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### Accounting Ethics and the Public Interest

David A. Costello

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## **ACCOUNTING, ETHICS AND THE PUBLIC INTEREST**

by  
**David A. Costello**  
**CPA, President & CEO**  
**National Association of State Board of Accountancy**  
**March 15, 1999**

[Introductory note: David A. Costello, CPA, is president and CEO of the National Association of State Boards of Accountancy (NASBA), a voluntary organization of the 54 boards of accountancy in the United States and its territories. These boards are responsible for the licensing of certified public accountants nationwide, as well as monitoring the continuing competence of their licensees through continuing education and practice review programs.

Mr. Costello began his career with Ernst & Ernst (a predecessor firm of Ernst & Young) and then headed into corporate auditing with Genesco, Inc. In 1982, he moved up to president of its General Adhesives, Inc., division, and in 1986 became president and chief operating officer of IGI Adhesives, Inc., a division of the International Group, Inc., before starting his own consulting firm in 1991. He also served for a year as the executive director of the Tennessee State Board of Accountancy.

Among his professional activities, Mr. Costello is a member of the AICPA, Tennessee Society of CPAs, and the New York Society of CPAs. He is a member of the Audit Committee of the Nashville Electric Service. He is also a member of the board of directors of the Rochelle Center and World Christian Broadcasting and serves in an advisory capacity for other businesses.

A native of Nashville, Mr. Costello is a graduate of David Lipscomb University and holds an MBA from Vanderbilt University.]

It is truly an honor to have been selected as one of the presenters for this year's Emanuel Saxe Distinguished Lecture Series. And, of course, it is always great fun for me to visit New York, a city I have always loved and been inspired by, and where I lived for a few years during my eclectic career as a CPA.

I began my career with Ernst & Ernst, which you all know as Ernst & Young, then moved into private industry, later started my own successful consulting firm, and in 1991 accepted a position as the executive director of the Tennessee State Board of Accountancy.

Since 1994, I have been the president and chief executive officer of the National Association of State Boards of Accountancy (NASBA). NASBA serves as a forum for the nation's state boards of accountancy, which administer the Uniform CPA Examination, license certified public accountants, and, most importantly, regulate the practice of public accountancy in the United States. On behalf of state boards, NASBA has also been influential in international trade agreements, such as the General Agreement on Trade in Services (GATS), US-Canada Free Trade Agreement, and the North American Free Trade Agreement (NAFTA). Additionally, through one of its divisions, NASBA provides examination services to more than half of the 140,000 CPA candidates who take the CPA examination annually. NASBA's most weighty functions are to enhance the effectiveness of state boards of accountancy and to provide the state boards of accountancy with tools and models to assist them in the

many facets of regulating professional accountants.

I want to share with you my insights into the accounting profession vis-a-vis ethics and the public interest, and provide you with an overview of the enormous changes occurring within the profession, the ethical considerations that these changes have brought about, and how the public interest is affected. I will touch on the historical aspects and traditional environment of the CPA juxtaposed to today's borderless economy and interwoven lines of expertise. I will also address the profession's most significant response to its new vista—the Uniform Accountancy Act. Finally, I will discuss the key ethical and public interest concerns.

The American Bar Association Journal recently wrote, "Accountants are straying too far from the beanfield." Of course, they were referencing the outdated image of the CPA as a bean counter. Although CPAs are licensed to perform the audit function, they have responded to the compelling forces of change by expanding their scope of services.

Historically, the mere consideration of change has not been embraced by any profession. In 1899, Charles H. Duell, the Commissioner of Patents, stated, "Everything that can be invented has been invented." Clearly, he could not even imagine that firstgraders would e-mail their parents from school during the day.

In 1903, Horace Rackham was advised by the president of the Michigan Savings Bank not to invest in the Ford Motor Company because "the horse is here to stay." Fortunately for Mr. Rackham (and the Rackham heirs), he ignored that advice and his investment of \$5,000 turned into \$12.5 million.

