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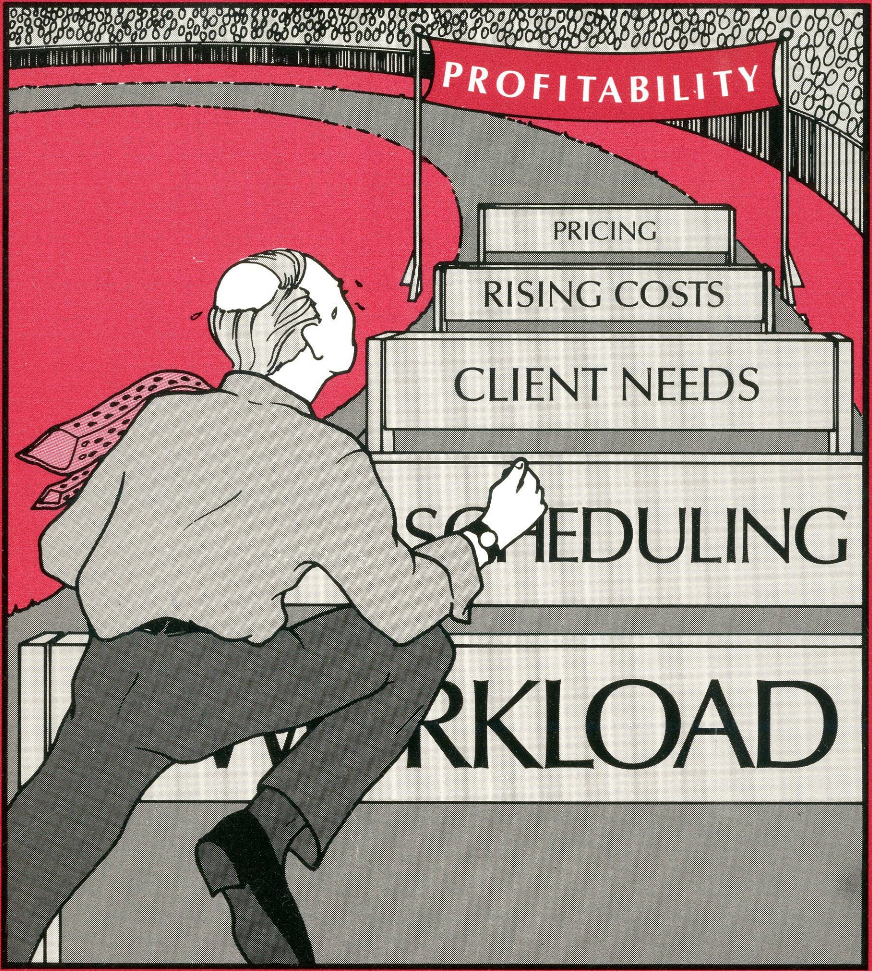
Coping with tax reform

Carol A. Myers

Ronald G. Weiner

COPING WITH TAX REFORM



Carol A. Myers, CPA with Ronald G. Weiner, CPA
for the
Management of an Accounting Practice Committee

AICPA
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Although the entire MAP Committee provided ideas to the authors, certain members contributed substantially to the guide. These members are: Robert J. Batson, Batson, Bennett, Carnahan & Co., Fort Myers, Florida; Darold D. Brockhaus, Wipfli, Ullrich & Company, Wausau, Wisconsin; Gary Carlson, Anderson, ZurMuehlen & Co., Helena, Montana; James R. Miller, Larson, Allen, Weishair & Co., Minneapolis, Minnesota; Albert S. Williams, Williams, Cohen, and Fike, Denver, Colorado.

1211 Avenue of the Americas, New York, N.Y. 10036-8775

1234567890 IPM 8987

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FOREWORD

The Management of an Accounting Practice (MAP) Committee of the AICPA has taken special interest in the Tax Reform Act of 1986 (TRA), not because of technical tax issues involved in the legislation, but rather because of TRA's impact on practice management.

