THE EVOLUTION OF THE CODE OF PROFESSIONAL ETHICS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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ABSTRACT

THE EVOLUTION OF THE CODE OF PROFESSIONAL ETHICS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

by Darwin J. Casler

The prominence and social importance of the professions in our society are unequalled in the history of most important civilizations. For the professions, an ethical code and the related quasi-judicial interpretations are vehicles for the projection of an image and an ethical ideal. In the literature of the sociology of occupations, ethical codes are a typically strong current component of the professional subculture. In contrast with those emphases, this study is a response to the following question: What sociological and practical significance is there in the evolution of a particular code of ethics?

The code of professional ethics of the American Institute of Certified Public Accountants was chosen for analysis because the Institute and its predecessor organizations have, since 1887, dominated the development of public accountancy and have published for fifty-seven years the only continuous stream of literature for that profession. Official publications of the Institute were the primary source of data for this study although other publications were freely used. The investigation involved these three steps: (1) the significant amendments of each rule were isolated; (2) a search was made of committee reports, minutes of meetings, and the professional literature for relevant explanative comments; and (3) an analysis was made of the data in order to identify the factors which led to the previously determined changes in the rules.

On the basis of this study, three categories of conclusions are drawn. A limited, tentative, sociological model of the dynamics of a code of ethics is devised. In addition, two social disorders of the profession are diagnosed and several probable changes in the profession's ethical stance are predicted.

A code of ethics is a dynamic, unique record of the mobility of an occupational group which seeks professional status. Rules of professional conduct can be meaningfully classified as expressions of integrity, technical standards or responsibilities, and attitude. No significant pattern is evident in the adoption of rules in those categories. The rules are used for purposes of moral suasion, disciplinary actions, and public relations. Because the code is primarily an internal control mechanism, the specific rules tend to be expressed in negative, imperative terms.

Unsuccessful efforts have been made to revise the rules in order to expand management services and preserve the internal unity of the Institute. Failure is probably due to these divergent interests: referrers want protection from the risk of loss of clients, referees oppose excessive restrictions on the extension of their services, and the Institute must not adopt a rule which might damage its professional image. That conflict is a symptom of a deficient sense of unity or consciousness-of-kind. Probably a lack of control over the education of its entrants and the ease of entry into and departure from the profession are related to the problem.

Serious problems are being precipitated by the expanding management services functions. If society does not sanction this diffusion and formally limits the profession's authority, the profession will lose prestige. Similarly, if society does sanction the diffusion, the integrity which is essential for the audit function will be shattered unless it can be demonstrated that the profession is somehow able to serve two masters--management and stockholders.

The profession will likely abandon the non-operational "state of mind" concept of independence. Practical considerations will probably force the Institute to accept professional incorporation. Ethical standards of competence for non-auditing services will not be quickly developed because it will first be necessary to formulate the related technical standards. Unfortunately, it appears that efforts are not being made to prohibit referral fees and the use of a firm name which deceptively implies the existence of a partnership.

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1963

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By

Darwin J. Casler

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In addition to the Michigan State University Library, the author drew upon the resources of the libraries of the University of Michigan and the University of Chicago. Miss Katherine Michaelsen was most helpful in locating materials and providing facilities for the author's use in the library of the American Institute of Certified Public Accountants in New York City.

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TABLE OF CONTENTS

CHAPTER		Page
I.	INTRODUCTION	1
	The Public Accounting Profession	1
	Purposes of the Study	4
	Methodology	8
	Order of Presentation	8
II.	THE INCIPIENT YEARS: 1887-1917	11
	Emergence and Identification of Public Accountancy: 1887-1904	11
	Second Phase of Professionalization: 1905-1917	17
	Summary	32
III.	PROFESSIONAL INTEGRITY	34
	Independence	34
	Concurrent Activities Incompatible with Public Accounting	67
	Contingent Fees	71
	Commissions, Brokerage, and Fee Participations	82
	Summary	90
IV.	PROFESSIONAL STANDARDS AND RESPONSIBILITIES	93
	Reporting Responsibilities	93
	Responsibility When Auditor Express No Opinion	106
	Expression of Opinion on Statements Audited by Another Accountant	117
	Estimates of Future Earnings	120
	Incorporation of a Public Accounting Practice	125
	Competence	132
	Responsibility for Work of Employee	135
	Confidential Relationship to Clients	137
	Summary	144

TABLE OF CONTENTS - Continued

CHAPTER	Page
V. PROFESSIONAL ATTITUDE	147
Introduction	147
Individual and Partnership Designations	148
Practice in the Name of a Member	157
Advertising	159
Soliciting Clients	187
Competitive Bidding	196
Soliciting Employees of Another Public Accountant	208
Referral Engagements	209
Scope of the Rules	213
Acts Discreditable to the Profession	216
Summary	218
VI. CONCLUSIONS	223
A Limited Model	223
Subcultural Identification	225
Professional Diffusion	227
Prognosis	230
BIBLIOGRAPHY	233
APPENDIX	246

CHAPTER I

INTRODUCTION

The Public Accounting Profession

It has been observed that the prominence and the social importance of the professions in our society are unequaled in the history of most important civilizations.[1] Among the occupational groups which have made noteworthy progress along the occupational continuum toward professional status are public accountants. Within the broad occupational classification of public accountants, there are two distinct subgroups: public accountants and certified public accountants. In general, the latter are distinguished from the former not only on the basis of the significance of the services which they typically perform but also by virtue of the higher standards of education and experience which they must satisfy.

Financial audits have been the traditional service of certified public accountants. The demand for that service resulted from the gradual separation of the following two entrepreneurial functions: the supply of venture capital and the management of the resources of a business enterprise. In the late nineteenth century these functions began to be performed by distinct groups of persons--stockholders and managers--whose mutuality of interest was typically limited to a particular corporate enterprise. With the development of that division of function, came the need for an independent expert who could examine the financial data of

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[1]Talcott Parsons, "The Professions and Social Structure," Social Forces, XVII (May, 1939), p. 457.

the enterprise in order to express an expert opinion upon the reliability of the financial reports which were prepared by management and submitted to investors.

The early public accountants who satisfied the need for an independent expert upon whose opinion investors could rely soon realized the service which they performed had many of the characteristics of a profession. That fact is apparent in the certificate of incorporation of the first professional organization of public accountants in the United States, the American Association of Public Accountants, which had only 22 members in 1887, the year of its founding. During the intervening 75 years, the Association and its successor organizations, the Institute of Accountants in the United States of America (1916), the American Institute of Accountants (1917), and the American Institute of Certified Public Accountants (1957), worked unceasingly for the professionalization of public accountancy. A partial result of those efforts was the adoption of various state laws which not only established formal certification for public accountants but also provided minimum standards of qualification which were expected of all candidates for certification. By August 31, 1961, there were approximately 72,000 certified public accountants in the United States and 40,506 were members of the national professional organization.

Despite the fact that the American Institute of Certified Public Accountants does not include all certified public accountants, it is the only national organization of certified public accountants and it has long played a dominant role in the development of the public accounting profession. Other organizations which exercise varying degrees of control over the practice of public accounting by certified public accountants are the various regional, state, and local chapters or societies of certified public accountants. Because membership in these organizations is voluntary, as it is in the American Institute, not all certified public

accountants are members of one or another of these professional groups. Similarly, some, but not all, certified public accountants accept engagements which require them to conform to the standards of the Securities and Exchange Commission or the Internal Revenue Service. However, all certified public accountants must conform to the standards enforced by one or more of the regulatory bodies of which there are 53 jurisdictions (not all of which have adopted ethical standards) in the United States.[1] Through its leadership and efforts to coordinate the work of the numerous groups which had an interest in the practice, regulation, and development of public accountancy, the American Institute of Certified Public Accountants has unquestionably established itself as the authoritative voice of the public accounting profession in the United States.

There are remarkable parallels between the formal rules of professional ethics of the Institute and other ethical codes applicable to both certified and non-certified public accountants. Many of the rules of professional ethics of the National Society of Public Accountants, the various state boards of accountancy, and the several state societies of certified public accountants are not merely similar but are virtually identical to the rules of the American Institute of Certified Public Accountants. Therefore, the rules of the code of professional ethics of the American Institute may be considered to be representative of the rules of professional conduct of the public accounting profession in the United States.

Despite the continuing interest of sociologists and others in the social phenomena which we call the professions, most of that attention has been devoted either to an abstraction of the general attributes of the professions or to the configuration of a particular profession. Among the very few writers who have dealt exclusively with professional ethics are

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[1]Clifford V. Heimbucher, "Fifty-three Jurisdictions," The Journal of Accountancy, CXII (November, 1961), p. 44.

Drinker[1] who discussed the ethics of the legal profession and Carey[2] who explained the meaning of the rules of professional conduct of the American Institute of Accountants. These writers interpreted the existing rules and the related quasi-judicial interpretations of those rules.

Purposes of the Study

Man has always had a healthy curiosity about himself and his past. Motivation for the study of the evolution of the formal rules of professional ethics of the public accounting profession might perhaps be based exclusively and adequately upon a natural curiosity which is stimulated not only by an interest in human behavior but also an academic interest in the public accounting profession. These factors are undeniably an important segment of the motivation for the investigation which is the subject of this report. However, academic tradition demands more than motivation. It requires also that an investigation of this kind be appropriately justified. The following purposes are submitted as justification for this study.

At many points during the course of this study, the writer has been plagued by a question which Everett Hughes has called a false question: "Is this occupation a profession?"[3] While it is not altogether clear that the question is a false one, the literature on the sociology of occupations makes it clear that the question cannot be objectively answered. The inability to answer the question follows from the generally recognized fact

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[1]Henry S. Drinker, Legal Ethics (New York: Columbia University Press, 1953).

[2]John L. Carey, Professional Ethics of Certified Public Accountants (New York: American Institute of Accountants, 1956).

[3]Everett Cherrington Hughes, Men and Their Work (Glencoe, Ill.: The Free Press, 1958), p. 45.

that heterogeneousness complicates and often prevents inter-professional comparisons. Indeed, when discussing his definition of a profession,[1] Cogan observed that "it is better to light a little lantern than to curse the darkness."[2]

As a result of the heterogeneity of the distinctive features of the various professions, sociologists have synthesized ideal types or models of a profession. On the basis of studies similar to those which Hall made of medical careers,[3] Greenwood has constructed a model of the professions in terms of their attributes.[4] Similarly, Hughes has attempted to construct a model of the professionalization process.[5]

It is generally recognized in the sociological literature of the professions that a code of ethics is an important element of the culture of a profession. Despite the recognition of the significance of codes of professional ethics, there is a dearth of material which seeks to explain the social process of the development of codes of professional ethics. Emerging from this study are tentative, limited answers to such questions as these:

1. Is there a typical pattern in the development of codes of professional ethics?
2. Are certain kinds of rules generally adopted at an early stage in the life cycle of the profession while other kinds of rules appear only in later stages?

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[1]Morris L. Cogan, "Toward a Definition of Profession," The Harvard Educational Review, XXIII (Winter, 1953), pp. 33-50.

[2]Morris L. Cogan, "The Problem of Defining a Profession," The Annals of the American Academy of Political and Social Science, CCXCVII (January, 1955), p. 105.

[3]Oswald Hall, "The Stages of a Medical Career," The American Journal of Sociology, LIII (March, 1948), pp. 327-36.

[4]Ernest Greenwood, "Attributes of a Profession," Social Work, II (July, 1957), pp. 45-55.

[5]Hughes, p. 158.

3. What are the functions of a code of professional ethics?
4. Can a study of the evolution of the rules of professional conduct be used to diagnose the social disorders of a professional organization?
5. Do certain kinds of rules typically result from interactions of the profession with the rest of society while other kinds of rules develop in response to conflicts which are internal to the profession?

Obviously the preceding questions cannot be conclusively answered on the basis of this study which for practical reasons is limited to the public accounting profession. However, this study will provide the basis for a limited model of the conceptual growth of a code of professional ethics. Subsequent comparisons of the model which emerges from this study with similar studies of other codes of professional ethics will provide the basis for the synthesis of a generalized model or an ideal type.

Despite the existence of an abundance of published material which is directly related to the professional ethics of public accountants, there is no integrated record of the evolution of the various rules of the formal ethical code which is a fundamental part of the subculture of the public accounting profession. Perhaps because this record is not readily available, conflicting dates have been suggested as marking the initial adoption of rules of professional conduct by the national professional organization of public accountants. Frederick H. Hurdman, who was then chairman of the Committee on Professional Ethics of the American Institute of Accountants, wrote in 1941 that it was not until 1907 that the accounting profession in the United States attempted to set up rules of professional conduct.[1] Recently another former chairman of the Committee on Professional Ethics of the American Institute wrote that the first written code of professional conduct applicable to the members of the Institute was adopted in 1917.[2]

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[1]Frederick H. Hurdman, "Ethics of the Accounting Profession," The Journal of Accountancy, LXXII (November, 1941), p. 413.

[2]Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," The Journal of Accountancy, CXIII (March, 1962), p. 29.

In fact neither of those dates is correct. In view of such discrepancies, a useful purpose will be served by a study which traces the evolution of the code of professional ethics.

This analysis of the evolution of the various rules also provides a unique record of the professionalization of public accountancy. It not only isolates the significant developments of each rule but also seeks to explain the factors which were influential in bringing about each change. In that way, the present study provides a dynamic and unique record of the maturation of the public accounting profession.

Furthermore, the present study isolates several important and recent developments in the practice of public accounting. The most obvious and significant of these factors is the growth of management services by certified public accountants. That trend raises a number of important ethical questions which, taken together, have serious implications for the profession.

Also emerging from the study is a general sense of apathy or disunity which seems to characterize the profession. One would expect this to be a dominant attitude among the many certified public accountants who have not chosen to identify themselves with a professional organization. But it is surprising to find indications of a strong sense of individualism in a professional organization which is typically perceived as being a manifestation of a developing consciousness-of-kind.[1] Probable reasons for the existence of this condition are offered in the concluding chapter of this study.

Finally, the analysis of the development of the rules of conduct provides a basis for an estimation of the probable future course of the evolution of these rules. Perhaps it may not be too presumptuous to assume that this study could also be useful to the profession itself.

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[1]Greenwood, Social Work, II (July, 1957), p. 51.

Repetitions of past mistakes and potentially dangerous trends are more likely to be avoided when explicit attention has been given these factors.

Methodology

From 1905 to 1947, the American Institute of Accountants and its predecessor organizations published annual yearbooks which contain the official record of the organization for that period. In addition to the search of these volumes for relevant material, subsequent reports of the Committee on Professional Ethics and other official documents have been examined. All issues of the official publication of the American Institute, The Journal of Accountancy, have also been reviewed for comments which were relevant to the evolution of the rules and the factors which brought about the various changes. In addition to these sources, reference was also made to numerous other books and periodicals which constitute a part of the professional literature. Because the Institute has published the only continuous stream of literature of the public accounting profession, most of the material for this study was gathered from those sources.

Information thus collected was classified according to the particular rule or rules to which it pertained. The data were then analyzed and evaluated in order to isolate the interactions, both internal and external, which were related to a specific change. This study is a report of the findings of that investigation.

Order of Presentation

Despite the adoption as early as 1905 of certain rules of conduct by the American Association of Public Accountants, the experience of the Association with its rules of conduct and the behavior of its members is discussed separately in Chapter II. The period from 1887 to 1917 has

thus been treated separately because it represents a preface or an introduction to the development of the purposive rules which began to evolve in 1917 when the American Institute of Accountants took up the campaign for the professionalization of public accounting.

Chapters III, IV, and V are the data chapters in which the evolution of the various rules is analyzed and discussed. An important part of the analysis is implicit in the functional classification of the rules. The classification which is utilized in this report grew out of the study and analysis of the rules. In Chapter III are the rules which give expression to the integrity of the profession. Integrity is an essential quality which implies not only moral principle and character but also an absence of conflicting relationships between the profession and other segments of society. The evolution of the rules by which the profession commits itself on an ethical basis to certain technical standards and responsibilities is the subject of Chapter IV. Finally, the remaining rules which are descriptive of the generally accepted values and norms of the colleague-colleague relationships are developed in Chapter V which is entitled "Professional Attitude."

Interestingly, the classification which has been devised for this report resembles and is consistent with another threefold classification of rules of professional ethics. R. M. MacIver recognizes three strands of interest in professional codes. Extrinsic interest involves economic and social status, reputation, authority, success, and the professional image. Secondly, the technical interest is concerned with the art and practice of the profession, standards of efficiency, development of methods and processes, and professional training. Finally there are the cultural elements which comprise the third area of interest.[1]

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[1]R. M. MacIver, "The Social Significance of Professional Ethics," The Annals of the American Academy of Political and Social Science, CCXCVII (January, 1955), pp. 121-22.

The volume of detail is so great in Chapters III, IV, and V that it has been necessary to limit those chapters almost exclusively to the analytic development of the various rules. Brief introductory and summary comments in those chapters are intended only to place the pertinent rules in their proper setting and to highlight the salient features of the developmental analysis.

Finally, in Chapter VI are presented the author's conclusions. These have been inferred from the evidential material which was studied and analyzed during the course of this investigation. A verbal model of the dynamics of the evolution of the code of professional ethics of the American Institute of Certified Public Accountants is presented. Also discussed in the final chapter are the problems of subcultural identification and professional diffusion. These social disorders were diagnosed on the basis of the symptoms which emerged from this study. Both of those problems have an academic as well as a practical significance. Finally the author points out several untenable ethical positions of the Institute and several probable future developments.

The current version of the code of professional ethics of the American Institute of Certified Public Accountants appears in the Appendix. That code became effective on March 6, 1962, after the membership had approved the proposed renaming and rearrangement of the rules which were formerly known as the rules of professional conduct.

CHAPTER II

THE INCIPIENT YEARS: 1887-1917

Emergence and Identification of Public Accountancy: 1887-1904

The American Association of Public Accountants: Founding and Purpose

The first professional organization of public accountants in the United States, the American Association of Public Accountants, was established on December 23, 1886. Eight of the ten original members became the incorporators of the Association under the laws of the state of New York on August 20, 1887.[1]

Evidently the founders of the Association were not only endowed with lofty ideals but also envisioned the growth of this new organization to include "the best and most capable" public accountants in the country. That attitude is unmistakable in the following excerpt from the Association's certificate of incorporation:

> The particular business and object of such is to associate into a society or guild for their mutual benefit and advantage the best and most capable public accountants practicing in the United States; and through such association to elevate the profession of public accountants as a whole, and to promote the efficiency and usefulness of members of such society, by compelling the observance of strict rules of conduct as a condition of membership.[2] (Italics mine)

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[1]James Don Edwards, History of Public Accounting in the United States (East Lansing, Mich.: Bureau of Business and Economic Research, Michigan State University, 1960), pp. 54-55.

[2]The quotation is taken from a copy of the certificate of incorporation of the American Association of Public Accountants. Ibid., p. 55.

Notwithstanding these ideals, Norman E. Webster indicates that he found no evidence which would indicate that the Association had formulated rules of conduct prior to 1906.[1] That no set of formalized rules of conduct for public accountants was in existence prior to 1905 is further supported by an editor of The Journal of Accountancy who wrote that there had been, up to that time, no attempt to codify rules of conduct for public accountants.[2]

The "Business" of Public Accounting

Prior to 1900, advertising and publicity for the American Association of Public Accountants and its individual members was considered desirable if not essential. The media included periodicals, circulars, and booklets. In addition to these efforts, the Association purchased for its members listings in directories. This activity was considered of such importance that a three-member Committee on Advertising was appointed in 1888.[3] During these early years, there were times when the Association made use of all three methods of advertising through the coordinating efforts of a single committee. The use of periodicals for advertising purposes was quite extensive. It has been found that periodicals were also used rather intensively as follows: by the use of bold type, the names of members of the Association were distinguished from those of other public accountants; active efforts were directed toward having published as news items certain stories about the Association; and publication

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[1]The American Association of Public Accountants: Its First Twenty Years 1886-1906, comp. Norman E. Webster (New York: American Institute of Accountants, 1954), p. 141.

[2]Editorial, "A Codification of Accountancy Ethics," The Journal of Accountancy, I (December, 1905), p. 139.

[3]Webster, p. 97. Chapters 22 through 28 provide the reader with numerous examples of advertising, publicity, and touting by public accountants during the period 1886-1906.

of undisguised advertisements.[1] Thus it is clearly established that by 1900, individual and organized public accountants were accustomed to the practice of advertising their services.

During the course of several meetings of the members of the American Association of Public Accountants held during the years 1893 and 1894, resolutions or proposed amendments of the by-laws of the Association were submitted which indicated that some members desired to impose severe restrictions on advertising. However, each of these proposals fell victim of one or another of numerous parliamentary procedures.[2] Again in 1904 the subject of advertising was given some consideration. It appears that "when the subject was considered the records suggest that the purpose may have been to discipline a few members rather than to fix a policy for all members of the Association."[3]

But advertising was not the only problem of professional conduct which confronted members of the Association. Robert H. Montgomery made rudimentary reference in 1905 to other contemporary practices. While there was no detailed analysis, the following problems were recognized and identified: (1) public criticism of a fellow public accountant, (2) supersedure of another accountant, (3) education and competence, (4) confidential nature of client communications, and (5) competitive bidding.[4]

Some accountants began to doubt that it was appropriate to allow non-partners of public accountants to participate in the "profits" derived

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[1]Ibid., p. 102.

[2]Ibid., pp. 120-25.

[3]Ibid., p. 125.

[4]Robert H. Montgomery, "Professional Standards: A Plea for Co-operation among Accountants," The Journal of Accountancy, I (November, 1905), pp. 28-39.

from accounting work. Although assistants and clerks might appropriately share the fees derived from work which they were instrumental in securing, accountants who used employees to solicit "business" for them were guilty of unprofessional conduct.[1]

Another problem, which was said to arise when a firm became engaged in an excessive amount of work, involved the extent to which an accountant assumed responsibility for work performed by his subordinates.[2]

Despite an expressed belief that contingent fees were not frequently accepted by accountants in the United States, at least one critic thought that a codification of the ethics of public accountants should include a prohibition of contingent fees. An attorney, whose duty it was to protect and advance the interest of a client, could properly accept a contingent fee. But an accountant

> whose reputation does not depend upon winning a case but upon the truthfulness of his reports, must not allow his professional integrity to be impugned by becoming a participant in the profits of any cause or undertaking whose accounts are brought under his investigation.[3]

Finally, there was also recognition of the problem involving the practice of public accounting under the corporate form of organization. The following comment is at once a description and a condemnation of this very dangerous threat to the practice of public accounting. Particularly worthy of note is the following justification for the incorporation of a public accounting practice:

> The Journal of Accountancy has no objection to the incorporation of accounting companies. The main and indeed the only reason which in our judgment justifies such incorporation, is the desire of members to transmit their interest in the good will of their concerns to their heirs. But while admitting the

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[1]Editorial, The Journal of Accountancy, I (December, 1905), p. 140.

[2]Ibid., pp. 140-41.

[3]Ibid., p. 141.

> propriety of incorporating audit companies in which the directors are practicing accountants, and where professional secrecy and responsibility are preserved, the severest condemnation should be visited upon audit or accounting companies whose directors are not practicing accountants, who are relied upon to furnish business to the concern because of their various connections, and who usually expect a return in confidential information in addition to their dividends.[1]

These audit companies were said usually to consist of a number of financiers who formed a corporation which employed accountants of varying degrees of efficiency to carry out examinations or audits for the corporation. But such examinations did not offer much protection to the public because the accountants

> cannot be independent and impartial so far as the affairs of these directors and of their friends or business associates are concerned. The latter are interested in putting their enterprises before the public in the most favorable light and are not, as is the independent public accountant, pledged by their training and by the ethics of their profession to protect the public against misstatements or over-sanguine statements of results which may be put before them.[2]

The foregoing discussion indicates the nature and the scope of the ethical problems with which public accountants were faced in 1906. Although the evidence indicates that no formal action had been taken by the organization to define explicitly its position on these questions, there is no doubt that several of the leaders of the American Association of Public Accountants were making active efforts to induce the membership to take group action on these issues. It was anticipated that the 1906 annual convention of the Association would be largely devoted to serious debate on the following questions: advertising, audit companies, and fees. The debate was expected to result in a formal set of resolutions

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[1]Editorial, "Two Kinds of Audit Companies," The Journal of Accountancy, I (February, 1906), p. 321.

[2]"Meeting of the American Association: Suggestions from Journal Committee," The Journal of Accountancy, I (March, 1906), p. 436.

which would define the position of the Association on these points.[1] But the absence of any reference to questions of ethical conduct in the official record of the Association for the year 1906 suggests that the hope of the leadership had been premature. Webster suggested that business sessions may have crowded this subject from the program and that in the election held at this meeting, those who spoke for or against particular candidates were little concerned with professional conduct.[2]

Appointment of a Committee on Ethics

Although a debate on ethics did not take place at the annual meeting, the Board of Trustees of the American Association of Public Accountants did authorize an action which was significant in terms of the development of the rules of professional conduct of the public accounting profession. In October, 1906, the chairman of the Board of Trustees was authorized to appoint a special, three-member committee on ethics.[3] The following members served on that committee: John A. Cooper (chairman, Illinois), Edward L. Suffern (New York), and W. M. Lybrand (Pennsylvania).

Formal Complaint Against a Member

Prior to its March, 1906, meeting, the Board of Trustees of the American Association of Public Accountants engaged in correspondence with respect to a complaint against a member. The member was summoned to appear before the Board. After hearing the member and his counsel, the Board concluded that it should take no action. The absence of details concerning this complaint is explained by a reference in the report to a policy of absolute secrecy with respect to both complainant

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[1]Editorial, "The American Association and Accountancy Ethics," The Journal of Accountancy, II (October, 1906), p. 459.

[2]Webster, p. 141.

[3]"Annual Meeting of the American Association of Public Accountants," The Journal of Accountancy, III (November, 1906), p. 82.

and respondent. The basis for the complaint was a section of the by-laws of the Association which provided for disciplinary action if a member was convicted of a felony, misdemeanor, or was finally declared by a court of competent jurisdiction to have committed a fraud and another section which provided for disciplinary action against a member who was found guilty of an act or default discreditable to a public accountant.[1]

Second Phase of Professionalization: 1905-1917

Adoption of Two Rules of Conduct

Two important rules were added to the by-laws of the American Association of Public Accountants by the Board of Trustees during a meeting held on January 10, 1905.[2] Adopted as Article VIII which was captioned "MISCELLANEOUS" were these rules:

> Section 1. No member shall allow any person not being either a member of the Association or in partnership with himself as a public accountant to practice in his name as a public accountant.
>
> Sec. 2. No member shall directly or indirectly pay to any attorney, broker or agent any portion of his professional charges, nor receive nor accept any portion of the fees of any attorney, broker or agent who may be concerned in any professional work in which such member is engaged.[3]

Certainly it is doubtful that any member was subjected to disciplinary

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[1] "Meeting of American Association: Report of the Board of Trustees," The Journal of Accountancy, I (March, 1906), p. 425. The pertinent sections of Article VII (section I, subdivisions 2 and 3) can be found in The American Association of Public Accountants Nineteenth Anniversary Year-Book (1906), p. 84.

[2] "Annual Meeting of the American Association of Public Accountants: Report of Board of Trustees," The Journal of Accountancy, I (November, 1905), p. 76.

[3] . . . Year-Book (1906), p. 85.

proceedings on the basis of these rules. Most of the elements of these rules were included in the rules of professional ethics which were adopted by the Association in 1907. That action is discussed in the following section.

The Twentieth Anniversary Meeting

Amid heated discussions and parliamentary maneuvers, major revisions were made in the constitution and by-laws of the American Association of Public Accountants during the first day of its twentieth anniversary meeting which was held in St. Paul, Minnesota, in October, 1907. Among these changes was a proposal to adopt a more extensive list of rules of conduct in lieu of those which had been adopted in 1905 and which were discussed in the previous section of this chapter. The proposal was offered by the Illinois Society of Certified Public Accountants and was adopted by the Association but not without significant amendment. The adopted version of the article on professional ethics follows:

ARTICLE VII.

PROFESSIONAL ETHICS.

> The following are declared to be the fundamental rules of the Association: for (a) the infraction of any part thereof, or if (b) convicted of felony or misdemeanor, or if (c) finally declared by a court of competent jurisdiction to have committed any fraud, or is (d) held by the Board of Trustees on the written complaint of any person aggrieved, whether a member or not, to have been guilty of any act or default discreditable to the profession, or is (e) declared by any competent court or commission to be insane or otherwise incompetent, or (f) fails to pay any subscription, dues, assessment, or other sum owed by him to the Association under its by-laws within three months after such debt has become due:
>
> A member renders himself liable to be expelled from the Association or to be suspended for a term not exceeding two years by resolution of the Board of Trustees sitting as a Trial Board.

RULES.

1. No member shall allow any person not being either a member of the Association or in partnership with him as a public accountant, or in his employ on a salary, to practice in his name as a public accountant.

2. No member shall directly or indirectly allow or agree to allow a commission, brokerage, or other participation by the laity in the fees or profits of his (the member's) professional work.

3. No member shall engage in any business or occupation conjointly with that of a public accountant, which in the opinion of the Board of Trustees is incompatible or inconsistent therewith.

4. No member shall certify to exhibits, statements, schedules, or other form of accountancy work, the preparation of which was not carried on entirely under the supervision of himself, a member of his firm, one of his staff, a member of this Association or of similar Association of good standing in foreign countries.

5. No member shall in his business advertisements use any initials as an affix to his name that is not either authorized by statutory enactment of this country or by the well-known associations established for a similar purpose in the British Empire, nor shall he affiliate or substantially recognize any society that is designated or in any way sets itself out to be a so-called Certified Public Accountant Society, without the State in which such Society is organized having the requisite statutory enactment in full force and effect.[1]

One of the rules which was stricken from the proposed professional ethics article related to the provisions of one of the two rules which had been adopted in 1905. The 1905 rule became the basis for two proposed rules. The one which was adopted prohibited the allowance of commissions or brokerage to the laity. The other provided that a member could not

> directly or indirectly accept or agree to accept any part of the fees or profits of the professional work of a lawyer or any commercial brokerage, bonus, or commission whatsoever as an incident to work in which such member is professionally engaged.[2]

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[1]"Constitution and By-Laws," The American Association of Public Accountants Twentieth Anniversary Year-Book (1907), pp. 238-39.

[2]"Proceedings, The American Association of Public Accountants, Twentieth Annual Meeting," ibid., p. 60.

The discussion which pertained to this proposal sheds some light upon the nature of the objections which were raised during the meeting. The heart of the problem lay in the great variety of situations which the proposed rule might or might not have covered. Examples of fees derived from work involving the merger of two businesses were offered to demonstrate that the new rule would unjustly prohibit such fees. Other members discussed the hypothetical arrangement in which the accountant entered into a fee agreement which would necessarily influence the result of his work. Doubt was also expressed that the proposed rule would cover the case in which an accountant received a commission from a stationery house as a result of engagements which were not purely accounting work. Because of the wide disagreement on the appropriate interpretation of the rule, it was rejected by the membership.

Another rule which did not win the favor of the voting members would have prohibited all contingent fee arrangements as follows:

> No member shall perform accountancy work payment for which is by arrangement upon the contingency of the result of litigation or other form of adjustment.[1]

A brief discussion during the meeting made it clear that the proposed rule was much too extensive to be acceptable to the membership. Those who spoke from the floor indicated that some rule on this question would be acceptable but that the present recommendation was too formal and rigid.

The Special Committee on Professional Ethics of the American Association of Public Accountants provides an interesting, indirect explanation of the abuses which led to the formulation of the fifth rule of the article on professional ethics. A complaint had been received concerning a member who used miscellaneous, unofficial initials after his name on his stationery. Perhaps as an isolated case this particular case

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[1] Ibid.

had no special significance. However, the committee expressed the opinion that this practice was already much too general and that it tended to belittle and "ridicule the statutory degree of Certified Public Accountant."[1] To the extent that such a practice was intended to deceive the reader, it is certainly a problem of ethical conduct. However, it is apparent that the practice would also be detrimental to certified public accountants who might lose or fail to elevate the distinctive prestige of the "C. P. A." designation if the proliferation of miscellaneous letters and initials was not eliminated. Perhaps this was the primary motivation. At any rate, the report of the Special Committee on Professional Ethics did not include a reference to the question of deceit.

With respect to the 1907 professional ethics rules, it should also be noted that neither rule 3, which prohibited a member from engaging in an incompatible or inconsistent occupation while engaged in public accounting, nor rule 4, which limited the persons upon whom a member could rely for the performance of accounting work, were rationalized in the literature. Perhaps the latter rule was intended to increase the unity of the membership and to advance the prestige of the American Association of Public Accountants. It is possible that some member certified public accountant was lending the prestige of the "C. P. A." designation to the work of a non-certified public accountant. Thus a certified public accountant might have signed his name (with the appropriate letters) to the work of the non-certified practitioner in return for a suitable fee. Alternatively, the rule may have been adopted in order to assure the general public that any work with which a member of the American Association of Public Accountants identified himself was certain to have been performed by a competent accountant. Unfortunately, the intent of this rule must remain a matter of speculation.

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[1] "Report of the Committee on Professional Ethics," ibid., p. 26.

A large part of the formal program of the twentieth anniversary convention (October 15-17, 1907) of the American Association of Public Accountants was devoted to professional ethics. Joseph E. Sterrett presented a lengthy paper entitled "Professional Ethics"[1] in which he expressed the belief that the ethical rules of the Association should be representative of the minimum standards adopted and observed by the membership. In marked contrast with that point of view was the opinion expressed by John A. Cooper in his discussion of the topic.[2] Cooper contended that accountants ought to adopt rules or precepts which would define the highest standard of conduct which was possible under existing conditions. Accordingly, Cooper included in his paper a list of thirty-three specific rules which he classified under these headings: Service, Clients, Inter-Professional, Publicity, and Corporations. Thus Sterrett and Cooper were in disagreement with respect to whether the rules should be idealistic or realistic. Robert H. Montgomery, who also had been invited to discuss "Professional Ethics,"[3] argued that the rules which had been adopted were no solution to current problems because there was no means by which the rules could be effectively enforced. Montgomery believed that improved conduct on the part of public accountants could best be achieved by means of state laws which would provide regulations similar to those applicable to the practice of law and medicine. These wide differences of opinion on the most fundamental issues involving the rules of conduct and the inevitable disagreement on specific proposals are probably typical of the range of opinion of the membership on questions of professional ethics in 1907. In view of this extensive lack of agreement, it is remarkable that the members of the American Association of Public Accountants had agreed to include the article on professional ethics in the by-laws of the Association.

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[1]Ibid., pp. 108-33.

[2]Ibid., pp. 133-46.

[3]Ibid., pp. 146-48.

Attempts to Modify and Amend the Rules

Among the problems encountered by those who sought to establish a high level of prestige for the Certified Public Accountant certificate was one which resulted in the adoption of another rule of professional ethics. The Illinois Society of Certified Public Accountants reported a case which was the basis for a rule which was recommended to the American Association of Public Accountants by the Committee on Ethical Rules of the Association. A certified public accountant migrated to Illinois where he established a school of accounting. He then sought to increase the attendance at his school by securing an amendment of the public accountancy statute so as to suspend the requirement of a high school diploma for applicants for certification as public accountants. Although the state society vigorously opposed this action, it was only able to limit the amendment to a two-year period. Motivated by this experience, a new rule of professional ethics was recommended in 1908 by the Committee on Ethical Rules to the Committee on By-Laws of the Association. The version of the proposed rule which was adopted in 1909 follows:

> No member shall interfere or in any way take part in any effort looking to the modification, alteration, or amendment of any state laws affecting the profession of accountancy, without the concurrence and cooperation of the society or societies of the state or district concerned, unless the action of such member shall not violate any of the fundamental rules of the association.[1]

This amendment of the rule was adopted by the Association in 1910:

> No member shall take part in any effort to secure the enactment, alteration or amendment of any state or federal law affecting the profession without giving immediate notice thereof to the secretary of this association, who in turn shall at once advise the secretary of the state or district society concerned.[2]

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[1] "Constitution and By-Laws," The American Association of Public Accountants Twenty-Second Anniversary Year-Book (1909), p. 357.

[2] Ibid., . . . Twenty-Third Anniversary Year-Book (1910), p. 269.

Despite the absence of an explanation for this action, it may be presumed that the rule was amended to provide a greater measure of sophistication. Other, less extensive, changes were made in some of the other rules at the same time.

Two other proposals were submitted in 1908 but were not adopted. The Committee on Ethical Rules recommended that the first rule of Article VII of the by-laws of the American Association of Public Accountants be amended by adding this sentence:

> Nor shall he conceal his personality under a corporate name, either nominal, personal, or fictitious.[1]

Evidently the majority of the membership continued to believe that the incorporation of a public accounting practice was justifiable because the action of the Board of Trustees in tabling this recommendation was ratified by the membership at the annual meeting.

A second unsuccessful proposal which was submitted by the Committee on Ethical Rules and recommended by the Committee on By-Laws of the Association involved contingent fees. Cooper, who was chairman of the former committee, indicated in his committee report that he believed the opposition to a rule which would prohibit contingent fees was due to a misunderstanding of the meaning of such fees. Consequently, he made an elaborate attempt to define the term. A fee which depends "upon the availability of the work performed by a practitioner for the purposes for which it is intended, such as the acceptance of the certificate in the money market,"[2] is not a contingent but an alternate fee. There would be no objection to those cases which involved the assistance of promotors or a syndicate in furthering a particular project if the accountant did so as a sequel to his professional service. Such activity was

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[1] "Report of Committee on Ethical Rules," The American Association of Public Accountants Twenty-First Anniversary Year-Book (1908), p. 100.

[2] Ibid., p. 99.

outside the boundary of public accountancy. Hence an accountant was considered to have left the practice of his profession while he joined those who sought gain in the outcome of some venture. But those situations in which the professional fee depended upon the outcome of a commercial venture or a case being litigated or arbitrated did involve contingent fees. Such fee arrangements, it was said, were not only wrong and vicious in their effect, but also destroyed the judicial attitude which an impartial accountant was expected always to maintain.[1]

Even that narrow definition of a contingent fee arrangement did not lead to the acceptance of the proposed rule. Instead, the decision of the Board of Trustees to report the new rule unfavorably was accepted by the members of the American Association of Public Accountants.

Probably the years from 1910 to 1916 represented a period of significant frustration for a few of the leading members of the Association who were dedicated to the task of establishing a high level of professional ethics in the practice of public accountancy. Although it was necessary to purge the published record of at least one annual meeting of the discussion of proposed amendments of the by-laws,[2] some members continued their efforts to bring about an expansion both in the scope and the significance of the rudimentary rules of conduct which were already a part of the by-laws of the Association. For example, the Committee on Constitution and By-Laws reported in 1913 (in compliance with instructions received at the previous annual meeting and at a subsequent meeting of the Board of Trustees) that it had prepared a list of formal precepts which were intended to be included with the rules of conduct in the by-laws of the

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[1] Ibid., pp. 99-100.

[2] "American Association of Public Accountants: Proceedings of the Annual Convention," The American Association of Public Accountants Twenty-Fifth Anniversary Year-Book (New York: The Ronald Press Co., 1912), p. 77.

Association.[1] Those precepts were not approved and no comment was found which would suggest that the recommendation was even discussed by the members of the Association.

In addition to the lack of membership support for its recommendations, the Committee on Constitution and By-Laws was also subject to internal dissension. Cooper and one other member of the Committee recommended two rules of conduct which would have prohibited members from using an impersonal designation or a corporate title, accepting commissions or brokerage from the laity, and performing accountancy work for a contingent fee. The third member of the Committee dissented from the recommended Precepts of Professional Conduct as well as the rule on the use of impersonal designations or corporate titles. The 1913 Committee report was referred to a Special Committee on Code of Ethics during the 1913 annual meeting of the Association. In 1914, the matter was referred to the Committee on Professional Ethics which, in 1915, reported no action and no recommendation with respect to either a code of ethics or the rules of conduct which were still a part of the by-laws of the Association.

Problems of Unprofessional Behavior

Editorially, The Journal of Accountancy frequently criticized advertising because it was inconsistent with professional service. It is equally clear that the economic implications of advertising by public accountants were also recognized. Thus it was said that

> a rule forbidding advertising is clearly altogether in favor of the small man. A giant firm presumably may always be assumed to be in possession of far greater resources, and thus, if paid

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[1] "Report of the Committee on Constitution and By-Laws," The American Association of Public Accountants Year-Book 1912-1913 (New York: The Ronald Press Company, 1913), pp. 228-29.

> advertisements were to be the order of the day, could wipe the small man off the road in a very few weeks. Professional accountants all gain by a mutual agreement not to add the costs of advertising to their already heavy expenses; but, in the absence of any such agreement, the benefits of advertising would naturally go to those who were prepared to spend the largest sums upon advertising, and this undoubtedly would not be to the advantage of the small man. It is thus to the advantage of all, but peculiarly to the advantage of the beginner, that advertisements that cost money should be banned.[1]

Despite the persuasiveness of that argument, it has not appeared frequently in the literature. Perhaps it was recognized that those accountants who abandoned regular advertisements would thereby provide a distinct advantage for those who continued to advertise. A widespread recognition of this consequence would certainly explain a general reluctance to abandon the use of advertisements. The extent to which this economic argument against advertising was accepted by accountants is indeterminate.

