's Executive Committee promptly endorsed its report (Report of the Committee on Establishment of an Accounting Commission 1971).

### **The Profession Loses Its Accounting Standard Setter**

Declining to share the standard-setting stage with the AAA, the Institute itself appointed a Study Group to recommend a better way of establishing accounting principles. This Study Group, chaired by Francis M. Wheat, a former SEC Commissioner, recommended the establishment of the Financial Accounting Standards Board (FASB), which was to be an independent body, not a committee of the Institute. The Institute's Council promptly endorsed the Wheat recommendation in its entirety, thereby, for the first time, ceding the authority for setting accounting standards to a body outside the province of the organized accounting profession. Members of the FASB would hold full-time appointments, be supported by a large research staff, and could count on financial support to be provided by a newly established, broad-based Financial Accounting Foundation (FAF) (Report of the Study on Establishment of Accounting Principles 1972). This sea change disenfranchised the Big Eight firms from representation on the standard-setting body. As will be seen, this repositioning of the big firms from the center to the margin of standard setting soon served to dampen their interest in actively participating in the public dialogue on accounting principles, which should be a *sine qua non* of professional discourse.

But the Institute did not surrender all of its influence over the new standard setter. The FAF's bylaws provided that four of the seven board members must be CPAs with experience in public practice and that the Institute's board of directors would be the sole elector of the FAF's trustees. Yet, in 1977, the FAF's trustees repealed both of these provisions (*Status Report No. 50* 1977, 1).

<sup>9</sup> For further discussion, see Chatov (1975, Chapters 13 and 14), Brooks (1973, Chapter 7), Seligman (1982, 417–430) and *Conglomerate Mergers and Acquisitions: Opinion & Analysis* (1970).

<sup>10</sup> The firms were Arthur Andersen & Co., Touche Ross & Co., and Arthur Young & Company (Zeff 1972, 224–225). Also see the letters from Harvey E. Kapnick, Robert M. Truett, and Ralph E. Kent in the attachments to AICPA President Marshall S. Armstrong's letter dated December 21, 1970 to Those Invited to Conference on Establishment of Accounting Principles.

In 1974, less than a year after the APB passed the standard-setting baton to the FASB, Leonard M. Savoie (1974, 64), the Institute's principal spokesman on APB matters from 1967 to 1972, expressed his disappointment with the handover and the recent behavior of the big firms:

In abandoning its rule-making function the AICPA has lost its most conspicuous source of prestige and good public relations potential. At the same time, it has extricated itself from the center of dissent and turmoil caused by recalcitrant accounting firms that were more interested in pushing their own views than in working within the institutional structure and reaching a consensus.

Even while the Wheat Study Group deliberated, the APB suffered another setback, again on the investment tax credit. In November 1971, when the Congress was about to enact a new form of the investment tax credit, the board, in its third such try, approved an exposure draft that required the deferral method, but the Treasury opposed it, as did the same large segment of industry as before. The opponents succeeded in persuading Congress to insert a provision in the eventual legislation that taxpayer corporations could use any method of accounting for the credit in their financial statements filed with the SEC. This denouement confirmed the inability of the Institute's standard-setting body to counter the self-serving forces arrayed against some of its more controversial Opinions (see Zeff 1972, 219-221). Three other setbacks occurred during 1971, when powerful industry pressures thwarted the APB from acting on accounting for marketable securities, leases, and oil and gas exploration (Zeff 1978, 14).