In 1962 Decca Records rejected a group of musicians because, "We don't like that sound." That group was the Beatles.

And, most ironically, in 1977, the president of the Digital Equipment Corporation stated, "There is no reason for any individual to have a computer in their home." Clearly he couldn't imagine that in 1999 most people would have a PC on their desk in the office, one on the counter of their kitchen, and a four-pound notebook to carry on the subway. Wouldn't he be surprised if his grandson, like mine, at the age of 5, asked Santa for his own PC—with, naturally, a color printer.

Of course, the accounting profession has seen changes of a similar magnitude, and this restyling of the profession has demanded attention to ethical considerations.

CPAs must comply with ethical standards regardless of the task they are performing. It is to the sincere advantage of the accounting profession if in all fields of activities it exercises care to maintain scrupulously all professional and ethical standards—competence, independence, integrity, and a professional attitude. The fact that CPAs have professional standards of competence and responsibilities that are enforceable to a considerable extent under state law adds to the confidence which the public assigns to them to render consulting and management services, as well as traditional accounting and auditing work.

CPAs must not only avoid a conflict of interest, but also the appearance of a conflict of interest. As Richard Walker, SEC director of enforcement stated, "Forces of change such as escalating competition to obtain and hold on to auditing clients, and potential conflicts of interest as accountants offer a literal supermarket of nonaudit services, present new challenges to auditor independence." However, our principles of professional conduct are meant to guide us not only when offering traditional services, but also when conducting any professional service on behalf of clients. As the profession continues to evolve, a CPA's competence will naturally increase in breadth and depth and honest concern for a special purpose.

The CPA's responsibility to the public is not only stated in our professional code, but is an inherent component of our existence and, most importantly, what differentiates public accounting as a profession

from merely a business or occupation. The Professional Standards of the AICPA state it succinctly: "A distinguishing mark of a profession is acceptance of its responsibilities to the public." The difficult task is pinpointing the definitions of the different publics.

Others have described the public interest as the "collective well-being of the community."<sup>(1)</sup> This community consists of government, employers, investors, creditors, and the business community. Additionally, the CPA has a responsibility as well as potential liability, to third parties who do not engage the CPA for his or her services.

The CPA must be the one with the principal concern for the public interest. The client naturally will be concerned with presenting itself in the most favorable light. Furthermore, the profession—that is, the state societies, the AICPA, and other volunteer organizations—must promulgate in their codes of professional conduct the importance of the public interest. Most importantly, the state boards must extend their regulation over the licensed professional.

Prior to the 1900s, even before I was born, the accounting profession was in its infancy. The leaders of the profession at that time foresaw that coupling the expertise of accounting and auditing with unassailable integrity would become a powerful business tool. However, one without the other would be of limited value.

At the end of the last century, accountants began to organize and become a profession as state societies and boards of accounting debuted. At that time a few companies began to issue financial statements; however, there were no established standards, codes of ethics, or generally accepted principles. Practitioners wishing to represent the economic reality of an entity had to rely on professional judgement. Over time, the profession evolved so that committees emerged to address these issues, and practitioners voluntarily abided by their guidance.

The cornerstones of the guidance provided by these early bodies remain as today's foundation of ethical behavior—objectivity, integrity, trust, and, most importantly, independence. Independence is not only a condition of mind, but one of character as well. As a professional, a CPA cannot subordinate his professional judgement to the views of his client and must not have any interest in the outcome. Additionally, he must be free of any bias. This principle is so important that the independence in question must not only be independence in fact but also in appearance.

Unrelenting objectivity is a necessity in environments where there are vested interests, focused opinion, and partial analysis. The ability of a CPA to maintain objectivity is at the heart of the deep-seated respect for assurances provided during an engagement.