Advertising seems to have been a rather broad term which was either identified with or related to a number of different practices. The periodical literature of the period 1907-1915 contains references to or examples of the following: (1) advertisements in the public press, (2) widespread distribution of booklets of various descriptions, (3) the use of business cards which manifested varying degrees of modesty, (4) circular letters which solicited accounting work and sometimes promised phenomenal savings in fees, (5) use of a postcard bearing an advertisement together with a personal photograph of the advertiser, (6) personal solicitation of potential clients, and (7) contract work or competitive bidding for accountancy work.

In 1914 The Journal of Accountancy published the views of three members of the Association who contributed to a symposium on the subject

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[1]Editorial, "It Favors the Younger Men," The Journal of Accountancy, IX (November, 1909), p. 60, quoting London Accountant.

of advertising.[1] Contrasts in the views which these authors expressed probably exemplify the range of opinion of the membership at that time on the question of advertising by public accountants. First, John A. Cooper assumed the attitude of a member of an established professional organization. His discussion involved professional modesty, dignity, and decorum. From this point of view, advertising by a professional man was absolutely unjustifiable. Edward E. Gore built a strong argument for the view that accountancy was not, in practice, a profession but was a commercial undertaking. Consequently the practice of public accounting would have been properly guided by the principles which were applicable to the conduct of any business enterprise. Midway between these polemic positions was the attitude of E. G. Shorrock who accepted the argument that the public must be made aware of the existence of public accountants and the nature of their services. The solution which he envisioned provided for institutional advertising by the Association.

It had been suggested as early as 1910 that the various state societies of certified public accountants should undertake publicity campaigns.[2] The president of the American Association of Public Accountants was authorized in 1912 to appoint a committee to investigate the possible usefulness of various kinds of publicity which might be undertaken by the Association.[3] Subsequent publicity campaigns were evidently quite disappointing. A primary reason for the ineffectiveness of these collective advertising campaigns was the absence of cooperation between the Association and the several state societies. In some cases this condition may have been the result of an indifferent attitude on the part of the members toward the

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[1]Symposium, "Should Accountants Advertise?" The Journal of Accountancy, XVIII (August, 1914), pp. 85-108.

[2]Editorial, "Deluded Old School Accountants," The Journal of Accountancy, X (May, 1910), p. 54.

[3]"American Association of Public Accountants: Proceedings of the Annual Convention," . . . Year-Book (1912), p. 83.

state organization and in other cases it may have been the result of a failure of the officers to bring the matter to the attention of the members.[1]

The professionalization of public accounting seems to have been the fundamental objective to which all problems involving the personal behavior of public accountants was related. Thus accountants who advertised, solicited, criticized colleagues, indulged in self-laudation, practiced under actual or fictitious corporate titles, distributed circular letters or booklets, or submitted competitive bids for audit engagements were barriers to the goal of the organization. Gradually it became clear that differences between policy and practice would always exist in the absence of central control over a significant number, if not all, certified public accountants.

An Organizational Transition

Although there were a few so-called members-at-large, the American Association of Public Accountants was essentially a federation of state societies of certified public accountants. The rules of conduct which the Association adopted were intended to serve as guides for the affiliated state societies. Theoretically, the Association retained authority over each member society. However, each state society retained autonomous jurisdiction over its individual members. Of course some state societies did follow the guides to the extent that similar rules were adopted by the state organization. Indeed, the Colorado Society of Certified Public Accountants was said to have adopted ethical rules which were more extensive than those of the Association.[2] But these actions were probably atypical. The heterogeneity of standards among the various societies

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[1]Editorial, "Educating the Public," The Journal of Accountancy, XX (December, 1915), p. 453.

[2]"Report of the Committee on Professional Ethics," . . . Year-Book (1908), p. 92.

and the need for effective control over practitioners were problems which were compounded by a wide divergence in the provisions of state accountancy laws and the administration thereof.[1] Disciplinary action was apparently nonexistent because the Association did not possess the necessary authority and the state societies declined to assume the responsibility.[2]

Thus the problem of disciplinary control was one of the chief factors which brought about the reorganization of the American Association of Public Accountants in 1916.[3] The successor organization was named the Institute of Accountants in the United States of America, but that name was officially changed during the following year to the American Institute of Accountants. Some years later, the Executive Committee of the American Institute had this to say in response to a suggestion that state societies should be given direct representation in the government of the Institute:

> When the Institute was organized to succeed the Association in 1916, it went in the opposite direction, because its experience had indicated that it was impossible to exercise much disciplinary authority over its members without control of their admission to membership, and that a government by delegates of state organizations led to a rather cumbersome internal machinery which retarded prompt and effective action.[4]

Quite significantly, the by-laws of the newly organized Institute of Accountants in the United States of America contained no reference to the rules of conduct which had been a part of the by-laws of the American

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[1]"Report of the President," The American Association of Public Accountants Year-Book 1914-1915 (New York: The Ronald Press Company, 1915), p. 149.

[2]"Report of Special Committee on Form of Organization of Association," 1916 Year-Book of the Institute of Accountants (New York: The Institute of Accountants in the United States of America, 1916), p. 113.

[3]"Report of Secretary," 1926 Year Book of the American Institute of Accountants (1926), p. 122.

[4]"Reports of the Executive Committee," Yearbook American Institute of Accountants 1942 (New York: The American Institute of Accountants, 1943), p. 70.

Association of Public Accountants. There were, however, two articles which contained provisions for disciplinary action against a member by the Institute's Council when it was convened as a trial board. Certainly the omission of the rules of conduct from the by-laws was not the result of an oversight because the by-laws had been carefully altered to omit all references to the rules of conduct. No official or unofficial explanation was found for this regression. However, it is possible to offer an explanation of this strategy which is at least plausible.

The unwieldy structure of the Association was a severe handicap which clearly threatened continued growth and development as well as progress in the professionalization of public accountancy. Evidently many members believed that the rules of conduct were appropriately adopted by the Association to serve as idealistic expressions. Surely it was not generally believed that such rules should be literally applied to the practice of a public accountant. In view of those attitudes, the risk of failure probably would have been significantly greater if the rules of conduct had been involved in the overall proposal for reorganization. Hence it was much safer and probably easier to deal with the question of reorganization as a separate issue. After the new form of organization had been achieved it was possible to attack the problems of professional conduct with far less risk of jeopardizing the future of the public accounting profession.

On April 9, 1917, the Council of the American Institute of Accountants adopted the rules of professional conduct[1] which had been formulated and recommended by the Committee on Professional Ethics of the Institute. In its September, 1917, report, the Committee noted that it had no amendments of or additions to the rules of professional conduct and expressed

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[1]A copy of the first rules of professional conduct of the American Institute of Accountants can be found in Edwards, pp. 255-56. The rules of professional conduct were not published in either the 1917 Year-Book or the 1918 Year-Book of the American Institute of Accountants.

the opinion that there were

> other matters of procedure, governing the organization of the institute, that should be worked out before any attempt is made to adopt any very comprehensive and formal written code of rules to govern the conduct of members in all their personal and professional relations. It is our opinion that it will not do to "crowd the mourners" too hard during the formative period of the institute. To go too far might disrupt our organization before it was firmly established. To go not far enough would be merely a piece of idle pleasantry. In our opinion the institute should carefully feel its way before it undertakes to regulate either the universe or the personal conduct of its members under every situation which might present itself.[1]

Note that the report provides very strong support for the comments of the preceding paragraph which explained the omission of all references to rules of conduct in the 1916 edition of the by-laws of the American Association of Public Accountants. It is also significant that the rules of professional conduct of the American Institute of Accountants were adopted by the Council of the Institute, not by the membership as a whole.

Summary

The founding in 1886 of the American Association of Public Accountants represents the first step in the process of the professionalization of public accountancy in the United States. Although the founders intended to require members of the Association to conform to rules of conduct, it was not until 1905 that two rules were adopted. Professional ethics was a major topic of discussion during the Association's twentieth anniversary meeting which was held in October, 1907. At that time, a formal article on professional ethics was incorporated in the by-laws in lieu of the two earlier rules. It is highly significant that these early rules were broad in scope and gave expression to standards of professional integrity, responsibility, and attitude.

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[1] "Report of the Committee on Professional Ethics," 1917 Year-Book of the American Institute of Accountants (1917), p. 173.

Early public accountants were typically engaged in the "business" of public accounting which was a highly competitive occupation. Indeed, most of the subsequent problems of unprofessional conduct were not only recognized but also were a well-developed part of the practice of public accounting prior to 1916. Among these competitive practices were the following: display advertising, competitive bidding for audits and other forms of accounting work, practice under actual or fictitious corporate titles, distribution of circular letters of solicitation and other materials, public criticism of fellow public accountants, solicitation of clients, various attempts to avoid responsibility for work performed for a client, use of an agent to solicit clients, allowance and acceptance of brokerage or commissions by accountants, performance of work on a contingent fee basis, and self-laudation.

Because membership in the American Association of Public Accountants was indirect, the Association could not require individual members to conform their behavior to the rules of conduct which had been adopted as guides for the constituent state societies of certified public accountants. Although disciplinary action was within their jurisdiction, the state societies generally neglected the conduct of individual members. Consequently, it became necessary in 1916 to reorganize the Association in order to assure the further growth and development of the profession. Although the leaders of the profession were admittedly cautious in their efforts to raise the ethical standards of the profession immediately after the reorganization, the first rules of professional conduct of the American Institute of Accountants were adopted by the Council on April 9, 1917.

CHAPTER III

PROFESSIONAL INTEGRITY

Among the rules of professional conduct of the American Institute of Certified Public Accountants there are several which are descriptive of the integrity of the profession. Integrity in the context of this study means the state or quality of being unimpaired and undivided. It is one of the distinctive qualities which are attributed to members of the organization by society as a whole. The sum total of these qualities and characteristics is the professional image of certified public accountants.

Those qualities which are descriptive of the integrity of the profession and which have been formally expressed in rules of professional conduct are considered in this chapter. Following the development of the rule on financial independence is the analysis of the development of the rule on concurrent activities. Next, the evolution of the rule on contingent fees is presented. Finally the development of the rule on commissions, brokerage, and fee participations is traced.

Independence

As applied to public accounting, independence can best be defined initially as the freedom from the control of those whose work is being reviewed. More than likely it is impossible actually to achieve this pure state, rather it should be considered as a conceptual ideal. Such an ideal is useful as a criterion for the evaluation of real world practice of public accounting.

An area of inquiry which has been the subject of a considerable amount of socio-economic interest is the increasing separation between

those who provide capital and those who are in effective control of vast corporate enterprises. For the investor in corporate securities, a considerable portion of the data which he needs for making investment decisions is believed to come from annual reports which are prepared and distributed by the management of these corporations. It is in this situation that the certified public accountant has performed a unique service as an impartial third party. The end product of the audit function is the expression by the auditor of his expert opinion on the financial statements prepared by management for the suppliers of corporate capital. It is generally believed that investors and others rely heavily upon the opinion which the certified public accountant expresses on financial statements.

Obviously his opinion would have little or no value if the certified public accountant was in fact, or if he was believed to be, subordinated to the managers of the corporation. But if the public accountant is free of the control of the persons who prepare and issue financial statements and if he can be relied upon to express his candid opinion based upon his expertise, then his service has value both to management and stockholders. The former is assured that the opinion of the certified public accountant lends credence to the financial report in the eyes of the stockholder. Similarly, the stockholder has the benefit of the expert opinion of the certified public accountant with respect to the reasonableness of the data which are summarized in the financial statements. Independence is perhaps the most important test of the professional status of public accountants and it was recognized very early in the development of the profession.

Early Recognition of the Concept

There can be little doubt that the concept of the independence of the auditor was one of the areas in which British practice influenced the

development of the profession in the United States. Because this influence has been generally recognized it is unnecessary to examine these relationships for the present purposes.

The following remarkably well-developed statement concerning auditor independence appeared in 1900:

> A public accountant acknowledges no master but the public, and thus differs from the bookkeeper, whose acts and statements are dictated by his employers. A public accountant's certificate, though addressed to president or directors, is virtually made to the public, who are actually or prospectively stockholders. He should have ability, varied experience and undoubted integrity.[1]

During the 1907 annual meeting of the American Association of Public Accountants, Joseph E. Sterrett presented a concept of independence when he said that

> where the interests of present or prospective investors are to be considered an accountant should keep his mind scrupulously clear of any taint of self-interest. "No man can serve two masters." The scales of justice are so delicate that he who would use them correctly must have a hand free from any tremor arising from personal hopes or ambitions. A logical conclusion of the thought just expressed is that an accountant should not allow himself to speculate in any securities a knowledge of which comes to him professionally.[2]

Apparently the views cited above were by no means universal. Indeed, an editor of The Journal of Accountancy noted in 1906 that an auditor was responsible to the management of a corporation which he audited. That is, a public accountant was considered to work under the authority of management and the results of his work were published by management. Consequently, the editor thought that it was not improper for the auditor to assume the role of accounting supervisor or even

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[1]Andrew Barr, "The Independent Accountant and the SEC," The Journal of Accountancy, CVIII (October, 1959), p. 32, quoting The New York Certified Public Accountant, (December, 1944), p. 707.

[2]J. E. Sterrett, "Professional Ethics," The American Association of Public Accountants Twentieth Anniversary Year-Book (1907), p. 117.

comptroller for the corporation. After all, the accountant was employed by and paid by management. It was also stated that the stockholder was not the client of the public accountant. Thus the auditor owed a responsibility only to the management of the corporation. The editor also stated that the reputation and integrity of the auditor required that he could certify[1] accounts as being correct only when he believed they were correct either in fact or in principle. If the auditor could not do so, it was said that he must give up the engagement but that he owed no duty to the stockholders to disclose any facts which he had discovered.[2]

It was not at all uncommon for an auditor to install and supervise for his client an accounting system. Indeed one writer expressed the belief that a more specific defense of this practice was needed and he noted that there were

> several instances where accounting firms have installed systems of accounts for large corporations, which have failed to work because the company's officials and employees were unfamiliar with the details. In one case, after an unsuccessful trial of a new system, the firm responsible for its installation was asked to assume responsibility for its successful operation by designating one of the members to act as comptroller or supervisory accountant. The firm accepted the task, and one of its members was appointed as desired, assuming the official title so that his authority might be unquestioned. The comptroller, thus appointed, accepted no compensation for his services and was not in any way controlled by the corporation in whose service he nominally was. The charges for the service rendered were paid to his firm in the same manner as charges for other services. Needless to say, the experiment was successful. The staff was trained in the new methods, and the work of the temporary official is now approaching completion.[3]

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[1]A public accountant "certified" financial statements until more recent years when his report has been referred to as his "opinion" or short form report rather than a "certificate."

[2]Editorial, "Collateral Employment of Accountants," The Journal of Accountancy, I (April, 1906), p. 505.

[3]Editorial, "Accountants as Corporation Officers," The Journal of Accountancy, II (May, 1906), pp. 53-4.

It was also argued that similar official status and authority should have been more common than it was at the time. Such arrangements, it was noted, would provide the supervisory accountant with full freedom of action in a delicate and difficult situation. Quite interestingly, these editorial views were not repeated after 1906 in The Journal of Accountancy. But the problem of independence which is involved in these relationships is remarkably similar to some of the problems faced by contemporary accountants.

In marked contrast with the previously cited editorial remarks is the concept of auditor independence which was expressed by Elijah W. Sells in 1908. In Sells's words, "the position of the public accountant in respect to corporations and their management is always an independent one. Unlike the attorney he is not expected to make out a case. The character of the service he renders is impersonal."[1]

Contemporary Concepts of Independence

In order to complete the development of the definitional concept of independence, it will be necessary to skip temporarily over about four decades of the history of the profession. A statement on independence was adopted and published in 1947 by authority of the Executive Committee of the American Institute of Accountants. Although this tentative statement was issued subject to revision after exposure to the criticism of the membership, it has a considerable degree of authority by virtue of the fact that it was issued by the Executive Committee. "Independence is an attitude of mind. . . . Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance

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[1]Elijah W. Sells, "Corporate Management Compared with Government Control," The Journal of Accountancy, V (January, 1908), p. 236.

depends the profession's strength and its stature."[1] Consistent with that definition but somewhat more explanatory is the following comment which was made by a member of the long-range objectives committee of the American Institute of Certified Public Accountants:

> Independence (in the sense of objectivity) is largely a frame of mind, a matter of individual intellectual integrity. Independence is that characteristic of the practicing professional which enjoins him from engaging in rationalization.[2]

A somewhat philosophical description of the concept was made by a past president of the American Institute of Accountants, Edward B. Wilcox. Note that Wilcox implies in the following statement that some parts of the practice of public accounting do not clearly require independence on the part of the public accountant:

> That part of public accounting which does clearly require independence relates to the expression of an expert opinion on representations in financial statements. The purpose of the expert opinion is to add to the credibility of the statements. Those who rely on this credibility are apt to be creditors or investors, or sometimes employees, customers, or governmental agencies. . . . As in other areas of public accounting the expert incurs professional obligations of an ethical nature, to do a sound, competent job. But he also incurs more than that. He incurs an obligation to his unknown audience for integrity. He must protect them even though he does not know who they are, and he must do so even when it means opposing and denying the wishes of those who have employed him, and who he knows may cease to do so. This is independence.[3]

No doubt many accountants were guided by an ideal similar to that which has just been quoted but it is probable that the view is not representative of the contemporary practice or application of the concept. It is noteworthy that these views expressed by the profession as a whole and by

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[1]"Reports of the Executive Committee, Exhibit A, Statement on Independence," Yearbook American Institute of Accountants 1947 (New York: American Institute of Accountants, 1948), p. 84.

[2]Robert M. Trueblood, "The Management Service Function in Public Accounting," The Journal of Accountancy, CXII (July, 1961), p. 42.

[3]E. B. Wilcox, "Independence from the Viewpoint of the Certified Public Accountant," How to Improve Accounting & Tax Service to American Business (New York: American Institute of Accountants, 1950), p. 73.

several of its prominent members do not lend themselves to a test of the independent status of particular individuals. Any evaluation which is based on these criteria must be the result of highly subjective, introspective evaluations by the individual whose independent status is in question.

The Securities and Exchange Commission is responsible for the administration of the Securities Act of 1933. That Act requires audits by independent public accountants of certain companies that are required to register with the Commission issues of securities which are offered to the public. Obviously a workable concept of independence was essential if the independence of an auditor was to be established as a fact and subject to verification by someone other than the auditor himself. Consequently the Commission "has consistently held that the question of independence is one of fact, to be determined in the light of all pertinent circumstances in a particular case."[1] Several objective measures have long been used by the Commission when the independent status of particular public accountants was being evaluated. These measures or tests have included financial interest, employee relationships (promoter, underwriter, voting trustee, director, officer, or employee), and all other relevant circumstances bearing on the relationship between the accountant and the client. Although it is true that the major emphasis has been placed upon financial interest and personal involvement by the accountant in the affairs of the client, this concept has been workable and the tests are objective although they are limited.

The previous paragraphs are illustrative of the diversity of the views regarding the concept of auditor independence. Sharaf and Mautz have noted:

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[1]Securities and Exchange Commission, Accounting Series Release No. 81, December 11, 1958, Accounting Series Releases: Compilation of Releases 78 to 89 Inclusive (Washington, D.C.: U. S. Government Printing Office, 1962), p. 31.

> It is one of those illusive ideas difficult to reduce to an easily understood definition. Thus one searches in vain for a comprehensive, authoritative statement of the meaning of independence in auditing. The idea of independence has, however, been approached in different ways for different purposes, and although one can easily find fault with individual treatments of the subject, together these several approaches amount to a substantial contribution.[1]

Sharaf and Mautz suggest that independence be viewed as a three-dimensional concept which takes into account the complex of economic, social, and personal relationships encountered by the auditor in his professional work. Each of the three dimensions--programming independence, investigative independence, and reporting independence--are elucidated by means of several detailed guides. Unfortunately the operationality of this system is conceived in terms of the introspective abilities of the auditor. An important assumption lies in the statement "that control or influence by the client may be so subtle as to escape notice unless the auditor is constantly and intelligently alert to the possibility."[2] Whether auditors are men who are capable of making such discriminating observations in situations in which they themselves are involved is at best a hypothesis which should be tested. Nevertheless the integration of the many aspects of independence which led to this expanded definitional statement of the concept is a contribution which hopefully will be more than a mere addition to the literature of the profession.

Events Leading to a Resolution on Independence

No evidence was found which would suggest that any member of the American Institute of Accountants was concerned with the ethical

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[1]Hussein A. Sharaf and R. K. Mautz, "An Operational Concept of Independence," The Journal of Accountancy, CIX (April, 1960), p. 49.

[2]Ibid., p. 52.

implications of independence prior to 1926. However, the report of the Committee on Professional Ethics for that year contained the following question which was neither answered nor discussed: "Is it ethical for a certified public accountant who is a director of a company also to certify to its balance-sheet?"[1]

An editorial which was purported to be a response to the question of a correspondent made it very clear "that the accountant should be so utterly divorced from financial or other participation in the success or failure of an undertaking under audit that no one could ever point an accusing finger, however unjustly, and allege the possibility of bias."[2] The editor also pointed out that in all cases, except those in which there are unusual circumstances, an accountant should not be stockholder, bondholder, officer or director of a corporation in which he holds an appointment as auditor. As an example of such an exception, the editor wrote that an auditor might be practically compelled to serve as director in a company which was passing through reorganization and therefore was in need of the direction of a man whose experience made him better acquainted with the facts than anyone else.

On September 16, 1931, during a session of the annual meeting of the American Institute of Accountants, Frederick H. Hurdman presented a paper entitled "Relations of Client and Accountant."[3] In this paper, Hurdman proposed this resolution for the consideration of the members:

> WHEREAS, The relation between a client, in the form of a corporation, and the auditor for that corporation should be one of entire independence, and

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[1] "Report of Committee on Professional Ethics," 1926 Year Book of the American Institute of Accountants (1926), p. 169.

[2] Editorial, "Should an Auditor Act as Director?" The Journal of Accountancy, XLV (March, 1928), p. 205.

[3] "Proceedings of the Annual Meeting," 1931 Year Book of the American Institute of Accountants (1931), p. 174.

> **WHEREAS,** It does not appear to be practicable for the auditor consistently to hold a dual relationship, as an auditor and executive of the corporation, and
>
> **WHEREAS,** The public interest and confidence will best be preserved by a complete separation of these two functions, therefore be it
>
> **RESOLVED,** That the maintenance of a dual relationship, as director or officer of a corporation, while acting as auditor of that corporation is against the best interests of the public and the profession and tends to destroy that independence of action considered essential in the relationship between client and auditor.[1]

After some discussion, the proposed resolution was referred to the Committee on Professional Ethics with instructions to report back to the 1932 annual meeting on this question. But no action was taken on the proposal in 1932. Furthermore, no comment was found which would indicate that action had simply been deferred to a later date.

During the year 1933 an event occurred which seems to have stimulated some interest among the members with respect to the problem created by the auditor who invests in the securities of his client. Quite understandably, even fewer details were published concerning this particular case than was normally the practice in a disciplinary action. On April 10, 1933, the trial board heard charges of conduct discreditable to the profession as it was authorized to do by the general disciplinary clause of the by-laws of the American Institute of Accountants.[2] This was

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[1] Ibid.

[2] "Report of the Council," 1933 Year Book of the American Institute of Accountants (1934), p. 208. Some of the mystery of this trial may have been dispelled by the following editorial discussion of the amendment by the Illinois Society of Certified Public Accountants of their rule on financial independence. "This whole concern for the effect of financial interest on independence originated in consideration of circumstances like these: A wealthy partner of a public accounting firm might own a substantial amount of a stock in a listed company. If his firm audited that company, it might seem desirable that impressive earnings be reported, so that the

the only trial conducted by the trial board during fiscal 1933. The respondents were 16 members of the Institute all of whom were partners in one firm. Following a lengthy hearing and debate these members were found guilty of the offense and were admonished to refrain from similar conduct in the future. As a result of this trial, the Committee on Professional Ethics was instructed to submit a rule which would cover the circumstances involved. Thus the Committee recommended to the Institute's Council on October 16, 1933, the following rule:

> No member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest.[1]

Unwilling to adopt the rule, the Council referred the proposal to the incoming Committee on Professional Ethics. Furthermore, the latter committee was instructed to consider "also the suggestion that admonitory resolutions of council be substituted for the rules of professional conduct."[2]

In its report for the year 1934, the Committee on Professional Ethics indicated that it had been instructed by the Council on October 19, 1933, to "consider what had been urged at this meeting of council as being preferable, namely, the drafting of clarifying or explanatory resolutions to throw light upon the rules of professional conduct in lieu of amending the rules as they now exist, or adding new ones."[3]

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market price of the stock would rise or be maintained at a high level. The personal interest of a major partner under these conditions might influence the firm's judgement in a close question of accounting procedure that could significantly affect reported profits." Editorial, "Another Rule on Independence of Accountants," The Journal of Accountancy, XCVII (June, 1954), p. 674.

[1]"Report of the Committee on Professional Ethics," 1933 Year Book . . . , p. 226.

[2]"Council: Regular Meeting, October 19, 1933," ibid., p. 187.

[3]"Report of the Committee on Professional Ethics," 1934 Year Book of the American Institute of Accountants (1935), p. 251.

Accordingly the Committee submitted this resolution which was adopted on October 15, 1934, by the Council after a proposal to delete the word "substantial" had been defeated:[1]

> RESOLVED, That no member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest.[2]

Similarly, the resolution was approved by the members who attended the 1934 annual meeting after another proposal to delete the word "substantial" had failed to win approval.

Differences of Opinion Between the SEC and the Institute

The public accounting profession was not alone in its concern for the independence of its practitioners. Under the authority of the Securities Act of 1933, the Federal Trade Commission (which was responsible for the administration of that Act prior to the establishment of the Securities and Exchange Commission) adopted on July 6, 1933, this rule:

> The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or with whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function.[3]

In view of the federal securities legislation, the events which had brought it about, and the economic condition of the nation, accountants

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[1] "Council: Regular Meeting, October 15, 1934," ibid., p. 193.

[2] Ibid.

[3] Barr, The Journal of Accountancy, CVIII (October, 1959), p. 34, quoting Rules and Regulations under the Securities Act of 1933, Federal Trade Commission, July 6, 1933.

were probably justified if they were apprehensive with regard to the future status of their profession. John F. Forbes, who was president of the American Institute of Accountants in 1934, warned in his report to the 1934 annual meeting that in the event the profession did not settle its questions of professional ethics, governmental and other agencies would usurp these prerogatives.[1] Another warning on the significance of independence was given the members of the Institute in 1937 by Robert H. Montgomery who said: "We must stand like the Rock of Gibraltar on our independence."[2]

Evidently those warnings were taken seriously and were followed by actions which were at least partially effective. Perhaps some of the interest of the Institute in the concept of auditor independence was channelled in the direction of the Securities and Exchange Commission which by 1936 was responsible for the administration of the Securities Act of 1933. It seems reasonable to suspect that the Institute might have had some influence on the Commission in its decision to amend one of its administrative rules. Formerly the rule had prohibited a public accountant from expressing his opinion on the financial statements of a client in whose securities he had "any interest." As amended, the rule prohibited "any substantial interest."[3] In this way the rule of the Commission was made to conform in 1936 with the 1934 resolution which had been adopted by the American Institute of Accountants. On the basis of a recommendation by the Special Committee on Cooperation with the Securities and Exchange Commission, the Institute's Council resolved on October 18, 1937,

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[1]"Report of the President," in 1934 Year Book . . . , pp. 211-12.

[2]"Report of the President," 1937 Year Book of the American Institute of Accountants (1938), p. 409.

[3]Barr, The Journal of Accountancy, CVIII (October, 1959), p. 34, quoting Rule 650 (b), General Rules and Regulations Under the Securities Act of 1933, January 21, 1936.

> that no accountant should have a substantial interest in the securities of a client regardless of whether or not such an interest might influence his judgment.[1]

However, these changes seem to have accomplished nothing if their purpose was to reconcile the difference between the concept of independence expressed by the profession and that of the Securities and Exchange Commission.

It has been pointed out that the administrative rule of the Securities and Exchange Commission and the resolution of the Institute were in agreement to the extent that a public accountant could not express his professional opinion on the financial statements of a firm which was financed by the public distribution of securities if he had a substantial financial interest in that enterprise. But the rule of the Commission went beyond the policy statement of the Institute in that the former explicitly prohibited certain non-economic personal involvements between a public accountant and his client. These similarities and distinctions are probably the natural result of the basic difference which existed regarding the concept of independence. Perhaps before noting the differences in the application of the policy statements, it would be advisable to review the differences in these statements themselves. Hurdman, who was chairman of the Committee on Professional Ethics and a past president of the American Institute of Accountants, carefully and accurately summarized in these words the attitude of the profession:

> The accounting profession had tacitly taken it for granted that independence was a state of mind; that if an accountant exercised his professional skill honestly, applied his best judgement without fear or favor, and expressed his opinion impartially and objectively, he was independent. The only evidence of lack of independence under this theory would be the expression of an opinion which was incorrect or inadequate as the result of outside influences.[2]

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[1] "Council: Regular Meeting, October 18, 1937," in 1937 Year Book . . . , p. 373.

[2] Frederick H. Hurdman, "Independence of Auditors," The Journal of Accountancy, LXXIII (January, 1942), p. 55.

Two months after the above statement was published, the Securities and Exchange Commission commented as follows:

> Independence tends to assure the objective and impartial consideration which is needed for the fair solution of the complex and often controversial matters that arise in the ordinary course of audit work. On the other hand, bias due to the presence of an entangling affiliation or interest, inconsistent with proper professional relations of accountant and client, may cause loss of objectivity and impartiality and tends to cast doubt upon the reliability and fairness of the accountant's opinion and of the financial statements themselves.[1]

Comments made by Jerome N. Frank on May 18, 1939, when he assumed the office of chairman of the Securities and Exchange Commission made clear not only the objective of the Commission but also the sincere intent to achieve that objective. Chairman Frank expressed his attitude as follows:

> Accounting is the language in which the corporation talks to its existing stockholders and to prospective investors. We want to be sure that the public never has reason to lose faith in the reports of public accountants. To this end, the independence of the public accountant must be preserved and strengthened and standards of thoroughness and accuracy protected. I understand that certain groups in the profession are moving ahead in good stride. They will get all the help we can give them so long as they conscientiously attempt that task. That's definite. But if we find that they are unwilling or unable, perhaps, because of the influence of some of their clients, to do the job thoroughly, we won't hesitate to step in to the full extent of our statutory powers.[2]

Many examples can be found in the publications of the Securities and Exchange Commission which indicate that the independent tests supplied by the Commission were absolute as well as objective. For example,

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[1]Securities and Exchange Commission, Accounting Series Release No. 22, March 14, 1941, Accounting Series Releases, Releases 1 to 52, Inclusive (Washington, D.C.: U.S. Government Printing Office, 1945), pp. 34-35.

[2]Securities and Exchange Commission, Fifth Annual Report (Washington, D.C.: U.S. Government Printing Office, 1940), p. 121.

an accountant was found lacking in independence when: (1) his employee or partner was the recipient and present owner of a large block of stock issued by the registrant for services performed when the company was organized, (2) he completely subordinated his judgement to the desires of his client, (3) he entered into an indemnity agreement with a client, and (4) he consciously falsified certain facts although he had no direct interest in or employment relationship with the registrant.[1] Certainly it is possible that none of the accountants involved in these cases were members of the American Institute of Accountants. But a comparison of the results of the application of the standards of the Institute and those of the Commission is provided by two cases, each of which involved at least one member of the Institute.

The first case[2] involved two members of the Institute who were not considered independent by the Securities and Exchange Commission when it was found that the combined holdings of these accountants and their wives in the stock of the registrant prevented a finding of independence. These holdings had a substantial aggregate value and over a period of four years, that aggregate value ranged from one-half of one per cent to nine per cent of the combined personal fortunes of these members and their wives. It was also determined by the Commission that one of the accountants had made loans to and received loans from certain officers and directors of the registrant.

Prior to the date of this case (1941) a procedure had been established to assure that matters involving members of the American Institute of

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[1]Accounting Series Release No. 22, Accounting Series Releases (1 to 52, Inclusive), p. 34.

[2]Securities and Exchange Commission, In the Matter of A. Hollander & Son, Inc., Securities Exchange Act of 1934, Release No. 2777, (1941). Only the pertinent points of this case are presented here. The SEC has summarized the salient features of this case in Accounting Series Release No. 22.

Accountants and the Securities and Exchange Commission would be brought to the attention of the Institute by the Commission.[1] On May 12, 1941, the Committee on Professional Ethics presented to the trial board of the Institute what it considered a prima facie case against the two members for having violated the 1934 resolution which proscribed the certification of financial statements by an auditor who had a substantial financial interest in the publicly held enterprise.[2] According to the published report of the trial, the following information was developed: that the stock in question was owned by the wives of the respondents; that this block of stock was insignificant relative to the aggregate outstanding stock of the company; that the value of the stock ranged from one-half of one per cent to nine per cent of the personal wealth of the members and their wives; that the alleged loans were personal, short-term, an accommodation, and insignificant relative to the means of the respondent; and that the alleged loans from the officials of the company to the respondent were indeed transactions in which the respondent, as an agent for the officials, handled their money.

Doubts were raised as to whether the respondents had technically violated the 1934 resolution because there was sufficient ambiguity with respect to the meaning of the words "substantial" and "beneficial" according to the report of the trial board. Because it was not alleged that the respondents had been induced to perform their auditing duties improperly, they were found not guilty of conduct discreditable to the profession. In the final paragraph of its report, the trial board expressed its attitude in these words:

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[1]"A Statement to the S.E.C. on Professional Disciplinary Procedures," The Journal of Accountancy, LXX (July, 1940), p. 59.

[2]"American Institute of Accountants Trial Board," The Journal of Accountancy, LXXII (July, 1941), pp. 89-90.

> For the guidance of the membership, however, the opinion was expressed that ownership by a member of the Institute or his immediate family of stock in a corporation of which he was auditor should be discouraged; that all financial transactions between independent auditors and their clients should be avoided; that in the future the council sitting as a trial board intended to apply more strictly the provisions of the existing rules of conduct relating to financial interest in client corporations.[1]

The other case[2] involved a member of the Institute who had given his opinion on the financial statements of a company which was financed in whole or in part by the public distribution of securities. At the time of this certification, the member was the actual or beneficial owner of a substantial or beneficial interest (eight per cent of the net worth of himself and his immediate family) in the client corporation. Having found the accountant not independent, the Securities and Exchange Commission suspended him from practice before the Commission for a period of sixty days. Similarly, the trial board of the American Institute of Accountants found the member guilty of a violation of the 1934 resolution and suspended his membership for one year.

According to its annual report for fiscal 1940, the Committee on Professional Ethics received and answered the following inquiry: "Should an accountant act as independent auditor of a corporation if he holds stock in that corporation?"[3] The Committee replied that a member was forbidden to do so by the 1934 resolution of Council. Furthermore, the correspondent was advised not to act as an independent auditor if his ownership of the stock of the client company was greater than one per cent of his personal fortune as indicated by Accounting Series Release No. 2 (May 6, 1937). But the interesting point in the response to this inquiry

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[1] Ibid., p. 90.

[2] Securities and Exchange Commission, In the Matter of Kenneth L. Logan, 10, SEC 982 (1942).

[3] "Reports of the Committee on Professional Ethics," 1940 Yearbook of the American Institute of Accountants (1941), p. 154.

is an extension of the previous situation to a case involving a close corporation rather than a publicly held corporation. "In the case of a closely held corporation, if the auditor's ownership of stock is fully disclosed, there probably would be no reason why he should not continue as auditor."[1] A similar exception had previously been made for joint service as auditor-director for a close corporation.[2]

Adoption of the First Rule on Independence

Together with numerous other proposals to amend the rules of professional conduct, the Committee on Professional Ethics submitted to the Council on October 14, 1940, a rule on financial independence which would replace the 1934 resolution. This rule, which was approved by the Council, the members who attended the annual meeting, and the members who voted on the mail ballot, became effective on January 6, 1941. The 1941 version of the rule follows:

> A member or an associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest; nor shall a member or an associate express his opinion on financial statements which are used as a basis of credit, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such interest, unless he discloses his financial interest in his report.[3]

No explanation was found for that part of the rule which deals with an opinion on financial statements which were to be used for credit purposes. Perhaps it was a provision which grew in acceptance over the

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[1] *Ibid.*

[2] *Editorial, "Auditor as Director," The Journal of Accountancy, LXIII (April, 1937), p. 244.*

[3] *"Council: Regular Meeting," 1940 Yearbook . . . , p. 50.*

course of several years. An opinion expressed in 1928 tends to support that belief. In that year an opinion which was attributed to the chairman of the Committee on Professional Ethics (T. Edward Ross) provided that disclosure of a dual relationship between the auditor and the company should have been disclosed to a bank which was considering a company's request for credit.[1] Quite interestingly, E. B. Wilcox, who was a member of the Committee on Professional Ethics which recommended the rule, later made it clear that he did not know the rationale for the exception for statements which were supposed to be used as a basis for credit. In Wilcox's opinion,

> the reasons for the distinction between a prohibition in the case of publicly held securities, and reliance on disclosure in the case of credit seeking, are not so clear. It may be that the distinction is one of emphasis, since public financing of securities does involve greater professional responsibility because the public is involved. It may be that the rule is intended to guard only against the appearance of evil, and is therefore more appropriate to cases of public financing. Or it may be that this is a case of incomplete development of an evolving code.[2]

Wilcox was critical of the questionable distinction between the financial statements of a client financed by a public distribution of securities and financial statements issued for credit purposes.

Revised Rule Reflects Opinions of SEC

A revision of the rule on financial independence was adopted on December 15, 1942, by the members of the American Institute of Accountants. The vote was 2,781 to 105.[3] The 1942 version of the rule follows:

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[1]Editorial, "Should the Auditor Be a Stockholder?" The Journal of Accountancy, XLV (March, 1928), p. 207.

[2]Wilcox, "Independence From the Viewpoint of the Certified Public Accountant," How to Improve Accounting & Tax Service to American Business, p. 77.

[3]"Reports of the Executive Committee," 1942-1943 Reports of Officers, Council, and Committees (New York: The American Institute of Accountants, 1943), p. 36.

> A member or an associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by a public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member or an associate shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest.[1]

Each of the new elements introduced in this revision appeared earlier in Securities and Exchange Commission decisions. On the one hand, the relationship of the financial interest of the public accountant to the total capital of the corporation was offered as a criterion of independence in Accounting Series Release No. 2 (1937). It was also offered without success as a defense In the Matter of Kenneth L. Logan, 10 SEC 986 (1942). On the other hand, the Securities and Exchange Commission had considered the financial interest of the accountants and their wives In the Matter of A. Hollander & Son, Inc., 8 SEC 586 (1941). It is not unreasonable to suppose that those cases had a direct influence in the development of the 1942 revision of the rule on independence.

The Securities and Exchange Commission announced in Accounting Series Release No. 37 (November 7, 1942) a revision of Regulation S-X, Rule 2-01. That amendment formalized the established practice of the Commission to consider not only the circumstances involving the work done by an accountant on the financial statements filed with the Commission but also the other work which the accountant may have done for that particular company on the same or other occasions. The public accounting

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[1] "Rules of Professional Conduct," Yearbook American Institute of Accountants 1942 (New York: American Institute of Accountants, 1943), p. 362.

profession interpreted this to mean that the Commission intended to judge the propriety of all accountant-client relationships in and of themselves. In order to allay these fears,

> the Commission made it clear that it was interested in relationships between a certifying accountant and a registrant only insofar as the existence of particular relationships might be relevant to its determination whether the accountant was in fact independent.[1]

The extent to which the Commission intended to apply that policy is indicated by a case in which a firm of accountants was considered not independent because the son of one of the partners of the accounting firm lived with his father and was employed as the assistant treasurer and chief accountant of the client-registrant.[2]

Such unrestrained zeal in the evaluation of the independence of public accountants evidently represented misguided effort on the part of the Securities and Exchange Commission as far as some members of the public accounting profession were concerned. The Executive Committee of the American Institute of Accountants is purported to have agreed with the Committee on Cooperation with Securities and Exchange Commission that relationships which would per se preclude independence ought to be limited to the relationships--direct or indirect financial interest and connections such as promoter, underwriter, voting trustee, director, officer, or employee--which were specified in subsection (b) of Rule 2-01.[3] It was also pointed out that relationships other than those specified should

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[1]Securities and Exchange Commission, Accounting Series Release No. 44, May 24, 1943, Accounting Series Releases, (1 to 52, Inclusive), p. 55.

[2]Securities and Exchange Commission, Accounting Series Release No. 47, January 25, 1944, Accounting Series Releases, (1 to 52, Inclusive), pp. 61-62.

[3]"Report of the Committee on Cooperation with Securities and Exchange Commission," Yearbook American Institute of Accountants 1943-1944 (New York: American Institute of Accountants, 1945), p. 65.

not be conclusive evidence of bias and a lack of independence in the absence of direct evidence of an actual lack of impartiality. Furthermore, when the independence of an auditor is given a fair and judicial investigation, weight should be given to his character and professional attitude (the state of mind doctrine). In the opinion of the Committee, these were the qualities which determine factual independence and whether or not an audit was performed with due objectivity and impartiality. This general attitude was consistent not only with the opinions expressed by the Committee on Professional Ethics in its reports but also the other literature published by the Institute during the decade before 1950.