The FASB's relations with the SEC during its first five years were anything but smooth. From 1972 to 1976, during Sandy Burton's term as SEC Chief Accountant, the Commission issued 70 Accounting Series Releases (more than a third of which dealt with financial reporting), compared with 126 from 1937 to 1972.<sup>11</sup> Arthur Andersen unsuccessfully challenged the propriety of one of the SEC's Releases in court (Our Firm Files Petition with SEC 1976; Arthur Andersen is Set Back in Bid to Bar SEC Rulings 1976). An activist Chief Accountant, Burton surprised the FASB by declaring that, while the FASB was to take the lead on matters of accounting measurement, financial disclosures properly fell within the province of the SEC (Burton 1974). Additionally, Burton criticized the FASB's 1974 exposure draft recommending general price-level accounting, and two years later he pressed ahead with his own solution, a requirement that some 1,300 large registrants report replacement cost data in a supplementary disclosure. Burton's initiative forced the FASB to issue its own standard, Statement No. 33, on the disclosure of current cost and constant dollar information.

In 1978, the SEC again rebuffed the FASB, this time on accounting for oil and gas exploration. Under intense political pressure from small oil and gas exploration companies, with assistance from members of Congress, the SEC rejected FASB Statement No. 19's required use of "successful efforts" costing and instead proposed a kind of current value accounting for oil and gas reserves. The SEC's decision took the FASB aback, yet the SEC made it clear that the oil and gas issue was a unique case and did not "represent any change in the Commission's basic policy of looking to the FASB for the initiative in establishing and improving accounting standards" (*Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role* 1979, 50). (Also see Gorton 1991; Miller et al. 1998, 125-127.)<sup>12</sup>

<sup>11</sup> John R. Evans, an SEC Commissioner from 1973 to 1983, argues that "the Commission was virtually forced to become more active [in the early 1970s] because of investor losses in companies, which had been able to exaggerate reported earnings and conceal financial problems, and because of permissive accounting standards and lax auditing procedures." He then cited several major corporate failures, including Penn Central and Equity Funding, and added: "Questions were raised as to why accountants charged with performing an independent audit of these companies had failed to detect or report on the developing problems. Some questioned whether accountants had participated actively with management in a fraud" (Evans 1984, 159). Also see Orben (1984, 142-143).

<sup>12</sup> For a fuller discussion of these standard-setting issues, see Miller et al. (1998, Chapter 5).

### An Important Implication of the Loss of the Profession's Standard Setter

It was not long into the FASB's tenure that the Big Eight firms began withdrawing from an active dialogue over accounting principles and standards, perhaps in the belief that their task had become one of persuading the FASB of their views and no longer persuading either academics or their brethren in the profession. Indeed, this was also a time when many accounting academics seemed to abandon interest in accounting policy issues as well. Another reason for audit partners' withdrawing from this public dialogue was the increasing proliferation, complexity, and technical detail in the FASB's pronouncements.

By the mid-1980s, speeches by Big Eight audit firm partners taking positions on controversial accounting issues had almost disappeared from the scene, and only a few audit partners in, at most, three of the Big Eight firms<sup>13</sup> continued to write articles intermittently on such topics. Moreover, in 1982 the *Journal of Accountancy*, the Institute's journal, announced that it was encouraging the submission of "practical" articles, code language for the avoidance of controversy (see Zeff 1986). As the audit market became more competitive, one inferred that the firms did not wish to give prominence to their views on controversial issues, lest it might offend important clients, who might seek an audit firm with more accommodating views. Opinion shopping, which began to occur in the 1960s, continued into the 1970s and 1980s, as companies actively sought out more client-friendly audit firms.

### More Scandals, and Attacks from Congress

In 1973, the sudden collapse of Equity Funding, coming on the heels of the Stirling Homex bankruptcy a year earlier,<sup>14</sup> jarred the accounting profession. (See Report of the Special Committee on Equity Funding 1975; Seidler et al. 1977.) As the Institute's executive director later wrote, "The huge losses by investors in [Equity Funding's] securities, closely following a series of other business failures, dealt a shattering blow to the credibility of independent auditors" (Olson 1982, 87-88). Propelled by these embarrassments, the Institute in 1974 appointed a Commission on Auditors' Responsibilities, headed by former SEC Chairman Manuel F. Cohen. These celebrated collapses, coupled with the discovery of illegal and improper payments by major corporations that were not disclosed in their financial statements, prompted two Congressional committees to level criticism at the accounting profession and at the private-sector setting of accounting standards.<sup>15</sup> The profession thus came under its first broad attack in the Congress.