When discussing integrity, I find it best to paraphrase the AICPA code of professional conduct: "Uncompromised integrity is a quality from which the public trust derives and the benchmark against which a member of the profession must ultimately test all decisions."

And of course, all of this is meaningless unless trust has been established. And this trust is an earned status and must be nurtured and guarded by the CPA as his most precious investment. For when the public's trust wanes the CPA is no longer the unique accounting professional.

The CPA's traditional environment focused on auditing, accounting services, tax, and management services. Some of these services in taxation and management can be competently rendered by others. Only CPAs (and other public accountants where permitted by law) are licensed to examine financial statements and express opinions for which they are responsible.

Today's environment is so entirely different from that of the early 1900s that it makes those days unrecognizable. Mergers and acquisitions, as well as new tools, new forms of firm structure and ownership, new competitors, new challenges, and new opportunities, have truly created a profession in transition.

However, through all these changes the principal concern of the regulators of the profession--the public interest--has not changed.

The most significant developments we have seen are as follows:

- Non-CPA competition
- Technology displacing the use of traditional skills
- A truly borderless economy
- The threat to the CPAs status as a "trusted professional"
- The semantic and literal differences between assurance and attest
- The perceived value of the profession's cornerstone services declining in the marketplace
- Business consolidation through mergers and acquisitions
- Significant continual decline in the number of candidates entering the profession
- And, most recently, the significant growth of alternative business structures such as American Express Financial and Business Services.

And if that's not enough, we also have to contend with:

- The blending of consulting and other service providers with CPAs
- The use of the title certified public accountant and how the public views the CPA--as an auditor? consultant? elder care specialist?
- In the world market is the CPA designation a certification, credential, or license?

Clearly today's environment is fraught with complicated issues. But complicated issues are no reason to maintain the status quo. No! The public interest demands appropriate responses. I believe that the aggregate response to this new landscape, the jointly issued NASBA/AICPA Uniform Accountancy Act, addresses the significant issues described above.

The Uniform Accountancy Act (UAA) has been subtitled "Real World Regulation" to reflect that it very much takes into account not only what is occurring in today's environment but also puts forth a realistic set of responsibilities.

It will be helpful to give you a little background of the activities leading to today's UAA.

In 1916, the AIA--the American Institute of Accountants (which later became the AICPA)--published its first Model Bill which stood unchanged until 1980, when NASBA published a Model Public Accountancy Act along with a Model Code of Professional Conduct that was keyed to the Act. In 1984, NASBA collaborated with the AICPA and issued the first joint model piece of legislation which could be adopted by boards as a whole or in part.

In the early 1990s, the cooperative effort was re-established and in 1992 a new document entitled The Uniform Accountancy Act was jointly issued. It is noteworthy to mention that this version was considered an "evergreen" document--and not just because it was printed with a dark green cover. NASBA and the AICPA agreed that it would be a living, ever-evolving document and each organization would appoint standing committees to study the pertinent issues and create and rewrite sections as necessary.

The goals of the new Uniform Accountancy Act are to create an equal playing field in the delivery of services to the public, facilitate the mobility of the professional among states, respond to the marketplace, and, of course, protect the public interest.

Most of us involved with the drafting of the most current version of the UAA are particularly pleased with the newly coined term "substantial equivalence," which means that states which adopt this section of the UAA will deem CPAs from any state that also adopts that section as "substantially equivalent" to

the CPAs of their state. The adoption of this term by the state boards will:

- Allow CPAs to move easily and practice across state lines in person and electronically.
- Rely on the UAA to determine substantial equivalency.
- Require CPAs to adhere to laws and rules in states where they practice under substantial equivalency.
- Subject CPAs to discipline/enforcement in state of licensure and other states where they practice under substantial equivalency.