Recent Developments in the Rule on Independence

It will be recalled that the Securities and Exchange Commission in 1936 had qualified its rule which prohibited an auditor from having any financial interest in a registrant whose financial statements he had audited for purposes of registration with the Commission. Surprisingly, the literature reveals virtually no response to the action of the Commission when it deleted the word "substantial" from the rule in 1950. With this action, the Commission thus restored its earlier prohibition against any financial interest, whether "substantial" or not. Furthermore, the amendment also made it clear that the independence of the auditor was not only necessary with respect to the registrant but also necessary with respect to any affiliate of the registrant.

Very soon after the Securities and Exchange Commission introduced those restrictions, efforts were being made by some members of the Illinois Society of Certified Public Accountants to extend the scope of their rule which prohibited members and their families from having a financial interest in a client which was substantial either in relation to the capital of the firm or the personal fortune of the member. As it was

initially proposed in 1951, the new rule[1] seems to have been an adaptation of the recently revised subsection (b) of Rule 2-01 of Regulation S-X. Of course it was tailored to suit the needs of the Illinois Society, but the prohibition of any financial interest and the specific personal relationships were the same as those specified in the Commission's rule. The financial independence rule of the Illinois Society which was in force at the time was very similar to the first rule which had been adopted by the American Institute of Accountants in 1941 except that the Illinois rule did not contain the anomalous exception for financial statements intended for credit purposes.

A new rule on independence was not adopted in 1951 by the Illinois Society of Certified Public Accountants. But the ballots cast in an opinion ballot conducted by mail subsequent to the annual meeting revealed that 738 members favored the amendment while only 174 indicated their opposition.[2] During the following year, 1952, the members of the Illinois Society did adopt an amendment of the rule with an effective date of June 1, 1954. That delay was intended to provide members with an opportunity to adjust their affairs in accordance with the new rule which also was remarkably similar to the then current independence rule of the Securities and Exchange Commission. The Illinois Society's new rule provided that

> a member will not be considered independent with respect to any person, organization, or affiliate thereof, in which he, his partners, or members of their immediate families living in the same household, have any financial interest, direct or indirect; or with which he or his partners are, or were, during the period of report, connected as promotor, underwriter, voting trustee, director, officer or employee.[3]

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[1]The text of the proposed rule was reproduced in the following article: Jackson W. Smart, "The Concept of Independence of the Public Accounting Profession," The Illinois Certified Public Accountant, XIV (December, 1951), p. 65.

[2]Ibid.

[3]"Illinois Amends Rules of Conduct," The CPA (October, 1952), p. 12.

Except for an editorial[1] which seems to have offended the Board of Directors of the Illinois Society of Certified Public Accountants,[2] there is no indication in either the literature of the profession or the reports of the Committee on Professional Ethics that the American Institute of Certified Public Accountants[3] even took cognizance of this development. Of course it is not true, in all probability, that the national organization of the public accounting profession did in fact ignore the advanced positions on auditor independence adopted by the Securities and Exchange Commission and the Illinois Society of Certified Public Accountants. About all that can be said with certainty is that silence was the official reaction of the Institute.

Finally, in 1960, there appeared a manifestation of the attention which apparently had been quietly devoted to the question of independence. In a report which was dated May 4, 1960, and which was directed to the Council of the Institute, the Committee on Professional Ethics strongly recommended approval of a proposed revision of the independence rule for submission to the members at the forthcoming annual meeting. Prior to the preparation of that report, the chairman of the Committee on Professional Ethics had written letters to the members of the Council. These letters explained the reasons for the belief of the Committee that there was a need to revise the existing rule. The Committee reported that some of the responses to this letter praised the recommendation and

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[1]"Another Rule on Independence of Accountants," The Journal of Accountancy, XCVII (June, 1954), pp. 673-4.

[2]L. B. McLaughlin, "Illinois Society Defends Its Stand on Independence of Accountants," (Letter), The Journal of Accountancy, XCVIII (September, 1954), pp. 278, 280, 282.

[3]The American Institute of Accountants changed its name on June 30, 1957, to the form which appears in the text.

others expressed concern with the restrictions of the proposed rule. But the feature about which the respondents were most apprehensive was the prohibition of dual service as auditor-director even in cases in which there was little or no ownership by the auditor of the stock of the client company.

Notwithstanding these misgivings, the Council, at its regular meeting in May, 1960, approved the proposal for submission to the members at the next annual meeting. An effort was made to rescind the recommendation during the meeting of the Council on September 24, 1960, the day before the annual meeting was scheduled to begin. Following a discussion of the question, the motion to rescind was put to a vote and was defeated.[1] Except for the words "or associate" which were added in 1961 and other minor changes, the following rule was submitted to the members of the American Institute who attended the 1960 annual meeting:

> Neither a member or associate, nor a firm of which he is a partner, shall express an opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise.
>
> Independence is not susceptible of precise definition, but is an expression of the professional integrity of the individual. A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationships with an enterprise to determine whether, in the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts.
>
> A member or associate will be considered not independent, for example, with respect to any enterprise if he, or one of his partners, (a) during the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, or (b) during the period of his professional engagement, at the time of expressing his opinion

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[1]Minutes of the Council Meeting, September 24 and 28, 1960, p. 11, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

> or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee. In cases where a member or associate ceases to be the independent accountant for an enterprise and is subsequently called upon to re-express a previously expressed opinion on financial statements, the phrase "at the time of expressing his opinion" refers only to the time at which the member or associate first expressed his opinion on the financial statements in question. The word "director" is not intended to apply to a connection in such a capacity with a charitable, religious, civic or other similar type of nonprofit organization when the duties performed in such a capacity are such as to make it clear that the member or associate can express an independent opinion on the financial statements. The example cited in this paragraph, of circumstances under which a member or associate will be considered not independent, is not intended to be all-inclusive.[1]

Following a lengthy and vigorous debate, consideration of the proposal was postponed with the understanding that the proposed rule could be called up for consideration again at the 1961 annual meeting. The vote favoring postponement was 447 to 367.[2] Thus consideration of the amendment was postponed for a year.

It should be recalled that following the general revision of the rules of professional conduct in 1941, all proposals to amend the rules had been submitted to the membership at an annual meeting of the Institute. A proposal which was approved by two-thirds of the members present at an annual meeting could only then be submitted by mail ballot to the entire membership of the Institute.

Except for a later effective date (January 1, 1964, rather than the same date in 1962) and the addition of "or associate" following each use of the word "member," the proposed rule was submitted without change

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[1] By-Laws, Code of Professional Ethics, Numbered Opinions of the Committee on Professional Ethics, Objectives of the Institute Adopted by Council (New York: American Institute of Certified Public Accountants, 1962), pp. 29-30.

[2] "Action on Rule 13," The CPA, XL (October, 1960), p. 2.

to the members who attended the 1961 annual meeting of the Institute. A considerable amount of persuasive publicity was given the proposal during the intervening year. The proposal was approved at the annual meeting and in the mail ballot of all members. Balloting on the new rule was reported as follows.

Vote on Independence

Balloting	For	Against	Total Vote
At 1961 Annual Meeting[1]			
In person	916	138	1,054
By Proxy	2,021	191	2,212
Totals	2,937	329	3,266
In the Referendum of January 1962[2]	12,713	4,097	16,810

A comparison of the votes cast on this issue in 1961 and in 1962 suggests that a remarkable increase occurred in the number of members who were interested in the independence rule. There were four times as many votes cast at the 1961 annual meeting as were cast on the proposed rule on independence at the previous annual meeting. The total number of votes favoring submission of the proposal to the membership in 1961 was more than 800% of the votes which were cast in the previous year in favor of the proposal. In contrast, the votes which were cast against the proposal in 1961 were less than 74% of the votes which were cast in the previous year in favor of postponement. It cannot be denied that a significant increase occurred in the number of members who cast a ballot either in person or by proxy on this proposal in 1961 as compared with 1960.

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[1] "Members at Annual Meeting Approve Amendment of Rule on Independence," The CPA, XLI (November, 1961), p. 2.

[2] "Results of AICPA Referendum Ballots of January 1962," The CPA, XLII (March, 1962), p. 3.

After the independence issue had been postponed in 1960, The Wall Street Journal reported that

> one Institute official said it appeared the votes for postponement came from not only those who were opposed to it but also delegates who favored the proposals but feared the adverse publicity effect a negative vote might have had at this time.[1]

It seems likely that the proposal would not have been resubmitted for a vote during the 1961 annual meeting if it had not been fairly certain that the revised version of the rule would be approved.

Perhaps it should be noted also that the members whose ballots were cast in the 1962 referendum represented approximately 41% of the membership of the American Institute of Certified Public Accountants. Certainly no evidence is available which would explain the failure of 59% of the members of the Institute to express a view on this question. But one may be justified in wondering whether the majority of the members could be any less interested in the growth and development of their profession. At any rate all members are now equally bound by the new rule which was adopted by approximately 31% of the membership of the Institute.

Some Other Aspects of Independence

Certain other aspects which have a relation to the concept of independence have appeared in the professional literature from time to time. If frequency of appearance or reiteration of previous statements of a particular phase of the concept is taken as a test, then no other aspect of independence has been as important to the profession as that of financial independence. Next in significance, according to this test, has been the question of personal independence in connection with the employee or agent relationships of the auditor to his client. To be sure

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[1]The Wall Street Journal, September 28, 1960, p. 5.

the profession has now formally joined the Securities and Exchange Commission in prohibiting joint service to an enterprise as auditor and promoter, underwriter, voting trustee, director, officer, or key employee. Perhaps a complacent attitude on the part of the profession would not be difficult to justify. But there are some observers who are questioning the relationship of management services to the concept of the independence of public accountants. Management services have been defined as "any service for management of a fact-finding or advisory nature, except for financial auditing and tax work."[1]

Apparently the Securities and Exchange Commission has not had a great deal of experience with cases involving an auditor who has provided auditing services as well as management services for a single registrant. That experience which the Commission has mentioned was related to situations involving corporations which were filing audited financial statements with the Commission for the first time. Although its experience may not be extensive, the attitude of the Commission is unmistakable in this comment:

> Another reason for finding a lack of independence, . . . is the fact that some accountants intending to certify financial statements included in such filings have been interested in serving the client's management, or in some cases large stockholders, in several capacities and in doing so have not taken care to maintain a clear distinction between giving advice to management and serving as personal representatives of management or owners and making business decisions for them.[2]

Notice that the Commission seems to imply that service in other capacities is not necessarily inconsistent with the independent role of the auditor. A conflict arises when the auditor extends himself beyond the advisory

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[1]Marquis G. Eaton, "Advisory Service: New Frontier," The Journal of Accountancy, C (November, 1955), p. 56.

[2]Securities and Exchange Commission, 23rd Annual Report (Washington, D.C.: U.S. Government Printing Office, 1958), p. 184.

level to that of a personal representative of or a substitute for management. An example of this sort of conflict was recently found by the Commission in a case in which it was found that a firm of certified public accountants was not independent because one of the partners also acted as legal counsel for the client.[1]

Presumably the policy of the Securities and Exchange Commission on the independence of auditors who perform other services for their clients is consistent with the attitude expressed by the Institute's Committee on Management Services by Certified Public Accountants. The Committee believes that "if the CPA in serving management keeps his relations, as he should, at the advisory level as distinct from the decision-making or operating level, he should be able to maintain his position as an independent auditor."[2] Thus, on the surface at least, it appears that the Commission and the American Institute are in agreement with respect to the relationship between the management services functions and the concept of auditor independence.

A sharp contrast with the attitude of the Securities and Exchange Commission and that of the American Institute is found in a recent critical examination of the concept of independence.[3] The authors of that study, Mautz and Sharaf, seem to hold no hope for the satisfactory performance of the audit function and management services by the same person or persons for a given enterprise. They view the compatibility of management services and auditing as follows:

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[1]News Report, "SEC Rules CPA Who is Client's Attorney is Not Independent," The Journal of Accountancy, CXIII (May, 1962), p. 14.

[2]Accounting and Auditing Problems, "SEC Comments on Independence with Respect to CPAs," The Journal of Accountancy, CV (April, 1958), p. 77, quoting Management Services by CPAs.

[3]R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (American Accounting Association, Monograph No. 6, 1961), Chapter 8, pp. 204-31.

> There tends to come a time in any arrangement for management services when the mutuality of interest of the consultant and the client becomes so significant that the accountant ceases to be independent in the sense that we feel he should be for auditing purposes.[1]

The views cited above represent the extremes of the range of opinion on the compatibility of the management services and the audit functions of public accountants. Of course there are many accountants whose viewpoints would fall somewhere between the two extremes. One such intermediate attitude recognizes that some doubt with respect to complete independence is probably inevitable when an accountant provides a client with both management services and auditing.[2]

Independence has also been questioned when an auditor has served a client as bookkeeper as well as auditor. Again there is a dicohtomy of opinion. On the one hand, the attitude of the American Institute was expressed by its Committee on Auditing Procedure following a joint consideration of the problem with the Committee on Professional Ethics. The committees agreed

> that if an accountant is in fact independent, and if he has performed all the auditing procedures necessary to supplement the information obtained through keeping the books, he should be entitled to express any opinion he may have formed. However, there was some uncertainty as to whether the two committees were in agreement regarding whether the accountant should disclose in his report the fact that he kept the books. After further consideration, the committees have agreed that this is a question which should be left to the judgment of the accountant in the light of the facts of each case. The committees believe that disclosure of the fact that he has kept the books is not usually necessary.[3]

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[1]Ibid., p. 222.

[2]Ira N. Frisbee, "Ethical Considerations in Rendering Management Services," The Journal of Accountancy, CIII (March, 1957), p. 33.

[3]Robert L. Kane, Jr. (ed.), CPA Handbook (New York: The American Institute of Accountants, 1952), Chapter 5, p. 19.

The Institute's attitude was recently restated by Thomas G. Higgins who served as chairman of the Committee on Professional Ethics during 1959 and 1960.[1]

In contrast with the Institute's position, the Securities and Exchange Commission has held that an accounting firm could not be considered independent because it had followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the staff of the registrant. The public accountants posted these journal records to the appropriate ledgers. Year-end audits were performed by personnel who were not involved with the recording of the accounting data.[2] Concern for this aspect of independence dates from 1941 when the Committee on Professional Ethics noted that the "technical and more or less mechanical task of writing up books from data submitted by a client may be performed by a certified public accountant without necessarily impairing his independence as auditor. Judgment must be applied to the circumstances of each case."[3] Evidently the Institute has consistently supported this attitude for more than twenty years.

There have been some misgivings within the profession with respect to the compatibility of the rules of professional conduct with tax practice. Some members of the Institute have wondered if a certified public accountant can assume the role of an advocator for his client in tax matters and still consistently retain his independence when auditing the records of that client. Again, there is considerable diversity of opinion on the matter.

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[1]Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," The Journal of Accountancy, CXIII (March, 1962), p. 33.

[2]Securities and Exchange Commission, Accounting Series Release No. 47, January 25, 1944, Accounting Series Releases, (1 to 52, Inclusive), p. 62.

[3]"Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1941 (New York: American Institute of Accountants, 1942), pp. 94-95.

That it is considered important by the Institute was demonstrated by the appointment of a ten-member advisory group to meet and work with the Committee on Professional Ethics on questions relating to the ethics of tax practice.[1] More recently the new Committee on Ethics of Tax Practice reported to the Council that, in its opinion, the rules of professional conduct which were in effect on February 1, 1960, were not specifically appropriate for tax practice.[2] The rule on independence was one of four rules which the new Committee recommended be specifically excluded from application to the area of tax practice. But the Committee on Professional Ethics deferred action on that recommendation because it believed the whole problem required more careful and exhaustive study.[3]

Concurrent Activities Incompatible With Public Accounting

A rule which prohibited a public accountant from participating in an activity which was inconsistent or incompatible with the practice of public accounting was among the rules of professional ethics which were adopted by the American Association of Public Accountants in 1907. John L. Carey has expressed the opinion that this rule was an adaptation of a similar provision which had been in force since 1880 in England and Wales.[4]

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[1]Report of the Committee on Professional Ethics, April 16, 1956, pp. 2-3, American Institute of Accountants, New York (in the files of the Institute library).

[2]Report of Committee on Ethics of Tax Practice, May 2, 1960, p. 3, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[3]Report of the Committee on Coordination of Tax Activities, Spring, 1961, p. 2, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[4]John L. Carey, Professional Ethics of Certified Public Accountants (New York: American Institute of Accountants, 1956), p. 208.

Only minor amendments have affected the rule since its adoption in 1907. In its present form, the rule was adopted in 1941 when the members of the American Institute of Accountants approved a general revision of the rules of professional conduct. Because no significant substantive change has been made in this rule, no useful purpose would be served by reproducing any of the earlier forms in addition to the current rule which follows:

> A member or associate shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.[1]

The literature of the profession does not explain, beyond the statement of the rule itself, the purpose of this restriction on the activities of a public accountant. It is nonetheless possible to fabricate a reasonable explanation which is consistent with the purpose of the English rule as described by Carey.

An avowed purpose of the American Association of Public Accountants, it will be recalled, was to promote the welfare of public accountants and to establish the professional status of public accountancy. Hence any individual activities which tended to detract from the status of the group as a whole were obviously detrimental to the best interests of the group. Changing the terminology slightly and the meaning of the observation not at all, this rule can be said to have served the function of preserving but not necessarily developing the professional image of certified public accountants. It was absolutely necessary to place some restriction upon public accountants in order to be able to say that the practice of public accounting was definable and that it met the various tests of professional status. Note that this function is still useful and is implied in the words of Carey: "The professional [sic] could not tolerate participation by any of its members in another vocation of a kind that would cast doubt on

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[1] By-Laws, Code of Professional Ethics, . . . (1962), p. 33.

their independence, integrity or professional attitude as certified public accountants."[1]

Before moving on to the other rules of conduct which have a bearing on the integrity of the professional image of certified public accountants, it will be useful to examine some aspects of the practical application of this rule. It is an interesting fact that the few references to this rule which appeared in the literature before 1943 made no explicit mention of the incompatibility of certain activities with the independence of certified public accountants either individually or as a group. Only since 1943 has the Committee on Professional Ethics of the American Institute emphasized in its interpretations of this rule the independent status of public accountants. Yet the significance of the concept of auditor independence had been demonstrated ten years earlier by the circumstances of the financial investment disciplinary trial of 1933.

In general, the application of the rule seems not to have been unduly restrictive as evidenced by the opinions expressed by the Committee on Professional Ethics. A certified public accountant was advised in 1945 that he would not necessarily violate the rule if he entered into a limited partnership in a brokerage firm which was "engaged in the purchase and sale of securities and commodities to the public on a commission basis . . . [but] an association of this kind would be inconsistent with standards of independence, and not in the best interests of the profession."[2] Perhaps that opinion was meant to imply that a member who engaged in this activity might be subject to discipline for conduct discreditable to the profession in accordance with the by-laws of the Institute. At any rate, that activity was not a violation of this rule. In another opinion,

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[1]Carey, p. 209.

[2]Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1944-1945 (New York: American Institute of Accountants, 1946), p. 88.

the Committee on Professional Ethics held that a practicing certified public accountant was not prohibited from being a licensed insurance broker and selling insurance. But the attention of the correspondent was directed to the possibility that a question might be raised as to the lack of independence of a member who carried on commercial insurance activities while practicing as a certified public accountant.[1] In a more strongly worded opinion, the Committee urged a public accountant not to attempt to act as an insurance broker for his auditing clients because it was believed that he could not maintain his independence in so doing.[2]

Two examples will now be cited which will give an indication of the kinds of activities which were permissible. It was considered appropriate for a certified public accountant to organize and to be actively involved in the internal management of a corporation which was engaged in the collection of past due business and professional accounts.[3] Similarly, a member was not prohibited from specializing in estate planning in his practice as a certified public accountant.[4]

From the preceding analysis it can be seen that the Committee on Professional Ethics has discouraged only those activities which were obviously in conflict with the independence of the auditor. In 1958 the Committee indicated in a formal opinion[5] that statistical tabulating services, which are similar to the write-up work or bookkeeping services

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[1]"Committee on Professional Ethics," American Institute of Accountants Annual Reports for the Year 1948-1949 (New York: American Institute of Accountants, 1949), p. 31.

[2]Report of the Committee on Professional Ethics, October 6, 1952, p. 9, American Institute of Accountants, New York (in the files of the Institute library).

[3]Ibid., p. 8.

[4]"Committee on Professional Ethics," April 1950 Reports to Council (New York: American Institute of Accountants, 1950), pp. 59-60.

[5]"Opinion No. 7: Statistical Tabulating Service," By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics. . . (1962), p. 40.

frequently rendered by many public accountants, are not incompatible with the practice of public accounting. This, of course, is entirely consistent with the previously discussed attitude of the Committee with respect to the dual service of a certified public accountant as auditor and bookkeeper for a single client.

Contingent Fees

Any agreement between a certified public accountant and his client which makes the fee for services rendered by the accountant dependent upon something which may or may not occur can be said to be a contingent fee. Without suitable clarification one might apply this concept to the typical per diem fee submitted by an accountant for audit services rendered. It could be argued that since receipt of this fee will depend upon the willingness and ability of the client to satisfy this debt, it is therefore a contingent fee. Thus any fee would be a contingent fee within the context of that interpretation and one would be faced with the necessity for developing criteria which would distinguish certain kinds of objectionable contingent fees from other contingent fees. In other words, all fees would be contingent fees, but some would and others would not be proper. Fortunately the concept of contingent fees in the public accounting profession is already restricted to certain fee arrangements which have been considered objectionable. These practices will be discussed below in connection with the development of the rule which partially prohibits the rendering of professional services for a fee which is contingent upon some future event.

Background of the Problem

It will be recalled that the question of contingent fees was one with which some members of the American Association of Public Accountants were very much concerned. But all attempts to secure the adoption of a

rule which would prohibit contingent fees were unsuccessful prior to 1919. Those were years in which public accountants were trying to convince businessmen that there was a need for the services which they had to offer. Advertising and other forms of publicity were widely used to bring to the attention of businessmen the existence of public accountants and the services which they had to offer. Equally understandable was the development of a practice which offered the public accountant a fee which was directly related to the gain accruing to the businessman as a result of the expert advice rendered by the accountant. With such an arrangement, the businessman could expect to avoid a fee for services which did not result in reduced costs or greater efficiency.

Notably such contingent fee arrangements had a ring of equity about them. After all, if a public accountant could reduce business costs or increase efficiency, should he not share in those savings? And if he could not provide a service which would result in a pecuniary gain for his client, why should he expect a monitary reward or a fee? Of course these arguments were acceptable to those who believed that public accounting was just another form of business enterprise. Those who rendered the services of public accounting on a business basis could see no objection to the fact that a contingent fee arrangement gave the accountant a financial interest in the results of his work. But many members of the Institute recognized that the pecuniary pressures of such fee arrangements would be detrimental to the integrity and objectivity of certified public accountants.

Development of an Unequivocal Rule

On September 15, 1919, the Committee on Professional Ethics recommended and the Council unanimously adopted the following rule:

> No member shall render professional service, the anticipated fee for which shall be contingent upon his findings and results thereof. This rule shall be construed as inhibiting only services in which the accountant's findings or expert opinion

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> might be influenced by considerations of personal financial interest.[1]

The phraseology of the rule implies that the primary motivation was a matter of enhancing a professional image through the establishment of an independent relationship between a public accountant and his client. Certainly an arrangement which tied the economic interest of the accountant to the outcome of his work would cast some doubt on his judicial attitude. That this is the proper inference is demonstrated by the following comment made by Carl H. Nau who was chairman of the Committee on Professional Ethics when the first rule on contingent fees was adopted. The reason for the adoption of the rule was explained by Nau as follows:

> The accountant occupies a judicial attitude toward the subject of his inquiry and work rather than the attitude of the advocate, he will readily appreciate that it would be expecting something more than human to look for calm and unbiased judgment if this judgment is to be exercised by a person whose fee is dependent upon the results of his judgment.[2]

The second sentence of the contingent fee rule qualifies what would otherwise be an unequivocal prohibition of contingent fee arrangements. This inconsistency seems to have been the result of mixed attitudes on the part of Council members with respect to contingent fees. On the one hand, it was considered that the rendering of professional services on a contingent fee basis was generally detrimental to the best interests of the profession. On the other hand, some members held the opinion that an accountant could properly render some services on a basis which was somewhat contingent upon the results of his work. Two examples of these kinds of services were mentioned: the installation of a system and a so-called efficiency engineering service. In such cases it was believed by

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[1]"Rules of Professional Conduct," 1919 Year-Book of the American Institute of Accountants (1920), p. 140.

[2]Carl H. Nau, "Growth of Professional Ethics," The Journal of Accountancy, XXXVII (January, 1924), p. 6.

some members of the Council that a portion of the economy or saving effected could properly form the basis for a charge for the service rendered.[1]

Almost immediately the new rule was the source of embarrassment and inconvenience for the Committee on Professional Ethics. The Committee reported in 1920 that during the year following the adoption of the rule it had received a number of complaints which involved contingent fee arrangements in relation to the preparation of tax returns and other services related to federal income and profits taxation. Some of these cases, the Committee warned, were a potential source of scandal for the American Institute.[2] Evidently the Committee believed it might be necessary to apply the rule to cases involving federal income taxation in which contingent fee arrangements seem to have been common practice. Unfortunately the Committee did not include a comment in its report with respect to the course of action which it recommended to the Council. But the action which was taken is recorded and is interesting. At this point it should be recalled that the rule had been adopted by the Council during the previous year, 1919, and it had been intended to permit the rendering of certain services for a contingent fee but apparently tax service was not one of these. Although the Council had the power to amend the rule just as it had the power to adopt such rules, it instead recommended to the members who attended the 1920 annual meeting that the rule be amended by deleting the second sentence. The rule was so amended.[3] After that amendment and another which was suggested by counsel and adopted by the Institute's Council in 1923, the rule reflected an unequivocal policy of opposition to contingent fee arrangements.

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[1]"Report of Committee on Professional Ethics," 1920 Year-Book of the American Institute of Accountants (1921), p. 118.

[2]Ibid., pp. 118-19.

[3]"Proceedings of the Annual Meeting," ibid., p. 70.

The 1923 version of the rule provided that:

> No member or associate shall render or offer to render professional service, the fee for which shall be contingent upon his findings and the results thereof.[1]

Because contingent fees had thus been unequivocally prohibited in connection with professional service, it is not surprising that the American Institute of Accountants adopted a resolution approving a related action by the United States Treasury Department and offered its cooperation.[2] This endorsement was extended to the provision of Treasury Department Circular No. 230 dated March 21, 1923, which provided that all attorneys or agents enrolled to practice before the Treasury Department in cases involving income and profits taxes must file specific declarations setting forth all facts pertaining to the arrangements with clients in which a contingent fee was involved. Alternatively, a general affidavit could be filed disclaiming any contingent fee arrangements. Some of the abuses which brought this regulation about were induced by the high tax rates which were said to have induced a significant increase in the number of claims for refund, abatement, and reconsideration. Because many of these actions were at best doubtful, contingent fee arrangements were entered into by "tax experts." Under the impetus of potentially large fees, many of the so-called experts helped further to increase the number of claims presented to the Treasury Department.[3] Whether or not members of the American Institute of Accountants were involved in these practices is not known. In any event, no evidence was found which suggested that a member of the Institute ever appeared before the trial board of the Institute on charges of having entered into a contingent

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[1]"Rules of Professional Conduct," 1923 Year Book of the American Institute of Accountants (1924), p. 199.

[2]Editorial, "Approved by Institute," The Journal of Accountancy, XXXV (May, 1923), p. 360.

[3]Editorial, "In Tax Practice," ibid., pp. 357-58.

fee arrangement although several complaints and inquiries were received by the Committee on Professional Ethics from time to time on questions of contingent fees.

Some public accountants cited certain exceptions to a rule of the American Bar Association as a basis for arguments that the American Institute rule on contingent fees should be modified.[1] An interesting comment was made by the editor of The Journal of Accountancy in reference to the incomplete prohibition of contingent fees by the legal profession: "Perhaps it may not be unreasonable for the accounting profession in a moment of elation to feel slightly superior to any profession in which the contingent fee is still tolerated."[2] In response to a defense of contingent fees by a lawyer-correspondent, the editor acknowledged that accountants also argued that many taxpayers could not afford to engage an accountant unless the latter agreed to a contingent fee. Observing that those who accept contingent fees seemed to be moved by a spirit of altruism, the editor commented as follows: "But, again, we are unable to distinguish between contingent fees and avarice or to accept avarice as an expression of benevolence."[3] But a more significant point was also made in this same editorial. While a lawyer is an advocate and an expert on legal evidence, the accountant should array the facts and serve as a witness without bias or prejudice. Thus the preparation of a case, whether in tax practice or another area of accounting, should be accomplished through the cooperation of a lawyer and accountant.[4]

Regressive Amendments: Some Contingent Fees Were Proper

An interesting series of events was initiated in 1933 when the

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[1]Editorial, "In Accountancy," ibid., p. 357.

[2]Editorial, "Why Not Prevent Injustice?" The Journal of Accountancy, XLVI (December, 1928), p. 442.

[3]Editorial, "A Lawyer's Views on Contingent Fees," The Journal of Accountancy, XLVII (January, 1929), p. 48.

[4]Editorial, "The Suspicion of Prejudice," ibid.

Committee on Professional Ethics received an inquiry from a prospective member. The potential member wished to know whether the rule on contingent fees of the American Institute would be applicable to his practice of representing taxpayers before the Bureau of Internal Revenue and the Board of Tax Appeals in return for fees which were contingent upon the tax benefits accruing to his clients as a result of his representation.[1] The Committee on Professional Ethics indicated that it believed the question was relevant to more than income tax practice. Hence the Committee asked the Institute whether it was proper for any member to apply his special skill and knowledge in a partisan manner as an advocate for a party involved in any controversy with the understanding that his fee would be entirely or partially contingent upon the degree of success achieved in the controversy by the client.[2]

The Committee on Professional Ethics reported that, in its opinion, the present rule did not prohibit the practice provided that the contingency did not rest on the "findings" of the accountant.[3] In support of its view, the Committee cited the personal opinions of ten members of the Institute who had responded to a request for an opinion on this question. Six of these respondents agreed with the Committee viewpoint, and four believed that it was an evasive interpretation of the rule. But all of these members were said by the Committee to have agreed that "except under such an interpretation the rule is commonly more honored in the breach than in the observance."[4] Recognizing the need for some kind of action which would not only clarify the policy of the Institute but also would take due cognizance of the practice of its members, the Committee on Professional

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[1]"Report of the Committee on Professional Ethics," 1933 Year-Book . . . , p. 227.

[2]Ibid., p. 228.

[3]Ibid.

[4]Ibid.

Ethics recommended that the rule be amended. Apparently unable to settle on one or the other of two alternatives, the Committee recommended that either the words "his findings" be deleted from the existing rule or a sentence be added to the present rule which "provided that the partisan position of the accountant is fully and openly recognized by all parties to the controversy."[1] Thus a contingent fee was unobjectionable provided that the contingency was a function of someone or some thing other than the accountant or his work.

No action seems to have been taken by the Council in 1933 on the recommended amendment of the contingent fee rule. Although no explanation was found for this failure to act, it should be remembered that this was the year in which sixteen members were summoned to appear before the trial board for having a financial interest in a client. But in 1934 the Committee on Professional Ethics reported that it recommended no change be made in the rule. In lieu of an amendment, the Committee had requested the editor of The Journal of Accountancy to publish an explanation of the existing rule. Of course that explanation made no mention of the fact that a revision of the rule had been considered.[2]

It is also interesting to note that this question appeared in the American Institute examination in auditing which was given during the month of May, 1934:

> You are asked by a client to undertake the recovery of an overpayment of federal income tax which was due to alleged errors in the return. As an inducement he offers to give you half the amount recovered as your fee. What would be your reply? Give your reasons.[3]

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[1]Ibid.

[2]Editorial, "Why Contingent Fees Are Condemned," The Journal of Accountancy, LVII (February, 1934), pp. 81-84.

[3]Editorial, "A Question of Ethics," The Journal of Accountancy, LVIII (July, 1934), p. 3.

The editor of The Journal of Accountancy pointed out that 70% of the candidates chose to answer an alternate question and out of eighty who answered this question, only one noted that "client" meant "a regular client." What is purported to be a proper reply to the question according to the personal opinion of a prominent practitioner is outlined by the editor. These six points were specified: (1) danger to the impartiality of the accountant, (2) possible overconscientiousness might damage the client rather than help his case, (3) danger in assuming the role of an advocate, (4) danger of loss of client confidence by accepting a contingent fee, (5) prohibited by the rules of professional conduct of the American Institute of Accountants, and (6) refuse any fee if the error is the fault of the accountant or accept a regular fee if the error is not the responsibility of the accountant.[1]

Apparently the Committee on Professional Ethics was still seeking an authoritative answer to its question in 1935, when it sought the advice of the Executive Committee with respect to an interpretation of the rule prohibiting contingent fees. The Executive Committee informed the Committee on Professional Ethics that only the Council was empowered to interpret the Rules of Professional Conduct. Anyway it seemed to the Executive Committee that the rules were stated in such a manner that each member should be prepared and willing to govern his actions under the rules according to his own best judgment.[2] This opinion was repeated by the Executive Committee in 1936 in response to an inquiry from the Board of Examiners of the American Institute.[3] A prospective member had indicated that he accepted tax cases on a contingent fee basis.

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[1]Editorial, "A Sad Lack of Knowledge," ibid., pp. 4-5.

[2]"Report of the Executive Committee," 1935 Year Book of the American Institute of Accountants (1936), p. 263.

[3]"Report of the Executive Committee," 1936 Year Book of the American Institute of Accountants (1937), pp. 423-24.

The Executive Committee answered that the applicant would have to subscribe to all the rules of conduct. Thus continued the period of indecision.

Finally a stand was taken when on October 19, 1936, the Council limited the scope of the rule which had, since 1920, appeared to prohibit contingent fee arrangements for all professional services rendered by members of the American Institute. To the rule was added the following sentence:

> This rule does not apply to cases such as those involving federal, state or other taxes, in which the findings are those of the tax or other similar authorities and not those of the accountant.[1]

A restatement of the rule on contingent fees was included in the recommendation of the Committee on Professional Ethics for the general revision of the rules of professional conduct in October, 1940. In addition to the revision of the first sentence, it was recommended that the exceptions of the second sentence for tax cases should be extended to "other matters" as well. Although the recommendations were approved in a mail ballot of the membership and became effective on January 6, 1941, the extension of the exceptions to "other matters" was revoked by the Council on October 20, 1941, on the recommendation of the Committee on Professional Ethics. However, a third sentence was added to the rule by the Council in October, 1941, in order to define certain fees which would not be considered to be contingent fees. All of these changes are reflected in the following:

> Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving federal, state or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.[2]

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[1] "Council: Regular Meeting, October 19, 1936," ibid., p. 352.

[2] "Reports of the Committee on Professional Ethics," Year Book . . . 1941, p. 87.

That rule was approved by the Council and the members who attended the 1941 annual meeting of the Institute. It became effective when it received the approval of a majority of the members of the Institute on a mail ballot. No important changes have been made in that rule since 1941.

It was reported in 1956 that the Committee on Professional Ethics intended to review the question: "Should not contingent fees in all matters be abolished?"[1] Assuming the question was indeed reviewed, the absence of further references to contingent fees in subsequent years is strong support for the presumption that the question received a negative answer.

Definition of Contingent Fees

Despite the fact that the American Institute has had a rule on contingent fees for more than 40 years, the term contingent fees has not been explicitly defined. On the basis of the evolution of the applicable rule, it can be seen that a contingent fee arrangement is one in which the size or existence of the fee is dependent upon the occurrence of some event, the results of the work of some person, or the studied conclusions of some individual. But when the term is applied to members of the American Institute, the definition must also provide that the factors which determine the size or existence of the contingent fee can be influenced by the public accountant whose fee is a function of one or more of those factors. If the accountant cannot influence the existence of or the amount of the fee, the arrangement is not prohibited as a contingent fee agreement.

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[1]News Report, "The Matter of Ethics," The Journal of Accountancy, CI (January, 1956), p. 6.

Commissions, Brokerage, and Fee Participations

The financial interest of public accountants in their clients has not been restricted to an investment in or a loan to a client enterprise. Nor has it been limited to the pecuniary interest in contingent fees. Apparently from the earliest days of the profession a problem was created by those public accountants who either paid someone a fee for having referred a client to the practitioner or received a payment from someone for whom the practitioner had performed a similar favor. The elimination of such arrangements was the purpose of one of the first two rules of conduct adopted by the American Association of Public Accountants on November 10, 1905.[1] A similar rule was adopted as a part of the rules of professional ethics which were adopted by the Association in 1907.[2] But the 1907 rule in contrast with the 1906 rule (see Chapter II for the text of these rules) involved only the payment of a monetary amount by a public accountant. A public accountant was not prohibited from receiving such monetary rewards.

On April 9, 1917, the Council of the newly organized American Institute of Accountants adopted a rule which prohibited such payments whether they were received by or paid by a member of the professional organization. That rule follows:

> No member shall directly or indirectly allow or agree to allow a commission, brokerage, or other participation by the laity in the fees or profits of his professional work, nor shall he accept directly or indirectly from the laity any such commission, brokerage or other participation for professional or commercial business turned over to others as an incident of his services to clients.[3]

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[1]"Constitution and By-Laws," The American Association of Public Accountants Nineteenth Anniversary Year-Book (1906), p. 85.

[2]"Constitution and By-Laws of the American Association of Public Accountants," . . . Year-Book (1907), pp. 238-39.

[3]James Don Edwards, History of Public Accounting in the United States (East Lansing, Mich.: Bureau of Business and Economic Research, Michigan State University, 1960), p. 256.

An amendment of the rule was proposed by the Committee on Professional Ethics in 1940 and was adopted by the members of the Institute in 1941. Since 1941, several changes have been made in the statement of the rule but none of these revisions is significant for the purpose of the present discussion. Therefore, it is the present version of the rule which follows:

> Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member or associate.
>
> Commissions, brokerage, or other participation in the fees, charges or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member or associate.[1]

Practical Applications of the Rule

Examples of the behavior which justified the adoption and the continued existence of this rule appear in the illustrations which follow:

> We can make you an attractive proposition whereby we give you 5% commission on any contracts your clients may give us at your instance, or if you prefer you can make the contracts direct with your clients and sublet them to us, in which case we would give you the quotation.[2]
>
> Believing you are in a position to use a considerable quantity of these goods when installing systems for your clients we have arranged to allow public accountants a special discount of 33 1/3% from the regular retail price of these goods. Please remember this is a confidential discount to accountants and in no instance to be quoted to the customers, otherwise we reserve the right to immediately cancel your discount.[3]
>
> Is it ethical for a member of the Institute to accept a split commission with a broker, when he has obtained for his client a loan from such broker, this particular transaction having no relationship to his practice as a public accountant?[4]

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[1] By-Laws, Code of Professional Ethics. . . (1962), p. 32.

[2] Editorial, "Professional Ethics," The Journal of Accountancy, XXVIII (December, 1919), p. 451.

[3] Editorial, "Commissions Again," The Journal of Accountancy, XXXVIII (December, 1924), p. 445.

[4] "Report of Committee on Professional Ethics," 1926 Year Book . . . , p. 169.

> We are happy to state that we have been able to pay many thousands of dollars in commissions to accountants who have referred issues to us and we hope this may be the means of establishing a profitable business relationship with you.[1]

In addition to those examples, the Committee on Professional Ethics has also ruled that a member of the American Institute is prohibited from accepting from a commercial banker an offer of 10% each month of the gross income from any customer which had been referred to the banker by the accountant.[2] Similarly, a member would violate this rule (as well as the confidential relationship between himself and his client) if he received a commission from a national finance company for having furnished a list of companies which were in need of financing.[3]

Two examples of situations which have not been considered violations of the rule involve payments by a firm on behalf of a deceased partner. Payments which are made to the widow of a deceased partner, even though they are calculated as a percentage of current fees, represent the purchase of good will rather than a division of fees with the laity.[4] A partnership agreement may properly provide that the capital of a deceased partner must be paid to his estate together with a share of the profits of the firm for a period of five years.[5] In a third case it was said that a lawyer and an accountant were not prohibited from a division of fees after they had worked together in the preparation of a case.

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[1]Editorial, "Thousands in Commissions," The Journal of Accountancy, LIII (February, 1932), p. 90, quoting a circular letter from a firm of brokers in New York.

[2]"Reports of the Committee on Professional Ethics," Yearbook . . . 1941, p. 95.

[3]"Professional Ethics," The Certified Public Accountant, (January, 1947), p. 4.

[4]"Reports of the Committee on Professional Ethics," 1940 Yearbook . . . , p. 146.

[5]"Report of the Committee on Professional Ethics," Yearbook . . . 1943-1944, p. 144.