Rep. John E. Moss, Democrat from California, chaired his subcommittee's investigation of federal regulatory agencies. The subcommittee's report recommended that the SEC play a direct role in setting accounting and auditing standards (*Federal Regulation and Regulatory Reform* 1976, 51-53) and thus remove this authority from the private sector. On the Senate side, a subcommittee headed by Sen. Lee Metcalf, Democrat from Montana, launched a major investigation of the accounting profession. His subcommittee's 1,760-page staff study, *The Accounting Establishment* (1976), consisted of an extensive factual examination of the Big Eight firms, the Institute, and the FASB, accompanied by a number of highly controversial conclusions and recommendations. Wallace E. Olson, the Institute's full-time chief executive, characterized the staff study as "almost as damaging to the profession as the Japanese attack on Pearl Harbor was to the U.S. Navy in 1941" (Olson 1982, 43).

<sup>13</sup> This included several partners from Arthur Andersen's Accounting Principles Group; Dennis R. Beresford of Ernst & Whinney until 1987, when he became FASB chairman; and Dale L. Gerboth of Arthur Young/Ernst & Young until 1990, when he retired.

<sup>14</sup> For the SEC's report on its investigation into the matters of Penn Central, National Student Marketing Corporation, and Stirling Homex, all of which were clients of the same audit firm, see its Accounting Series Release No. 173 (July 2, 1975).

<sup>15</sup> See an extract from a 1977 speech by Rep. Moss in Olson (1982, 39) and the comments by Senators Metcalf and Charles H. Percy, Republican from Illinois, and Rep. Moss in *Accounting and Auditing Practices and Procedures* (1977, 3, 10, 14). Also see Nelligan (1980, 111).

Two of the staff study's conclusions were that the Big Eight firms lacked independence from their clients and that they dominated both the Institute and the process of setting of accounting standards. The study also asserted that the Big Eight firms, through their influence on the FASB, did the bidding of their corporate clients (*The Accounting Establishment* 1976, 1–24). Almost mirroring the course taken by the Moss subcommittee, the Metcalf subcommittee's staff study recommended that the federal government set accounting and auditing standards for publicly traded corporations (*The Accounting Establishment* 1976, 20–24). Although both subcommittees held hearings and issued reports, they produced no legislation.<sup>16</sup> Nonetheless, the two subcommittees' lengthy and well-publicized investigations, which finally concluded in 1979, put the accounting profession on the defensive.

In April 1977, both the Institute and the FASB responded at length to the Metcalf staff study's findings and recommendations. The Institute issued a 40-page booklet, *The Institute Responds ...*, in which it countered the arguments in the Metcalf staff study. To the charge that the Big Eight firms compromised their independence when they advocated positions that were favorable to their clients, the Institute asserted that, by doing so, "they are not tools of their clients" (*The Institute Responds ...* 1977, 32). Yet, a scant six years later, Touche Ross & Co. issued a booklet, *Employers' Accounting for Pensions* (1983, 3), in which it offered to help clients prepare "an effective and persuasive response" to the FASB by which the firm would "assist your company in evaluating the effects, developing empirical supporting evidence, and identifying the economic consequences of the positions your company supports and rejects." Thus, as the competition for the favor of clients intensified in the 1980s, at least one of the Big Eight firms—Touche Ross—was willing to become a blind advocate for its clients. In its 44-page reply, the FASB defended the integrity, independence, and objectivity of its process (FASB 1977).

