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# Accounting Law Bulletin

A bulletin designed to keep clients and other friends informed on accounting law matters



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September, 1998

## RESPONDING TO A CHANGING ENVIRONMENT

There is little doubt that the world is undergoing a major transformation as a result of advances in information and communications technology. Businesses have been forced to become more competitive as global communications have greatly increased the number of competing companies in each market segment. Moreover, information technology has enabled business enterprises to measure costs and operating efficiencies in a way and to an extent that was never before imaginable, much less possible. What is somewhat frightening is the pace at which these changes have taken place and will continue to take place.

The accounting profession itself has not escaped the press for greater efficiencies. Companies such as American Express, Century Business Services, and Comprehensive Business Services have invaded the accounting arena, using their substantial resources, marketing skills, and economies of scale to cut the costs of tax preparation and bookkeeping services. The initial reaction of the accounting profession was to oppose these intruders, citing illegal practice of public accountancy. Those efforts have largely been rejected by the courts and regulators, with the result that the invasion of non-traditional accounting firms is starting to gather momentum and will likely overwhelm CPA firms that rely heavily on tax preparation and bookkeeping services to sustain their practices.

In response, the accounting profession, aided largely by the AICPA's Visioning Project, has focused on a host of new services that its members can supply to both individual and business clients. Unlike the more traditional tax preparation, accounting, and auditing services, the new services tend to add appreciable value to the client's assets or operations and, accordingly, tend to command higher fees. These new services largely focus on assisting business clients to install and utilize information systems and to measure operating costs and productivity. They also include a number of additional verification services designed to facilitate additional or greater commercial activity by their clients.

Some of the new services being offered by accounting firms not only expand the scope of traditional CPA activities, but also encroach on service areas traditionally performed by other professionals. For example, many accounting firms are now providing litigation support services, pension and benefit consulting services, acquisition due diligence services, and estate planning services, all of which have traditionally been performed by the legal profession. Aided by their widespread familiarity with the tax laws, generally lower cost structures and experience in organizing large tasks, accounting firms have proven themselves strong competitors in these areas.

CPA firms have also discovered that their clients require numerous other financial services which they can provide, such as investment advice and asset management. Thus, CPA firms in growing numbers have begun to enhance their revenue bases by capitalizing on their hard-earned positions of trust. At least one firm has sought to capitalize on its client base by referring its clients and acquaintances to a financial service provider.

The movement into new service areas has also posed a number of organizational problems. First, many of the new service areas require skills for which many CPAs have not received formal training. This is particularly true for those services that are outside the scope of traditional CPA practice. This, in turn, has prompted accounting firms to hire and promote non-CPAs, a practice which runs counter to the state law requirement that CPA firms be wholly-owned by licensed CPAs. Fortunately, most state regulators have been content to countenance the fiction that non-CPA "principals" are not "partners." This practice, however, becomes troublesome when the number of non-CPA owners approaches the number of CPA owners, a problem that the Big Five are beginning to encounter. It also raises the question of whether a CPA firm can be truly independent if the firm provides its attest clients with substantial "consulting services," a question now being debated by the Independence Standards Board. Ultimately, CPA firms may have to separate their attest functions from the remainder of their operations, similar to the paths taken by American Express and Andersen Worldwide.

Another issue raised by the movement into new practice areas is the problem of having more than one culture within a single firm. This problem has long confronted law firms that have practice areas (such as mergers and acquisitions) that are highly profitable and require the best available talent as well as practice areas (such as insurance defense) that are highly price competitive and cannot afford to pay "top dollar" for professional talent. This causes serious policy differences within the firm as to how the firm should be managed, how partners should be compensated, and how professional employees should be recruited and compensated. These are destabilizing factors which put pressure on the internal structure of professional firms.

As accounting firms move into more lucrative practice areas, they too will experience these destabilizing factors, as the partners of Andersen Worldwide can easily attest. This will place a premium on structuring accounting firms in a manner that promotes stability to counteract these new forces. This is generally done by properly configuring the firm's governance structure, its compensation system, and its contractual arrangements addressing partner defections. Because each of these important keys to firm stability tends to be incorporated into partnership agreements, having a properly drawn agreement becomes increasingly important as firms move further into the information age.