But it was considered preferable by the Committee on Professional Ethics that lawyers and accountants make individual arrangements for their compensation by a client.[1]

The rule on commissions seems never to have been the subject of a public controversy. Indeed, it was not until 1957 that a concern was expressed in the literature about the fact that no one had yet bothered to define the word "laity" which had been a part of the rule for 40 years. At that time, the Committee on Professional Ethics reported that it planned to expose to the membership a proposal to delete "laity" from the rule and in its place substitute the words "any individual or firm not in the public practice of accounting."[2] Thomas G. Higgins, who was then a member of the Committee on Professional Ethics, acknowledged a different basis for distinction when he wrote that it seemed reasonably clear that "laity" included non-accountants who were not members of any recognized profession. According to that interpretation, laity did not include such professional men as lawyers and engineers.[3]

Perhaps those conflicting views are indicative of a difference of opinion among the members of the Committee on Professional Ethics. The phrase recommended by the Committee would seem to exclude lawyers and engineers because as such they are not public accountants. However, this seems not to have been the intent for in January, 1958, the Committee issued a formal opinion on the concept of "laity." There the Committee wrote, a firm of certified public accountants could properly coordinate

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[1]"Reports of the Committee on Professional Ethics," Yearbook . . . 1941, p. 91.

[2]Report of Committee on Professional Ethics, April 15, 1957, p. 4, American Institute of Accountants, New York (in the files of the Institute library).

[3]Thomas G. Higgins, "Division of Fees," The Journal of Accountancy, CIII (January, 1957), p. 50.

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work with an engineering, legal or other professional firm on a single project provided that the accounting firm took care neither to extend its services beyond its particular field nor to fail to make clear the limitations of its responsibility for services rendered.[1] Although the partnership of a certified public accountant and a non-certified public accountant is not prohibited, the Committee indicated that it hoped the day would come when all public accounting partnerships would be composed of certified public accountants.

It is noteworthy that the Committee on Professional Ethics has expressed a favorable attitude toward the cooperative services of a firm of certified public accountants and another professional firm on specific projects. But it has not indicated whether such temporary arrangements between an individual certified public accountant and another individual professional practitioner would be acceptable, although it has indicated that permanent agreements (partnerships) between such individuals ultimately should be prohibited. These statements illustrate a frustrating situation. On the one hand, partnerships with certain non-certified public accountants are considered to be undesirable for the profession. On the other hand, partnerships with non-certified specialists in management services could have a practical value. From this analysis it is clear that the problem is fundamentally a question of permissible partnerships. More specifically, the problem is related to the belief "that in the management field many clients would profit if they could be served jointly by accountants and engineers under one fee arrangement."[2]

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[1]"Opinion No. 6: Concept of 'Laity' in Sharing of Fees," By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics, . . . (1962), p. 39.

[2]Report of the Committee on Professional Ethics, April 16, 1956, p. 5, American Institute of Accountants, New York (in the files of the Institute library).

Referral Fees

Significantly, however, the rule on commissions does not prohibit two or more members of the American Institute of Certified Public Accountants from splitting or sharing a fee among themselves. Such fees are sometimes called forwarding or referral fees. A referral fee is one which is paid or allowed by one certified public accountant to another because the latter referred a client to the former for a professional service. As an example, there is a small firm in San Francisco, California, which operates a tax department under the direction of a partner who has specialized in tax accounting. The firm provides the services of its tax department to other practitioners for a fee which is 80% of the regular rate which the firm would charge an ordinary client for that particular service. In turn, the referring firm charges the client the normal rate for the service performed. Hence the referring firm in effect receives a referral fee which is equal to 20% of the normal fee which is billed to the client.[1]

Referral fees were explicitly approved by the Committee on Professional Ethics in 1941. However, it was made clear that there was no obligation on the part of the accountant who had been recommended to pay a referral fee if it had not been subject to a prior agreement. "Payment of forwarding fees is entirely proper when arranged in advance with acquiescence of both accountants, but it would be undesirable to encourage expectation of a commission merely for suggesting another accountant's name, without prior arrangement."[2] Another minor qualification was

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[1]Practitioners Forum, "Referrals in Specialized Fields," The Journal of Accountancy, CX (November, 1960), p. 77.

[2]"Reports of the Committee on Professional Ethics," Yearbook . . . 1941, p. 94.

added when it was noted in an official publication of the Institute that a referral fee was proper provided that it was reasonable in amount. A reasonable referral fee was one which would "not be so great as to allow only a small margin of profit to the firm doing the work."[1] From these comments it is clear that on the one hand, a referral fee is one which is paid or allowed by one accountant to another. If the fee has been agreed upon in advance and if it is not unreasonable in amount, such arrangements are considered as being both legitimate and proper. On the other hand, a referral fee paid by an accountant to someone other than another public accountant is a commission, brokerage, or other participation in the fees of professional work and as such it is inconsistent with professional conduct.

At least two members of the profession have been unable to accept the distinction which makes a referral fee proper when paid to another public accountant but improper when it is paid to a non-accountant. Professor Lawrence, after a thorough analysis of the issue, recommended that the rule be amended to prohibit a member of the American Institute from allowing to or accepting from any person a commission, brokerage, or fee participation which was based solely on the referral of engagements.[2] That recommendation was not intended to prohibit a fee which was based on valid and useful services which had been rendered. Aside from the moral question involving a fee for which no professional service has been performed "there is always the possibility that the firm which does the work will try to collect an additional 10 per cent from the client or tailor the job to fit the reduced fee."[3] No official recognition seems

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[1]CPA Handbook, Chapter 5, p. 12.

[2]Charles Lawrence, "Professional Responsibilities in Referral Fees," The Journal of Accountancy, CVI (September, 1958), p. 59.

[3]Norman G. Maiden, "Referral Fees," (Letter), The Journal of Accountancy, CVI (November, 1958), p. 28.

to have been given by the profession to these objections to referral fees.

Although the public accounting profession believes that referral fees are proper for its members, public accountants have been willing to help the medical profession to raise its standards by eliminating "fee-splitting" and "kick-backs." Independent auditors were engaged by an organization of surgeons in Columbus, Ohio, to audit the accounting records and tax returns of its members for purposes of enforcing a ban on fee-splitting. It was reported that those surgeons who refused to agree to have their records audited were considered to have admitted splitting their fees. Certified public accountants also audited the books of medical doctors in Iowa when an effort was made by the American College of Surgeons to stop fee-splitting by physicians and surgeons in that state.[1]

Perhaps it is worthy of note that referral fees or kick-backs are, in general, deductible expenses for federal income tax purposes provided that (1) such payments are normal, usual, and customary in the particular profession and community; (2) the payments are appropriate and helpful in obtaining business; and (3) the practice does not conflict sharply with national or state policies as defined in governmental declarations.[2] The public accounting profession seems to be in a position to meet each of these tests. Perhaps the fact that referral fees are deductible for tax purposes is related to the fact that the public accounting profession has not found it necessary to abolish referral fees.

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[1]News Report, "Surgical Fee Splitting," The Journal of Accountancy, XCIX (February, 1955), p. 14. It is interesting to note that the terms "kick-back" and "fee-splitting" are used here where the discussion involves the practice of the medical profession. Typically, when these arrangements are discussed with reference to the public accounting profession, the terms "referral fees" and "forwarding fees" are used. The connotative implications are obvious.

[2]Current Notes, "MDs, CPAs Cooperate in Raising Ethical Standards of the Medical Profession," The Journal of Accountancy, XCIV (November, 1952), p. 540.

Summary

The rules of conduct which have been discussed in this chapter are expressions of the minimum standards of professional integrity applicable to members of the American Institute of Certified Public Accountants. However, it appears that there are at least two definitions of the concept of integrity which are equally applicable to certified public accountants. On the one hand, there is the definition of integrity which implies a basic honesty or soundness of moral character. That meaning of integrity obviously is equally applicable not only to public accountants but also to all of the professions. On the other hand, integrity is also defined as the state or quality of being unimpaired and undivided. The latter definition is uniquely applicable to the audit function of certified public accountants. Furthermore, it is this concept of integrity which unifies the rules on independence, incompatible activities, contingent fees, and commissions.

Independence is the sine qua non of professional auditors. The public accounting profession, which has emerged to perform the audit function in our economy, has made significant improvements in its standards of independence. On the basis of the evidence presented in this chapter, it is obvious that the Securities and Exchange Commission has had an important and beneficial influence on the profession's emergent standards of independence. Contrary to the general trend, there is reason to suspect that the public accounting profession may have prevailed upon the Securities and Exchange Commission to shift temporarily from its prohibition of any financial interest in a client to a prohibition of a "substantial" financial interest.

Although the significance of the concept of independence was recognized by several pioneer public accountants prior to 1907, it was not until 1933 when a serious indiscretion was committed by sixteen members of the Institute that the organization restricted the financial investment of its members in their clients. Finally, in 1941, the Institute approved a

formal rule of conduct which imposed certain limitations on the financial interest of members in their clients. On January 1, 1964, members of the Institute will be bound by a rule which significantly increases the standards of financial independence and introduces other important tests of independence. Adoption of the most recent rule suggests that the public accounting profession will ultimately abandon its adherence to the "state of mind" concept of independence in favor of a set of operational standards.

Very early in the development of the public accounting profession, it was recognized that contingent fee arrangements were potentially incompatible with the independent attitude of the public accountant. But it was not until 1923 that members of the Institute were prohibited from entering into such agreements. However, many members of the Institute questioned the wisdom of that rule when it became evident that contingent fee arrangements were particularly well-suited to tax engagements. In 1941, after a long period of indecision, the Institute formally permitted its members to accept contingent fees for tax engagements and fees which were determined by courts or other public authorities.

Circumstances have altered the purpose but not the importance of the rule on commissions. One of the first rules of conduct adopted by the American Association of Public Accountants and its successor organization, the rule was obviously necessary in order to restrict certain practices which were inconsistent with either of the definitions of integrity. Although the rule had been frequently cited by the Committee on Professional Ethics, it was not until 1958 that the word "laity" was defined. Yet it is that word which has been fundamental to the application of the rule for many years. Rather than adopt an explicit policy on permissible partnerships, the Institute has used the rule to achieve some control over conglomerate partnerships. Partnerships involving certified and non-certified public accountants are believed to be undesirable and may ultimately be prohibited. But working arrangements between certified

public accountants and members of certain other professions do not conflict with the goals of the Institute. The rule on commissions does not restrict the payment or allowance of commissions between members of the Institute. Despite the fact that the public accounting profession calls these referral fees, such arrangements are essentially commission agreements and seem to be remarkably similar to the kick-back or fee-splitting problem of the medical profession.

CHAPTER IV

PROFESSIONAL STANDARDS AND RESPONSIBILITIES

Reporting Responsibilities

Adoption and Development of a Rule

By 1917 the attention of the emergent public accounting profession was being directed ever more frequently to its responsibility to the public in contrast with the earlier attitude of many public accountants. As an example of this change, a special committee of the Institute had cooperated with the Federal Trade Commission in the preparation of a general statement on auditing and the preparation of balance sheet statements. The Council of the American Institute unanimously approved that statement and it was published in the April, 1917, issue of The Federal Reserve Bulletin. In view of the increasing emphasis on the public reporting function of public accountants, the adoption of a minimum standard of professional responsibility was a natural development. Adopted on April 9, 1917, was the first version of the reporting responsibility rule which follows:

> The preparation and certification of exhibits, statements, schedules, or other forms of accountancy work, containing an essential mis-statement of fact, or omission therefrom of such a fact as would amount to an essential mis-statement shall be, ipso facto, cause for expulsion, or for such other discipline as the Council may determine, upon proper presentation of proof that such mis-statement was either willful or was the result of such gross negligence as to be inexcusable.[1]

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[1]James Don Edwards, History of Public Accounting in the United States (East Lansing, Mich.: Bureau of Business and Economic Research, Michigan State University, 1960), p. 255.

Experience in the application of this rule was quickly gained by the Committee on Professional Ethics. The Committee received numerous complaints which were resolved without the necessity of trial board action.[1] However, two members did appear before the trial board in 1917 under the provisions of this rule. These two members were admonished and suspended from membership for thirty days.[2] Again in 1918, four members of the Institute who were partners were tried under the provisions of this rule. One of these members was suspended for six months. Each of the other three were suspended for three months.[3] On September 20, 1920, another member was found guilty of a violation of the provisions of this rule but in view of his penitent attitude, no punishment was added to the admonishment which was given to him by the trial board.[4]

As a result of these experiences with the new rule, the Committee on Professional Ethics recommended in 1919 that several rather minor changes be made in the rule. The Council approved these revisions and, in 1920, also approved the recommendation by the Committee that the rule be amended by adding a clause which would require disclosure by the auditor of material facts not specifically presented in the balance sheet. The amended version of the rule follows:

> The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential

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[1] "Report of the Committee on Professional Ethics," 1917 Year-Book of the American Institute of Accountants (1917), p. 174.

[2] "Council: Regular Meeting, September 17, 1917," ibid., p. 74.

[3] "Council: Regular Meeting, September 16, 1918," 1918 Year-Book of the American Institute of Accountants (1918), p. 72.

[4] "Council: Regular Meeting, September 20, 1920," 1920 Year-Book of the American Institute of Accountants (1921), p. 78.

> or material fact not specifically shown in the balance-sheet itself, [italics mine] shall be, ipso facto, cause for expulsion or for such other discipline as the council may impose upon proper presentation of proof that such misstatement was either wilful or the result of such gross negligence as to be inexcusable.[1]

Reaction to New Pressures

No major problems seem to have been encountered in the administration of the new rule by the Committee on Professional Ethics during the decade following 1920. However, the economic pressure brought about by the deterioration of the securities markets and the deepening of the depression seem to have had a particularly significant impact on the public accounting profession. In its report for the year 1932, the Committee indicated that the increasing public attention which was being directed to the certificates and reports of public accountants made it even more important to prevent members from bringing discredit to the Institute by certifying misleading financial statements or statements which were not as informative as they were purported to be.[2] Three cases were cited as being typical of the large volume of complaints: (1) a corporation balance sheet did not indicate that an increase in assets was the result of a revaluation of leaseholds, (2) a parent corporation in its consolidated balance sheet included an asset based upon a ficticious write-up of a subsidiary stock, and (3) an accountant who substituted a synonym for a common expression later argued that an entirely different meaning was intended.[3]

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[1] Ibid., p. 79.

[2] "Report of the Committee on Professional Ethics," 1932 Year Book of the American Institute of Accountants (1932), p. 217.

[3] Editorial, "Some of the Short-Comings," The Journal of Accountancy, LIV (September, 1932), p. 162.

Soon, the Committee on Professional Ethics found that it was neither in a position to resolve the complaints through discussions with the members nor was it considered practicable to submit certain of these complaints for trial. The reason for this dilemma was that the "omissions amounting to essential misstatements have had such a degree of sanction by usage as to make it unfair for the accountants involved in these cases alone to be brought to trial."[1] Consequently, the Committee suggested that the profession make certain authoritative pronouncements which would not only provide a guide for individuals but also serve as a standard in the evaluation of complaints. It was suggested that these pronouncements should take the form of resolutions adopted by the Council and published with the rules of professional conduct. In accordance with this recommendation, the Committee submitted four proposed resolutions which dealt with the following: (1) charges to surplus or reserve accounts which were material in amount relative to the net worth of that period, (2) disclosure of the difference between the stated value of capital stock and the dollar amount received for shares which had been sold, (3) disclosure of surplus credits arising from sources other than undistributed net income, and (4) a requirement that each item in a financial statement should be accompanied by a direct reference to any footnote or memorandum which may have been included as an explanation or comment on that item.[2] The subject matter of these resolutions indicates clearly that the efforts of the Committee on Professional Ethics were being frustrated because it had no standard by which it could evaluate questions involving matters of accounting procedure.

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[1] "Report of the Committee on Professional Ethics," 1933 Year Book of the American Institute of Accountants (1934), p. 226.

[2] Ibid., p. 227.

Apparently the majority of the members of the Council of the Institute were not convinced that the course of action which had been suggested by the Committee on Professional Ethics was appropriate in the circumstances. The four resolutions were referred for study to the new Special Committee on Accounting Procedure in consultation with the Committee on Professional Ethics. Following a year of consultation and study, the Committee on Professional Ethics reported that it unanimously acquiesced with the consensus of the Special Committee on Accounting Procedure that individual cases under this rule of conduct should be handled on an ad hoc basis because it was impracticable to enumerate specific causes of complaint beforehand.[1] It is significant that this action did nothing to provide the Committee on Professional Ethics with the standards which it needed to evaluate the reasonableness of financial statement disclosures.

Various efforts were made between 1934 and 1937 to encourage the cooperation of the Committee on Professional Ethics and the Special Committee on Accounting Procedure with respect to certain questions dealing with accounting technique and procedure. This intended collaboration was formalized when the Council adopted on October 15, 1934, a formal resolution which empowered the Committee on Professional Ethics "to submit to the special committee on accounting procedure for its opinion any question upon which the committee on professional ethics wishes advice, and thereupon the special committee on accounting procedure shall render to the committee on professional ethics a decision upon the questions so submitted."[2]

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[1] "Report of the Committee on Professional Ethics," 1934 Year Book of the American Institute of Accountants (1935), p. 252.

[2] "Report of the Executive Committee," 1935 Year Book of the American Institute of Accountants (1936), pp. 263-64.

Very shortly after this arrangement had been established, the Committee on Professional Ethics requested the opinion of the Special Committee on Accounting Procedure on a question. But the latter Committee was unwilling to express an opinion because the question involved an interpretation of the rules of professional conduct. Thus it was recognized by some members of Council that the intended cooperation of these two committees was impossible because on the one hand, the Committee on Professional Ethics was unwilling to answer questions concerning accounting procedure and on the other hand, the Special Committee on Accounting Procedure refused to express itself on questions involving the rules of professional conduct. Consequently, an attempt was made to have the Council rescind the resolution which provided for the cooperation of these two committees with respect to complaints alleging a violation of the rules. However, the recommendation was not adopted by the Council and the formal procedure which resulted in a division of responsibility was allowed to remain in effect.[1]

The cooperative arrangement seems to have been allowed to die a natural death after the Committee on Professional Ethics in 1937, pointed out the difficulty which it encountered in attempting to explain to various persons what was or was not good accounting practice. At that time, the Committee expressed the belief that the functions of passing judgment on questions of accounting procedure should be delegated either to the Committee on Accounting Procedure (then a standing committee) or to the Special Committee on Cooperation with the Securities and Exchange Commission in those cases in which the Commission was involved.

A tribute to the significance of the rule on reporting responsibilities is evident in the comment of the Committee on Professional Ethics that most of the total number of complaints which it received alleged a

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[1] "Council: Regular Meeting, October 14, 1935," ibid., p. 204.

violation of this particular rule. Furthermore, a majority of these complaints were based on the findings of the Securities and Exchange Commission in stop-order proceedings.[1]

Significant Revisions of the Rule

Several significant developments caused the Committee on Professional Ethics of the American Institute of Accountants to recommend that a major revision be made in the rule on reporting responsibilities. For example, the phraseology of the old rule was such that the Committee was not sure just which offenses were actually banned by the rule. Accordingly, a major reason for amendment was the clarification of the rule.[2] In addition, however, it was also considered necessary to bring the rule into agreement with two important statements which had been published by the Institute: Examination of Financial Statements (1936) and "Extensions of Auditing Procedure" (1939).[3] The new rule, which became effective January 6, 1941, follows:

> In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall be held guilty of an act discreditable to the profession if:
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> (a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
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> (b) He fails to report any material misstatement known to him to appear in the financial statements; or
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> (c) He is grossly negligent in the conduct of his examination or in making his report thereon; or
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> (d) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an

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[1] "Report of the Committee on Professional Ethics," 1937 Year Book of the American Institute of Accountants (1938), p. 475.

[2] Frederick H. Hurdman, "Ethics of the Accounting Profession," The Journal of Accountancy, LXXII (November, 1941), p. 414.

[3] "Council: Regular Meeting, October 14, 1940," 1940 Yearbook of the American Institute of Accountants (1941), p. 51.

opinion; or

(e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.[1]

In terms of the practical applications of this rule, Frederick H. Hurdman, who was then chairman of the Committee on Professional Ethics, wrote in 1941 that this rule was the most important of all the rules of professional conduct and that cases involving an alleged violation of this rule were the most difficult cases which the Committee had to consider.[2] Hurdman also wrote that most of the complaints which involved violations of this rule were referred to the Committee by the Securities and Exchange Commission.

Regarding a comparison between the findings of the Securities and Exchange Commission and the Committee on Professional Ethics of the American Institute, Hurdman had this to say: "We do not always agree with the view of the Commission, and when we do agree we do not always conclude that the matter involved is of sufficient importance to warrant a finding of prima facie violation of our by-laws or the rules of professional conduct."[3] Unfortunately the public record of the disciplinary action taken by the Committee on Professional Ethics and the trial board of the American Institute does not consistently contain data which would permit an objective, detailed comparison of the variation between the reporting standards applied by the Securities and Exchange Commission and those of the American Institute. However, taken as a whole, the material which is available suggests that the American Institute seldom agreed with the conclusions of the Securities and Exchange Commission.

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[1]"Rules of Professional Conduct," ibid., p. 533.

[2]Hurdman, The Journal of Accountancy, LXXII (November, 1941), p. 414.

[3]Ibid.

To be sure, this point of view is not necessarily in conflict with the comment made by Hurdman that the Institute did not always agree with the Commission. Obviously, however, the method of expression chosen by Hurdman leads to an inference of near-agreement which is manifestly unwarranted by the available evidence.

In support of that view, it is pertinent to note that during the five years, 1937 through 1941, seven members appeared before the trial board of the Institute on charges of having violated the rule on reporting responsibilities. Many complaints had been considered by the Committee on Professional Ethics, but only seven were submitted to the Council for a trial board hearing. Four of the members involved in these hearings were found guilty and were given punishments which varied from an admonishment to a suspension of membership for two years. The remaining three members were found not guilty although one of them was admonished by the trial board to refrain from similar acts in the future.[1] Those actions are consistent with the policy of the Committee on Professional Ethics as expressed by Hurdman: "Except where willful misstatement or carelessness existed, resulting in omission of material facts, we have not considered that we should submit cases to the council."[2]

The Executive Committee of the American Institute of Accountants in 1950 requested a special committee to suggest a revision of the rule on reporting responsibilities. In accordance with that request, the special committee suggested that "may" be substituted for "shall" in the basic section of the rule and that "materially" be substituted for "grossly"

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[1]The actions to which reference is made are recorded in the following reports of trial board action. "American Institute of Accountants Trial Board," The Journal of Accountancy: LXIII (June, 1937), p. 448; LXV (June, 1938), p. 465; LXVI (December, 1938), p. 360; LXX (July, 1940), p. 8; and LXX (December, 1940), pp. 487-88.

[2]Hurdman, The Journal of Accountancy, LXXII (November, 1941), p. 415.

in subsection (c) of the rule. That recommendation was approved by the Council and became effective on December 19, 1950, after it had been approved by the membership of the Institute. Those changes appear in the current version of the rule which follows:

> In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if
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> (a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
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> (b) he fails to report any material misstatement known to him to appear in the financial statement; or
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> (c) he is materially negligent in the conduct of his examination or in making his report thereon; or
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> (d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or
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> (e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.[1] (Italics mine.)

With respect to the first of these changes, the imperative form of the rule was unsatisfactory because "the trial board should be allowed discretion in determining whether the degree of materiality involved in alleged violations under this rule is sufficient to cause it to hold the member guilty of 'an act discreditable to the profession'."[2] Equally important is the second change. In this case, the problem was said to

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[1]By-Laws, Code of Professional Ethics, Numbered Opinions of the Committee on Professional Ethics, Objectives of the Institute Adopted by Council (New York: American Institute of Certified Public Accountants, 1962), pp. 30-31.

[2]"Report of Special Committee (Appointed to Review Trial Procedures)," Annual Reports for the Year 1949-50 (New York: American Institute of Accountants, 1950), p. 32.

be the result of the legal connotation of the phrase "grossly negligent." A finding by the trial board that a member was "grossly negligent" might be considered equivalent to fraud and, on the basis of the Ultramares decision, the liability of the accountant could be extended to third persons.[1]

Questions Regarding the Scope of the Rule

An unfortunate situation confronted the Committee on Professional Ethics of the American Institute in 1947. A member had apparently been grossly negligent when "answering in the negative the question on a federal corporation income tax return as to whether the corporation was a personal holding company."[2] However, the Committee was without power to act because the rule on reporting responsibilities, which was the only rule pertaining to gross negligence, was only applicable to a formal opinion on representations in financial statements which had been examined by the accountant. Consequently, the Committee asked the Institute Council for an opinion on the question of the extension of this rule to cover gross negligence in the preparation of federal income tax returns.

In response to this request, a special committee was appointed to consider this question in addition to the possible revision of another rule. This Committee reported its recommendations on November 3, 1947.[3] Consideration was given by the committee to the question of applying the two major tests for lack of quality--existence of gross negligence and a

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[1] Ibid.

[2] "Committee on Professional Ethics," Yearbook American Institute of Accountants 1947 (New York: American Institute of Accountants, 1948), p. 98.

[3] "Special Committee to Consider Rules 5 and 7," ibid., pp. 102-104.

failure to disclose material facts or misstatements--to the work of certified public accountants in areas other than auditing. "Such areas would include, for example, (a) long form or other reports containing financial statements submitted without expressions of opinion, (b) reports of special investigations, (c) reports of recommendation as to systems of internal control or cost systems, (d) preparation of tax returns, (e) preparation of tax briefs."[1]

The special committee report with which the Council concurred, contained a recommendation that no change be made in the existing rule. The committee cited four reasons for this conclusion. The major reason for the belief that the rule should not be extended was the absence of generally accepted standards which could be used to evaluate special reports of investigation or reports and recommendations relative to a system of internal control or a cost system. Related to that reason was the potential source of embarrassment to a member who might have to prove to a jury of laymen in a court of law the existence of generally accepted principles applicable to special investigations, cost system design, and tax practice. A third reason was found in the difficulty which would be encountered in any attempt to distinguish between gross negligence and inferior technical competency. Also it was pointed out that the requirement for disclosure in these other areas of work performed by a certified public accountant meant little more than a general requirement for honesty. Finally, the committee pointed to the fact that complaints involving questions of gross negligence, lack of independence, or moral turpitude in areas of professional work other than auditing could be resolved under the general disciplinary provisions of the by-laws which provide for the punishment of an act which is discreditable to the profession.

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[1]Ibid., p. 103.

Another major interpretation of the rule on reporting responsibilities was made necessary when a detailed inquiry was submitted on July 29, 1958, by Leonard Spacek, the senior partner of Arthur Andersen and Company.[1] That inquiry involved the applicability of subsection (e) of the rule on reporting responsibilities to the recently published financial statements of five railroad corporations. Specifically, Spacek asked whether the rule was "violated if an auditor's certificate on financial statements of a railroad states that the statements are in conformity with accounting principles and practices prescribed or authorized by the Interstate Commerce Commission without making any reference to generally accepted accounting principles."[2] A letter, which was dated March 23, 1959, from the Committee on Professional Ethics informed Mr. Spacek that the audit reports which he had questioned were not in conflict with the provisions of the reporting responsibilities rule. There were two reasons for this conclusion. First, the Committee believed there was a strong presumption that the accounting procedures prescribed by the Interstate Commerce Commission for railroad companies constitute generally accepted accounting principles for that industry. Secondly, it was noted that there had been no authoritative statement by the Committee on Auditing Procedure of the American Institute of Accountants which prescribed reporting standards for the special reporting problem posed by the regular financial statements of the companies in regulated industries. The Committee noted that in the absence of such authority, the validity of any reporting practice must be based on general use and acceptance. On this point, the Committee found "that of 48 railroads

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[1]The text of the response to this inquiry can be found in the Report of the Committee on Professional Ethics, October 23, 1959, Exhibit A (four separately numbered pages), American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[2]Ibid., p. 2.

whose 1957 financial statements were certified by 8 different accounting firms only the 5 railroads certified by Arthur Andersen & Co., included reference to generally accepted accounting principles."[1]

A recent opinion of the Accounting Principles Board of the Institute could stimulate another examination of the question of the applicability of the phrase "generally accepted accounting principles" to the financial statements of companies in the regulated industries. The Board advised the Committee on Insurance Accounting of the American Institute that the financial statements of fire and casualty insurance companies

> when prepared in accordance with insurance commission accounting requirements do not necessarily present financial position and operating results in accordance with generally accepted accounting principles. When they are not in accordance with generally accepted accounting principles, the auditor's opinion should so state.[2]

It may be that the basis for that opinion of the Accounting Principles Board will lead the Committee on Professional Ethics to abandon its general use and acceptance criterion. Or perhaps the opinion of the Accounting Principles Board constitutes an authoritative statement on a reporting standard which is relevant to a question on the same reporting standard for the financial statements of railroad companies.

Responsibility When Auditor Expresses No Opinion

Some very questionable practices developed during the years in which the rule on reporting responsibilities was evolving. Although the Institute recognized its responsibilities in the improvement of the audit reporting standards of certified public accountants, no rule of professional conduct of the American Institute specified prior to 1958 the reporting

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[1] Ibid., p. 3.

[2] "APB Advises on Insurance Company Statements," The CPA, XLII (May, 1962), p. 5.

responsibilities of a public accountant when his work was not accompanied by the expression of an opinion. The development of the rule which describes those responsibilities is the subject of the present section.

Recognition of Abuses and Responsibilities

Numerous criticisms of contemporary practices in the publication of audit "certificates" appeared on the editorial pages of The Journal of Accountancy during the twenty years preceding 1940. It will be useful to cite some of these criticisms in order to establish the nature and significance of those abuses as well as the long period of time over which they developed.

An example of an early abuse in the publication of the opinion or certificate of a public accountant is provided in an editorial criticism which appeared in 1920. Those comments pertained to the practice of publishing condensed, modified, or abridged versions of the certificate of an auditor.[1] One such device, which was said to have been entirely misleading and at best entirely meaningless, limited the reference to the audit of the financial statements to this cryptic comment: "The Accounts Have Been Audited."[2] The following comment was borrowed from the 1918 publication, Approved Methods for the Preparation of Balance-Sheet Statements: "The certificate should be as short and concise as possible, consistent with a correct statement of the facts, and if qualifications are necessary the auditor must state them in a clear and concise manner."[3] A common phenomenon in the securities markets in 1938 was the abridged prospectus which frequently did not display the name of the accountant or else it misused the reference

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[1]Editorial, "Misuse of Accountants' Certificates," The Journal of Accountancy, XXX (August, 1920), pp. 138-39.

[2]Editorial, "The Accounts Have Been Audited," The Journal of Accountancy, XXXIX (May, 1925), pp. 393-94.

[3]Editorial, "The Qualified Certificate," The Journal of Accountancy, XLI (January, 1926), p. 38.

to his name in some other way. It was reportedly implied in several cases that reputable auditors had found the accounts in good order although they had in fact found conditions which were far from satisfactory.[1]

Statement on Auditing Procedure No. 1 ("Extensions of Auditing Procedure") which appeared in 1939, contained the following comment on auditor responsibility in the absence of the expression of a formal opinion by the auditor:

> The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion.[2]

If an accountant was unable to express an opinion, he should

> state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor. He may also, if appropriate, comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which required the denial of an overall opinion.[3]

Significantly, however, this requirement did nothing to assure the readers of published financial statements that they would be given any evaluation of the reliability of the data therein summarized. As a matter of fact, it seems to have required only that the client would be provided with a statement of the findings of the auditor and, when appropriate, an explanation of the reason for his inability to express an opinion. The following

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[1]Editorial, "Reference to Accountant Often Misleading," The Journal of Accountancy, XLV (January, 1928), p. 31.

[2]American Institute of Accountants Committee on Auditing Procedure, "Recommendation Made to Clarify Accountant's Representations When Opinion Is Not Expressed," (Statement on Auditing Procedure No. 23), The Journal of Accountancy, LXXXV (January, 1948), p. 39.

[3]Ibid.

discussion will make it clear that deceptive uses of the name and title of certified public accountants was not unknown notwithstanding Statement on Auditing Procedure No. 1.

An anonymous critic made reference in 1947 to a discussion at a recent meeting of accountants in which the problem of the association of the name of a public accountant with uncertified financial statements was the topic of discussion.[1] That practice was said to be an old, bad practice which, in the opinion of that writer, represented a substantial portion of the total work done by accountants, particularly those who practiced in smaller communities. The following example was given as typical of the most objectionable of such reports:

> The accountant verifies the bank balances, adds the accounts-receivable ledger, perhaps checks the extensions and footings of the inventory, and emits a report; "We have verified bank balances, added the accounts-receivable ledger, checked extensions and footings of the inventory. . . . The profit compares with last year, so and so. . . . The working capital had increased . . . etc., etc. . . . Yours truly."[2]

It was said that such reports which contained no expression of opinion were then submitted as an audit report by the client to a bank. In the absence of profound knowledge of auditing procedures and reports on the part of the officers of the bank, the writer argued, the report would be accepted as an audited statement.

The same critic also wrote that it was common practice for accountants (again practitioners in small communities) to prepare financial statements from the accounting records of the client without first subjecting these records to independent verification tests. These financial statements were submitted to the client without any explanatory comment on

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[1]Anonymous, "Auditor's Report," (Letter), The Journal of Accountancy, LXXXIII (January, 1947), pp. 68-69.

[2]Ibid., p. 68.

the stationery of the accountant. Such documents were then circulated by the client who referred to them as the report of his accountant. It was said that financial statements prepared on plain paper were unacceptable to credit grantors. In contrast, financial statements which were not accompanied by an opinion would be accepted if they were submitted on the stationery of a public accountant.[1]

While the testimony of an anonymous critic might be subject to doubt, the fact that the comments appeared upon the pages of The Journal of Accountancy is not without some significance. But the existence of these practices has been acknowledged by the authoritative Committee on Auditing Procedure of the American Institute of Accountants. The following are illustrations which were used by that Committee:

(a) The presentation of financial statements on the stationery of the accountant without comment, opinion, or signature; or with the assertion that the statements are "for management purposes only."

(b) The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an accountant in which financial statements and comments on the scope of the audit are included.[2]

These practices, the committee observed, tended to create uncertainty in the minds of those readers who did not have the benefit of special information. For those persons, there was no basis for the determination of the inferences which were warranted by the appearance of the name of the accountant. Because the accountant in such cases failed to make clear the extent of his responsibility, these third parties might place undue reliance on the financial statements. Consequently, the Committee on Auditing Procedure recommended that the statement

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[1]Ibid.

[2]Committee on Auditing Procedures, The Journal of Accountancy, LXXXV (January, 1948), p. 38.

"Extensions of Auditing Procedure" be amended. The proposed amendment (Statement on Auditing Procedure No. 23) provided that an accountant should only express an opinion on financial statements taken as a whole. He should not express an opinion on a portion of financial statements when his examination had been restricted so as to prevent the expression of an overall opinion.[1]

Following the adoption of Statement on Auditing Procedure No. 23 in November, 1949, an interesting controversy developed which involved the question of responsibilities assumed by a public accountant who prepared unaudited financial statements for a client. On the one hand, if the accountant used plain paper for the unaudited financial statements of his client, it was argued that his name might be verbally associated with the statements. In which case it was possible that an unwarranted reliance would be placed on the statements by the reader. That reliance, if it was later proven to have been unwarranted, could damage the reputation of the practitioner as well as that of the profession.[2] On the other hand, it was argued that the alleged identification of a public accountant with a set of financial statements with which his name did not appear in print was a falacious assumption. To the extent that any third party did make such an assumption, it was an indication of the need for giving attention to the profession's public relations.[3]

Carman Blough quoted a correspondent who argued that the absence of the name of the certified public accountant from financial statements was justifiable for only one of two reasons. Either the accountant had

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[1]Ibid., p. 39.

[2]Auditing Practice Forum, "Name Paper Recommended," The Journal of Accountancy, LXXXIX (April, 1950), p. 357, quoting The Texas Accountant, (January, 1950).

[3]Current Accounting and Auditing Problems, "Reader Replies to Arguments in Favor of Plain Paper for Statements," The Journal of Accountancy, XCII (July, 1951), p. 93.

nothing to do with their preparation or he had nothing to do with the preparation of those statements in a professional capacity. In either case his name should not be associated with the statements. It was noted that the name of the accountant who assembled the statement was of no greater significance than that of the typist.[1]

Rule Delayed Pending Acceptance of Statement 23

Subsequent to the adoption of Statement on Auditing Procedure No. 23, several suggestions were made to incorporate in the rules of professional conduct the standards which were expressed in that statement. The Committee on Auditing Procedure of the American Institute of Accountants recommended in October, 1950, that an organized educational campaign should precede the adoption of disciplinary procedures.[2] A similar decision was made in 1952 to defer action on an amendment of the rules of professional conduct which would require compliance with Statement 23. Again it was believed advisable to postpone such action until further educational efforts could bring about a greater measure of compliance with the standards expressed in that statement.[3]

Despite the numerous published articles and technical meetings which had been devoted to the reporting standards expressed in Statement 23, a 1954 survey of financial reports revealed that the results of these educational efforts were less than completely satisfactory. That study,

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[1]Current Accounting and Auditing Problems, "Plain Paper Recommended," The Journal of Accountancy, XCI (May, 1951), p. 736.

[2]Report of the Committee on Professional Ethics, April 15, 1955, p. 2, American Institute of Accountants, New York (in the files of the Institute library).

[3]Report of the Committee on Professional Ethics, October 6, 1952, pp. 12-13, American Institute of Accountants, New York (in the files of the Institute library).

which was conducted by the Committee on Auditing Procedure in co-operation with commercial bankers, showed that about 20% of the financial reports which were reviewed failed to comply with the standards expressed in Statement on Auditing Procedure No. 23.[1]

Once again in the spring of 1955, the Committee on Professional Ethics asked the Committee on Auditing Procedure for an expression of its views on the question of incorporating the provisions of Statement 23 into the rules of professional conduct of the American Institute. The Committee on Auditing Procedure summarized its deliberations as follows:

> In discussing the proposal at this meeting, particular consideration was given to whether or not application of the statement was well enough understood generally so that the time is now appropriate for covering it in the rules of conduct. Some of those present expressed the belief that the implications of Statement 23 with respect to long-form reports are not well understood and that, accordingly, members of the Institute should not be subject to disciplinary action under the rules of conduct for failure to apply it properly. The view was also expressed that the rules should be general in nature, and that it is not desirable to incorporate Statements on Auditing Procedure in the rules specifically.
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> As against these views, it was pointed out that the major problems under consideration with respect to long-form reports arise in opinion reports (as opposed to non-opinion reports), and that, while the language of the amendment of the rules has not yet been developed, it will probably be general in nature and contain only the substance of Statement 23. It was also noted that the substance of the statement was incorporated in the summary of auditing standards in the booklet 'Generally Accepted Auditing Standards,' and that education work had been conducted for approximately seven years.[2]

Following a discussion of the issue, it was agreed (by a vote of eleven to six) to advise the Committee on Professional Ethics of the withdrawal of

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[1]Report of the Committee on Professional Ethics, April 15, 1955, pp. 2-3.

[2]Ibid., pp. 3-4.

the previous request of the Committee on Auditing Procedure to defer action on a rule of conduct involving the standards of Statement No. 23.

Approximately one month after the Committee on Auditing Procedure withdrew its objection to a rule which would express the reporting responsibilities of an auditor with respect to financial statements on which he expressed no opinion, the issue was considered by the Council. But the majority of the members of the Council of the Institute were unable to agree that the time had finally come when a rule of conduct should be adopted which would give expression to Statement 23.

The issue seems to have been avoided for two years until April, 1957, when a rule of professional conduct was recommended to the Council of the American Institute of Accountants by the Committee on Professional Ethics. Certain sections of the suggested rule were subject to serious objections. Those sections have been emphasized in the following:

> A member engaged in public accounting shall not permit his name to be associated with statements purporting to show financial position or results of operations in conformity with generally accepted accounting principles unless he shall: (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the financial statements as a whole and indicate clearly his reasons therefore, or (4) disclose on the financial statements that they were not audited.[1] (Italics mine.)

Some members of the Council objected to the phrase "in conformity with generally accepted accounting principles." Following an extended discussion, the Council referred the proposal back to the Committee on Professional Ethics for a revision which would delete the objectionable phrase. It was reported that the proposed rule was rejected because it failed to conform to the wording of Statement on Auditing Procedure No. 23,

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[1]Minutes of the Council Meeting, April 15-18, 1957, p. 15, American Institute of Accountants, New York (in the files of the Institute library).

but there was no explanation of how or why the proposed rule failed in this respect.

Another criticism involved the possibility that the proposed rule, if adopted, "might forbid an Institute member who was treasurer of a corporation from signing the corporation's financial statements in his official capacity."[1]

After the rule had been revised to eliminate the sources of criticism which were discussed in the preceding paragraph, other questions were raised by the Committee on Auditing Procedure. That Committee and the Committee on Professional Ethics resolved these questions and agreed upon a solution before the annual meeting of the Institute in October, 1957. The proposed rule was further amended to include a phrase in subsection (4) which would permit a member of the profession to prepare for a client unaudited financial statements on plain paper.