### Under the Gun, the Institute Reforms

The unwanted public attention led the Institute to adopt a hurried reform in September 1977: creation of a Division for CPA Firms, composed of an SEC Practice Section and a Private Companies Practice Section. Wm. R. Gregory, the Institute's board chairman in 1979–80, explained the move as follows:

Council created the division for CPA firms without seeking a vote of the membership because it believed that Congress would enact new legislation to regulate the profession if immediate steps were not then taken to bolster the profession's system of self-regulation. That perception was borne out by the introduction by Congressman Moss on June 16, 1978 of H.R. 13175, which provided for a new federal statutory regulatory organization under the oversight of the SEC, to be known as the National Organization of Securities and Exchange Commission Accountancy. (Gregory 1980, 3)

The body proposed in Rep. Moss's bill, which died in committee at the end of 1978, foreshadowed in a striking number of respects the Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act of 2002.

The Institute also installed a Public Oversight Board (POB), composed of distinguished public servants, to oversee the activities of the SEC Practice Section, including the setting and enforcing of quality control standards and a newly established peer review process. The SEC, which had ordered several major firms to undergo peer reviews because of alleged audit deficiencies in early and middle 1970s, welcomed the Institute's new section and the POB (*Securities and Exchange*

<sup>16</sup> Rep. Moss retired from the House on December 31, 1978. Sen. Metcalf died suddenly in January 1978, and the work of his subcommittee was carried on by Sen. Thomas F. Eagleton, Democrat from Missouri, in his own subcommittee until 1979, when interest in the subject lapsed. See Olson (1982, Chapter 3).

*Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role* 1978, 15–27). But pressure from Congress had clearly precipitated the Institute's restructuring.

### **Intrusions of Federal Antitrust Bodies That Fundamentally Altered the Professional Climate**

During the 1970s and 1980s, the Institute also felt unrelenting pressure from the Department of Justice and the Federal Trade Commission (FTC) over portions of its Code of Professional Ethics alleged to be in restraint of trade. In 1972, the Institute gave in to Justice by removing the ban on competitive bidding from its code of ethics. By 1979, Justice and the FTC compelled the Institute to drop its rules prohibiting direct, uninvited solicitation and advertising that is purely informational (see Bialkin 1987, 105–106). Many Institute members strongly opposed these forced concessions. During the 1980s, the FTC also pressed the Institute to remove its ban on contingent fees and commissions. In the end, the two bodies reached a compromise: to allow the receipt of commissions only from nonattest clients (Chenok 2000, 106). These amendments to the Institute's code of ethics, particularly on competitive bidding and direct, uninvited solicitation, profoundly changed the climate in which audit firms conducted their affairs. Competition among firms came to be signified more in the idiom of commerce—the aggressive pursuit of profit—thus, placing strains on professional values.

Whether because of the changes in the code of ethics or because of changing conditions in the practice of public accounting, allegations began to surface that competition among firms for clients was becoming more intense and vicious. In an article in *Barron's*, an editor who had long been a close observer of the accounting profession wrote as follows:

What's happened, essentially, is that the nation's top accounting firms—some big, some smaller—are locked in a fierce battle marked by vigorous price cutting. Some blame a growth-at-any-cost syndrome they say has afflicted some of the profession's top firms. Others contend that it's an inevitable consequence of a slowing in chargeable hours as the pickings for new clients get slimmer. (Anreder 1979, 9)

The Institute's Commission on Auditors' Responsibilities also pointedly remarked, "The practice of accepting an audit engagement with the expectation of offsetting early losses or lower revenues with fees to be charged in future audits is a threat to the independence of the auditor" (The Commission on Auditors' Responsibilities 1978, xxx).

The elimination of the Institute's bans on competitive bidding, uninvited solicitation, and advertising, coupled with the apparent topping out of the audit market, all fundamentally changed the character of CPAs' relations with clients. Eli Mason, the managing partner of a medium-sized CPA firm in New York City who had long been a vocal critic of the big firms and the Institute, complained in 1985 that the practice of accounting was no longer a profession, but an industry: "Today, the media describes public accounting as an industry, seldom as a profession—and it does have all the earmarks of an industry including cut-throat competition, 'low-balling,' cheap advertising, and open solicitation by one CPA of another CPA's clients." Mason blamed the FTC and the Justice Department for creating this "unprofessional and undignified atmosphere" (Mason 1985, 732; also see Mason 1994).