The UAA also strives to create equality among CPAs so that the public is no confused as to whether a CPA's conduct and practice are under regulatory authority. Therefore, all CPA's that are licensed and regulated, regardless of their field or place of employment, are equal before state boards of accountancy as long as they meet the basic criteria. The criteria for licensures as stated in the UAA are:

- 150 semester hours of education
- Passing the Uniform CPA Examination under consistent guidelines and conditions
- One year of basic experience in their respective professional fields of work

Moreover, regulation of CPA firms is required and includes the following in its definition:

- Attest services can only be performed by licensed CPA firms, which includes sole practitioners.
- CPAs that do not perform attest services may also organize as CPA firms but must comply with all requirements.
- Licensed firms must meet certain requirements, such as

—Peer review;

—Ownership, where a simple majority of the firm owners must be CPAs; and

—Experience under separate professional standards for those who supervise and sign reports on financial statements.

- CPA firms must undergo peer review every three years.
- A majority of the ownership of the CPA firm (financial interests and voting rights) must belong to licensed CPAs.
- All non-CPA owners of the firm must be active participants in the firm or its affiliated entities.
- Individuals in the firm who supervise attest engagements and sign reports on financial statements must meet appropriate experience requirements to be defined in professional standards.

The UAA also addresses the other types of services CPAs may offer while calling themselves CPAs. Other than attest services, CPAs may provide services to the public through any type of business entity while marketing themselves as CPAs. These business entities do not require licensure by the state boards.

Moreover, all CPAs working in such entities must hold valid licenses and are subject to regulation and discipline by the state board.

The UAA also focuses on the regulation of fees, and states, "In general, CPAs may accept commissions and contingent fees that are disclosed to clients, except in situations where they perform attest services for the same client. The acceptance of contingent fees are prohibited for preparing an original tax return. However, contingent fees may be accepted for the preparation of amended tax returns or refund claims, as long as the claim is subject to a substantive review by the taxing authority."

As you can well imagine, the section regarding attest services is the nucleus of the UAA. In that respect, the UAA provides that attest services performed in accordance with professional standards are restricted to licensees. The UAA defines attest services as follows:

- Audits as described in "Statements on Auditing Standards."
- Review and compilation as described in "Statement on Standards for Accounting and Review Services."
- Examinations of prospective financial information as described in "Statements on Standards for Attestation Engagements."

Furthermore, attest services can only be performed by licensees operating in licensed firms; firms that perform attest services must undergo peer review every three years; and, firms must show that attest services are under the charge of a licensee.

Licensees who supervise attest engagements and sign reports for the firm must meet certain experience requirements. Additionally, licensees cannot accept commissions and contingent fees from clients for whom they perform attest services.

During the drafting of the UAA much of the heated discussions centered around the experience requirement . It was agreed that the UAA would require modifies experience requirements to acknowledge the concept that a CPA equals a CPA, regardless of the state initially licensed in. This requirement is a compromise because states vary widely on this requirement, and state board representatives feel very strongly about the issue.

Additionally, experience was no longer limited to "public accounting" experience. This opened the door for individuals to garner experience in industry, in response to the recognition that more than half of accounting graduates pursue initial employment outside of public accounting and less than 50 percent of CPAs currently practice in public accounting.

The experience requirement was further broken down into experience needed to become licensed and the actual experience needed to be eligible to perform attest services. The experience for licensure includes:

- One year of experience providing any type of professional service in accounting, attest, management advisory, financial advisory, tax or consulting services.
- Experience that can be gained through employment in government, industry, academia, or, of course, public practice.

To complement the broad experience requirement for licensure, a new attest experience requirement was added, and the requirement applies to all firms that offer attest services. Any licensee responsible for supervising attest services in a firm and who signs or authorizes someone to sign a report on financial statements for the firm must meet the experience requirements dictated by professional standards. Compliance with the requirement will be verified during the Peer Review process.

The experience requirement is being developed by the Auditing Standards Board with input from NASBA. Additionally, prior to the adoption of this new standard, there will be an exposure process to allow for input of this new standard, state boards, and the public. This new requirement is designed to provide protection to the public in the service area of greatest sensitivity to the public.