On January 20, 1958, the rule became effective after it had been approved by the Council, by a majority of the members who attended the 1957 annual meeting of the Institute, and by a majority of all of the members of the Institute who voted by mail on the proposal. Several insignificant changes, which have not been discussed here, appear in this, the current version of the rule:

> A member or associate shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall:
>
> (a) express an unqualified opinion; or
>
> (b) express a qualified opinion; or
>
> (c) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor; or
>
> (d) when unaudited financial statements are presented on his stationery without his comments, disclose

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[1] "AIA Spring Council Meeting," The CPA, (May, 1957), p. 7.

prominently on each page of the financial statements that they were not audited.[1]

Interpretations of the Rule

A member of the Council of the American Institute of Accountants asked whether the provisions of the new rule would be violated if a certified public accountant expressed an opinion on financial statements in which comparable data were provided for a prior year and on which data the accountant had neither expressed an opinion nor disclaimed an opinion. The Council was advised that the Committee on Auditing Procedure had considered the question and that no comment with respect to the data of prior years was required when the data were submitted as a comparison with current year figures.[2]

Opinion No. 8 was issued in February, 1959, by the Committee on Professional Ethics of the Institute. The need for this opinion was demonstrated by a number of inquiries which indicated that some certified public accountants believed that their responsibility was discharged if they merely denied an opinion rather than disclosed the fact that they believed a particular set of financial statements was false and misleading. A specific case was related by Carman Blough as an illustration of these inquiries. An auditor who had not been permitted to confirm receivables or to observe the physical inventory procedures had assured himself by other means that the inventory was understated by at least a quarter of a million dollars. Management frankly admitted that he was correct and that the inventory had been understated for the purpose of avoiding income taxes. In this case the certified public accountant contended that a denial of this opinion was an adequate warning to the readers

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[1] By-Laws, Code of Professional Ethics . . . (1962), p. 31.

[2] Minutes of the Council Meeting, April 21-24, 1958, p. 34, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

of the financial statements that the inventory valuations may not be correct. Furthermore, he believed his denial of opinion relieved him of further responsibility because he was not involved in the preparation of the income tax returns of the client.[1] In response to similar situations, the Committee on Professional Ethics made clear its belief that in such circumstances the mere denial of an opinion was unsatisfactory. The pertinent portion of Opinion No. 8 follows:

> In a circumstance where a member believes the financial statements are false or misleading as a whole or in any significant respect, it is the opinion of the committee that he should require adjustments of the accounts or adequate disclosure of the facts, as the case may be, and failing this the independent accountant should refuse to permit his name to be associated with the statements in any way.[2]

Expression of Opinion on Statements Audited by Another Accountant

One of the rules of professional conduct which has been the subject of very little controversy and even less literary comment was adopted by the American Association of Public Accountants in October, 1907. That rule specified certain relationships which must exist between a member of the Association and a person upon whose work the member could rely. Unfortunately, the purpose of the following rule is a matter of speculation:

> No member shall certify to exhibits, statements, schedules, or other form of accountancy work, the preparation of which was not carried on entirely under the supervision of himself, a member of his firm, one of his staff, a member of this Association or of similar Association of good standing in foreign countries.[3]

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[1]Carman G. Blough, "Responsibility to Third Parties," The Journal of Accountancy, CIX (May, 1960), p. 63.

[2]By-Laws, Code of Professional Ethics . . . (1962), p. 41.

[3]"Constitution and By-Laws," The American Association of Public Accountants Twentieth Anniversary Year-Book (1907), p. 238.

John L. Carey wrote that early non-certified public accountants obtained engagements in which it was necessary to have the audit certificate signed by a certified public accountant. In these cases a non-certified public accountant might ask a certified public accountant to sign the certificate for a fee.[1] This explanation was implied by the Committee on Professional Ethics in 1952 when it was stated that the rule was "designed to prevent a member from serving as a 'front' for a non-certified accountant."[2] Perhaps this is indeed the reason for the adoption of the rule; however, no evidence was discovered which would either refute or support that explanation.

Consistent with Professionalization

Whatever were the specific conditions which stimulated the adoption of the rule, it can be argued that the rule was consistent with the purpose of the American Association of Public Accountants--the professionalization of the practice of public accounting. To the extent that a member of the Association relied only upon the work of his employees or partners, he was supposedly in a position to evaluate their abilities and was also technically responsible for their work. Furthermore, a member of the Association could rely upon any other public accountant whose membership in a professional organization testified to the adequacy of his competence and qualifications. In this way the rule tended to restrict the professional relationships of a member of the Association, insofar as the Association was able to do so, to persons who also were clearly identified with the practice of public accounting.

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[1]John L. Carey, Professional Ethics of Certified Public Accountants (New York: American Institute of Accountants, 1956), p. 104.

[2]Report of the Committee on Professional Ethics, October 6, 1952, p. 10, American Institute of Accountants, New York (in the files of the Institute library).

It is interesting to note that in 1907 the rule involved the "preparation" of accountancy work. However, in 1910, accountancy work was "verified."[1] This change, although a minor revision, is perhaps significant. Certainly it would have been inconsistent for public accountants to claim professional status if they merely "prepared" such accountancy work for their clients. Indeed it was the fact that they "verified" the accountancy work of their clients which was basic to their claim of professional status.

Adoption of the Present Rule

One of the rules of professional conduct which was adopted by the Council of the American Institute of Accountants in April, 1917, was very similar to the rule of the American Association of Public Accountants which was discussed above. However, two minor changes appeared in the Institute rule. First, the word "accounts" was added to the list of specified forms of accountancy work which were subject to certification by public accountants. Secondly, it was specified that a member could rely on the work of a member of a similar foreign association which had been approved by the Council. It seems reasonable to suppose that some member or members of the American Association of Public Accountants had given a rather liberal interpretation to the phrase "of similar Association of good standing in foreign countries."

The present version of the rule follows:

> A member or associate shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member or associate of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.[2]

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[1] "Constitution and By-Laws," The American Association of Public Accountants Twenty-Third Anniversary Year-Book (1910), p. 269.

[2] By-Laws, Code of Professional Ethics . . . (1962), p. 30.

That rule was adopted on January 6, 1941, by the members of the American Institute of Accountants in substantially its present form. Note that prior to 1941 the rule made no mention of the possibility that a member might rely on the work of a certified public accountant. Perhaps this distinction was not made because some non-certified public accountants had formerly been admitted to membership in the Institute.

The Committee on Professional Ethics is currently considering an amendment of the present rule which in its present form "might be interpreted to mean that a member may issue an opinion on financial statements not examined by him simply on the basis of an examination made by another CPA or CPA firm."[1] Although the Committee did not elucidate, it does not seem likely that it intends to restrict correspondent engagements which involve the verification of branch inventories or other segments of the audit of a large company whose facilities are widely dispersed.

Estimates of Future Earnings

Forecasting is an art which is not practiced with an impressive record of reliability. Neither is its practice governed by generally accepted standards which would make it possible precisely and objectively to evaluate the credibility of a forecast. Presently, the only reliable test of a forecast is the future.

A certified public accountant who would express his favorable opinion on estimates of future earnings might lend considerable credibility to these forecasts. Favorable estimates of future earnings, if they were supported by the opinion of a certified public accountant, might favorably affect the sale of securities. The general public probably would assume the data

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[1]Report of Committee on Professional Ethics, May 21, 1962, p. 2, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

were reliable simply because of the prestige which accompanies the opinion of a certified public accountant. But the accountant, because forecasts are inherently tenuous, could not assume the responsibility which the public has generally come to associate with his opinion in connection with financial data. The greater the number of certified public accountants who would avoid their responsibility for the reliability of their work in this way, the more rapid would be the shattering of the public confidence in the work of the profession. Of course that result follows from the assumption that the opinion of a public accountant on a forecast cannot be as reliable as his audit opinion. Obviously, the profession has a self-interest as well as a responsibility to the public in the satisfactory performance of work in which the user can place his confidence.

Adoption of a Resolution

Apparently it was not until 1929 that the association of the name of a member of the American Institute of Accountants with forecasts or estimates of the future earnings of a client became a significant problem. But in that year numerous members complained that certain textile factors had mailed objectionable questionnaires to some of the clients of these accountants. An investigation led the Executive Committee of the Institute to conclude that the objections were due to a mistaken impression created among the accountants by the questionnaire. However, the questionnaire, which apparently had been authorized by the clients of the accountants, seems to have requested information which was not a mere exposition of fact because the Executive Committee advised that a public accountant was "not justified in making any prediction or expressing any opinion upon the management and the credit responsibility of the client."[1]

[1] "Report of the Executive Committee," 1929 Year Book of the American Institute of Accountants (1929), p. 156.

It was also in 1929 that the Committee on Professional Ethics reported that there was a case then pending before that Committee which involved the use of estimates of future earnings. The Committee observed that this case involved the important and interesting question of the legitimate province of the accountant.[1]

Three important committees of the American Institute--the Executive Committee, the Committee on Professional Ethics, and the Committee on Cooperation With Bankers--concurred in 1931 that it was improper for an accountant to certify statements of future earnings of his clients. That position was officially approved by the Council which also requested the Committee on Professional Ethics to submit the draft of a rule of conduct which would give expression to this policy.[2] The rule which was suggested by the Committee on Professional Ethics would have prohibited a member from signing or certifying an estimate of earnings contingent upon future transactions. However, the proposed rule also made it clear that an accountant could properly assist in the preparation of such estimates provided that he did not permit his name to be used in a manner which would lead third parties to believe that he verified the accuracy of the estimate.[3]

Interest in this problem coincided with the beginning of the period during which admonitory resolutions were considered more preferable than rules of conduct. Consequently the Council adopted on April 11, 1932, the following resolution:

> WHEREAS, Estimates of earnings contingent upon future transactions should always be clearly distinguished from statements of actual earnings evidenced by definite records, and

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[1]"Report of Committee on Professional Ethics," ibid., p. 168.

[2]"Report of the Executive Committee," 1931 Year Book of the American Institute of Accountants (1931), p. 214.

[3]"Report of Committee on Professional Ethics," ibid., p. 223.

> WHEREAS, An accountant may properly assist a client in estimating the results of future transactions, so long as no one may be led to believe that the estimates represent certainties,
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> BE IT RESOLVED, That no public accountant should permit his name to be used in conjunction with such an estimate in a manner which might lead anyone to believe that the accountant could vouch for the accuracy of the forecast; and
>
> BE IT FURTHER RESOLVED, That violation of this dictum by a member or an associate of the American Institute of Accountants be considered by the committee on professional ethics as cause for charges under the provision of Article V, Section 4 (e) of the by-laws, or rule 2 of the rules of professional conduct of the American Institute of Accountants, or both.[1]

The reference in the final paragraph of the resolution refers to that provision of the by-laws which provides for disciplinary action for an act which was discreditable to the profession. Reference is also made in the final paragraph of the resolution to the rule of conduct which provided for disciplinary action against a member who was found guilty of violating his reporting responsibilities. The development of that rule was traced in the first section of the present chapter.

Rule Adopted

The policy resolution of the American Institute of Accountants which forbade a member from adding to the credibility of an estimate of future earnings remained in force for almost nine years. Then, in 1940 when the rules of professional conduct were being generally revised, it was proposed that the 1932 resolution on earnings estimates be adopted as a formal rule. The following rule was initially approved and became effective on January 6, 1941. Only inconsequential revisions have been made in the rule during the past twenty years, hence it appears here in its present form:

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[1]"Resolutions," 1932 Year Book . . . , pp. 269-70.

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> A member or associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.[1]

Recent Interpretation

Note that the rule prohibits the use of the name of a member of the Institute only if it might lead to the belief that the member verified or certified (vouched for) the accuracy of the forecast. Presumably the members of the Institute lived quietly with this rule for many years. But in 1959 there was some doubt that the rule was compatible with management service engagements which involved the preparation of a budget for a client.

In 1959 the Committee on Professional Ethics reported that a subcommittee was currently "studying the applicability of rule 12, which has to do with estimates of earnings contingent upon future transactions, to budget preparation and presentation."[2] After more than a year of work, the Committee issued in November, 1960, Opinion No. 10 entitled "Responsibility of Members for Pro Forma Statements and Forecasts Under Rule 2.04."[3]

Opinion No. 10 contains a clear expression of appreciation for the importance of pro forma financial statements, cost analyses, budgets, and similar special purpose reports or data involving the anticipated results of future operations. Explicit recognition was given to the important function which these reports perform in management decisions which involve the future of a business organization. But it is also clear

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[1] By-Laws, Code of Professional Ethics . . . (1962), pp. 31-32.

[2] Report of Committee on Professional Ethics, October 23, 1959, p. 2, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[3] By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics . . . (1962), pp. 42-43.

that such work is an important part of the services which certified public accountants perform for their clients. Accordingly, whenever the name of a member is associated with such statements or analyses

> full disclosure must be made of the source of the information used, or the major assumptions made, in the preparation of the statements and analyses, the character of the work performed by the member, and the degree of responsibility he is taking. Such disclosure should be made on each statement, or in the member's letter or report attached to the statements. The letter or report of the member must also clearly indicate that the member does not vouch for the accuracy of the forecast. It is the opinion of the committee that full and adequate disclosure would put any reader of such statements on notice and restrict the statements to their intended use.[1]

The impact of Opinion No. 10, if indeed there will be a discernible reaction, remains to be seen in future events.

Incorporation of a Public Accounting Practice

Traditionally the public accounting profession has been opposed to the practice of public accounting by corporations because of the resulting limitation of the personal liability of the accountants for their work. This tradition developed very slowly and seems to have been firmly established approximately twenty years ago. But the recent interest in the question of the incorporation of public accounting firms has developed because repeated attempts to revise the federal income tax law have been wholly unsuccessful. The continuing and illogical disparities in the tax treatment of corporate and self-employed retirement plans have stimulated members of several of the professions and other groups to seek a remedy in the enactment of state legislation. In general, remedial state legislation permits the incorporation of professional practitioners or the formation of professional associations so that their retirement plans

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[1] Ibid., p. 43.

will qualify for the same advantageous tax treatment which presently is permitted in connection with corporate retirement programs. Each of these areas will now be examined in connection with the development of the rule of conduct which prohibits a member of the Institute from participating in a corporation which offers public accounting services to the public.

From Acceptance to Opposition

Early critics of the incorporation of a public accounting practice emphasized the objectionable behavior of some audit companies. It was said that the most offensive audit corporations were formed by financiers or promoters who were interested in their own personal objectives rather than the protection of the general public from actual misstatements or misleading optimism reflected in the financial data.[1]

Although The Journal of Accountancy in 1906 approved the incorporation of public accounting firms as a means of transmitting the good will of the partners to their heirs,[2] it should not be inferred that all public accountants unanimously approved the formation of audit companies even by reputable, responsible public accountants. Joseph E. Sterrett said in 1907 that despite the fact that some of these audit companies were

> more in the nature of a partnership conducted in a corporate form, and while a thoughtful consideration of the subject fails to produce cogent reasons justifying this form of organization, their existence might be accepted with a mental reservation as to the questionable taste of their organizers.[3]

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[1] "Meeting of the American Association: Suggestions From Journal Committee," The Journal of Accountancy, I (March, 1906), p. 436.

[2] Editorial, "Two Kinds of Auditing Companies," The Journal of Accountancy, I (February, 1906), p. 321.

[3] J. E. Sterrett, "Professional Ethics," The American Association of Public Accountants Twentieth Anniversary Year-Book (1907), p. 131.

Some of the incorporated public accounting firms were criticized because they used such designations as "CPA" or "Certified Public Accountants." In one particular case, not only was a designation illegally applied to an audit company, but also it was reported that none of the officers or shareholders of that company were certified public accountants.[1] Unsuccessful attempts were made in 1908[2] and in 1909[3] to amend the by-laws of the American Association of Public Accountants to prohibit a member from concealing his identity under a corporate name which was either nominal, personal, or fictitious. No record was found of any further efforts to deal with the corporate practice of public accounting by the American Association of Public Accountants.

During the third annual meeting of the American Institute of Accountants which was held in September, 1919, consideration was given to a resolution on audit companies which had been adopted by the Council on September 15, 1919. That resolution, which follows, is typical of the predominant attitude of the members of the American Association of Public Accountants more than ten years earlier:

> RESOLVED, That there be submitted to the general meeting of the Institute a proposition that within three years from this date no member of the Institute be permitted to continue his membership if he be an officer, director or responsible manager of an audit company or other corporation or other company maintaining a department organized for the purpose of carrying on a general accounting and auditing practice unless all the stockholders and directors and officers of such corporation be and continue to be practising public accountants.[4] (Italics mine.)

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[1] "Report of the Illinois Society of Certified Public Accountants," The American Association of Public Accountants Twenty-Fourth Anniversary Year-Book (1911), p. 134.

[2] "Report of Committee on Ethical Rules," The American Association of Public Accountants Twenty-First Anniversary Year-Book (1908), p. 100.

[3] "Report of the Committee on By-Laws," The American Association of Public Accountants Twenty-Second Anniversary Year-Book (1909), p. 73.

[4] "American Institute of Accountants: Proceedings of the Annual Meeting," 1919 Year-Book of the American Institute of Accountants (1920), p. 66.

Although more than ten years had passed since the incorporation of public accounting firms was first publicly criticized, the members who were in attendance at the 1919 annual meeting voted to postpone their consideration of the matter for another year. However, the following resolution was then presented and was unanimously approved:

> RESOLVED, That it is the sense of this meeting that audit companies and similar organizations are detrimental to the best interests of the accounting profession.[1]

The problem of incorporated audit companies apparently was dormant for a little more than a decade following the adoption of the gentle policy statement of 1919. But in 1932, the profession was the subject of an informative and interesting article published in Fortune magazine.[2] Here it was reported that the Audit Company of New York was one of the largest of the national public accounting firms and that among its clients were eleven firms whose securities were listed on the New York Stock Exchange. Woolworth, American Car and Foundry, Diamond Match, International Business Machines, and Sears, Roebuck were specifically identified as clients of the Audit Company of New York.[3] That report is a strong indication that the incorporation of public accounting practices was not merely a minor, peripheral phenomenon.

Finally, in April, 1938, the Committee on Professional Ethics reported to the Council of the American Institute of Accountants that nearly twenty years had passed since the Institute first expressed its disapproval of audit companies. During that period a number of states had enacted legislation prohibiting the practice of public accounting by corporations and other states had forbidden the use of "CPA" designations

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[1] Ibid.

[2] "Certified Public Accountants," Fortune, V (June, 1932), pp. 63-66, 95-96, 98, 101-102.

[3] Ibid., p. 63, 102.

by corporations. Specifically, the Committee on Professional Ethics suggested to the Council that the time had come when a definite rule should be adopted which would prohibit a member of the Institute from an affiliation with any corporation which was engaged in the practice of public accounting.[1] Accordingly, the Council directed the Committee to prepare and submit such a rule. This was done and the following rule was adopted by the Council on September 16, 1938:

> After September 16, 1939, no member or associate of the Institute shall be an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.[2]

No major change which is relevant to the present study has been made in the rule since it was revised in 1941. At that time the effective date was omitted and the rule was ratified by the membership of the American Institute. The current version of the rule follows:

> A member or associate shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.[3]

Current Interest in Professional Incorporation

The existence of tax benefits which are applicable to corporate but not individual retirement programs has stimulated the recent interest in professional incorporation. Because the Congress has repeatedly failed to pass legislation which would provide equitable tax treatment for the retirement programs for the self-employed, proposals began to appear which favored the formation of professional associations or

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[1] "Report of the Committee on Professional Ethics," 1938 Yearbook of the American Institute of Accountants (1939), p. 108.

[2] "Rules of Professional Conduct," ibid., p. 179.

[3] By-Laws, Code of Professional Ethics . . . (1962), p. 33.

corporations. It was pointed out that the use of this device would extend to professional practitioners the favorable tax treatment of corporate pension plans. However, it was necessary in most states to secure the passage of legislation which would permit professional incorporation.

If legislative activity in the various states on the question of professional incorporation is taken as an index of the reaction to the professional incorporation proposals, it appears that a major innovation is in progress in the practice of the professions. It was reported in June, 1961, that thirteen states had enacted, considered, or rejected "legislation permitting groups of doctors and other professional practitioners to form corporations, or associations taxable as Corporations in order to become eligible for various benefits now available only to corporate employees and executives."[1] Less than one year later, 18 states had enacted legislation which permits doctors and other professional practitioners to form professional corporations or associations and "it seems likely that most, if not all, of the fifteen legislatures which are now meeting in states without such laws may well join the procession."[2] In sharp contrast with the official reaction of several of the professions, the Institute's Council adopted in April, 1961, a resolution of opposition to state legislation which permits the practice of public accounting under the corporate form of organization.[3]

Recently, it was reported to the membership of the American Institute of Certified Public Accountants that the Executive Committee had been giving the question of professional association or incorporation its constant review but that nothing had occurred which indicated a need

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[1]News Report, "Professional Incorporation," The Journal of Accountancy, CXI (June, 1961), p. 9.

[2]"Executive Committee's Statement on Professional Incorporation and CPAs," The CPA, XLII (April, 1962), p. 6.

[3]Editorial, "Professional Association or Incorporation," The Journal of Accountancy, CXII (November, 1961), p. 39.

for a change in the policy of the Institute on this issue.[1] In its report,[2] the Executive Committee reviewed the reasons for the opposition of the Institute to the professional incorporation legislation. First, it was pointed out that the prohibition of corporate practice is traditional in most professions and is intended to prevent an evasion of personal liability by practicing members of the profession. If personal liability were limited by incorporation, an accountant might take risks or might be suspected of taking risks which he would not take if he was fully responsible for his personal acts. Although it was admitted that these objections are or can be overcome, it was believed that any current action to modify the policy of the Institute would be premature. Also noted was the fact that attorneys and agents are prevented by the rules of the Treasury Department from practicing before the Treasury in the corporate form of organization. Secondly, it was noted by the Executive Committee that appropriate legislative safeguards imposed on professional corporations may nullify their claim to corporate tax status. A third hazard is the possibility that the income of the professional corporation might be taxed as personal holding company income and that it may be subject to state franchise taxes. Fourth, the considerable variation between the several state laws would create serious difficulties for a professional corporation engaged in interstate practice. Finally, the question of the public relations of the accounting profession was cited as an important reason for the present policy of the Institute with respect to professional incorporation. There is said to be a real danger that the professional corporations may be attacked as a device for tax avoidance because the corporate nature of an entity may be ignored if no function is served other

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[1] "Executive Committee's Statement . . . ," The CPA, XLII (April, 1962), p. 6.

[2] Ibid., pp. 6-7, 12.

than the tax-savings objective. Even if that argument was ineffective, it could be especially damaging to the reputation of the accounting profession which has long been closely identified with tax practice. The preceding discussion summarizes the reasons for the opposition of the American Institute of Certified Public Accountants to any legislation which would permit certified public accountants to form corporations for the practice of public accounting.

Competence

An unlimited and personal responsibility of the individual for his professional acts is only one aspect of professional responsibility. There is also the responsibility of the profession as a whole for the proficiency of its individual practitioners. Professional licensing and registration laws serve this purpose to the extent that a registrant is required to have successfully passed a comprehensive written examination and perhaps to have met certain standards of experience before he is registered to practice his profession without the direct supervision of a licensed member of the profession. Beyond these minimal requirements which must be satisfied by all licensed practitioners, some professional organizations assume a group responsibility for the competence of their individual members. A notable example of this is the American Medical Association which recognizes, as a principle of ethics, that the medical profession has a responsibility to the public and itself for the moral character and professional competence of physicians.[1]

Recently the question of the responsibility of a professional organization for the competence of its members was brought to the attention of the members of the American Institute of Certified Public Accountants. After more than a year of study and thought, the Committee on Professional

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[1]John L. Carey, "From the Executive Director's Desk," The CPA, (December, 1958), p. 4.

Ethics released the draft of a proposed new rule of conduct involving the competence of members of the American Institute. That proposal was reported in the membership bulletin of the Institute in March, 1957. It provided that "a member shall not undertake professional services, to be performed by himself or his employees, unless he or a member of his firm is competent as evidenced by training or experience to perform or supervise such services."[1]

The need for the proposed rule was brought about by the increasing specialization in the management services rendered by certified public accountants. In view of the fact that the uniform certified public accountant examination does not test the competency of applicants in such areas as mathematics, engineering, or production technology, the recommended rule seems to have been quite appropriate. However, the sponsor of the proposed rule, the Committee on Professional Ethics, was very quickly shown by a deluge of criticism the inappropriateness of either the content of the rule or the timing of the proposal. This was made clear by the April 15, 1957, report of the Committee on Professional Ethics in which it was indicated that because of the many criticisms of the proposed rule, the Committee had decided to defer a specific recommendation for a rule on competence at that time.[2] But the Committee also expressed an intent to submit to the Council a draft resolution of a detailed statement on the problem. No statement has yet been published by the Institute for the guidance of the membership in their responsibility for competence.

Although the area of management services has, during the past five years, continued to expand relative to the total services offered by

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[1] "Proposed Changes in AIA Rules of Professional Conduct," The CPA, (March, 1957), p. 6.

[2] Report of Committee on Professional Ethics, April 15, 1957, pp. 3-4, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

certified public accountants, no evidence was found which indicates that the Committee on Professional Ethics reconsidered the question of competence after it was forced to beat a hasty retreat in 1957. Perhaps the present attitude of the profession is reflected in the comments of two recent writers. Robert M. Trueblood, who is a recognized authority on management services, has written on the subject of the competence of certified public accountants to perform management services utilizing recently developed measurement techniques.[1] He mentions no ethical responsibility on the part of the profession for the competence of its individual members in the use of these new non-accounting and non-auditing tools of analysis. Thomas G. Higgins, who is a past chairman of the Committee on Professional Ethics, has acknowledged the existence of widely varying opinions on the question of what service a certified public accountant can or cannot properly perform in the area of management services. Consequently, he recommends that the American Institute undertake an exhaustive study of the work performed in the management services area as a basis for a statement which would guide members on questions of their competence in certain of these specialized areas.[2] It is significant that neither this proposal nor the comments of the previous writer indicate any recognition of the responsibility of the professional organization for the competence of the members who render these non-accounting and non-auditing services.

Although the Institute has not assumed a broad responsibility for the professional qualifications of its members who practice in specialized fields, it has imposed upon its members an ethical responsibility for the work of their employees. This special application of the concept of

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[1]Robert M. Trueblood, "The Management Service Function in Public Accounting," The Journal of Accountancy, CXII (July, 1961), pp. 37-44.

[2]Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," The Journal of Accountancy, CXIII (March, 1962), p. 35.

competence which is discussed in the following section was induced by the interprofessional relationships of certified public accountants and lawyers.

Responsibility for Work of Employee

Shortly before the final decision was handed down on September 20, 1956, in the famous Agran Case,[1] the Committee on Professional Ethics of the American Institute reported a list of fifteen questions which it believed were worthy of intensive study.[2] Among those problem areas were two which undoubtedly were related to the long list of occasions on which members of the accounting profession found themselves in disagreement with various bar associations on questions involving the unauthorized practice of law. These problems were posed in the following rhetorical questions:

> Should not the rules of professional conduct prohibit the preparation by members in public practice of legal documents as listed in the Joint Statement of Tax Practice, to wit: agreements, conveyances, trust instruments, wills, or corporate minutes?
>
> Should not employed lawyers with accounting firms be prohibited from doing anything a certified public accountant is not authorized to do?[3]

The first of these questions apparently did not generate a significant amount of interest among the members of the Institute. In contrast, the second question was ultimately answered when the membership of the Institute adopted a rule of conduct in 1958.

The ethical questions related to the preparation of legal documents and the employment of lawyers by certified public accountants were

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[1]Editorial, "The Agran Case in Perspective," The Journal of Accountancy, CII (December, 1956), pp. 29-31.

[2]Report of the Committee on Professional Ethics, October 21, 1955, pp. 3-4, American Institute of Accountants, New York (in the files of the Institute library).

[3]Ibid., p. 3.

assigned in 1955 to a subcommittee of the Committee on Professional Ethics of the American Institute. After more than a year of study, the Committee on Professional Ethics in March, 1957, released the draft of a proposed rule of conduct. That rule was "designed to prohibit a member in public practice from rendering through his employees any service which the member would be prohibited from performing."[1] Furthermore, the Committee believed that the proposed rule made it clear "that a member who 'may not' practice law should not permit a lawyer-employee to perform legal services for the member's clients."[2] The proposed rule was approved by the membership of the American Institute and became effective on January 20, 1958. The present version of the rule follows:

> A member or associate in his practice of public accounting shall not permit an employee to perform for the member's or associate's clients any services which the member or associate himself or his firm is not permitted to perform.[3]

Obviously questions of unauthorized practice of the law which must be settled in court are the source of a considerable amount of the animosity between lawyers and certified public accountants. But difficulties are also created by the appearance of certain behavior patterns which are viewed with irritation and suspicion by many lawyers. A major source of irritation for the legal profession is the propensity of public accountants and public accounting firms to hire substantial numbers of lawyers. As an example, the following paragraph is purported to have been part of a lawyer's letter to Dean Griswold of the Harvard Law School:

> With regard to the CPA item, nothing is surprising in this field. A large accounting firm now has approximately ten lawyers in

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[1] "Proposed Changes in AIA Rules of Professional Conduct," The CPA, (March, 1957), p. 6.

[2] Ibid., p. 7.

[3] By-Laws, Code of Professional Ethics, . . . (1962), p. 33.

> the 'Tax Department' of its local office alone, having only one approximately three years ago. Another firm has about twenty-five lawyers and lawyer-CPAs in its 'Tax Department' and thirty-five in its 'Auditing Department.'[1]

Despite the righteous indignation or pure intentions of public accountants, it seems likely that lawyers will continue to believe that "the presence of law-trained assistants on a CPA's staff may be regarded as circumstantial evidence of improper intentions."[2] Certainly the present rule cannot be expected to relieve the anxieties of members of the legal profession who note that public accounting firms are increasing the number of lawyers in their employ.

Confidential Relationship to Clients

Public accountants have long recognized the importance of observing and safeguarding the privacy of confidential information which comes to them during the course of an audit or the performance of other professional service. On the basis of written comments which appeared during the period 1905-1910, there were two distinct aspects of the confidential relationship which existed between an accountant and his client.

On the one hand, there was the question of the confidential relationship between a client and the accountant from the purely ethical point of view. Viewed in this manner, each public accountant was expected to have a clear sense of responsibility to each of his clients for the preservation of the secrecy of the confidential information which he gained during the performance of his professional service for the client.

On the other hand, there was the problem of the undesirable and perhaps unintentional disclosure of the confidential information pertaining to the affairs of a client. Such disclosure might occur if a public

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[1]Editorial, "Employment of Lawyers by Accounting Firms," The Journal of Accountancy, CIV (September, 1957), p. 28.

[2]Ibid., p. 30.

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accountant was required to give testimony in a court of law with respect to his knowledge of the affairs of his client.[1] Therefore, it was frequently suggested that the Institute should undertake active efforts to encourage the amendment of the various state accountancy laws in order to provide for the privity of the accountant-client relationship. Of course it was recognized that if the legal protection of privileged communications could be extended to public accountants, "the service which accountants can perform for their clients will be very greatly increased in value and a closer relationship can be built up between the accountant and his client."[2] But because the concept of privileged communications is a question of the legal status of the accountant-client relationship, it will not be discussed here.

Adoption of a Rule

Specific attention was drawn in 1928 to the ethical question which was raised when public accountants were requested to divulge information pertaining to the affairs of their clients. In that year, requests for credit information were sent to public accountants by trade associations[3] and certain factors in the textile industry.[4] Again in 1932, a member reported that he had received a questionnaire from a company which was engaged in gathering credit information on various business firms.[5]

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[1]Robert H. Montgomery, "Professional Standards: A Plea For Cooperation Among Accountants," The Journal of Accountancy, I (November, 1905), p. 36.

[2]"Report of the President," 1923 Year Book of the American Institute of Accountants (1924), p. 114.

[3]Editorial, "Evils of the Inquisition," The Journal of Accountancy, XLVI (August, 1928), pp. 128-29.

[4]Editorial, "Accountants and Credit Questionnaires," The Journal of Accountancy, XLVII (January, 1929), p. 42.

[5]Editorial, "A Wrong Way to Seek Information," The Journal of Accountancy, LIV (August, 1932), pp. 88-89.

The response to these complaints by the editor of The Journal of Accountancy was typically articulate and unequivocal--an accountant was never justified in releasing confidential information about a client without the explicit approval of the client. However, these editorial comments were not supported by an established policy of the American Institute.

Finally, the Committee on Professional Ethics indicated in its 1940 report that it had directed its attention to the question of the confidential relationship of the public accountant to his client. In response to an inquiry, the Committee advised a correspondent that he had violated the confidential relationship between himself and his client if his role had been that of an independent auditor. But the Committee cited neither the authority nor the basis for its answer to the inquiry. Evidently it was assumed that the confidential relationship between an accountant and his client was a generally accepted, unwritten rule of the mode of operation of public accountants.

Again in 1941, the attention of the Committee on Professional Ethics was directed to an incident which involved a member of the Institute who had disclosed to a third party certain information about the affairs of his client. The disclosed information had been acquired in the course of the professional work of the member.[1] After noting that it had criticized this action by the member, the Committee observed that

> the incident drew attention to the absence from the Institute's rules of professional conduct of any statement regarding the confidential relationship which should exist between client and accountant. The necessity for preservation of this relationship seems so obvious to your committee as hardly to require elaboration, but since the rules of conduct purport to indicate cardinal points which members of the Institute should bear in mind, the committee concluded that it might be desirable to add to the rules a statement on this subject.[2]

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[1]"Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1941 (New York: American Institute of Accountants, 1942), p. 87.

[2]Ibid.

Accordingly, the Committee recommended early in 1941 the adoption of the following rule which was not approved by the Council:

> All information concerning his client's financial affairs which a member has acquired shall be considered confidential and, except as disclosure may be required by legal process, no member shall, directly or indirectly, furnish a third party with any information with respect thereto without the consent of his client.[1]

The failure of the Institute to approve that rule is especially interesting in view of the fact that the proposal was limited to the financial data of a client. Obviously there are other important confidential data which also come to the attention of the public accountant and which he should also safeguard. The historical record is silent with respect to the reason for the failure of this rule to achieve acceptance. But an abbreviated rule which did not limit the confidential relationship to financial data was adopted and became effective on October 20, 1941.[2] Because subsequent amendments of the rule have been inconsequential, the current version follows:

> A member or associate shall not violate the confidential relationship between himself and his client.[3]

Practical Applications

A rule which simply directs a public accountant not to violate the confidential relationship which exists between himself and his client does little to inform the reader of the operational content of that proviso. Therefore, it will be necessary to review some practical applications of the doctrine in order to establish its significance.

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[1] Ibid.

[2] "American Institute of Accountants: Proceedings of the Annual Meeting," Yearbook American Institute of Accountants 1941 (New York: American Institute of Accountants, 1942), p. 29.

[3] By-Laws, Code of Professional Ethics, . . . (1962), p. 29.

A certified public accountant who was enrolled to practice before the Treasury Department was advised not to report to the Treasury Department a matter of tax evasion which had been discovered during his regular audit. In those circumstances, if a client is unwilling to permit the filing of an amended return, an enrolled agent of the Treasury Department is required merely to inform the client, preferably in writing, of the relevant facts concerning the violation. But the Committee on Professional Ethics of the American Institute has gone beyond that requirement to recommend that the accountant urge his client to file an amended return. If this fails, a member of the Institute should withdraw from the engagement and inform the client of his reasons for withdrawal.[1]

The Committee on Professional Ethics also advised a certified public accountant not to volunteer to testify in the bankruptcy hearing of a firm which was his former client. The accountant believed that it was desirable to make it known that the petition for reorganization did not correctly state the assets of the firm. Although he was not permitted to volunteer his testimony, the Committee advised him that if he was subpoenaed to testify he could state the facts which were known to him concerning the bankrupt firm.[2]

Another member was advised that he would violate the confidence of his clients if he used an independent mailing service for the confirmation of the accounts receivable and the accounts payable of his audit clients.[3] The confidential relationship between a public accountant and

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[1]"Reports of the Committee on Professional Ethics," 1942-1943 Reports of Officers, Council and Committees (New York: American Institute of Accountants, 1943), p. 55.

[2]"Committee on Professional Ethics," Yearbook . . . 1947, pp. 99-100.

[3]"Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1945-1946 (New York: American Institute of Accountants, 1947), pp. 91-92.

his client would be violated if the public accountant submitted to a large finance company, lists of his clients which might be in need of financing.[1] Again, the confidential relationship would be violated if a public accounting practitioner sold his accounting practice and transferred to his successor his working papers and other confidential information pertaining to the affairs of his clients unless he had obtained the permission of his clients to do so.[2]

Those examples clearly indicate that the rule forbids a member from making a voluntary disclosure of confidential information about the affairs of a client. Notwithstanding the simplicity of the rule, certified public accountants become involved in situations in which a practical application is very difficult. In one case, a certified public accountant discovered that some employees of a client corporation were, contrary to company policy, receiving payments from a supplier corporation which was audited by the same accountant.[3] Because that knowledge came to him during his audit of the supplier corporation, he decided he could not do more than inform the top management of the first corporation that the policy which forbade acceptance by employees of payments from suppliers was being violated.

Another difficult situation involved an individual who, during the course of an audit of a chamber of commerce, learned that the chamber had donated land to a corporation as an inducement to locate its plant in the community. Subsequently, the same auditor examined the accounts of the corporation and learned that the property had been deeded by the

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[1]Professional Ethics, "Lists of Prospects for Commercial Financing," The Certified Public Accountant, (January, 1947), p. 4.

[2]"Committee on Professional Ethics," May 1949 Reports to Council (New York: American Institute of Accountants, 1949), p. 28. This decision was restated in January, 1957, when the Committee issued its Opinion No. 3 entitled "Confidence of a Client." See By-Laws, Code of Professional Ethics, . . . (1962), pp. 36-37.

[3]T. A. Wise, "The Auditors Have Arrived," Part II, Fortune, LXII (December, 1960), p. 146.

chamber of commerce to the president of the corporation. Furthermore, the auditor learned that the corporation had purchased the land from the president for a price which was equivalent to its fair market value.[1] In this case, it was suggested that the auditor might urge the directors of the chamber of commerce to trace the ownership of the property through the county records. However, the difference between that suggestion and full disclosure by the auditor appears to be one of degree, not of substance.

The following opinion of counsel for the Institute is pertinent to this and similar problems encountered by certified public accountants:

> It seems clear that voluntary disclosure of confidential information by a CPA might be justified ethically only if it were necessary to prevent a crime not yet committed. There seems no legal or ethical requirement of voluntary disclosure of past acts, even though fraudulent, so long as there is no affirmative act of concealment on the part of the CPA, such as suppression of the evidence, harboring of the criminal, or other positive act designed to conceal from the authorities the fact that a crime has been committed, and so long as the CPA has not relieved, comforted or assisted the offender to hinder or prevent his punishment. The CPA who does make a voluntary disclosure might be sued for false and malicious prosecution. In any event, a CPA confronted with the problem should seek the advice of counsel, since the facts of each case may have a bearing on legal responsibilities.[2]

In view of the existence of such complex legal responsibilities, a public accountant would be ill-advised to rely on the ethical rule in any but the most trivial situations.

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[1]H. T. Scovill, "The Accountant and His Conscience," The Illinois Certified Public Accountant, XIV (March, 1952), pp. 31-32.

[2]Editorial, "Confidential Relationship Between CPA and Client," The Journal of Accountancy, XCV (March, 1953), p. 295.

Summary

Each of the rules of professional conduct, the evolution of which has been traced in this chapter, expresses some aspect of the profession's responsibilities to its clients or to society as a whole. By 1917 public accountants were becoming increasingly aware of the existence of a complex set of social responsibilities which were related to the audit function. In that year, the members of the Institute were bound by the standards which were expressed in these two rules: reporting responsibilities and expression of opinion on statements audited by another accountant. Those rules were hardly more than an ethical commitment to honesty.

The scope of the external ethical responsibilities of the Institute's members was not extended until 1939. A rule which became effective in that year prevented a member from engaging in the corporate practice of public accounting. Thus in a little more than thirty years, the general attitude had shifted from the acceptance and justification of incorporated audit companies to absolute rejection of that form of organization for public accounting firms. By means of this rule, the Institute joined forces with the established professions which had long opposed the limitation of personal, professional responsibility through incorporation. Recent interest in professional incorporation has been stimulated by the failure of the Congress to extend to the retirement programs of the self-employed, income tax provisions which are comparable to the favored tax treatment of corporate pension plans.

Members of the Institute further defined the ethical ideal of public accountants when in 1941 they adopted two new rules. One of these--the rule on estimates of future earnings--was a further development of a resolution which had been adopted by the Council in 1932 and which specified the conditions under which a member could associate his name with an earnings forecast. That policy statement was abbreviated but its

content remained unchanged when it became the subject of a rule of conduct in 1941. Current interest in that rule is related to budgets, cost analyses and similar management services which certified public accountants perform for their clients.

Also adopted in 1941 was a rule which gave expression to a public accountant's responsibility for preserving the secrecy of the information which comes to him in the course of his professional service. Evidently the necessity for the preservation of the confidential relationship between themselves and their clients had long been informally recognized by most public accountants. Several examples make it clear that this responsibility can make it very difficult for a certified public accountant to choose and follow, under certain kinds of circumstances, a proper course of action.