Arthur W. Bowman, the editor of *Public Accounting Report*, documented some of the deep cuts in audit fees that companies negotiated in the early 1980s, which pitted the major accounting firms against one another in the sharply competitive bidding process. He reported tenders of between 25 and 50 percent under the previous year's audit fee charged by a company's current audit firm (Bowman 1985, 705–713). (Also see Berton 1985a; Berton 1985c; Berton 1985d, 12.) In a disquieting remark, he said, "If [companies] can get an audit for 0 dollars, they'd get them" (Bowman 1985, 720). Indeed, in 1991, Norman Lipshie, the president of the New York State Society of Certified Public Accountants, was quoted as saying, "I've seen three recent instances where Big Six firms

were bidding zero to do audits" (Brenner 1991). (Following two mega-mergers in 1989, creating Ernst & Young and Deloitte & Touche, the Big Eight became the Big Six.)

In an interview in 1984, incoming Peat Marwick deputy chairman and chief operating partner Robert W. Beecher complained that other firms' practice of cutting fees "has dangerous implications" (An Interview with Our New Management Team 1984, 5). Price competition between audit firms existed in earlier years, but the firms sold quality as well as price. Clients prized audit quality, before they began to view the audit as a commodity. Leonard Spacek, the architect of the modern firm of Arthur Andersen & Co., wrote in 1984, reflecting the values of an earlier era:

The competition [today] is in fees only. We always had such competition, but to offset it a firm can strengthen itself by the energetic position it takes to make it a leader. ... outstanding service is equally an offset, and both characteristics are prime offsets to price. I know because I practiced it for 20 years—saying publicly that we *were* the highest priced firm, but the higher price was more than matched by quality. Prospective clients seek these qualities to prove they risk the most thorough accounting tests.<sup>17</sup>

The heightened competitive climate in which the firms operated seemed to haunt partners' conduct in audit engagements. A gradual development within the Big Eight firms during the 1980s was a significant shift in the posture of audit partners toward their clients, probably spurred by their perceived pressure to retain valued clients. In previous years, partners conveyed a firm position on the propriety of any borderline accounting and disclosure practices adopted by the client, but increasingly in the 1980s partners would be seen huddling with the firm's technical specialists to find any means—perhaps restructuring a major vehicle, reconfiguring a transaction, or straining to rationalize the application of a suitable analogy—to enable the firm to approve the accounting treatment sought by the client. The "accommodation" or "negotiation" mentality fostered by this important shift in focus may have led many audit partners to incline toward compromise rather than invoke their principles even in routine discussions with clients. More will be said about this development later.

### Management Advisory Services Come under SEC Fire

Consulting, then still known as management advisory services (MAS), increasingly became an issue in the 1970s. In 1969, *Business Week* reported the following anti-establishment view:

"Some firms," says an unnamed senior partner of a big New York accounting firm, "say they draw the line against consulting that involves them in management decision making. But don't let anybody fool you. We take on any job." (Accountants Turn Tougher 1969, 124)

The term "scope of services" entered the profession's vocabulary, referring to the range of consulting services that an audit firm could render without surrendering its objectivity or independence. In the SEC's 1978 annual report to Congress submitted at the request of the Senate's Metcalf subcommittee, Chairman Harold M. Williams wrote as follows:

Another important issue requiring immediate attention is the question of the appropriate range of services—other than the performance of the audit itself—which accounting firms should be permitted to offer to their audit clients ...

In considering this issue, it will be necessary to resolve three basic questions:

- Are there situations in which the magnitude of the potential fees from management advisory services are so large as to affect adversely an auditor's objectivity in conducting an audit?
- Are there some services that 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?

<sup>17</sup> Letter to the author dated December 20, 1984.