As you can see, the UAA is a very meaningful document--it provides state boards with a model piece of legislation that they can adopt in whole or in part, and it provides a strong ethical blueprint for the practice of public accountancy. Currently, states are in the process of adopting the Act, and I am proud to say that my home state, Tennessee, was the first state to adopt the entire Act.

As I have discussed, ethics are truly the cornerstone of the accounting profession and have a great impact on corporate America. Unethical activity can have devastating consequences--such as the junk bond debacle and the savings and loan catastrophes. Traditionally, the accountant has been placed in the role of watchdog; however, in today's business environment a trusted accountant can provide more by guiding business to live up to its own ethical standards and leading the way to increased profits, cost

savings, and new business.

The four key ethical and public interest concerns today are auditor independence, commissions, alternative practice/business structures, and non-CPA ownership. Interestingly, two of these issues, independence and commissions, historically have been concerns of the profession, while the other two issues, alternative business structures and non-CPA ownership, are fairly new concerns.

Auditor independence is without a doubt the most significant virtue of the profession. John Carey, long-time executive secretary of the AICPA and respected author, suggests independence has three meanings. "First, in the sense of not being subordinate," he wrote, "it means honesty, integrity, objectivity, and responsibility. Second, in the narrower sense in which it is used in connection with auditing and expression of opinions on financial statements, independence means avoidance of any relationship which would be likely, even subconsciously, to impair the CPAs objective as auditor. Third, it means avoidance of relationships which to a reasonable observer would suggest a conflict of interest."<sup>(2)</sup>

A discussion of independence is incomplete without a commentary of the crucial importance of the state of being independent in both fact and appearance. Therefore, a CPA must really have two kinds of independence. Independence in fact refers to a CPAs objectivity, to the quality of not being influenced by regard to personal advantage. The latter means freedom from potential conflicts of interest, which might shake the public confidence in independence in fact.<sup>(3)</sup> An auditor must assess his relationship with a client in order to determine whether his opinion would be considered objective and unbiased by one who had knowledge of all of the facts.<sup>(4)</sup> AICPA Rule 101 on independence indicates that independence is impaired if there is any material or direct monetary interest in the company for which the services are provided. Therefore, it would be safe to assume that if an auditor had any financial interest in a firm or served as an officer or director, his judgment could appear to be clouded and independence would be considered impaired.

The issue of independence is so vital, not only to the profession but also to the world economy, that in 1997 the SEC and AICPA jointly created the Independence Standards Board to develop and maintain independence standards for auditors of SEC registrants. As stated in the introduction of an ISB publication,

Auditor independence is of critical importance to the efficient functioning of our capital markets, which depend on continuous flow of reliable financial information... Independence is one of the most deeply ingrained values of the accounting profession. Indeed, the issue is not whether independence standards and policies should be strengthened or relaxed, but rather what approach best advances the public interest in the highest quality of independent audits of public entities.... Dramatic changes in the world economy, in combination with astonishing breakthroughs in information technology, are redefining the audit function, placing new demands on auditors and permanently altering the relationships between accounting firms and their clients.

The issue of independence is also being tested by the amazing changes occurring to the traditional CPA firm. The new structures fall loosely into two categories: alternative business structures (also known as ABSs) and non-CPA ownership.

Alternative business structures are fairly new to the scene. They are created when an acquired CPA firm is split into two pieces:

- regulated services--audits, financial attestation services, compilations, and reviews that are performed by the CPA firm or a successor firm; and
- nonregulated services--tax return preparation and all consulting services that are performed by the acquiring entity or a subsidiary.