In a personal service firm, the clients (one of the firm's most important assets) are frequently attached to the individual or individuals servicing them. If those persons leave, the client leaves. While firms try hard to institutionalize their clientele (i.e., retain their clients through the scope and quality of services they provide), the reality remains that, except for very large corporate clients, client loyalty is governed by individual service. It is for this reason that firms must seek to assure the loyalty of their clients by securing the loyalty of their partners and principals who regularly interface with the firm's clients. This is generally accomplished by (1) making the firm profitable, (2) dividing those profits fairly and through a mechanism that instills confidence, and (3) imposing financial penalties upon those who seek to depart the firm.

High levels of profitability require appropriate firm governance which is not likely to be achieved in the absence of an appropriate governing structure and a means for renewing that structure. This means that the firm leaders must be free to lead the firm in directions of greater profitability, which requires that they not be mired in administrative minutiae of day-to-day operations and that they have the respect and confidence of the firm's owners. It also means that the firm's leaders must be reassessed on a periodic basis, so that their leadership can be reconfirmed, redirected and/or replaced. While many senior members of small CPA firms may resist the notion that they must periodically submit their leadership to review by their partners, but also it is not only important to the continuing vitality of the firm, it is the only way that firms can continue for more than one generation. Therefore, if the firm's founders wish to be well-paid for their share of the enterprise which they have created, they must either create a democratic firm governance structure or be prepared to merge their firms as they approach the end of their professional careers. This, in large measure, explains why so many accounting firms sell or merge their practices at or about the time their founders retire. Thus, firms with partnership agreements which require the firm's founders to fill the leadership roles rarely survive their founders' retirement.

The means for dividing profits is also critical to the longevity of a personal service firm. Here, the goal is two-fold: (1) the distribution of profits must be fair and (2) the process for determining the distribution must be perceived as being fair. If these requirements are *not* met, highly productive members of the firm will be prompted to depart to other firms where they believe they will be better compensated for their services. Moreover, even those who remain will become less productive as a result of their perception that they are unlikely to be compensated for any extraordinary efforts on their part. This does not mean that every annual distribution must be the subject of a firm-wide debate. It does mean, however, that the process for determining the distribution of firm profits must be sufficiently flexible to reward those firm members who have made extraordinary contributions to those profits and broad enough so that each participant feels that he or she has had a meaningful input in that process. Thus, a system in which the managing partner unilaterally determines each partner's share of the firm's profits can satisfy these requirements if the managing partner operates within recognized guidelines and consults with all (or designated



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representatives of all) firm partners before determining profit distributions.

No governance or profit distribution system is likely to fully satisfy all firm owners; and those most likely to remain unsatisfied may be the fastest rising stars within the firm who may feel that they perceive the future clearer than the firm's leaders and who may believe that the firm's compensation process has a systemic bias that unduly rewards prior years' achievements rather than current contributions to the firm's well-being. Because these are the very people that the firm cannot afford to lose (as the firm's professionals are its most important assets), it is critical that the firm establish additional means for holding them. This is generally accomplished through a system of covenants within the firm's partnership agreement. Because the law disfavors restrictions on the free choice of employment, such covenants must be carefully drafted so as not to be declared unenforceable. In short, this is an area in which more can definitely result in less.

The proper drafting of employment covenants is complicated by the fact that the courts do not treat each restriction in a like manner. Thus, whereas a court might treat harshly any provision restricting the repayment of a partner's capital account, it may pay little heed to a provision that calls for the recognition of contingent liabilities, including unfavorable (compared to the market) lease terms in determining total firm capital. Similarly, whereas a court might view favorably a provision for a departing partner to compensate the firm for each client which the partner takes, it might take a different position depending upon the time period of the payments and how partners are treated for contributing or taking clients in other situations. This means that provisions in partnership agreements dealing with departing partners must be carefully drafted if they are to have the desired effect of holding partners in the firm.

Because of the stresses now being placed upon accounting firms as a result of the changing economics of an accounting practice, it is important for firms to review their systems for internal governance and profit distributions as well as the provisions in their partnership agreements for restricting partners from leaving.

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