Following a long series of conflicts with the legal profession, the Institute adopted in 1958 a rule of conduct which imposes an ethical responsibility upon a member for the work of his employee. That rule prevents a member from permitting an employee (lawyer) to perform services (legal counsel) which the member is not permitted to perform. Outward appearances may have been a more important factor in the development of this rule than was actual practice.

An important extension of the ethical ideal of the public accounting profession appeared in 1958. The Institute adopted in that year a rule of conduct which embodied the technical standards applicable to situations in which the auditor allows his name to be associated with financial statements on which he does not express an opinion. Although the rule gives expression to the standards of Statement on Auditing Procedure No. 23, approximately nine years passed before Statement No. 23 had gained sufficient acceptance to justify the adoption of a related rule of conduct. Some of the abuses which brought about a need for these standards were acknowledged and criticized as early as 1918.

None of the rules of the Institute's code of professional ethics imposes upon its members a general explicit ethical responsibility for technical competence. Only the first of the rules which are discussed in this chapter gives expression to ethical standards of competence and those are applicable only to audit services. A proposed general rule on competence was quickly withdrawn by the Committee on Professional Ethics when a deluge of criticism made it clear that too many certified public accountants were not yet ready to accept formally an ethical responsibility for technical competence in all of the services which they perform.

CHAPTER V

PROFESSIONAL ATTITUDE

Introduction

This chapter is devoted to the evolution of a group of rules of professional conduct which serve to maintain the internal cohesion of the national professional organization of certified public accountants. They function as a mechanism for the internal control of the American Institute of Certified Public Accountants. The rules developed in this chapter thus differ from the rules previously discussed because the latter were expressions of the relationships between members of the profession and the rest of the society. Each of the remaining rules of conduct describes one or more aspects of the intra-professional relationships of the members of the Institute.

Some of the remaining rules give expression to acceptable standards of courtesy which members of the Institute are expected to observe in their professional interactions with other public accountants whether or not the latter are members of the Institute. A few of these rules prescribe a measure of uniformity for the descriptions which may be used by public accounting firms and individual practitioners. Others give expression to objectionable practices which should be avoided by a member of the profession who desires to avoid the criticism of his contemporaries with respect to the conduct of his practice.

Most important perhaps is the fact that most of these rules give expression to modes of behavior which by social custom are incompatible with professional status. Hence it can be said that the rules which are evolved in this chapter define the professional attitude as it is perceived

by the members of the national professional organization of certified public accountants.

Individual and Partnership Designations

On April 9, 1917, the Council of the American Institute of Accountants adopted the rules of professional conduct in order to achieve an adequate disciplinary control over the members of the profession. This, it will be recalled, was a primary reason for the establishment of the Institute as the successor of the American Association of Public Accountants. The first of these new rules was one which was no doubt necessary, but which is not obviously important from the point of view of the ethics of the profession. That rule follows:

> A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, all the individual members of which are not members of the Institute, or an individual practising under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practising under a style denoting a corporate organization, shall not describe themselves as "Members of the American Institute of Accountants."[1]

Certainly that rule served to restrict the distinction of individual identification with the Institute to persons who had given their support to the organization and its efforts to establish the professional status of public accountants. Beyond this, the rule was also useful in that it prescribed a uniform method by which a member could identify himself with the professional organization.

The existence of a specified method of identification with the Institute prevented or discouraged other techniques which may have been more

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[1]James Don Edwards, History of Public Accounting in the United States (East Lansing, Mich: Bureau of Business and Economic Research, Michigan State University, 1960), p. 255.

flamboyant and perhaps in conflict with the developing concepts of professional dignity. That there was an interest in the use of such distinctive designations was reported by the Executive Committee in 1919. Two members of the Institute who used the initials "M. A. I. A." with their names had been advised by the Executive Committee that the use of such distinctive initials was not authorized by the by-laws of the Institute. Hence they were found guilty of a failure to conform to the requirements of membership.[1] But because the use of initials was of considerable interest to the membership, the Executive Committee referred the matter to the Council with the suggestion that the issue be brought up for discussion at the annual meeting of the Institute. This was done, but the members who attended the 1919 annual meeting rejected a proposal to permit members to use the initials "M. A. I. A." and associates to use the letters "A. A. I. A."[2]

Although the proposal to permit the use of distinctive initials was defeated, the rule of professional conduct was revised in a way which probably helped the advocates of the proposal to accept defeat. Specifically, the rule was amended in September, 1919, so as to permit a firm or partnership which was composed of both members and associates[3] to describe itself as "Members of the American Institute of Accountants."[4]

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[1]"Report of Executive Committee," 1919 Year-Book of the American Institute of Accountants (1920), p. 98.

[2]"American Institute of Accountants: Proceedings of the Annual Meeting," ibid., p. 65.

[3]Both associates and members of the Institute must now hold a valid certified public accountant certificate and must have passed an acceptable examination in accounting and related subjects. However, an associate is not required to satisfy the two year practical experience requirement which is a prerequisite for admission to membership in the Institute. Only members have the right to vote. Similar distinctions were made for associates in earlier years.

[4]"Rules of Professional Conduct," ibid., p. 139.

That version of the rule was not the subject of an important revision until 1946 when references to associates of the American Institute were deleted as a result of the abolition of that special class of membership. But when the associate classification was reinstated in December, 1960, the privilege of a mixed partnership of members and associates of the Institute to describe itself as "Members of the American Institute of Certified Public Accountants" was not reinstated. It is the current version of the rule which follows:

> A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Certified Public Accountants," but a firm or partnership, not all the individual members of which are members of the Institute, or an individual practicing under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practicing under a style denoting a corporate organization shall not use the designation "Members of the American Institute of Certified Public Accountants."[1]

Styles Which Misleadingly Imply Partnership

The preceding discussion has been restricted to the positive functions of the rule. But the rule serves also to introduce two interesting matters which are pertinent to the present study. The first of these issues involves questions of style in the selection of a firm name. These are the questions which will be considered in the present section. In the following section, consideration will be given to the partnerships which members of the Institute are permitted to enter.

It is important to note that the rule does not prohibit a sole practitioner from using a firm name which denotes a partnership. The rule simply prohibits the use of the plural designation "Members of the American

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[1] By-Laws, Code of Professional Ethics, Numbered Opinions of the Committee on Professional Ethics, Objectives of the Institute Adopted by Council (New York: American Institute of Certified Public Accountants, 1962), p. 33.

Institute of Certified Public Accountants." Occasional references by the Committee on Professional Ethics have been made to the inappropriate use of a plural firm name for more than twenty years. It was also the subject of editorial comments in 1924[1] and again in 1929.[2] Yet there is no reason to believe that an effort has been made by the Institute to forbid this deception.

In 1941, the Committee on Professional Ethics stated that "it is the purpose of this provision to avoid the possibility of misleading anyone into the belief that a partnership exists when this is not so."[3] Yet it was not the partnership nature of the firm name which was considered misleading and objectionable. The Committee indicated that a sole surviving partner would be conforming to the requirement of the rule if, even though he retained the partnership name, he used the designation "Member . . ." in conjunction with his own individual name.[4] That interpretation was restated in 1944 when a sole practitioner was told that there was no reason why he could not continue to practice under his former partnership name provided that his letterhead clearly indicated the identity of the members of the firm.[5] Another sole practitioner was advised in 1946 that no rule of the Institute would prohibit the use of "& Company" in his firm name although he could not also use the plural designations

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[1]Editorial, "Single Partnerships," The Journal of Accountancy, XXXVIII (December, 1924), p. 442.

[2]Editorial, "The Plural Prerogative," The Journal of Accountancy, XLVII (February, 1929), pp. 126-27.

[3]"Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1941 (New York: American Institute of Accountants, 1942), p. 94.

[4]Ibid.

[5]"Report of Committee on Professional Ethics," Yearbook American Institute of Accountants 1943-1944 (New York: American Institute of Accountants, 1945), p. 43.

"Certified Public Accountants" and "Members. . . ."[1] Despite the fact that a state board of accountancy placed a member on a two-year probation in 1952 for practicing under a "plural firm designation," neither the state society of certified public accountants nor the American Institute found cause for disciplinary action against that member.[2]

A memorandum on the selection of a firm name was published in the monthly membership bulletin of the Institute in 1945. The following cautious comments, which were attributed to the Committee on Professional Ethics, suggest that an attempt was being made by the Committee to abandon its previous permissive attitude:

> The purpose of this memorandum is to indicate the principles that should be observed by certified public accountants in partnership in choosing a firm name and style for the partnership.
>
> The name of a firm of practicing accountants should denote a personal association. Such a firm should not adopt for its name any non-personal or misleading title.[3]

As if it were citing an authoritative statement, the Committee on Professional Ethics repeated that memorandum in response to an inquiry received in 1950.[4] Two years later, the Committee advised a certified public accountant that the continued use by a sole surviving partner of the firm name of the former partnership was not a violation of the rules of professional conduct. But, the Committee reported, this practice had

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[1]"Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1945-1946 (New York: American Institute of Accountants, 1947), pp. 92-93.

[2]Mid-Year Report of Committee on Professional Ethics, April 27, 1952, p. 5, American Institute of Accountants, New York (in the files of the Institute library).

[3]Professional Ethics, "Ethical Considerations Respecting Choice of Name for a Firm of Public Accountants," The Certified Public Accountant, (October, 1945), p. 4.

[4]"Committee on Professional Ethics," April 1950 Reports to Council (New York: American Institute of Accountants, 1950), pp. 60-61.

"been questioned on the ground that it implies the existence of a partnership and therefore might be misleading."[1]

A dearth of written references to this practice during the past ten years is strong support for the presumption that the interest in restricting the use of misleading firm names has been very limited at best. With respect to the importance of this problem, the Executive Director of the American Institute has written that individual practitioners who practice under a style denoting a partnership are believed not to be uncommon.[2]

Questions have also been raised from time to time with regard to the propriety of the continued practice of public accounting under the name of a former partner who had previously withdrawn and perhaps was no longer living. Apparently the most bothersome questions have been raised by the various state legislatures which have shown an interest in this practice. Legislative efforts which were designed to interfere with the choice of public accountants in the selection of a firm name caused the Council of the American Institute to oppose promptly, clearly, emphatically, and unanimously all such legislation. That opposition was expressed in a resolution which the Council adopted on April 13, 1936.[3]

The immediate cause for the formal statement of opposition seems to have been a bill proposed to the legislature of New Jersey under the following heading:

> An act for the protection of the public and prevention of fraud by prohibiting a person, partnership or corporation to practise as a

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[1]Mid-Year Report of Committee on Professional Ethics, April 27, 1952, p. 7, American Institute of Accountants, New York (in the files of the Institute library).

[2]John L. Carey, Professional Ethics of Certified Public Accountants (New York: American Institute of Accountants, 1956), p. 204.

[3]Editorial, "'Firm-Name' Legislation Opposed," The Journal of Accountancy, LXI (May, 1936), pp. 321-22.

> certified public accountant, auditor or public accountant under a false, assumed, fictitious or trade name and providing penalties for the violation thereof.[1]

The 1936 resolution did not merely represent a passing interest in the matter because in 1943 the Council again gave formal expression to its opposition to legislation which would restrict the selection and use of a firm name by public accountants. This time it was resolved

> that in the opinion of the council of the American Institute of Accountants neither the public interest nor the interest of the accounting profession as a whole would be served by legislation preventing the use by public accounting firms of firm names or titles which contain the names of partners who have died or withdrawn from the firm. . . .[2]

Mixed Partnerships

A firm which is composed entirely of members of the American Institute of Certified Public Accountants may properly describe itself as "Members. . . ." This statement of course implies that a member of the Institute may enter into partnership with someone who is not a member. The marked degree of latitude which members of the Institute have in the selection of their partners will be evident from the material which is presented in this section.

The national professional organization of certified public accountants does not restrict its members to partnerships composed entirely of public accountants whose qualifications have been established by successful completion of the certified public accountant examination. Some members evidently have experienced doubts with respect to that policy. The Committee on Professional Ethics reported in 1952 that it had considered the

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[1]Editorial, "Another Attempt to Interfere with Practice," The Journal of Accountancy, LXI (April, 1936), p. 245.

[2]Professional Ethics, The Certified Public Accountant, (October, 1945), p. 4.

matter of partnerships between certified and non-certified public accountants.[1] The Committee noted that any change in the policy of the Institute with respect to these partnerships would require a provision for the continuation of the mixed partnerships which were then in existence.

No additional comments on mixed partnerships appeared until 1955 when the Committee on Professional Ethics listed this question in its report: "Should not the formation of new partnerships with non-certified public accountants be forbidden?"[2] Again in 1958 the Committee expressed its views on this practice when it said it was looking forward to the day when partnerships entered into by members of the Institute would be composed entirely of certified public accountants.[3] Still another three years passed during which time the question seems to have been dormant. But in 1961, the Committee on Professional Ethics reported that the question of mixed partnerships was being referred to a subcommittee which had been appointed to study the question and to submit its recommendations.[4] Later that year, the Committee reported that it was considering a possible new rule of conduct on the subject of mixed partnerships.[5]

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[1]Report of the Committee on Professional Ethics, October 6, 1952, p. 13, American Institute of Accountants, New York (in the files of the Institute library).

[2]Report of the Committee on Professional Ethics, October 21, 1955, p. 4, American Institute of Accountants, New York (in the files of the Institute library).

[3]"Opinion No. 6: Concept of 'Laity' in Sharing of Fees," By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics, . . . (1962), p. 39.

[4]Report of the Committee on Professional Ethics, April 19, 1961, p. 9, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[5]Report of the Committee on Professional Ethics, October 28, 1961, p. 2, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

Mixed partnerships are not restricted to partnership agreements between certified and non-certified public accountants. Engineers and lawyers have also been admitted to partnerships in firms of certified public accountants.[1] But the Committee on Professional Ethics ruled in 1946 that a proposed partnership composed of a public accountant, a lawyer, an engineer, an architect, a realtor, an advertising man, and an investment consultant was objectionable because it would violate the rule which forbids members to divide their fees with the laity.[2] The criterion which governed in these opinions was a test of the professional status of the proposed partners. If the would-be partners were members of another profession, the resulting mixed partnership was not considered objectionable.

That doctrine was abandoned in 1958 when the Committee expressed the opinion "that no useful purpose would be accomplished by attempting to establish a special definition for use solely within the accounting profession which would include certain non-accounting professional groups and exclude other such groups."[3] At the same time, the members of the Institute were advised of the adoption of a new criterion for the determination of illicit fee-sharing arrangements. From that time on, members were urged not to share fees "with any individual or firm not engaged or employed in the practice of public accounting."[4] Obviously, the changes in the interpretation of the rule which prohibits a member of the Institute

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[1]Henry O. Jordahl, "Ethics in Management Services," Technical Papers Presented 1958 (Jackson Lake Lodge, Wyoming: Mountain States Conference of Certified Public Accountants, 1958), p. 78.

[2]"Reports of the Committee on Professional Ethics," Yearbook. . . 1945-1946, p. 87.

[3]"Opinion No. 6: Concept of 'Laity' in Sharing of Fees," By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics, . . . (1962), pp. 38-39.

[4]Ibid., p. 39.

from sharing fees with certain other persons are relevant to the question of mixed partnerships because it is the fee-sharing proviso which is used to discourage conglomerate partnerships involving members of the Institute.

An interesting contrast emerges from this change of policy. On the one hand, the Committee on Professional Ethics has expressed the belief that members of the Institute should no longer be permitted to enter into partnership with non-certified public accountants. On the other hand, the Committee has formally expressed the opinion that a member of the Institute may share fees (which is tantamount to entering into a partnership) with any individual or firm which is engaged or employed in the practice of public accounting. This inconsistency suggests an attempt on the part of the Committee to allow the members to have their cake and eat it too. Perhaps these conflicting opinions are not so much the result of an effort to limit partnerships with non-certified public accountants as they are the result of pressures created by the allure and subsequent expansion of management services by certified public accountants.

Practice in the Name of a Member

In the early days of the public accounting profession in the United States, it was common practice for a certified public accountant to enter into an agreement with a non-certified public accountant to share joint office facilities. Although both names might appear on the door, their fees were not shared and there was no partnership agreement.[1] It cannot be denied that such an arrangement was a potentially misleading situation. Certainly it is conceivable that some persons (clients, potential clients, or the general public) might reasonably assume that the arrangement was in fact a partnership and that each of the accountants was

[1]Carey, p. 103.

responsible for the work of the other. Furthermore, the non-certified public accountant might directly or indirectly encourage the assumption that his arrangement with the certified public accountant was indeed a partnership. Even worse, the certified public accountant might himself be tempted to permit or to encourage such deception.

Evidently the results of these arrangements were recognized as being detrimental to the professionalization of the practice of public accounting as early as 1905. In that year, the American Association of Public Accountants added the following rule to its by-laws:

> No member shall allow any person not being either a member of the Association or in partnership with himself as a public accountant to practice in his name as a public accountant.[1]

In 1907, the following version of the rule was adopted:

> No member shall allow any person not being either a member of the Association or in partnership with him as a public accountant, or in his employ on a salary, to practice in his name as a public accountant.[2]

Although the substance of the rule remained unchanged in the 1907 revision, the scope of the rule was expanded to permit an employee to practice as a public accountant in the name of a member of the Association.

Numerous minor changes have been made in the rule since 1907. But none of those amendments affected the substantive content of the rule. The current version of the rule follows:

> A member or associate shall not allow any person to practice in his name who is not in partnership with him or in his employ.[3]

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[1] "Constitution and By-Laws," The American Association of Public Accountants Nineteenth Anniversary Year-Book (1906), p. 85.

[2] "Constitution and By-Laws," The American Association of Public Accountants Twentieth Anniversary Year-Book (1907), p. 238.

[3] By-Laws, Code of Professional Ethics . . . (1962), p. 33.

It has been said by the Committee on Professional Ethics of the American Institute that this rule was "designed to prevent a member from serving as a 'front' for a non-certified accountant."[1] The executive director of the American Institute has expressed a concurrent opinion.[2]

Advertising

The propensity of many public accountants to advertise their services has been a persistent and distressing barrier for those who sought to establish the professional status of public accountants. Indeed, the general attitude of organized public accountants has completed a full cycle of change from approval of the practice to unequivocal opposition. It will be recalled from the discussion in Chapter II that as late as 1900, advertising was an accepted part of the practice of public accounting. That position has been gradually abandoned. In 1960 the cycle was completed when a rule of conduct was adopted which forbade a member of the Institute to advertise his professional attainments or services. It is this development which will now be traced.

The Censorship Episode

Evidently the efficacy of formal advertising by public accountants was one of the first problems which was studied in 1916 by the Committee on Professional Ethics of the newly established Institute. After more than a year of study, however, the Committee reported in 1918 that it was unable to draft a recommended rule of conduct because any such rule would be subject to a literal interpretation. Thus, the Committee

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[1]Report of the Committee on Professional Ethics, October 6, 1952, p. 10, American Institute of Accountants, New York (in the files of the Institute library).

[2]Carey, p. 103.

reasoned, a specific rule might inhibit not only objectionable advertisements but also the proper and unobjectionable forms of publicity. This was likely to be the result because the proper and the unobjectionable could only be recognized by those who had good taste and who possessed a decent regard for the welfare of the profession. A public accountant whose intuition was defective in this manner was believed to be incapable of understanding the rule and would interpret the rule in a way which would permit him to continue advertising while he criticized the actions of others who were not guilty of any improper activity.[1]

Since it was the belief of the Committee on Professional Ethics that some forms of publicity were proper and some were not, it followed that any effort to deal with the question of advertising should be based on this principle. Accordingly, the Committee recommended the appointment of a committee whose task it would be to approve or revise proposed circulars prior to their use by members of the Institute. On September 19, 1918, the Council of the Institute approved the following rule which had been recommended by the Committee on Professional Ethics:

> In the event that a member shall be requested so to do by the Committee on Ethical Publicity, he shall thereafter submit all proposed circulars or other instruments of publicity to it, and for a period of two years he shall not issue or permit the organization with which he is identified to issue any circular or any other instrument of publicity without first forwarding a copy thereof to the committee on ethical publicity.[2]

One year later, in 1919, the Council adopted the following abbreviated version of the rule again on the recommendation of the Committee on Professional Ethics:

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[1] "Report of Committee on Professional Ethics," 1918 Year-Book of the American Institute of Accountants (1918), p. 101.

[2] "Council: Regular Meeting, September 19, 1918," ibid., p. 75.

> For a period not exceeding two years after notice by the committee on ethical publicity no member or associate shall be permitted to distribute circulars or other instruments of publicity without the consent and approval of said committee.[1]

The Committee on Ethical Publicity, which was established to put into effect the provisions of the new rule, might more appropriately have been called the Committee on Censorship.[2] But the distinctive title which was given the Committee is probably not the reason for its unimpressive first year of activity. In the first annual report of the Committee on Ethical Publicity, chairman W. Sanders Davies reported that with one exception the Committee handled only routine matters. The one exception involved a member of the Institute who had been required to submit his proposed advertisements to the Committee for its approval. However, the member had chosen to ignore this request and subsequently resigned his membership in the Institute.[3]

The Committee on Ethical Publicity reported in 1920 that it also had considered a rule of professional conduct on the question of advertising, but

> at the present time there does not seem to be sufficient sentiment in the profession generally to make such a rule effective, and that in certain parts of the country it is claimed by the members of the profession that the public has to be educated as to the work performed by accountants and the desirability of their employment.[4]

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[1] "Council: Regular Meeting, September 18, 1919," 1919 Year-Book . . . , p. 75.

[2] Editorial, "Ethical Publicity," The Journal of Accountancy, XXVI (October, 1918), p. 292.

[3] "Report of Special Committee on Ethical Publicity," 1919 Year-Book . . . , p. 113.

[4] "American Institute of Accountants: Meeting of Council, April 12, 1920," The Journal of Accountancy, XXIX (May, 1920), p. 365.

Significantly, the Committee cited the old argument that advertising by public accountants was necessary in order to bring to the attention of the public the nature of the services which they had to offer. This was the basis for the organizational advertising of the American Association of Public Accountants twenty-five years previous to 1920[1] and was also a part of the rationale for an institutional advertising campaign by the American Institute more than twenty-five years later.[2]

With respect to the ill-fated plan to censor the advertisements of the unreformed members of the Institute, the Committee on Ethical Publicity did not even bother to submit a written report at the end of 1920 because the chairman believed that "until all members agreed not to advertise in any way the labors of his committee would be largely wasted."[3] With that comment, the episode of censorship of advertising by public accountants was brought to a close although the Committee on Ethical Publicity was not abolished until 1923.

Continuing Concern: Internal and External

Despite the futility of the effort to censor objectionable advertisements, the leadership of the Institute continued its efforts to cope with the problem. The most important of these efforts was the appointment of the Special Committee on Professional Advancement. Under the chairmanship of W. Sanders Davies, that Committee made a study of the problem and submitted its report in September, 1921. The fact that the report was printed and distributed to the membership prior to the annual

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[1]See Chapter II.

[2]"Institutional Advertising of Public Accounting," The Certified Public Accountant, (October, 1947), pp. 3-4.

[3]"Council: Regular Meeting, September 20, 1920," 1920 Year-Book of the American Institute of Accountants (1921), p. 80.

meeting is evidence of the seriousness of the problem. Committee reports were normally submitted to the Council at its regular meeting on the day preceding the annual meeting of the membership. But this particular report was so important and the question with which it was concerned was so serious that the Executive Committee authorized the advanced distribution of the report to all members of the Institute.[1]

Briefly, the Special Committee on Professional Advancement summarized its findings and introduced its report with this pseudo syllogism:

> It is generally admitted by all members of the Institute that accountancy is a profession. Self-praise is unprofessional.
>
> All advertising must be characterized by a certain amount of self-praise.
>
> Therefore, all advertising is unprofessional and accountants should abstain from it.[2]

The Committee noted that a serious objection to the use of circular advertisements was the fact that the circulars frequently went to the clients of other accountants. In addition to this, it was generally believed that the cost of newspaper, magazine and other advertising exceeded the benefits therefrom.

The Committee was adamant in its rejection of the proposal that national or state organizations should jointly or severally substitute for individual propaganda efforts, a general educational advertising campaign designed to impress upon the general public the value to the business community of the services of public accountants. While the theoretical appeal of the proposal was granted, the Committee argued that it was neither feasible nor likely to yield results proportionate to the cost.

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[1]"American Institute of Accountants: Proceedings of the Annual Meeting," 1921 Year Book of the American Institute of Accountants (1921), p. 75.

[2]Ibid., p. 74.

Similar efforts previously undertaken by the American Association of Public Accountants and several state societies had been abandoned almost immediately after inception. Even if the funds could be raised, the campaign would be criticized by members whose practice was limited to areas in which no advertisements were placed. Furthermore, the general public would not likely be favorably influenced by such a grave departure from the dignified and self-respecting attitude of a profession. Finally, the Special Committee on Professional Advancement recommended that a rule of professional conduct be adopted which would prohibit a member of the American Institute from engaging in circularizing, advertising, and "publicity which would be deemed unethical by the other learned professions."[1]

In addition to a stimulating discussion of the report of the Special Committee on Professional Advancement, the members of the Institute who attended the 1921 annual meeting also were privileged to hear some pointed comments from a representative of the Bureau of Internal Revenue. The speaker represented the Commissioner of Internal Revenue who had been invited the previous day but was unable to accept the invitation.[2] The speaker advised the members of the Institute that regulations would soon be adopted which would require of accountants and agents practicing before the Treasury Department, the same high level of ethics by which other learned professions were governed. It was said that advertising which described the services to be rendered or the capacity or ability to render such services would be prohibited although the usual letterheads and business cards could continue to be used. Also banned would be circular letters, personal letters, advertisements, and interviews not warranted by previous relationships. These provisions were incorporated

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[1] Ibid., p. 75.

[2] Ibid., p. 70.

in Treasury Department Circular 230 in an amendment which was dated April 25, 1922.[1]

Following the summary of the report of the Special Committee on Professional Advancement and the remarks of the representative of the Treasury Department, the question of advertising by public accountants was opened for general discussion. During that discussion, the following resolution was introduced:

> RESOLVED, That the committee's report be approved and that it is the sense of this meeting that the publication or circulation of ordinary simple business cards, being a matter of personal taste or custom and convenience, is not improper, but solicitation of business by circulars or advertisements or by personal communications or interviews, not warranted by personal relations, is unprofessional and should not be permitted. It is desirable that the publication of books and articles on accountancy subjects should be encouraged to the fullest extent, but care should be taken that such publications do not contain self-laudatory expressions. If it deems it necessary the council is authorized to formulate rules for the guidance of the members to the end that a high standard of professional ethics and conduct shall be maintained.[2]

That resolution was adopted by a vote of 150 to 68.[3] The affirmative votes represented approximately 12% of the membership of the American Institute of Accountants at that time. Later it was moved that the resolution be submitted to a referendum in order to get the most broad approval which it was possible to obtain. Unfortunately the details of the discussion were omitted from the official record, but after President Carl H. Nau opposed the referendum motion, it was withdrawn.[4] It may not be unreasonable to suspect that the leadership of the Institute doubted that the relatively mild resolution would be approved by a majority of the members.

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[1]Editorial, "Ethics by Regulation," The Journal of Accountancy, XXXIII (June, 1922), p. 438.

[2]"Proceedings of the Annual Meeting, September 20 and 21, 1921," 1921 Year Book . . . (1921), pp. 75-76.

[3]Ibid., p. 76.

[4]Ibid., p. 77.

The momentum which was gained during the 1921 annual meeting was apparently used to good advantage during the following year by the leadership of the Institute. On September 18, 1922, the Council adopted, with only one vote of dissent, this rule of professional conduct:

> No member or associate of the institute shall advertise his or her professional attainments or service through the mails, in the public prints or by other written words; but any member or associate may cause to be published in the public prints or otherwise what is technically known as a card. A card is hereby defined as an advertisement of the name, title (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation) and address of the advertiser without further qualifying words or letters, or in the case of announcement of change of address or personnel of firm the plain statement of the fact for the publication of which the announcement purports to be made. Cards permitted by this rule when appearing in newspapers shall not exceed two columns in width and three inches in depth; when appearing in magazines, directories and similar publications cards shall not exceed one quarter page in size. This rule shall not be construed to inhibit the proper and professional dissemination of impersonal information among a member's own clients or personal associates or the properly restricted circulation of firm bulletins containing staff personnel and professional information.[1]

Although the resolution that was adopted at the 1921 annual meeting authorized the Council to adopt any rules of conduct which it deemed necessary, the new rule was submitted to and was approved by the members of the American Institute of Accountants who were in attendance at the 1922 annual meeting.

It should be noted that the 1922 rule of the Institute did not include an explicit reference to class of service information on the published card of a member. But the amended rules of the Treasury Department did permit enrolled attorneys and agents to designate any special field of service which they offered. In 1926, four years after the adoption of the

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[1] "Rules of Professional Conduct," 1922 Year Book of the American Institute of Accountants (1923), p. 195.

rule by the Institute and the amendment of the Treasury Department rule, the Committee on Professional Ethics reported that a few cases had come to its attention in which a member had included in his card such class of service designations as "audits," "income-tax service," "cost accounting," and "appraisals." Because these advertisements were dignified, the Committee expressed the opinion that there should be no objection to the designation on a card of the class of service offered by a member.[1]

A second deficiency in the advertising rule was reported in 1926 by the Committee on Professional Ethics. The Committee observed "that certain members and associates of the Institute have availed themselves of the decisions of the income-tax department of the government as an excuse for the issuance of circular letters quoting such decisions, which have not been confined to their own clients, but have been sent out promiscuously."[2] While this practice was prohibited by the rule which was then in existence, the Committee believed that the rule would be clarified if circular letters were explicitly prohibited. Accordingly, the Council adopted an amendment of the advertising rule. The amended part of the rule follows:

> No member or associate of the Institute shall advertise his or her professional attainments or service through the mails, in the public prints, by circular letters or by any other written word except that a member or associate may cause to be published in the public prints or otherwise what is technically known as a card. A card is hereby defined as an advertisement of the name, title (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service and address. . . .[3] (Italics mine.)

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[1] "Report of Committee on Professional Ethics," 1926 Year Book of the American Institute of Accountants (1926), p. 170.

[2] Ibid.

[3] "Rules of Professional Conduct," ibid., p. 220.

A Period of Adjustment

Several comments which were made in the year immediately following the adoption of the rule on advertising suggest that the leadership of the Institute may have been either unduly optimistic or indulging in a bit of wishful thinking. In 1923, one year after the rule had been adopted, the Committee on Professional Ethics estimated that 90-95% of the members of the Institute subscribed to and conformed their practice to the provisions of the new rule.[1] About the same time, an editor of The Journal of Accountancy stated that the small minority who had opposed the rule had now willingly complied with the will of the majority and that only a very few members had resigned in order to continue to proclaim their qualifications to the public.[2] A brief examination of the disciplinary experiences with this rule and the advertising practices in which the members of the Institute indulged will provide a rough indication of the progress which had been achieved.

With respect to the enforcement of the rule, the Committee on Professional Ethics reported in 1923 a pattern of administration of the new rule which was typical of its administration of most of the rules. Specifically, the Committee sought by means of discussion, argument, and persuasion to secure the compliance of members who were reported to have violated the provisions of the rule.[3] However, the Committee found it necessary in two cases to bring formal charges against members who had violated the advertising rule. One of these members was admonished by the trial board to refrain in the future from acts which

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[1]"Report of Committee on Professional Ethics," 1923 Year Book of the American Institute of Accountants (1924), p. 144.

[2]Editorial, "Professional Advertising," The Journal of Accountancy, XXXVIII (July, 1924), pp. 43-44.

[3]"Report of Committee on Professional Ethics," 1923 Year Book . . . , p. 144.

were similar to those on which the complaint was based.[1] The other case involved a formal complaint against two members and an associate who were alleged to have solicited clients, to have solicited engagements on a contingent fee basis, and to have advertised in the public press. When advised of the complaint, these respondents--members A. C. Ernst and Horace Manning and associate Lester W. Blyth--promptly submitted their resignations which were accepted by the Council.[2] Apparently A. C. Ernst remained convinced that the Institute rule on advertising was ill-advised because in 1932 he was identified as a prominent public accountant "who believes, contrary to tradition, that a public accountant does well to advertise."[3]

The reports of the Committee on Professional Ethics did not consistently include detailed information with respect to the complaints and inquiries which were referred to the Committee. Yet it is possible to make an estimate of the relative frequency of advertising complaints on the basis of the information which was reported by the Committee. Approximately 25% of the complaints and inquiries--of which there was an average of approximately sixty during each of the years from 1923 to 1932--involved the advertising rule. During that ten year period, nine accountants were cited in formal complaints. The final dispositions of these cases involved the resignation of two members and one associate, the admonition of one member, the reprimand of two members, and the suspension of three members--one for two years and two for six months each.

Among the advertising practices which were not immediately affected by the advertising rule of the Institute was the distribution of

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[1]"Council: Regular Meeting, September 17, 1923," ibid., p. 93.

[2]Ibid., pp. 92-93.

[3]"Certified Public Accountants," Fortune, V (June, 1932), p. 65.

"boiler plate" material by certain members. Pamphlets and booklets which contained material that was supposed to be of general interest were called "boiler plate." Large quantities of these materials were produced by ambitious, enterprising publishers and were then sold to a single accounting firm in a city. Space was provided in which the accounting firm could imprint its name on the material before it was distributed to business firms.[1] Businessmen supposedly inferred that the material had been originated by the accounting firm. No objection to this practice could be made with reference to the advertising rule because that rule explicitly permitted a member to disseminate impersonal information or firm bulletins provided that circulation was restricted to the clients or personal associates of the member.

Although the rule did not prohibit the use of "boiler plate," the Committee on Professional Ethics was critical not only of the content of some of these pamphlets but also of the lack of professional dignity on the part of those who circulated such materials.[2] In 1931 the Committee on Professional Ethics requested the Executive Committee to express its opinion on the propriety of the circulation of the so-called "boiler plate" by members of the Institute. The Executive Committee resolved that it was improper for public accountants to mail such material even though it was restricted to clients and it advised the Committee on Professional Ethics to discourage this activity in so far as it was possible so to do.[3] If the Committee on Professional Ethics was making an effort to discourage the rise of "boiler plate" it was doing so quietly because more than ten years passed before the problem again appeared in the public record of the Institute.

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[1]Editorial, "Some Other Instruments," The Journal of Accountancy, XLIII (March, 1927), p. 203.

[2]"Report of Committee on Professional Ethics," 1927 Year Book of the American Institute of Accountants (1927), p. 157.

[3]"Report of the Executive Committee," 1931 Year Book of the American Institute of Accountants (1931), p. 215.

Evidently the editor of The Journal of Accountancy had seen examples of the advertisements of public accountants which strongly suggested that the deference which was given the rule pertained more to the letter rather than the spirit of the rule. Some announcements of change of firm personnel or office address, the editor wrote, were so embellished that the original purpose of the announcement was lost in the display. Furthermore, he said that the time had come when it was necessary for the Institute to express itself on the pictorial and typographical museums which were then masquerading as harmless letterheads.[1]

The Committee on Professional Ethics reported in 1933 that the volume of alleged violations of the advertising rule was declining and it noted that this was particularly surprising in view of the spreading influence of the depression through all parts of the economy. This trend, according to the Committee, was a manifestation of "a gratifying recognition by members of the obligations laid on them by their professional status."[2] But even these offenses could be further reduced the Committee believed, if it could get the support of the Council for its definition of the terms "clients" and "personal associates" as used in the final sentence of the advertising rule. Therefore, the Committee recommended in 1933 and again in 1934 that the Council adopt the following resolution:

> RESOLVED, That the terms "clients" and "personal associates" as used in the last sentence of rule 11 of the rules of professional conduct shall be understood to refer only to clients presently looking to the member for service and advice, and personal associates of the member in his professional practice, as partners or staff members.[3]

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[1]Editorial, "Other Ways of Offending," The Journal of Accountancy, XLIII (March, 1927), p. 202.

[2]"Report of the Committee on Professional Ethics," 1933 Year Book of the American Institute of Accountants (1934), p. 227.

[3]"Report of the Committee on Professional Ethics," 1934 Year Book of the American Institute of Accountants (1935), p. 252.

That proposed resolution was referred to the incoming Committee on Professional Ethics in 1933. In 1934 the Council tabled the resolution which had been recommended for the second time.[1] After that action by the Council, the issue was dropped by the Committee on Professional Ethics.

The number of violations of the advertising rule was increasing in 1937 primarily as a result of tax practice.[2] Despite a reluctance to bring a first offender to trial for an offense which was committed in ignorance, the Committee on Professional Ethics recommended that if the large volume of violations of the advertising rule continued, it would be necessary to file formal charges in order to impress upon the membership of the Institute the fact that such activities would not be condoned. It is doubtful that the rule was ever administered with that degree of rigor. On the one hand, the reports of the Committee in subsequent years contain no further comment on the question of the increased rigor of the enforcement of the rule on advertising. On the other hand, the great volume of comment on the question of advertising continued to appear in The Journal of Accountancy as well as in the form of responses to inquiries and case summaries in the reports of the Committee on Professional Ethics. Furthermore, the published reports of the trial board indicate that only five members have appeared before the trial board on charges of advertising since 1935. For these reasons it seems likely that no radical change was initiated in the administration of the advertising rule either in 1937 or thereafter.

A Simplification of the Rule

On January 6, 1941, the general amendment of the rules of professional conduct was approved in a referendum of the members of the

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[1] "Council: Regular Meeting, October 15, 1934," ibid., p. 193.

[2] "Report of the Committee on Professional Ethics," 1937 Year Book of the American Institute of Accountants (1938), p. 475.

Institute. The following version of the advertising rule became effective at that time:

> Members or associates shall not advertise their professional attainments or services, but the publication of what is technically known as a card is not prohibited by this rule. A card is defined as an advertisement of the name, title (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service, and address of the advertiser, or announcement of change of address or personnel of firm, not exceeding two columns in width and three inches in depth if appearing in a newspaper, or not exceeding one-quarter of a page if appearing in a magazine, directory, or similar publication.[1]

Note that the reference to the proper and professional dissemination of information and firm bulletins to clients or personal associates was omitted from the rule. It will be recalled that the Committee on Professional Ethics had encountered differences of opinion with respect to the meaning of the terms "clients" and "personal associates" and that it had unsuccessfully asked the Council to approve its definitions. Probably the fact that the controversial terms were deleted from the rule reduced the probability of a conflict with respect to their operational meaning. Of course it also seems to have eliminated the probability that the rule could be used to curtail the distribution of purchased pamphlets and bulletins by the members of the Institute.

Because the subsequent editions of the rule are also silent on the question of the distribution of pamphlets and other materials by members of the American Institute, the development of the Institute policy on this phase of the professional advertising of public accountants will be brought up to date before tracing the recent developments in the advertising rule.

"Boiler Plate" and Newsletters

In retrospect, it seems clear that the omission from the rule of an explicit reference to "the proper and professional dissemination of

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[1] "Rules of Professional Conduct," 1940 Yearbook of the American Institute of Accountants (1941), p. 534.

information" to clients was only the beginning of a long campaign. The Committee on Professional Ethics issued in 1951 the following opinion on so-called canned newsletters:

> Questions have been raised concerning the propriety of members of the Institute furnishing, to clients and others, newsletters prepared by others with their accounting firm name imprinted thereon.
>
> While the distribution of such letters to clients presently served may not be a direct violation of any specific rule of professional ethics, the committee looks with disfavor upon the distribution of such material because it carries with it the misleading implication that the accountant, himself, had prepared the material.
>
> Some members of the committee feel that this is advertising the professional attainments of the accountant. When such material finds its way into the hands of clients of other accountants, as is frequently the case, there would seem to be basis for complaint.[1]

That opinion was repeated in 1953 when the Committee noted that the most troublesome questions which it received were those which involved the distribution of canned newsletters.

The Committee reported that it had received letters from members who complained about the promotional efforts of the publishers of canned newsletters and who suggested the amendment of the rules of professional conduct in order to prohibit the distribution of such materials. However, it was noted that there was no accurate information on either the extensiveness of the distribution of canned newsletters or their value to the recipients. Thus the Committee proposed to study carefully the numerous questions related to the problem and later to publish a short statement of the favorable and unfavorable arguments which it was hoped would stimulate an expression of the views of the members.[2]

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[1]Report of the Committee on Professional Ethics, April 13, 1953, pp. 3-4, American Institute of Accountants, New York (in the files of the Institute library).

[2]Ibid., p. 4.

Presumably that period of study by the Committee on Professional Ethics resulted in the publication of the first of its formal, numbered opinions. Opinion No. 1, which was first published in December, 1956, follows:

> In the opinion of the committee, imprinting the name of the accountant on newsletters, tax booklets or other similar publications which are prepared by others and distributed by a member of the Institute does not add to the usefulness of the material to the reader. Use of the imprint, in the committee's opinion, is objectionable in that it tends to suggest (and has been interpreted by many as a means of) circumventing Rule 3.01 of the Code of Professional Ethics, which says that a member shall not advertise his services.
>
> It is the conclusion of the committee that distribution of newsletters, tax booklets or similar publications, prepared by others, when imprinted with the name of the accountant furnishing the material, is not in the interest of the public or the profession.
>
> The committee sees no grounds for objection to furnishing material of the type indicated to clients or others provided that such material does not carry the imprint described and provided that such distribution is limited in a manner consistent with Rules 3.02 and 5.01.[1]

Absent from that opinion is the former explicit reference to the misleading implication that an accountant had prepared materials upon which his name had been imprinted. Yet a close examination of the opinion suggests that this is the primary thought on which the policy statement is based. Thus a member of the Institute should not distribute to anyone printed material which carries an imprint of his name and which was prepared by someone other than himself. But if he prepared the material himself, it could include the imprint of his name and it could properly be distributed provided that the rule on solicitation of clients[2] was not thereby violated.