- 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? (*Report to Congress 1978, 12*)

Even though these three policy questions were raised at the threshold of the era of the giant diversified services firms, they are still being raised today.

In June 1978, the SEC issued Accounting Series Release (ASR) No. 250, which mandated the disclosure in a company's proxy statement of the percentage relationship to audit fees of (1) aggregate nonaudit fees, and (2) the fee for each specific nonaudit service. A year later, the SEC promulgated ASR No. 264, "Scope of Services by Independent Accountants," a strongly worded document that was issued "without prior warning or discussion with the AICPA" (Olson 1982, 218). The Release had an unmistakable target:

the growing array of nonaudit services offered by some independent public accountants—and the growing importance of management advisory services to the revenues, profits, and competitive position of accounting firms—are a cause for legitimate concern as to the impact of these activities on auditor independence, objectivity, and professionalism.

The Release was intended to "sensitize the profession and its clients to the potential effects on the independence of accountants of performance of nonaudit services for audit clients." Mark Stevens, a close student of the profession, wrote that it "also cautioned the CPAs to avoid supplanting client management's role, to be cautious of accepting engagements that involve an audit of their own work (such as a review of internal controls installed by the auditor's MAS arm), and that client audit committees should gauge the relative merits of the firm's auditor providing nonaudit services" (Stevens 1981, 210–211). The Release had a chilling effect on the profession, as the firms expected companies to pull back from drawing on such services from their audit firm. The Release was couched in such categorical language that Chairman Williams felt it necessary to assure the profession in a speech that the Commission did not intend to prohibit any particular kind of MAS engagement (Williams 1980, 422).

Reacting to Release Nos. 250 and 264, Harvey E. Kapnick, the chairman and chief executive of Arthur Andersen, proposed to his partners in 1979 that the firm be split into two related firms: auditing and consulting. He reported on his private discussions with SEC Chairman Williams, who, he said, would soon require all of the big firms to make such a split. Kapnick's proposal shocked his partners, and it met with stiff resistance. Although Kapnick did not accept the views of the SEC, he believed that this was the principled action to take before the SEC acted unilaterally. The heated controversy generated by his proposal led him to take premature retirement from the firm several weeks later: (*A Vision of Grandeur 1988, 150–151*).<sup>18</sup>

In the end, however, both SEC Release Nos. 250 and 264 were rescinded by the Commission in 1981/82, reflecting the new federal policy of deregulation under President Ronald Reagan. Nonetheless, the Commission averred in ASR No. 296 (1981) that "its views [expressed in ASR No. 264] are unchanged." Because the Institute opposed both Releases, one supposes that it welcomed President Reagan's selection as SEC Chairman, John S. R. Shad, in May 1981.

The profession went on the offense by arguing that auditors rendering management advisory services to an audit client actually had a deeper knowledge of the client from an audit standpoint. John C. (Sandy) Burton, the immediate past SEC Chief Accountant, adopted this view and believed

<sup>18</sup> Also see Stevens (1991, 112–115) and "The Palace Revolt at Arthur Andersen" (1979). It was Kapnick who promoted an unprecedented openness of, and scrutiny over, his firm's operations. In 1973, under his leadership, Arthur Andersen became the first firm to issue an annual report (see Bows 1973), and in 1977 it was the first firm to publish audited financial statements. In 1974, Kapnick established a Public Review Board, composed of prominent outsiders, to review and report publicly on the firm's operations.



that the "scope of services" issue was mainly one of perception by those who do not possess an understanding of the audit process (Burton 1980, 51).

Yet, in 1979 the Public Oversight Board released a major study on *Scope of Services by CPA Firms*, in which it said:

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. (Public Oversight Board 1979, 56)

The board concluded, however, that "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" (Public Oversight Board 1979, 5). In its second year of operation, the POB was not prepared to take on the profession.

---

**END OF PART I**

---

Copyright of Accounting Horizons is the property of American Accounting Association. The copyright in an individual article may be maintained by the author in certain cases. Content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.