There are other structures that combine CPA firms and other professional entities to form one-stop



shopping centers. These structures are testing the established safeguards that ensure independence between clients of the CPA firm and the other entities that are providing services to the client. Organizations such as American Express and H&R Block have recognized that the CPA holds a valuable asset-the client relationship-and are quickly acquiring local and regional firms. These buyouts can be very enticing to small firms, especially as the founding partners face retirement. Other structures are also emerging-various types of alliances, partnering, consolidating, franchising, and affiliating. No matter the structure, the main issue is the same: Now that some CPAs may be wearing two hats to serve the same client, are independence, objectivity, and integrity compromised? The age-old question arises: Can firms perform objectively if they are conducting both attest and nonattest services?

SEC Chief Accountant Lynn Turner has also posed other significant questions to the form of practice of CPA firms:

- Would investors perceive an auditor as independent from a client who invests in the auditing firm?
- Would independence be impaired if an investor has a financial interest in a public accounting firm and then retains that firm to audit other companies in which the investor has ownership interest?
- How would indemnification agreements among investment advisors, underwriters, and bankers affect the independence of a CPA firm that is also the auditor of these firms?
- What would be the impact on independence of public ownership if the firm's focus was on achieving consensus forecasts of analysts rather than maintaining the integrity and objectivity necessary for an independent audit?

Clearly these are difficult questions facing the profession and the Independence Standards Board. However, the issue of independence and the question of who in fact is practicing public accounting ultimately will be determined by the State Boards of Accountancy.

Although alternative business structures are forms of non-CPA ownership of public accounting firms, firms have also dealt with the issue of providing partnership status to employees who are not CPAs. As consulting services became more and more lucrative to accounting firms, the employees providing those services obviously became more and more valuable. Many of these services were offered in areas outside the traditional CPA's domain and were conducted by non-CPAs. These individuals were contributing equally to the firms' bottom lines and were demanding the stature and recognition of full-fledged partners. To recognize this change in professional landscape, the new UAA defines a CPA firm as one in which a simple majority of ownership, in terms of financial interest and voting rights, belong to individuals licensed as CPAs. Although the non-CPA owner is not required to maintain a Professional Code of Ethics in order to maintain a professional license, it is believed that because the majority of the shareholders are CPAs, all of the firm's employees and shareholders will maintain the necessary integrity, objectivity, and independence. This position is further strengthened by the UAA requiring firm registration. Historically, the acceptance of commissions and contingent fees has not been permitted under the AICPA Code of Ethics and state law. Currently, contingent fees may be accepted in certain instances, such as when representing an individual in an examination by a revenue agent, and referrals may be accepted as long as the practice is fully disclosed to the client. Most states ban the acceptance of commissions when the licensee is providing audit, review, or compilation services. The acceptance of commissions is allowed in some states under certain conditions, and only when the practice is fully disclosed to the client. What is particularly interesting about this issue is that this rule was established to protect the client by ensuring that the licensee remained completely objective. However, the rule change is driven by the client and the marketplace. In other words, clients want their CPAs to advise them on financial instruments. Traditionalists would say that commissions and contingent fees will create a lack of independence and objectivity.

I hope I have made my point-that the CPA's very foundation is professional ethics and public trust. Accounting laws, the code of ethics, and the UAA have all enforced that foundation. Most important, professional ethics and public trust have truly made the profession what it is today-and have created the

CPA as a respected professional. Today's CPA is honored with a trust that very few other professions have achieved.

All CPAs are accountants, but not all accountants are CPAs. Ethics and public trust must create a sum that is greater than the whole-the certified public accountant. CPAs are truly more than just accountants. We dare not lose sight of our ethical obligations and the public trust we have earned.

## FOOTNOTES

- (1) AICPA, Code of Professional Conduct, as amended January 14, 1992. (New York: AICPA), 1109.
- (2) John L. Carey and William O. Doherty, Ethical Standards of the Accounting Profession (New York: American Institute of Certified Public Accountants, 1966) 41-42.
- (3) Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," The Journal of Accountancy (March 1962) 31.
- (4) Carey and Doherty, Op cit., 20.