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[1]"Opinion No. 1: Newsletters, Publications," By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics . . . (1962), p. 35.

[2]The rule which prohibits a member of the Institute from soliciting clients is discussed in a subsequent section of this chapter.

It should also be noted that a member of the Institute who feels compelled to distribute printed materials which were prepared by someone other than himself need not do so anonymously. A professional public accountant proposed to send to his clients canned newsletters to which his business card would be clipped in lieu of having the newsletters imprinted with his name. The Committee on Professional Ethics did not object seriously but it was recommended as an alternative that the material be accompanied by a cover letter which would make it clear that the material was not the work of the accountant.[1] Thus the potential deception was eliminated without significantly interfering with the basic purpose of newsletters and other printed materials which are distributed by professional public accountants.

Two Progressive Amendments

An interesting revision of the advertising rule appeared in 1944. Evidently it was recognized that the advertising rule of the American Institute had always had an internal inconsistency in that a member was prohibited from advertising although he was permitted to publish a card which was defined as an advertisement and which could properly include the address of the advertiser. Perhaps someone pointed out that if a member could not advertise, the space which he purchased in a newspaper or other publication should not be called an advertisement and the member should not be called an advertiser. The situation was corrected when the following rule became effective on December 27, 1943:

> A member or an associate shall not advertise his professional attainments or services. The publication of what is technically known as a card is restricted to an announcement of the name, title (member of American Institute of Accountants, CPA, or other professional affiliation or designation), class of service, and address of the person or firm, issued in connection

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[1]Carey, p. 65.

with the announcement of change of address or personnel of firm, and shall not exceed two columns in width and three inches in depth if appearing in a newspaper, and not exceed one-quarter of a page if appearing in a magazine, directory, or similar publication.[1]

Because the record is unusually complete, a detailed examination of the chain of events which led to the adoption of this version of the rule will be presented. In 1942, the Committee on Professional Ethics advised the Council that it favored an amendment of the advertising rule which would prohibit advertising of all kinds including cards. Evidently the Committee was a bit apprehensive with respect to the reaction of the membership of the Institute to such a drastic change. This doubt was at least implied when the Committee wrote "that the elevation of standards of ethical conduct should be gradual, and that it is perhaps more harmful than helpful to adopt rules more stringent than a majority of the members of the profession would be willing to observe."[2] As a test of the probable reaction to its proposal, the Committee on Professional Ethics asked the advice of the members of the Advisory Council of State Society Presidents. The points of view expressed by the 21 state society presidents who responded to the request of the Committee are tabulated here:

Response of Twenty-one State Society Presidents to the Proposed Prohibition of All Forms of Advertising by Members of the American Institute of Accountants[3]

Number	Response
7	Favored absolute prohibition of advertising.
8	Modify the rule, but limit the format and frequency of publication of cards.
3	Not an appropriate time to amend the rule but a two- or three-year educational program would be beneficial.
3	No change should be made in the rule.

[1] "Report of Committee on Professional Ethics," Yearbook . . . 1943-1944, p. 42.

[2] "Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1942 (New York: American Institute of Accountants, 1943), p. 83.

[3] Ibid.

The question was again considered by the members of the Advisory Council of State Society Presidents during their annual meeting which was held in September, 1942. At that time

> the Advisory Council recommended to council of the Institute that a rule of conduct be adopted by the Institute prohibiting all advertising in any form by members and associates of the Institute, with the proviso that this prohibition would not apply to announcements of changes of address, changes in partnership or in key personnel, and similar announcements, and that the rule should not become effective until one year after its adoption.[1]

Almost immediately the Committee on Professional Ethics began to lay the groundwork for the next significant revision of the rule. The first step was the publication of an interpretation of the 1944 edition of the rule.[2] With respect to the application of the rule to the listing in directories of names and addresses of members and associates of the Institute, the Committee expressed the belief that the rule prohibited such listings in bold type or in any other form which would differentiate them from other names and addresses in the same list. This interpretation, the Committee advised, was based upon the fact that the rule provided that neither a member nor an associate was permitted to advertise his professional attainments or services. In the opinion of the Committee, directory listings in special type or boxes were a form of display advertising which was intended to attract attention to professional services. Some progress was soon evident when the Committee on Professional Ethics reported in September, 1944, that several cities had discontinued display or bold-type listings for accountants in the classified section of telephone directories.[3]

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[1] "Reports of the Committee on Professional Ethics," 1942-1943 Reports of Officers, Council, and Committees (New York: American Institute of Accountants, 1943), p. 51.

[2] "Interpretation of Rule No. 10," The Certified Public Accountant, XXIV (March 15, 1944), p. 9.

[3] "Report of the Committee on Professional Ethics," Yearbook . . . 1943-1944, p. 141.

Interest in the directory listings of members of the American Institute continued unabated. Perhaps a large measure of this interest stemmed from a proposal by a Chicago company to publish "The American Accountants Directory."[1] The Committee on Professional Ethics did not object to the publication provided that it would conform to the requirements of the advertising rule of the Institute and the interpretations of that rule which had been issued by the Committee and which were reiterated for the benefit of the publishers of the proposed directory. Evidently the publishers did not follow the advice of the Committee because in 1947 it was reported that the first edition of the directory constituted a violation of the advertising rule and that the directory would not again be published in the same form as the first edition.[2]

Whether or not the Illinois Society of Certified Public Accountants objected to the proposed directory of accountants is not known. However, at the request of the Board of Directors of the Illinois Society, a rule of conduct was proposed which would have prohibited a member of the Institute from paying to have his name listed in any directory with the exception of a classified telephone directory in which a free listing was restricted to firm names.[3] When listings were so restricted it was provided that uniform listings for individual members and employees of the firm could be purchased. The Council approved the proposed rule in principle and referred it to the Committee on Professional Ethics which was to submit a revised draft to the Council for formal consideration at the annual meeting of the Institute. But in October, 1945, the Council rejected the rule

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[1]Ibid., p. 140. See also "Reports of the Committee on Professional Ethics," Yearbook American Institute of Accountants 1944-1945 (New York: American Institute of Accountants, 1946), p. 86.

[2]"Committee on Professional Ethics," Yearbook American Institute of Accountants 1947 (New York: American Institute of Accountants, 1948), p. 98.

[3]"Reports of the Committee on Professional Ethics," Yearbook . . . 1944-1945, p. 87.

which had been drafted by the Committee because the proposed rule was much too specific.

A temporary stalemate was reached when the Committee advised the Council that it was impracticable to draft a rule on directory listings which would not be complicated by a considerable amount of detail. The Committee believed it would be preferable to continue to deal with questions of directory listings by issuing interpretations of the advertising rule as it had done in the past. Accordingly, the Committee on Professional Ethics reported that from October, 1945, to April, 1946, it had corresponded with 77 members with respect to directory listings and interpretations of the advertising rule.[1]

It will be recalled that the Board of Directors of the Illinois Society of Certified Public Accountants had made it clear that they believed the standards which were then enforced by the Institute were not adequate. Other state organizations of certified public accountants were also becoming concerned with directory listings by certified public accountants. For example, the Massachusetts Society of Certified Public Accountants adopted a rule which prohibited listings which were set in special type or otherwise differentiated.[2] In Pittsburgh it was reported that the 1945 telephone directory contained only five bold-type listings as compared with almost fifty in 1944.[3] The New Jersey Society of Certified Public Accountants passed a resolution which provided that bold-faced and other types of advertising listings of its members in directories were violations of its Code of Ethics.[4]

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[1]"Reports of the Committee on Professional Ethics," Yearbook . . . 1945-1946, p. 86.

[2]Professional Ethics, "Directory Listings," The Certified Public Accountant, (December, 1945), p. 7.

[3]Ibid.

[4]Professional Ethics, "Bold Face Listings Forbidden," The Certified Public Accountant, (June, 1946), p. 3.

In its May, 1947, report to the Council, the Committee on Professional Ethics recommended on the basis of its experience, the following rule:

> A member shall not advertise his professional attainments or services:
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> (a) The publication of what is technically known as a card is restricted to an announcement of the name, title (member of American Institute of Accountants, CPA, or other professional affiliation or designation), class of service, and address of the person or firm, issued in connection with the announcement of change of address or personnel of firm, and shall not exceed two columns in width and three inches in depth if appearing in a newspaper, and not exceed one-quarter of a page if appearing in a magazine or similar publication.
>
> (b) A paid listing in a directory is restricted to the name, title, class of service, address and telephone number of the person or firm and it shall not appear in bold type, box or other form of display or in a style which differentiates it from other listings in the same directory.[1]

That rule became effective on January 20, 1948, after it had been approved by the Council and a majority of the members who voted on the proposal.

Multiple Listings in Directories

It was not until 1946 that the Committee on Professional Ethics reported that a member had asked whether it was permissible for him to have his name listed under the caption "Business Counselor" as well as under the captions "Certified Public Accountant" and "Public Accountant." He was advised by the Committee that the separate listings of the name of an accountant under multiple captions did not necessarily constitute advertising. Furthermore, the Committee said that no objection could be made to the use of the "Business Counselor" designation on the basis of the

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[1] "Committee on Professional Ethics," Yearbook . . . 1947, p. 98.

rules of professional conduct of the Institute although it might be subject to question on the basis of good taste.[1] Similarly, a public accounting firm was advised in 1949 that it could list its name in a classified telephone directory under such classifications as "Management Service" and "Industrial Engineering."[2] The Committee also ruled in 1950 that a member could list his name under a caption entitled "Systems Analyst."[3] However, a member of the Institute was not permitted to add specialized designations to a listing of his name under the "Certified Public Accountants" classification which was presumed to be sufficiently informative in itself.[4] Other designations which reportedly have been printed on the stationery used by public accountants include Tax Accountant, Tax Consultant, Tax Counselor, System Specialist, and Management Consultant.[5]

Class of Service Designations

A court decision which was handed down in 1948 had very important implications for the public accountants who were accustomed to the use of various class of service designations which defined the areas of service offered to the public. The Appellate Division of the Supreme Court of the State of New York in its 1948 decision of the Bercu Case enjoined a public accountant from using such designations as tax counsel, tax counselor, or tax consultant.[6] Not long thereafter a local bar association

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[1]"Reports of the Committee on Professional Ethics," Yearbook . . . 1945-1946, p. 92.

[2]"Committee on Professional Ethics," Annual Reports for the Year 1948-1949 (New York: American Institute of Accountants, 1949), pp. 30-31.

[3]"Committee on Professional Ethics," April 1950 Reports to Council, p. 61.

[4]Ibid.

[5]J. C. Bowden, "Professional Dignity," The PA, (June, 1955), p. 4.

[6]Editorial, "CPA Denied Designation of 'Tax Consultant'," The Journal of Accountancy, LXXXVI (November, 1948), p. 354.

advised a certified public accountant to discontinue his use of the designation "Tax Consultant" in accord with the court order in the Bercu Case. The Committee on Relations With the Bar of the American Institute of Accountants was reported to be "inclined to believe that it would be desirable for accountants to discontinue the use of such designations altogether."[1]

Two significant statements which had an important impact on the special income tax practice designations used by certified public accountants were issued in 1950. First, the Standing Committee on Unauthorized Practice of Law of the American Bar Association asked the publishers of directories to cooperate with the legal and accounting professions in the elimination of such self-bestowed and deceptive titles as "Tax Consultant."[2] Secondly, the joint statement on tax practice which was produced by the National Conference of Lawyers and Certified Public Accountants included the proposition that an accountant should not describe himself as a "Tax Consultant" or a "Tax Expert." The pertinent paragraph follows:

> Prohibited Self-Designations. An accountant should not describe himself as a "tax consultant" or "tax expert" or use any similar phrase. Lawyers, similarly, are prohibited by the canons of ethics of the American Bar Association and the opinions relating thereto, from advertising a special branch of law practice.[3]

That prohibition became an integral part of a formal opinion which was issued in March, 1957, by the Committee on Professional Ethics.

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[1]Editorial, "Use of Designation 'Tax Consultant' Is Challenged," The Journal of Accountancy, XC (July, 1950), p. 5.

[2]*Official Decisions and Releases*, "Use of Term 'Tax Consultant' Opposed by American Bar Association Standing Committee on Unauthorized Practice of Law," The Journal of Accountancy, XCI (February, 1951), p. 307.

[3]*Official Decisions and Releases*, "Lawyers and CPAs Join in Statement of Principles Defining Proper Areas of Federal Tax Practice for Members of Both Professions," The Journal of Accountancy, XCI (June, 1951), p. 870.

There the Committee carefully noted that the Institute's Council had approved the joint statement on tax practice and that a member who refused to abide by the prohibition would be liable to disciplinary action on the basis of his refusal to give effect to a decision of the Council. It was the belief of the Committee that sufficient time had passed for the members of the American Institute to have revised their stationery as well as their directory and other listings.[1]

Cards, Class of Service, and Multiple Listings Prohibited

In the summer of 1958, the Committee on Professional Ethics of the Institute submitted to the ethics committees of the state societies and to the state boards of accountancy, the draft of a revised advertising rule. After it had considered many constructive suggestions relative to the exposure draft, the Committee recommended the adoption of the following rule which was designed to prohibit the publication of cards or announcements, to eliminate class of service designations in directory listings, and to prohibit the listing of a name of a member of the Institute in more than one place in a classified directory. Because subsequent amendments of the rule have been inconsequential, the current version follows:

> A member of associate shall not advertise his professional attainments or services.
>
> Publication in a newspaper, magazine or similar medium of an announcement or what is technically known as a card is prohibited.
>
> A listing in a directory is restricted to the name, title, address and telephone number of the person or firm, and it shall not appear in a box, or other form of display or in a type or style

[1] "Opinion No. 5: Prohibited Self-Designations--Use of Title 'Tax Consultant,' 'Tax Specialist,' or Similar Description Forbidden," By-Laws, . . . Numbered Opinions of the Committee on Professional Ethics . . . (1962), p. 38.

> which differentiates it from other listings in the same directory. Listing of the same name in more than one place in a classified directory is prohibited.[1]

That rule was approved by approximately 60% of the members of the Council in April, 1959.[2] On February 2, 1960, the amended rule became effective after it had been approved by approximately 72% of the members who voted on this question in a mail ballot of the membership of the American Institute of Certified Public Accountants.[3]

The Committee on Professional Ethics released a significant formal opinion in May, 1962, in which it is stated that the rule on advertising not only prohibits the use by a member of the various tax practice designations but also "any other designations which indicate the special skills that a member possesses or particular services which he is prepared to render."[4] Furthermore, it was pointed out that the rule also prohibits a member from imprinting his name on tax booklets or other publications prepared by others. That, of course, does not prevent a member from distributing the material as long as he does not imprint his name upon it.

Continuing Problems

Although the present rule is considerably more restrictive than was any previous advertising rule of the Institute, there is an important class

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[1] By-Laws, Code of Professional Ethics . . . (1962), p. 32.

[2] Minutes of Council Meeting, April 20-23, 1959, pp. 47-48, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[3] "Membership Approves By-law Amendment and Rule Change," The CPA (February, 1960), p. 5.

[4] "Ethics Committee Opinion No. 11: Advertising Prohibitions and Restrictions Relating to Announcements, Directories, Business Stationery, Business Cards, and Office Premises," The CPA, XLII (May, 1962), p. 7.

of published materials the use of which is not significantly regulated by the present rule on advertising. For example, some public accounting firms have prepared brochures, slide films, and motion pictures in order to inform clients of the availability and nature of the management services which they have to offer.[1]

Aside from the basic but general question of whether the distribution of descriptive or promotional material is consistent with a professional attitude, there are several specific objections which have been raised. First, if large accounting firms which have the extensive facilities necessary for broad management service engagements do continue to produce and distribute these materials, publishers of advertising materials may find an opportunity to supply similar brochures and films to small practitioners who specialize in certain areas of management services.[2] Obviously there is an analogy between the distribution of these materials and the circulation of canned newsletters and other promotional materials by public accountants. Secondly, there is a danger of the monopolization of management services engagements if public accounting firms are permitted to utilize expensive promotional materials which are beyond the means of small but perhaps capable firms of certified public accountants.[3]

Another problem area involves the preparation, publication, and sometimes broad distribution by a public accounting firm of research reports or treatises on an important problem or subject of interest.[4]

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[1]Jordahl, p. 78.

[2]Ira N. Frisbee, "Ethical Considerations in Rendering Management Services," The Journal of Accountancy, CIII (March, 1957), p. 31.

[3]Ibid.

[4]Robert M. Trueblood, "The Management Service Function in Public Accounting," The Journal of Accountancy, CXII (July, 1961), p. 43.

Of course, the abuses in the latter category are not restricted to publications pertaining only to the management services offered by public accountants.

Soliciting Clients

In addition to the prohibition of advertising, the members of the American Institute of Certified Public Accountants have found it necessary also to forbid the solicitation of clients. Public accountants who would solicit clients might do so directly or indirectly in a letter addressed to the desired client. Or a verbal approach could be made to a potential client. But in neither case is the action consistent with a professional attitude.

A public accountant who would so ingratiate himself as to solicit a client would also damage his professional status and that of other certified public accountants. After having employed the art of salesmanship to obtain an engagement, a public accountant may find it impossible to oppose the desire of the client on a question of accounting procedure or the disclosure of pertinent information. In this way, an accountant who solicits clients brings discredit not only upon himself but also upon the profession as a whole.

Another and perhaps more apparent danger is involved in the solicitation of clients by a public accountant. No doubt it is most disconcerting for an accountant to lose a client to a public accountant who had solicited the engagement. Such activity must obviously be prohibited in order to preserve the general welfare and unity of the professional organization.

Early Recognition

The Special Committee on Professional Ethics of the American Association of Public Accountants reported in 1907 that it had received

a complaint involving a firm of accountants whose form letter was designed to solicit patronage and was an undignified parody on another profession.[1] It was ruled by the Committee that the alleged solicitation was unprofessional, lacking in dignity, and harmful to the profession.

Again in 1910 the report of the Special Committee on Professional Ethics contained references to several form letters and circulars of solicitation. One of these form letters was reproduced in the report of the Committee. That example, which is typical of other published examples, follows:

> I desire to obtain whatever business you can offer a Public Accountant. For that business I wish to pay the usual Attorney's commission. In addition I offer your clients exceptional advantages.
>
> In the first place, they will not pay one cent more than if they dealt directly with me. In the second place, I will furnish them with unsurpassed service for less cost I believe than they can secure such services elsewhere.
>
> In former years, when employed by the leading accountants of America, my employers received $25.00 per day for my services. At present I offer more valuable service, due to the increased experience and efficiency, for $15.00 per day.
>
> My staff of assistants is carefully selected from experienced Public Accountants of recognized ability. For the work of these strictly highgrade men I receive from $10.00 to $15.00 per day according to their value. Some Audit Companies employ and are composed of poor bookkeepers out of a job. The difference between the value of these cheap men and recognized Public Accountants is greater than between the "shyster" lawyers and accredited attorneys.
>
> My patrons are numbered among the representative attorneys and businessmen of Chicago. I will be glad to place you in communication with some of them upon request. You will appreciate the information they will furnish concerning my work.[2]

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[1] "Report of the Committee on Professional Ethics," . . . Year-Book (1907), p. 26.

[2] "Report of the Committee on Professional Ethics," The American Association of Public Accountants Twenty-third Anniversary Year-Book (1910), p. 80.

The problem of client solicitation was treated by the American Association of Public Accountants as a part of the related but more general problem of advertising. Of course no disciplinary actions were taken because the Association did not have the authority to discipline individual members. Furthermore, its rules of conduct prohibited neither advertising nor client solicitation.

One of the rules of professional conduct which was adopted on April 9, 1917, by the Council of the newly organized American Institute of Accountants prohibited a member of the Institute from soliciting the client of another member. That first version of the rule on the solicitation of clients follows:

> No member shall directly or indirectly solicit the clients nor encroach upon the business of another member, but it is the right of any member to give proper service and advice to those asking such service or advice.[1]

It is noteworthy that the Council of the Institute was apparently confident that it could enforce the soliciting ban which applied only to clients of other members. Yet the related rule on advertising was not adopted until 1922. In retrospect, it is obvious that the rule on client solicitation was much more fundamental to the internal control of the Institute than was the advertising rule. There was perhaps less need to "crowd the mourners" on the advertising problem.

External Support

Although the solicitation of clients was freely criticized, there is no indication that any formal disciplinary actions were referred by the Committee on Professional Ethics to the trial board during the four years following 1917 when the rule became effective. Not until 1921 did the Committee on Professional Ethics report that it had considered several

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[1]Edwards, p. 256.

cases of alleged encroachment on the clients of members through the use of circular letters and letters of direct solicitation.[1] But the Committee reported that it had taken no action and was not prepared to report on these cases until it had an opportunity to benefit from a full and fair discussion of the report of the Special Committee on Professional Advancement. Subsequent reports of the Committee on Professional Ethics do not indicate that action was later taken on these cases.

Previous reference has been made to the interest which was expressed by a representative of the United States Treasury Department in the advertising practices of public accountants. Also being considered was a proposal to prohibit the solicitation of clients by enrolled agents. That standard was imposed on public accountants who were enrolled to practice before the Treasury Department when the following rule became effective with the revision of Circular 230 on April 25, 1922:

> The solicitation of claims or other business as attorney or agent for others before the Treasury Department by circulars, advertisements or other means, including personal letters, communications or interviews not warranted by previous business or personal relations with the persons addressed, is forbidden. . . .[2]

Enforcement of the Rule on Soliciting

It was in 1923 that two members (A. C. Ernst and Horace Manning) and one associate (Lester W. Blyth) resigned from the Institute because they had been summoned to appear before the trial board to face charges of having solicited the clients of another member, advertised, and accepted work on a contingent fee basis.[3] Between 1923 and 1956, eleven other

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[1] "Report of Committee on Professional Ethics," 1921 Year Book . . . , p. 130.

[2] Editorial, "Ethics By Regulation," The Journal of Accountancy, XXXIII (June, 1922), p. 438.

[3] "Council: Regular Meeting, September 17, 1923," 1923 Year Book . . . , pp. 92-93.

members of the Institute were alleged to have violated the rule on solicitation. Their cases were the subject of formal complaint filed by the Committee on Professional Ethics for trial board action. Each of these eleven members who were charged with having solicited clients was found guilty. The punishments were as follows: two were expelled from membership; one was suspended from membership for two years, another for one year; three were admonished; and four were reprimanded.

Two Important Amendments of the Rule

The Committee on Professional Ethics recommended in 1932 that the rule on solicitation of clients be amended to prohibit the solicitation of the clients of any public accountant.[1] The Committee reasoned that solicitation by professional practitioners was improper in itself. Therefore, the Council ought not to be limited to enforcement of the rule only in cases in which a member of the Institute was offended. That proposal was referred, apparently without a recommendation by the Council, to the members who attended the 1932 annual meeting of the Institute.[2] No evidence was found that any action was taken on the proposal at that meeting.

It was not until 1940 that a similar proposal again appeared in the literature. Once more the Committee on Professional Ethics recommended that the rule be revised to prohibit a member from soliciting the clients of any public accountant.[3] The following version of the rule was approved in 1940 and became effective in January, 1941, after it had been

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[1] "Report of the Committee on Professional Ethics," 1932 Year Book of the American Institute of Accountants (1932), p. 217.

[2] "Report of the Council," ibid., pp. 202-203.

[3] "Council: Regular Meeting, October 14, 1940," 1940 Yearbook . . . , p. 48.

approved by a majority of the members of the Institute:

> A member or an associate shall not directly or indirectly solicit the clients or encroach upon the practice of another public accountant, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.[1]

A special committee was appointed in May, 1947, to study the rule on solicitation of clients and the rule on reporting responsibilities. In its report,[2] the committee pointed out that the solicitation rule did not as much as imply that members of the Institute were prohibited from soliciting professional engagements from persons who had not yet retained a public accountant. This, according to the committee, was in contrast with the prevailing standard of practice of the public accounting profession. Consequently, the special committee recommended the substitution of the following rule for the one which had been in effect since 1941:

> A member shall not directly or indirectly solicit clients by circulars or advertisements, nor by personal communication or interview not warranted by existing personal relations, and he shall not encroach upon the practice of another public accountant. A member may furnish service to those who request it.[3]

That rule became effective in January, 1948, after it had been approved by the membership of the Institute.

Obviously, the 1948 rule on soliciting was more extensive and more explicit in its prohibitions. But another significant feature of the rule is the phrase "not warranted by existing personal relations." The Committee on Professional Ethics and other members of the Institute had been annoyed for several years by the problem which was created when a public accountant established his own practice and sent announcements of that fact to the clients of his former employer. In 1942 the Committee had

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[1] "Rules of Professional Conduct," ibid., p. 534.

[2] "Special Committee to Consider Rules 5 and 7," Yearbook . . . 1947, pp. 102-104.

[3] "Rules of Professional Conduct," ibid., p. 215.

said that it was undesirable for a member to send such announcements to the clients of a former employer.[1] However, the Committee noted two years later that it was permissible to make announcement of a new partnership to an organization which had been served as an employee of another accountant.[2] Finally in 1947, before the new rule was recommended by the special committee, the Committee on Professional Ethics stated unequivocally that a public accountant who mailed announcements of the establishment of his own practice to the clients of his former employer would be violating the rule on solicitation.[3] In other words, contact with the clients of a former employer was "not warranted by existing personal relations."

A Premature Proposal

Occasional references have been made to the ethical problems which accompany a change of auditors. The Committee on Professional Ethics reported in 1941 that it had received the suggestion

> that a rule of conduct should be adopted providing that members or associates invited to undertake professional engagements should inquire whether or not the prospective client is being, or has recently been, served by another public accountant, and, if so, should communicate with that accountant.[4]

The Committee referred the suggestion to the Council without recommendation. The absence of any reference to this suggestion by the Council is sufficient reason to suspect that the Council was even less enthusiastic about the proposal than was the Committee on Professional Ethics.

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[1] "Reports of the Committee on Professional Ethics," Yearbook . . . 1942, p. 83.

[2] "Report of the Committee on Professional Ethics," Yearbook . . . 1943-1944, p. 143.

[3] "Committee on Professional Ethics," Yearbook . . . 1947, p. 95.

[4] "Reports of the Committee on Professional Ethics," Yearbook . . . 1941, p. 95.

It is probably significant that the proposal to require communication with an incumbent auditor coincided with the proposal and adoption of the rule which gives expression to the confidential relationship between a public accountant and his client. A natural conflict between the proposed rules probably explains the reason for a lack of interest in the requirement that a public accountant contact the incumbent auditor before an engagement could be accepted. Prior to 1941, the proposals for required communication with an incumbent auditor were motivated by a desire to protect the public accountant from an unwarranted discharge from an auditing engagement. More recent interest in this question seems to have been motivated by another reason.

Edward J. McDevitt, who had just completed three years of service as chairman of the Committee on Professional Ethics, noted in 1955 that a recent study indicated that neither the American Institute nor any state society of certified public accountants had a rule which required a public accountant to communicate with his predecessor on an engagement.[1] McDevitt also pointed out that it was not the custom in the United States for a public accountant to communicate with the former accountant before accepting an engagement. Furthermore, he doubted that the members of the Institute would favor mandatory communication with a previous auditor before an appointment could be accepted.

After a four-year dormancy, the matter reappeared in 1959 when the Committee on Professional Ethics recommended and the Council approved the addition of the following sentence to the rule on solicitation:

> However, a member shall not agree to perform any services for a client of another public accountant without first notifying such accountant.[2]

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[1]Edward J. McDevitt, "Ethics and a Change of Auditors: A Summary of British--U.S. Views," The Journal of Accountancy, XCIX (May, 1955), p. 47.

[2]Report of Committee on Professional Ethics, October 23, 1959, p. 3, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

In those cases in which a business organization customarily engaged two or more public accounting firms, notification would not be applicable. Neither would it be reasonable when an engagement involved only a relatively simple tax return. However, it is significant that communication would be required when a firm other than the regular public accountant was requested to do some special work, for example in the area of management services.[1] That reference to the applicability of the proposed rule to management service engagements and the wording of the proposal itself are strong support for the presumption that this amendment was intended to improve or maintain the intraprofessional relationships without restricting the expansion of specialized management service engagements.

Explanations for the rejection of the proposal at the 1959 annual meeting of the Institute are not convincing. It was suggested that the proposal failed to win approval because the period of education and discussion was too brief prior to the submission of the proposal.[2] Of course this view is in agreement with the opinion expressed by McDevitt more than four years earlier. The executive director of the American Institute of Certified Public Accountants, John L. Carey, wrote that he believed that many members voted against the rule because they believed the new rule would have been difficult to enforce.[3] A former chairman of the Committee on Professional Ethics, Frank L. Wilcox, is reported to have made some comments at the 1959 annual meeting which suggest that the proposal failed to win approval because the members of the Institute preferred the status quo even on the mundane issues which only involved questions of professional courtesy.[4] The latter explanation is probably

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[1]Notice of Seventy-second Annual Meeting, American Institute of Certified Public Accountants, October 27, 1959.

[2]"By-Law and Rule Changes," The CPA (November, 1959), p. 7.

[3]"Editorial Note," The CPA (February, 1960), p. 7.

[4]John L. Carey, "A Setback to Higher Standards," The CPA, (December, 1959), p. 14.

more realistic than either of the others.

Division of the Rule

In order to integrate the rule on solicitation into the proposed codification of the rules of professional conduct, the Committee on Professional Ethics found it necessary to separate the rule into its component parts. Thus the first part of the rule was classified with the rules on promotional practices and became effective March 6, 1962. That rule follows:

> A member or associate shall not directly or indirectly solicit clients by circulars or advertisements, nor by personal communication or interview, not warranted by existing personal relations.[1]

Classified under the heading "Relations with Fellow Members," was the second part of the old rule:

> A member or associate shall not encroach upon the practice of another public accountant. A member or associate may furnish service to those who request it.[2]

Competitive Bidding

Few people would criticize a professional practitioner who provides his client or prospective client with an estimate of the fee which will be charged for a particular professional service. Frequently, the practitioner may be able to specify a flat fee for a standardized service which is often rendered. But some cases involve known or potential complications which it is impossible to evaluate beforehand. Because the impact, or indeed the very existence, of these factors cannot be foretold with accuracy, it is not possible to take these elements into consideration when an estimate is given for a professional engagement which may or may not involve such

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[1] By-Laws, Code of Professional Ethics . . . (1962), p. 32.

[2] Ibid., p. 34.

elements. Consequently, it is customary for an estimate which involves a service of this kind to take the form of a range--not less than a given minimum amount and not likely to exceed a stated maximum amount. Competitive bidding should not be confused with this practice.

As applied to the public accounting profession, a competitive bid is one "that includes some special inducement to the client in the matter of charges to be made or work to be performed, which would not be made if it were not known that some other accountant was also bidding for the work."[1] The term "special inducement" typically has been expressed in terms of price competition. No evidence was found which would suggest the existence of other forms of special inducements. Of course this observation should not be taken to mean that no forms of non-price competition were utilized by public accounting practitioners during the past sixty years.

Competitive Rivalry and Professionalism

Competitive bidding was one of several manifestations of a well-developed rivalry among public accountants. It was said in 1907 that some competitive bidding for public accounting engagements (audits of municipalities) was perhaps unavoidable but that efforts should be made to minimize the practice and to educate the public with respect to the evils of such competitive behavior.[2] Accountants who received letters inviting the submission of a bid were urged to decline the invitation when it was known that the letter was sent to other accountants as well.

The Journal of Accountancy published a symposium in 1915 which included the views of one practitioner from each of these states:

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[1]"Discussions on Competitive Bidding," Bulletin of the American Institute of Accountants, No. 119 (March 15, 1934), p. 11.

[2]Sterrett, "Professional Ethics," . . . Year-book (1907), p. 127.

Minnesota, Texas, Washington, and Georgia.[1] Here it was suggested that competitive bidding was not as prevalent in large centers of population where the public was better acquainted with the use and value of the services of public accountants.[2] Competitive bidding was only one of the practices which had been devised by accountants in order to obtain "business." Other methods included these: setting daily rates with a maximum price for an entire job, undercutting the daily rates of competitors, making "free" preliminary surveys and recommendations in the hope of "selling" the client on a bigger job, and making lump-sum bids.[3] If the low bidder won, he was tempted to scale his work accordingly. If the high bidder won, he was tempted to prolong the work in order to seem to justify the expenditure by the client. But in either case, the client lost.[4]

As the first step in its campaign to overcome competitive bidding, the American Association of Public Accountants published and distributed a bulletin which had been prepared by the Committee on General Relations.[5] Note that the first paragraph of that bulletin clearly established the basis for the attack on competitive bidding:

> If it be true that competition is the life of trade it is no less true that competition is the death of a profession. Introduce into any profession the element of personal rivalry and you instantly place it upon a commercial basis and deprive it of its professional status.[6]

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[1]"Competitive Bidding," The Journal of Accountancy, XX (August, 1915), pp. 81-90.

[2]Ibid., p. 82.

[3]Ibid., p. 86.

[4]Ibid., p. 87.

[5]Editorial, "Competitive Bidding," The Journal of Accountancy, XX (November, 1915), pp. 365-66.

[6]Ibid., p. 365.

It was the purpose of the bulletin to convince the reader that the services rendered by a public accountant were such that a businessman would be foolish to engage a public accountant who would stoop so low as to submit a competitive bid for an accounting engagement.

Moral Suasion and Admonitory Resolutions

Criticisms of competitive bidding continued to appear on the editorial pages of The Journal of Accountancy in the years following 1915. By 1931, there was a noticeable increase in the frequency with which these criticisms were appearing.

Several examples can be cited which will illustrate the range which seems to have been typical of competitive bids for specific jobs. An engagement which had been performed at an actual cost of $8,000 in 1930 was undertaken in the following year by another firm for a price of $4,000. Similarly, an engagement for which a bill of $17,500 had been rendered in the past was accepted by a firm whose bid of $7,500 had been accepted.[1] In another case, the highest bid was reported to have been $100,000 and the lowest bid was $28,800.[2]

After having considered the question of competitive bidding for two years, the Committee on Professional Ethics recommended in 1932 that an appropriate resolution be adopted by the Council. A policy statement in the form of a resolution was intended to indicate that the practice was generally considered improper, but it was not of sufficient importance to warrant a prohibitory rule.[3] Although the Council referred the proposal

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[1]Editorial, "The Suicidal Practice of Bidding," The Journal of Accountancy, LI (March, 1931), p. 161.

[2]Editorial, "Where Bidding Leads," The Journal of Accountancy, LIV (October, 1932), p. 243.

[3]"Report of the Committee on Professional Ethics," 1932 Year Book . . . , p. 217.

to the members who attended the 1932 annual meeting, the resolution was not approved.

The Committee on Professional Ethics continued its criticism of competitive bidding and made the following observation in its 1933 report:

> It should be recognized as unprofessional for an accountant to importune any prospective client for an engagement, offering a low fee as an inducement; how much more certainly should he refuse to negotiate with a prospective client who already has established relations with a brother accountant and has no cause to dismiss him except to substitute someone willing to accept a lower fee.[1]

Also in 1933, a rule was proposed which would have prohibited an advance quotation of a fee unless it was known that other known quotations had already been definitely and finally rejected. But the collective opinion of the Council favored a resolution rather than a rule because it was feared that such a rule could not have been enforced.[2] Consequently the proposal was referred to the incoming Committee on Professional Ethics.

Submitted to the Council in 1934 was this resolution which indicates that the Committee on Professional Ethics had extended the scope of its previous proposals in order to prevent ruinous competition with any accountant, not just members of the Institute:

> RESOLVED, that no member or associate shall quote in advance the fee for a professional engagement which he proposes to undertake, when it is known that another accountant will be asked to quote a fee for the same engagement.[3]

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[1] "Report of the Committee on Professional Ethics," 1933 Year Book . . . , p. 229.

[2] "Competitive Bidding," The Certified Public Accountant, XVIII (March, 1938), p. 2.

[3] "Report of the Committee on Professional Ethics," 1934 Year Book . . . , p. 252.

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According to the published record of the October 15, 1934, Council meeting, there was a considerable amount of discussion after which the following resolution was adopted:

> RESOLVED, That the council of the American Institute of Accountants regards competitive bidding for professional accounting engagements as contrary to the best interests of members' clients and of the public generally and urges members of the Institute to endeavor by all means at their disposal to eliminate the practice of competitive bidding.[1]

A Moment of Truth

So convinced was the Committee on Professional Ethics that a rule banning competitive bidding could not be enforced, that it advised the Maryland Association of Certified Public Accountants to adopt a general policy oriented toward education rather than prohibition.[2] Despite this discouragement, it was said that two state societies had adopted prohibitory rules on competitive bidding several years prior to 1938.[3] The Connecticut Society of Certified Public Accountants adopted a prohibitory rule on competitive bidding in October, 1937,[4] and was soon forcefully reminded of previous warnings that accounting firms in New York, New Jersey, and Massachusetts would be free to submit bids in Connecticut despite the prohibitory rule which was applicable only to members of that society.

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[1] "Council: Regular Meeting, October 15, 1934," ibid., p. 193.

[2] "Report of the Committee on Professional Ethics," 1935 Year Book of the American Institute of Accountants (1936), p. 277.

[3] "Competitive Bidding," The Certified Public Accountant, XVIII (March, 1938), p. 2.

[4] "Competitive Bidding," The Certified Public Accountant, XVII (December, 1937), p. 28.

Indeed, some accountants who were not members of the Connecticut Society of Certified Public Accountants were not only free to submit bids in Connecticut, but also were ready and willing to do so.[1] Two alternatives were available to the American Institute of Accountants in so far as the Connecticut Society was concerned: a rule could be adopted by the Institute which would define and ban competitive bidding by Institute members, or the Institute could adopt a rule which would require its members to abide by the rules of the various state societies. Specific rules had been drafted by the society and were submitted to the Institute along with this comment: "The Connecticut Society demands that the American Institute take a decided stand in this matter and feels confident that it will not be compelled to abandon its position because of failure of Institute support."[2]

After a lengthy discussion of the problem of competitive bidding, the Council adopted on April 11, 1938, the following resolution:

> RESOLVED, That competitive bidding by a member or associate on work to be done in any state, territory or the District of Columbia where the governing body of certified public accountants has adopted a rule prohibiting competitive bidding may be considered an act discreditable to the profession.[3]

Although it became a rule in 1941, the content of that policy statement was not significantly amended until 1962. It is also noteworthy that the policy statement was a resolution, not a formal rule. Consequently its import was somewhat less than had been demanded by the Connecticut Society of Certified Public Accountants. However modest, it was a beginning.

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[1]Charles F. Coates, "Connecticut's Rule Against Bidding," The Certified Public Accountant, XVIII (March, 1938), p. 7.

[2]Ibid., p. 10.

[3]"Report of the Council," 1938 Yearbook of the American Institute of Accountants (1939), p. 95.

A Period of Continuing Education

The text of a statement on competitive bidding which had been drafted by the Executive Committee and approved by the Council of the American Institute was published in December, 1939.[1] It was intended that copies of the statement would be sent by the members of the American Institute of Accountants to persons who had invited them to submit competitive bids for professional engagements. In addition, it was suggested that the officers of state societies and the secretary of the Institute send letters similar to the statement when they were notified of a case in which a competitive bid had been or was being sought.[2] According to the 1940 report of the Council, 5,515 copies of the statement had been distributed approximately one year after its release. That number barely exceeded the total number of members and associates of the American Institute of Accountants as of August 30, 1940. The statement was published again in 1946 after several minor revisions had been made.[3]

Similar educational efforts are manifest in a joint statement on competitive bidding for audit services to governmental agencies.[4] That pronouncement was issued in 1955 by the Committee on Governmental Accounting of the American Institute of Accountants and the General Committee on Accounting of the Municipal Finance Officers Association of the United States and Canada. The joint statement on competitive bidding was revised and reissued in 1961.[5] Competitive bidding was a

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[1]"Competitive Bidding for Audit Engagements," The Journal of Accountancy, LXVIII (December, 1939), pp. 367-68.

[2]"Reports of the Executive Committee," 1939 Yearbook of the American Institute of Accountants (1940), p. 119.

[3]Official Decisions and Releases, "Competitive Bidding for Audit Engagements," The Journal of Accountancy, LXXXII (August, 1946), pp. 178-79.

[4]News Report, "Competitive Bidding for Audits," The Journal of Accountancy, XCIX (May, 1955), pp. 22, 24.

[5]Official Releases, "Statement on Competitive Bidding for Audit Services," The Journal of Accountancy, CXI (April, 1961), p. 71.

problem which for many years had been particularly identified with municipal audit engagements.[1]

While the national organization was occupied with educational efforts, the practical reforms were left in the hands of the local organizations of certified public accountants and the state boards of accountancy. By 1940, accounting societies of sixteen states had officially expressed an opposition to this practice. Ten state societies had either by-laws or rules of conduct which discouraged competitive bidding: Arizona, Colorado, Connecticut, District of Columbia, Florida, Indiana, North Carolina, Louisiana, Utah, and West Virginia. State societies which opposed the practice were Georgia, New Jersey, Pennsylvania, Texas, and Virginia. The Illinois Society of Certified Public Accountants had adopted a resolution which specified that competitive bidding was a discreditable act and was subject to the general disciplinary provisions of the by-laws of the Society.[2] As of 1957, thirty-five state societies had formally discouraged or prohibited competitive bidding for professional engagements.[3] That pattern developed because "it is extremely difficult at the national level to obtain the full facts on alleged violations and that in the nature of things such disputes must of necessity be resolved in most cases at local level."[4]

No Rule or a New Rule?

Early in 1960 the Executive Committee was requested by the Institute's Committee on Professional Ethics to consider a change in the rule

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[1]John L. Carey, "Competitive Bidding," The Certified Public Accountant, (February, 1947), p. 5.

[2]"Rules on Competitive Bidding," The Certified Public Accountant, XX (September, 1940), p. 9.

[3]"Competitive Bidding," The CPA, (November, 1957), pp. 12-13.

[4]Thomas G. Higgins, "Professional Ethics and Public Opinion," The Journal of Accountancy, CVI (November, 1958), p. 38.

on competitive bidding. No reason was discovered for this unusual procedure. However, it may be that the Executive Committee was believed to have unique familiarity or authority on the question of competitive bidding as a result of the formal statements which it had issued in 1939 and again in 1946. Nevertheless, while the proposal to amend the rule was being considered by the Executive Committee, it received an interesting opinion from the attorneys for the Institute. Counsel had earlier expressed an opinion that the present rule on competitive bidding created the risk of legal action against the Institute under the Sherman Anti-Trust Act. Then, in 1960, counsel reaffirmed the earlier opinion and recommended that the present rule on competitive bidding be repealed and that no new rule on competitive bidding should be introduced. The Executive Committee agreed with this advice and made its recommendation to the Committee on Professional Ethics accordingly. As a means of filling the void which would be created by the repeal of the existing rule, it was suggested that another policy statement be issued.[1]

The Committee on Professional Ethics met with counsel for the Institute in September, 1960, at which time it was decided that no recommendation should be made until there had been more time for discussion of the matter. Presumably these discussions led to the recommendation by the Committee in April, 1961, that the time had come for the Institute to declare itself on the subject of competitive bidding.

These reasons were given by the Committee on Professional Ethics as a basis for its conclusion on the question of competitive bidding: (1) it is not consistent with the public interest, (2) it is a form of solicitation, (3) it erroneously implies that auditing and other services can be measured by exact specifications, (4) it presupposes reasonably accurate knowledge of the auditor with respect to conditions which will be encountered

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[1]"Executive Committee Meeting," The CPA (July-August, 1960), pp. 1-2.

in an audit, (5) it implies that audit practices and procedures are standardized rather than a matter of professional skill and judgment, (6) it threatens auditor independence to the extent that the auditor is not free to extend or limit his tests as required to discharge his responsibility, (7) it would lower standards and quality of performance in the long run, and (8) a uniform standard for all members should replace the variety which is found in the various rules adopted by state societies and boards of accountancy.[1]

On March 5, 1962, the following rule was declared effective after it had been approved by more than 90% of the members who voted in the referendum:[2]

> A member or associate shall not make a competitive bid for a professional engagement. Competitive bidding for public accounting services is not in the public interest, is a form of solicitation, and is unprofessional.[3]

In terms of the practical application of the new rule, the Committee on Professional Ethics indicated in its April, 1961, report that a member could furnish a prospective client with an estimate of the probable cost of an engagement as long as there was no representation (expressed or implied) or warranted inference by the recipient that the estimate was a firm bid or commitment and provided that the estimate was made in good faith. An estimate which is made in good faith is one which is as realistic as the existing circumstances and information permit. But an estimate which is appreciably lower than probable cost would be presumed to influence the decision of a prospective client and would be considered to be a form of competitive bidding.

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[1]Report of the Committee on Professional Ethics, April 19, 1961, pp. 4-6, American Institute of Certified Public Accountants, New York (in the files of the Institute library).

[2]"Results of AICPA Referendum Ballots of January 1962," The CPA, XLII (March, 1962), p. 3.

[3]By-Laws, Code of Professional Ethics, . . . (1962), p. 32.

Obviously, the operational meaning of such phrases as "good faith," "realistic," "appreciably lower," and "probable cost," will be significant factors in an application of this rule to a specific situation. Certainly the situation is much too complex to warrant a prediction with respect to the degree of effectiveness which will be applicable to the rule. However, if the Committee on Professional Ethics applies the new rule as it has indicated it would, competitive activity of the kind described in the following report may become cause for disciplinary proceedings:

> A firm with a high proportion of its junior and senior accountants idle may submit a bid well under "the normal range" just to get them working again. Al Jennings, the senior partner of Lybrand, Ross Bros. & Montgomery, recalled recently that his firm had lost a big account to another of the Big Eight, which put in a "loss-leader" bid--after it had managed to wangle an invitation to make a presentation. Firms often submit such bids in the hope that after they get a foot in the door, they can gradually expand the volume of their work and their fees.[1]

Evidence which tends to support the authenticity of the above report can be seen in an editorial comment written by the executive director of the American Institute of Accountants: "Accounting fees are depressed in some areas by competitive bidding, by careless quotation of 'estimates' without adequate information, by a custom of taking on 'off-season' work at lower than normal rates."[2]

A fixed fee in an unrestricted audit engagement will probably continue to be outside the scope of this rule which only forbids a member to make a competitive bid.[3]

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[1]T. A. Wise, "The Auditors Have Arrived," Part I, Fortune, LXII (November, 1960), p. 186.

[2]John L. Carey, "From the Executive Director's Desk," The CPA, (July, 1954), p. 3.

[3]Accounting and Auditing Problems, "Fixed Fees in Unrestricted Audit Engagements," The Journal of Accountancy, CVII (March, 1959), p. 71.

Soliciting Employees of Another Public Accountant

It was mentioned in a previous section of this chapter that a public accountant would be most unlikely to view with favor the loss of a client as a result of the soliciting efforts of another public accounting practitioner. Perhaps equally disturbing to a public accountant would be the loss of an efficient, well-trained member of his staff who was lured away by the attractive offer of employment with some other public accountant. Such predatory actions as the solicitation of the clients or employees of another accountant would, if committee with impunity, quickly destroy the unity and harmony of the professional organization. But a large measure of the prestige which individual certified public accountants enjoy, is attributable to the general reputation which has been established through the efforts of the professional organization. Therefore, it is a matter of self-interest for the individual members to set certain minimum standards of professional courtesy which are essential to the continuity of the Institute. One of these minimal standards is the requirement that no member of the Institute shall secretly solicit the services of an employee of another public accountant.

The original rule which prohibited solicitation of the employees of another public accountant was adopted by the Institute's Council on April 14, 1919. That version of the rule follows:

> No member shall, directly or indirectly offer employment to an employe [sic] of a fellow member without first informing said fellow member of his intent. This rule shall not be construed so as to inhibit negotiations with anyone who of his own initiative or in response to public advertisement shall apply to a member for employment.[1]

In 1918, the year before the first version of the rule was adopted, two members who were partners appeared before the trial board on charges of having solicited the employees of another member. It was found

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[1] "American Institute of Accountants: Semi-annual Meeting of Council," The Journal of Accountancy, XXVII (April, 1919), p. 370. See also "Rules of Professional Conduct," 1919 Year-Book . . . , p. 140.

that the defendents had indeed communicated with the employees of the complaining member in an attempt to induce his employees to enter into their employ. The trial board ruled that such action on the part of the defendents was unprofessional and improper conduct. The defendents were admonished not to repeat this conduct in the future.[1] Neither the record of the Committee on Professional Ethics nor the minutes of the Council meeting during which the trial was held, indicate what by-law or rule of professional conduct was the basis for that disciplinary action. On the basis of the published reports of the Committee on Professional Ethics and the trial board, it can be assumed that no member has, since that trial in 1918, been formally charged with having solicited the employees of another public accountant.

Although several minor revisions were made in the rule, it continued to apply only to the employees of another member or associate until 1941. In that year, a new rule became effective which extended the prohibition to cover the employees of all public accountants.[2] No significant changes have been made in the rule since 1941. The following is the current version of the rule:

> Direct or indirect offer of employment shall not be made by a member or associate to an employee of another public accountant without first informing such accountant. This rule shall not be construed so as to inhibit negotiations with anyone who of his own initiative or in response to public advertisement shall apply to a member or associate for employment.[3]

Referral Engagements

Sometimes a public accountant will accept a professional engagement which involves the referral of a portion of the work to another public

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[1] "Council: Regular Meeting, September 16, 1918," 1918 Year-Book . . . , p. 70.

[2] "Rules of Professional Conduct," 1940 Yearbook . . . , p. 534.

[3] By-Laws, Code of Professional Ethics . . . (1962), p. 34.

accountant or public accounting firm. These arrangements have long been common in certain kinds of audit engagements. A public accountant whose client has facilities located throughout a broad geographic area might refer inventory verification or other work to a certified public accountant whose office is near the location at which the referral work is to be performed. These arrangements appear to be beneficial to clients and public accountants alike. That a public accountant who had performed a referral engagement of this kind would be in a position to encroach upon the engagement of the referring public accountant seems at best a remote possibility.

Supersession is not such a remote possibility in a class of referral situations which have developed quite recently and are still growing in importance. Suppose for example that an auditor learns that his client needs advice on automatic data processing. If the auditor's training does not qualify him competently to advise his client on questions of automatic data processing, he has a professional responsibility to refer his client to someone who is believed to be capable of giving competent advice.

At this point it is important to note a significant characteristic of the firm of certified public accountants which is large enough to offer such specialized service and to which a small practitioner might refer the special problem of his client. Not only does the large firm offer specialized services, but also it performs the general services of certified public accountants--auditing and tax work. In view of these facts, a certain amount of hesitancy may be understandable on the part of a public accountant whose client needs a service which he should refer to a public accounting firm that is better qualified to render the particular service. Indeed, it has been said that one of the major obstacles in the referral of professional engagements among public accountants is the fear of many accountants that ultimately they will lose completely a client who is referred for whatever reason to another public accountant.[1]

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[1]George R. Catlett, "New Demands on the Accounting Profession," The Journal of Accountancy, CIV (July, 1957), p. 27.

Although there seem to have been convincing reasons for public accountants to avoid whenever possible the referral of professional engagements to other public accountants, the role of certified public accountants in the general area of management services has grown phenomenally in recent years. In fact, Louis H. Penney, who is a past president of the American Institute, observed that

> the field of management services demands even more in the way of specialization. One partner in a large firm states that the needs of a substantial clientele are so diversified today, particularly in the field of management services, that the fully staffed organization will require, if not a hundred specialists, at least men with experience and qualifications in a hundred specialities.[1]

Responding in 1957 to these developments, the Committee on Professional Ethics submitted to the state societies of certified public accountants, state boards of accountancy,[2] and the membership of the Institute for the expression of comment or opinion, the following proposed rule:

> A member who receives an engagement for specialized services by referral from another member shall not extend his work beyond the specialized services without approval of the referring member.[3]

That rule was proposed by the committee in order "to encourage members at all times to see that their clients receive the best professional assistance by bringing in specialists when needed."[4] Furthermore, it was said that the rule would protect the referring member to the extent that a specialist would be deterred from rendering other services for the client

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[1]Louis H. Penney, "The Significance of Mergers of Accounting Firms," The Journal of Accountancy, CXII (November, 1961), pp. 51-52.

[2]"Professional Ethics," The CPA, (December, 1956), p. 7.

[3]"Proposed Changes in AIA Rules of Professional Conduct," The CPA, (March, 1957), p. 7.

[4]Ibid.

although it was recognized that a specialist could not forever be forbidden from the performance of additional services for the client.

The comments which the Committee on Professional Ethics received with respect to the proposed rule led it to conclude that an extension of the services performed by a specialist should not depend upon the approval of the referring member. It is reasonable to suppose that those whose services would have been restricted by the proposal would be opposed to it. But there is no reason to suppose that referring members would object to their own protection. At any rate, the objectionable features of the proposed rule were easily eliminated. The Committee simply deleted the phrase "without the approval of the referring member" and in its place substituted the phrase "without consulting with the referring member." It also substituted the precise phrase "specific engagement" for the former "specialized services." After these revisions had been made, the proposed rule received the overwhelming approval (13,782 for adoption as compared with 608 opposed) of the membership of the Institute in a mail ballot.[1] The rule became effective on January 20, 1958, and appears here in its present form:

> A member or associate who receives an engagement for services by referral from another member or associate shall not extend his services beyond the specific engagement without consulting with the referring member or associate.[2]

The effect of the rule on referral engagements, which was adopted in 1958 by the Institute, was not completely satisfactory. That fact was made clear in 1959 when the Committee on Management Services by Certified Public Accountants recommended to the Committee on Professional Ethics that the following rule be adopted:

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[1] "Votes on Rules," The CPA, (February, 1958), p. 1.

[2] By-Laws, Code of Professional Ethics . . . (1962), p. 34.

> A member who receives from another member a referral engagement will be precluded from accepting from the client work not included within the scope of the specific engagement for a period of two years after completion of the engagement, unless permission to perform additional work is first secured from the referring member.[1]

Evidently the proposal was intended to be a compromise between the initial proposal which required the approval of a referring member and the existing rule which only required consultation. It was said that the proposed rule would increase referrals among members of the Institute and would reduce the need to refer engagements to specialists outside the profession.

Although subsequent reports of the Committee on Professional Ethics contain no reference to the latest proposal to amend the rule on referral engagements, the phraseology of the proposed rule may well have been considered to be inappropriate for a rule of professional conduct. Similarly, one can imagine that the initially proposed rule was rejected because it limited forever an extension of services. The current rule is acceptable to everyone but is ineffective.

Scope of the Rules

The Committee on Professional Ethics reviewed in 1940 a complaint which involved an Institute member who was alleged to have committed a particularly flagrant act in contravention of the rule which prohibited a member from soliciting the clients of another member. Notably, the accused member was simultaneously a partner in a public accounting firm and a partner in a separate firm which designated itself as "management consultants." It was the management consultants who had issued and distributed a firm bulletin in a manner which violated the ban on the

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[1] "Rules of Professional Conduct," The CPA, (December, 1959), p. 11.

solicitation of clients. Coming quickly to the heart of the matter, the Committee reasoned that

> if in his capacity as a management engineer or consultant such a member acted in a manner not permitted to members of the Institute practising only as public accountants, it would appear that to some extent the Institute's rules were nullified, and it might be presumed, consequently, that the practice as management engineer or consultant would be incompatible with the practice of public accounting. . . .[1]

Accordingly, the Committee recommended that the Council adopt the following resolution:

> RESOLVED, That a member or an associate of the American Institute of Accountants engaged simultaneously in the practice of public accounting and in another occupation must in both capacities observe the by-laws and rules of professional conduct of the Institute.[2]

Evidently the members of the Council were as disturbed by this case as were the members of the Committee on Professional Ethics because the presentation of the report of the Committee was interrupted by the Council in order to adopt that resolution. The normal procedure would have delayed any action on specific recommendations until the presentation of the Committee report had been completed. During the same Council meeting, the resolution was adopted as a rule of conduct and was included in the general revision of the rules of professional conduct which became effective on January 6, 1941.

Several years passed during which time the rule on simultaneous occupations of members of the Institute was applied by the Committee on Professional Ethics to a series of routine situations. But in 1947 the Committee on Professional Ethics received a complaint involving a member who was the executive vice-president of a corporation which advertised

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[1] "Reports of the Committee on Professional Ethics," 1940 Yearbook . . . , p. 151.

[2] Ibid.

and solicited bookkeeping and tax service business under a nationally advertised trade name. On the basis of its experience in that case the Committee noted that

> a member engaged in public accounting practice, who might also be the officer of a business corporation which advertised its products, and solicited customers for its products, might be held to be in violation of the rule. . . . It has developed that members engaged in businesses (such as public bookkeeping) or professional activities other than the practice of public accounting (such as management engineering), in which they rendered services similar to services rendered by public accountants, would not be prevented from advertising under Rule 15, unless they were simultaneously engaged in the practice of public accounting.[1]

These factors led the Committee to believe that the administration of the rule would be improved and the ambiguities would be eliminated if the rule was revised as follows:

> A member of the American Institute of Accountants, engaged in an occupation in which he renders services of a type commonly rendered by public accountants, must observe the by-laws and rules of professional conduct of the Institute in the conduct of that occupation.[2]

That version of the rule became effective on December 4, 1948.

Apparently the Committee on Professional Ethics never found it necessary to elucidate the phrase "services of a type commonly rendered by public accountants." However, John L. Carey wrote in 1956 that "commonly" probably was not used in the sense of "widely" but was intended to imply "not unusually." Thus, according to Carey, the rule "would probably apply to services of a type rendered by even a comparatively small number of accounting firms, so long as it was not unusual for any accounting firm to render this type of service."[3] No doubt that

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[1]"Committee on Professional Ethics," May 1948 Reports to Council (New York: American Institute of Accountants, 1948), pp. 25-26.

[2]Ibid., p. 26.

[3]Carey, Professional Ethics . . . , p. 148.

opinion was consistent with the practical applications of the rule by the Committee on Professional Ethics and the unique definition of "commonly" was presumably the product of unpublished Committee interpretations.

In order to expand the application of the rule beyond bookkeeping services, the Committee recommended in 1957 that the phrase "or other professional services" be added to the existing rule. If that phrase were made a part of the rule, the Committee believed it could more effectively restrain the promotion of management services and other activities which some practitioners might contend were not services "commonly rendered by public accountants."[1]

Shortly after the proposed version of the rule had been submitted for the member's comment, the Committee submitted a revised proposal to the Council. Since January 20, 1958, the rule has not included the word "commonly," but it is obviously consistent with what was said to have been the intent of the former rule. The following is the current version of the rule:

> A member or associate engaged in an occupation in which he renders services of a type performed by public accountants, or renders other professional services, must observe the by-laws and Code of Professional Ethics of the Institute in the conduct of that occupation.[2]

Acts Discreditable to the Profession

The most recent addition to the rules of conduct of the Institute became effective on March 6, 1962, when the codification of the rules of professional conduct also became effective. The following is the newest rule:

> A member or associate shall not commit an act discreditable to the profession.[3]

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[1] "Proposed Changes in AIA Rules of Professional Conduct," The CPA, (March, 1957), p. 7.

[2] By-Laws, Code of Professional Ethics . . . (1962), p. 33.

[3] Ibid., p. 29.

Although not a rule, that proviso had long been included in the by-laws of the American Institute of Certified Public Accountants and its predecessor organizations. Even in 1906, the by-laws of the American Association of Public Accountants provided that a member who was "guilty of any act or default discreditable to a public accountant"[1] would be liable to expulsion or suspension for a period of up to two years. A similar provision has, since 1906, been included in the by-laws of the American Association of Public Accountants and its successor organizations. Despite the codification of this rule, the by-laws of the American Institute still provide that "a member or associate renders himself liable to expulsion or suspension by the trial board or a sub-board thereof if . . . he is held . . . to have been guilty of an act discreditable to the profession. . . ."[2]

The generality of the new rule is perhaps its greatest virtue. Even if it was possible to specify in advance every conceivable act of misconduct of which a member of the profession might be guilty, it would probably be impracticable to adopt rules for each and every one of these potential violations of the professional attitude. It was thus a practical matter to have a provision in the by-laws which would serve as a basis for disciplinary actions in those cases which are not covered by the specific rules of professional conduct. Because this provision of the by-laws is important and has been the basis of formal charges against members of the Institute on numerous occasions, it is natural that it should also appear in the code of professional ethics of the American Institute of Certified Public Accountants.

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[1]"Constitution and By-Laws," . . . Year-Book (1906), p. 84.

[2]By-Laws, Code of Professional Ethics . . . (1962), p. 7.

Summary

Some of the most difficult of the ethical problems encountered by the national professional organization of certified public accountants have involved the colleague-colleague relationships. Advertising, soliciting the clients or employees of another public accountant, and competitive bidding for professional engagements are manifestations of the keen competition and rivalry which characterized the practice of public accounting for many years. Of course those patterns of behavior were in conflict with the professionalization of the practice of public accounting. Therefore, in order to establish the professional status of public accountants, it was necessary to eliminate behavior which was not characteristic of the members of established professions.

The first rule of conduct which is discussed in this chapter is a necessary rule but not from an ethical point of view. Although the rule merely specifies the conditions for identification of membership in the Institute, it introduces indirectly two important ethical considerations. First, members are not forbidden to use such partnership designations as "& Company" even though the "firm" is in fact a lone certified public accountant. Such devices are clearly deceptive. Secondly, the rule is indirectly related to the problem of mixed partnerships which the profession has not yet resolved but is studying. Consideration of mixed partnerships is also found in the application of the rule on commissions (see Chapter III). The problem is complicated by the fact that the partnership of a certified and a non-certified public accountant is objectionable while the partnership of a certified public accountant and a member of certain other professions has many desirable features particularly with respect to management services.

Advertising was generally used by the earlier public accountants in the United States to expand the number of their clients. It was

considered necessary because so few businessmen were aware of their need for and the nature of the services of public accountants. This rationale was also heard by those who in 1918 proposed a rule of conduct which provided for the censorship of the proposed advertisements of the members of the American Institute of Accountants. The ineffectiveness of the censorship approach was evident by 1922 when the Council adopted a rule of conduct which imposed some restrictions on the advertisements of the members of the Institute. It was at this time that the Treasury Department had prohibited advertising by enrolled agents. However, because the Treasury Department's rule permitted public accountants to designate the class or classes of service which they offered, the Institute's rule on advertising was amended in 1926 also to permit class of service designations.

Members of the Institute were permitted to publish with unlimited frequency a "card" provided that it conformed to certain standards of format and size. Finally, in 1944, the publication of a card by a member was restricted to an announcement of a change of address or personnel of a firm. Those members of the Institute who were opposed to the much-abused directory listings of public accountants were able, in 1948, to secure the adoption of a revised advertising rule which imposed certain restrictions on the format of paid listings in directories of members of the Institute. However, listings of the name of a certified public accountant under multiple designations in a single directory were not banned until the current version of the advertising rule was adopted in 1960 when class of service designations in directory listings and the publication of cards and announcements were also prohibited.

Severe limitations are not imposed upon the distribution of literature by the Institute's members. The Committee on Professional Ethics has expressed the opinion that a member may furnish newsletters, tax booklets, and other printed materials to clients and others provided that

the name of the member is not imprinted on materials which he has not prepared and provided further that such distribution does not represent a solicitation of the client of another public accountant. Only the latter restriction is applicable to materials which have been produced personally by the certified public accountant.

Public accountants who solicited "business" from the clients of other public accountants were not unknown to members of the American Association of Public Accountants. But it was not until the American Institute of Accountants had been organized that the practice was prohibited. Even then, the rule only prohibited the solicitation of work from the clients of other members of the Institute. That prohibition was extended in 1941 to the clients of all public accountants. Finally, the rule was amended in 1948 to prohibit members from soliciting engagements from any potential client.

A recently proposed amendment of the rule would have required a member of the Institute to communicate with a public accountant whose client had requested the member to accept an engagement. Explanatory comments which were offered by the Committee on Professional Ethics together with the phraseology of the proposed addition to the rule indicate that the amendment was primarily intended to preserve the internal unity of the Institute while encouraging the expansion of management services engagements. The failure of the proposal to win the approval of the membership may be presumed to mean that the improvement or preservation of the internal unity of the Institute and the expansion of management services by certified public accountants are presently incompatible goals.

Competitive bidding was one of the most persistent manifestations of the competitive spirit of public accountants. Of course many forms of rivalry were recognized as being incompatible with professional status, but none seemed to be more difficult to overcome than was competitive bidding.

A continuous stream of literary criticism of competitive bidding for public accounting engagements began to appear in 1907. Finally, in 1933, the Committee on Professional Ethics of the American Institute of Accountants proposed a mild rule which was rejected by the Council because it was feared that a rule could not be enforced. While the Institute's Council adopted a bland resolution on competitive bidding in 1934, several state societies adopted prohibitory rules. The Connecticut Society of Certified Public Accountants demanded in 1938 that the members of the Institute be prohibited from submitting competitive bids in states in which the state society of certified public accountants had banned competitive bidding for its members. In compliance with that demand, the Council adopted a resolution which became the basis for a rule of professional conduct in 1941.

While the American Institute focused its efforts on such educational devices as formal statements of opposition, more and more state societies of certified public accountants formally discouraged or prohibited competitive bidding. This pattern developed because the Institute's Committee on Professional Ethics found that it could not effectively investigate violations of a ban on competitive bidding.

In 1960, counsel for the Institute and the Executive Committee recommended the repeal of the rule on competitive bidding. It was said that the existence of the rule created the risk of legal action against the Institute under the Sherman Anti-Trust Act. As a means of filling the void created by the abolition of the rule, it was suggested that a formal policy statement could be adopted. Contrary to this advice, the Committee on Professional Ethics recommended the adoption of a stronger rule which prohibited members of the Institute from submitting a competitive bid for a professional engagement. That proposal became effective on March 6, 1962.

It was pointed out that an unsuccessful effort to amend the rule on the solicitation of clients was intended to preserve the unity of the members and to expand the management services of certified public accountants. The incompatibility of those goals is evident also in the development of the rule on referral engagements. Two unsuccessful proposals required that a member who received by referral an engagement for specialized services and who wished to extend his work to other services for the client must secure the approval of the referring member. But the rule which became effective in 1958 required only that a member must not extend his services without consulting with the referring member. It is probable that the difficulty which has been encountered in the development of the rule on referral engagements is the result of these conflicting interests: referrers fear encroachment, referrees oppose excessive limits on the extension of their services, and the Committee on Professional Ethics is solicitous about the outward appearance of the rules of conduct.

The management services of certified public accountants have been the source of numerous problems which involve the ethical code of the profession. One of these problems resulted in the adoption of a resolution which required members of the Institute to abide by the rules of conduct not only in the practice of public accounting but also in simultaneous occupations. Later developments in the evolution of the rule were also the result of the practices of certified public accountants in the area of management services.

CHAPTER VI

CONCLUSIONS

A Limited Model

A code of ethics is not the ultimate expression of the ethical values, norms, and symbols of a profession although members of the profession tend to perceive it as being, at any given time, a complete collective representation of the ethical ideal. Far from being static, a code of professional ethics is a unique, dynamic record of the movement of an occupational group toward professional status.

Surprisingly, the earliest rules of conduct which were adopted by public accountants involved integrity, technical standards and responsibilities, as well as the professional attitude. Thus a well-rounded but not a fully developed professional image was projected to society in an early stage of the development of the profession. That image was created by the commitment which the group itself had made to the values and norms which were considered to be typical of the generally recognized professions. Subsequent adoption of rules in each of the three functional classifications tended to be evenly distributed over time.

The most significant and enduring obstacle to professionalization was a well-developed competitive spirit. Competitive rivalry is a behavior pattern which is consistent with the conclusion that professional men, as individuals, are not typically motivated by a sense of altruism.[1]

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[1]Talcott Parsons, "The Professions and Social Structure," Social Forces, XVII (May, 1939), p. 465.

Gradually the overt forms of competition became more subdued as professionalization progressed.

In addition to the projection of a professional image, the rules of conduct also contribute to the internal control of the profession. Moral suasion is the first and primary function of the code of ethics. However, in order to continue the professionalization process, it became necessary for the group to protect itself by taking disciplinary action against the recalcitrant members. Ultimately the admonition, suspension, or expulsion of even a very few unfit members required that the rules upon which those actions were based had to have the sanction of a majority of the membership. An evidence of an increasingly efficient system of internal control is the fact that while membership has increased phenomenally, the number of members who are formally disciplined remains relatively unchanged. As Hughes has also noted, secrecy in the disciplinary affairs of the profession is commonplace.[1]

Conscious efforts were made to avoid the adoption of rules which did not have the sanction of a majority of the members of the organization. Although several exceptions can be cited, the rules have generally represented minimal standards. It is perhaps for that reason that the rules have typically been expressed in an imperative rather than a suggestive or advisory form although many were first adopted as suggestive admonitory resolutions.

On the basis of the present study it is not possible to say with certainty that the public accounting profession has developed an informal ethical code. Nor was it one of the purposes of this study either to establish the existence of such a code or to isolate any of its components. However, at the time of the adoption of the rule which gives expression

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[1]Everett Cherrington Hughes, Men and Their Work (Glencoe, Ill.: The Free Press, 1958), p. 142.

to the confidential relationship of the accountant to his client, the belief was expressed that the concept had long been honored informally. Further evidence of the possibility of the existence of an informal code can be seen in the long-standing provision for punishment of an act which is considered discreditable to the profession. That proviso is ideally suited to the task of encouraging compliance with the unwritten norms and values of the group. Thus the existence of an informal code is neither refuted nor adequately demonstrated, but it is an area in which further investigation is recommended.

Subcultural Identification

Although the public accounting profession has made considerable progress along the occupational continuum in the direction of professional status, there are several signs which suggest the possibility of regression.

The Institute has finally adopted rules which prohibit its members from advertising and submitting competitive bids for professional engagements. In marked contrast with those achievements, proposals to amend the rules which prohibit solicitation of clients and encourage referral engagements have been unsuccessful. Those proposals were motivated by a desire to increase the management services of certified public accountants and to preserve the internal unity of the Institute. But firms of certified public accountants do not typically limit their services to one or more specialties; they also perform the audit function. Notably, however, auditing is the basic and perhaps the only service of the public accountant who is expected to refer his clients to another firm when they need a service that he is not competent to perform. Because the firm of specialists typically offers auditing services in addition to its management services, it is obvious that a referring accountant risks the loss of an audit client in a referral situation. To the referring public accountant,

the result is the same whether the loss of a client occurs because the client freely chose to consolidate all of his work with one firm of certified public accountants or whether he was encouraged to do so.

As a result of these relationships, there is ample reason for the apprehension and anxiety of the non-specialized certified public accountant whenever he considers management services in terms of referrals and encroachment. This condition is symptomatic of a social disorder of the Institute: a deficient group unity or consciousness-of-kind which is supposed to be characteristic of professional organizations. Other disunifying divisions of interest probably contribute to the basic social disorder. For example, fundamental differences between the audits of the lone practitioner and those of the large firm probably cause the formation of groups with divergent interests. Progress along the professional continuum has probably been retarded because the profession has not been able to induce the proper individual unity and personal commitment to the welfare of the profession.

Further study is needed in order to determine whether the absence of an adequate group cohesion is the result of an insufficient qualitative or quantitative individual identification with the subculture of the public accounting profession or whether the subculture itself is ill-defined, inappropriate, or underdeveloped.

It seems likely that the subcultural identification problem of the public accounting profession is related to the fact that the profession does not control the education of its entrants. In contrast with the medical and legal professions, the public accounting profession has no accrediting process by which it can control the number, location, and the professional curriculum of the colleges and universities which are now becoming the typical method of gaining entry to the profession. Although the profession partially controls access on a technological basis by means of the licensing system for certified public accountants, it has not yet extended its

control to the ideologic training which is a function of accredited professional schools.

Perhaps there is another factor which contributes to the deficiency of individual identification with the subculture of the public accounting profession. As compared with the medical profession and to a lesser extent with the legal profession, access to the public accounting profession is still relatively easy. Similarly, departure from the public accounting profession appears not only to be easier but also to occur with greater frequency. Transient members of the profession would not be likely to make more than a token commitment to the subculture of the profession. If there is in fact a higher incidence of transiency in public accounting as compared with the medical and legal professions, that factor could be contributing significantly to the problem of subcultural identification.

Professional Diffusion

The public accounting profession has never considered it necessary to limit its province to auditing. That failure is readily apparent in the rapid growth of the management services functions to which repeated reference was made in the analysis of the development of several rules of conduct. Thus the expansion of management services has precipitated and is the potential source of serious problems with respect to independence, fee-splitting with the "laity," competence, referral engagements, and advertising through the use of film strips or brochures. Questions concerning the proper province of the profession do not arise only for public accountants. Hughes has found a "constant discussion of what is whose work in medicine and what part of it all is the physician's work, privilege and duty."[1] Similarly, the legal profession is confronted with

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[1]Ibid., p. 122.

problems of specialization and the expansion of services.[1]

Perhaps the rules can be reconciled with the characteristics of the management services of certified public accountants. But that solution seems to be neither practicable nor desirable. As a practical matter, various rules have been recognized as being incompatible with or inapplicable to the tax practice of certified public accountants. Yet the Institute has been reluctant either to exclude tax practice from the scope of its rules of professional ethics or to make appropriate modification in those rules. There is no reason to believe it will be less reluctant to limit the rules in order to compensate for the ethical problems created by the increasingly important management services. From the viewpoint of desirability, it is obvious that any lowering or limitation of its ethical standards could and probably would have an adverse effect upon the professional image.

Let us assume for the moment, not at all unrealistically, that the profession elects to do nothing about the ethical problems related to management services. Whatever authority the profession enjoys is based upon the sanction of society. In effect, society has provided independent public accountants with a monopoly on the function of examining and expressing an independent expert opinion upon the financial statements of business enterprises. Society may or may not extend the professional authority of public accountants to the broad, nebulous management services area. Perhaps through the Securities and Exchange Commission or some other social institution, society will withhold its sanction of the recent -- and continuing expansion of the professional boundary. As a consequence, the profession would incur a serious loss of prestige if not a more seriously damaging effect. The authority of a profession is not limitless, but is restricted to those areas in which a professional is qualified to

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[1] Ibid., p. 132.

practice by virtue of his training and education. Parsons has called this the concept of functional specificity.[1]

On the other hand, if society does sanction this extension of professional authority, the integrity[2] of the public accounting profession will inevitably be damaged. That must be the result of any action which extends the professional service to functions that are not clearly compatible and consistent with the auditing or attest function of certified public accountants.

Thus it seems clear that it would be dangerous for the profession to ignore the ethical problems which are the result of an increasing emphasis upon management services by certified public accountants. The profession must choose between the pecuniary rewards of management services engagements and the damage to its integrity which must be the inevitable result of the diffusion into areas which are not genuinely compatible with its raison d'etre--the audit function.

One might wonder why it is that the public accounting profession was motivated to expand so readily and remarkably into the non-auditing services. Is this phenomenon merely a manifestation of homo economicus? Has the profession reached the limits of its service to society in the auditing or attest function so that the future growth of the profession depends upon the introduction of new service functions? Does the management services area represent to certified public accountants an opportunity for creative self-expression as opposed to the drab, unglamorous audit function? These questions are raised in order to suggest to others an area in which investigation might be fruitful.

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[1]Parsons, Social Forces, XVII (May, 1939), p. 460.

[2]Integrity in this context is the state or quality of being undivided and unimpaired.

Prognosis

Recent developments in the standards of independence to which members of the American Institute of Certified Public Accountants have committed themselves indicate that the public accounting profession has been responsive to the influence of the Securities and Exchange Commission. The influence of the Commission is apparent in the acceptance by the Institute of the Commission's objective tests of independence. It is hoped that the profession will eventually dissociate itself from the non-operational "state of mind" concept of independence which seems still to be implied in the second paragraph of the new rule on independence.

At the moment, the American Institute of Certified Public Accountants is clearly opposed to the formation of professional incorporations or associations of certified public accountants. Despite this opposition, the Institute's attitude is one of watchful waiting. The probability that equitable tax provisions for the pension plans of the self-employed will be achieved through an amendment of the federal income tax law appears to be insignificant. Of the five reasons which the Executive Committee recently gave for the policy of opposition, each would either be seriously weakened or eliminated if the efficacy of professional corporations is established in the other professions which have employed this device. In view of these facts, it is likely that the Institute will be compelled to abandon its opposition to professional incorporation or association for certified public accountants.

Competence is an ethical problem which is not likely to be subject to an easy or quick resolution by the Institute. Before meaningful ethical standards of competence for the non-auditing services can be formulated, it will be first necessary to establish technical standards. But the development of the technical and ethical reporting standards for audit opinions indicates that there will be a considerable lag between the adoption

of technical standards and the related ethical standards for non-auditing services. Thus it is doubtful that rules will be quickly developed to cover the ethical responsibilities of the members of the profession for their competence in the non-auditing areas of practice.

Finally, there are several brief observations with respect to the standards of courtesy and dignity to which the members of the American Institute of Certified Public Accountants have bound themselves. Referral fees or kick-backs are vigorously condemned if they involve a member of the Institute and a non-member of the profession. On the other hand, referral fees or kick-backs which are not justified by economic service are sanctified if they involve only members of the public accounting profession. It is probably impossible to justify that distinction and only somewhat less difficult to rationalize its existence. Fortunately, the American Institute of Certified Public Accountants has attempted neither justification nor rationalization of the practice. Therefore, it has merely to do that which it has helped certain medical societies to do--eliminate kick-backs.

An individual practitioner is appropriately prohibited from use of the phrase "Members of the American Institute of Certified Public Accountants." It is even more appropriate that an individual practitioner should not be permitted to use a firm name which deceptively implies the existence of a partnership. Simple honesty, to say nothing of a professional attitude, demands that the profession purge itself of that practice.

Because a code of professional ethics is a dynamic expression of an evolving ethical ideal, it would indeed be strange if one could not find areas in which the public accounting profession could better define its integrity, attitude, and responsibilities. Yet potential developments do not overshadow the progress which has been made. In 75 years, the national professional organization has grown from 22 to more than 40,000 members. A unique parallel of that phenomenal numerical growth is

the equally impressive development of the ethical code of the profession. Indeed, the evolution of its code of professional ethics does provide a unique history of the birth and growth of the American Institute of Certified Public Accountants.

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APPENDIX

CODE OF PROFESSIONAL ETHICS

American Institute of Certified Public Accountants

As Amended March 6, 1962

The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality and integrity. To this end, a member or associate of the American Institute of Certified Public Accountants shall at all times maintain independence of thought and action, hold the affairs of his clients in strict confidence, strive continuously to improve his professional skills, observe generally accepted auditing standards, promote sound and informative financial reporting, uphold the dignity and honor of the accounting profession, and maintain high standards of personal conduct.

In further recognition of the public interest and his obligation to the profession, a member or associate agrees to comply with the following rules of ethical conduct, the enumeration of which should not be construed as a denial of the existence of other standards of conduct not specifically mentioned:

ARTICLE 1: Relations with Clients and Public

1.01 A member or associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member or associate shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest.

1.02 A member or associate shall not commit an act discreditable to the profession.

1.03 A member or associate shall not violate the confidential relationship between himself and his client.

1.04 Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving federal, state, or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

ARTICLE 2: Technical Standards

2.01 A member or associate shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member or associate of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

2.02 In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if

(a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(b) he fails to report any material misstatement known to him to appear in the financial statement; or

(c) he is materially negligent in the conduct of his examination or in making his report thereon; or

(d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

2.03 A member or associate shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall:

(a) express an unqualified opinion; or

(b) express a qualified opinion; or

(c) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor; or

(d) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited.

2.04 A member or associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.

ARTICLE 3: Promotional Practices

3.01 A member or associate shall not advertise his professional attainments or services.

Publication in a newspaper, magazine or similar medium of an announcement or what is technically known as a card is prohibited.

A listing in a directory is restricted to the name, title, address and telephone number of the person or firm, and it shall not appear in a box, or other form of display or in a type or style which differentiates it from other listings in the same directory. Listing of the same name in more than one place in a classified directory is prohibited.

3.02 A member or associate shall not directly or indirectly solicit clients by circulars or advertisements, nor by personal communication or interview, not warranted by existing personal relations.

3.03 A member or associate shall not make a competitive bid for a professional engagement. Competitive bidding for public accounting services is not in the public interest, is a form of solicitation, and is unprofessional.

3.04 Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member or associate.

Commissions, brokerage, or other participation in the fees, charges or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member or associate.

ARTICLE 4: Operating Practices

4.01 A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Certified Public Accountants," but a firm or partnership, not all the individual members of which are members of the Institute, or an individual practicing under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practicing under a style denoting a corporate organization shall not use the designation "Members of the American Institute of Certified Public Accountants."

4.02 A member or associate shall not allow any person to practice in his name who is not in partnership with him or in his employ.

4.03 A member or associate in his practice of public accounting shall not permit an employee to perform for the member's or associate's clients any services which the member or associate himself or his firm is not permitted to perform.

4.04 A member or associate shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.

4.05 A member or associate engaged in an occupation in which he renders services of a type performed by public accountants, or renders other professional services, must observe the by-laws and Code of Professional Ethics of the Institute in the conduct of that occupation.

4.06 A member or associate shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

ARTICLE 5: Relations with Fellow Members

5.01 A member or associate shall not encroach upon the practice of another public accountant. A member or associate may furnish service to those who request it.

5.02 A member or associate who receives an engagement for services by referral from another member or associate shall not extend his services beyond the specific engagement without consulting with the referring member or associate.

5.03 Direct or indirect offer of employment shall not be made by a member or associate to an employee of another public accountant without first informing such accountant. This rule shall not be construed so as to inhibit negotiations with anyone who of his own initiative or in response to public advertisement shall apply to a member or associate for employment.

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