The legislation requires many clients who were on fiscal years for tax reporting purposes to now change to calendar years. The domino effect on practitioners is to transfer additional work to the busy season. Depending on the nature of the firm's practice and its client mix, the impact may be devastating, particularly on small- and medium-sized firms.

Many practitioners have been focusing on the technical issues of TRA and have not had an opportunity to fully appreciate the management impact on their practices. Unless positive action is taken, some practitioners will be caught unaware and will be working to the point of "burnout" this winter and in subsequent years. Others will rush to hire additional personnel to cope with the workload without fully appreciating the impact it could have on the immediate and long-term profitability of their firms. One of the MAP Committee's objectives in producing this guide is to help practitioners understand the issues affecting their practices.

Finding creative solutions is more difficult than identifying the issues. For many practitioners, no easy answers exist and, in most cases, more than one management change will be required. In this guide, the MAP Committee presents numerous management ideas and approaches that are being tried by members of the profession in the wake of TRA. From these ideas, you can plan a course of action that is most suitable for your firm.

We hope this material provides practitioners with useful insights and strategies for managing their practices.

Carl R. George
Chairman
Management of an Accounting
Practice Committee

Nancy Myers
Director
Industry and Practice
Management Division

INTRODUCTION

The Tax Reform Act of 1986 (TRA) made monumental changes in the tax law—changes that are having a substantial impact not only on your practice but on the entire profession. These changes do not represent merely temporary problems; they may affect your practice for years to come.

Ironically, it is not the complexity of the technical tax issues that is having the most profound impact on the profession. Instead, it is TRA's impact on practice management.

The first objective of this guide is to help you understand the issues affecting your practice. No easy answers exist and, depending on client mix, staff flexibility, and other factors, each firm may be affected differently. The second objective is to provide alternatives and information from which you can draw your own conclusions and plan your own course(s) of action.

The most significant impact of TRA legislation is that it requires many clients to change from fiscal years to calendar years for tax reporting purposes. Most clients will correspondingly change their financial reporting years to coincide with their tax years. The consequence for the practitioner is to transfer more work to the busy season. This causes a domino effect on all areas of a CPA's practice which include—

- More scheduling of personnel and workload to meet peak demands.
- More overtime during the busy season, and more nonchargeable time during the remainder of the year.
- Further domino effect on other areas of practice.

The factors listed above could have a major impact on the profitability of your practice.

Planning is the key to survival. You will have to take extra effort to manage the changes in your practice, rather than allowing the changes to manage you. To help you take the initiative, two exercises are included in the section on "Analyzing Your Practice." The first is to forecast your firm's workload, and the second is to forecast your chargeable time available to meet the demand. An illustrative firm, *Sample CPA Firm,* is provided as an example. The information is based on that of a real firm and TRA's projected impact on it.

TAX REFORM ACT

TRA was passed in 1986, and most of its provisions became effective in 1987. Therefore, most practitioners are already familiar with its key technical provisions.

Several provisions, however, have a greater impact on administering a practice than others. As a starting point, we will briefly highlight these provisions.

CHANGE IN TAXABLE YEARS

Partnerships, S-corporations, personal service corporations, and trusts must now use a taxable year conforming to that of their owners/beneficiaries. [A few S-corporations that can demonstrate a business purpose (for example, a natural business year) can use a fiscal year.] Most individual taxpayers are on a calendar-year basis, and it is nearly impossible for individuals to obtain IRS permission to change to a fiscal-year basis. Consequently, many of these entities will have to change from fiscal years to calendar years for tax purposes.

In the short term, a change in taxable years increases the practitioner's time requirements for preparation of additional short-period tax returns. In addition, most clients will want to change their fiscal year for financial reporting purposes so it coincides with their taxable year, resulting in increased accounting work for the practitioner. In the long term, the change in taxable years creates a substantial year-end time "crunch" by making a simultaneous deadline for a greater number of both tax returns and—more importantly—financial statements.

CHANGE IN TAX RATES

Under TRA, the maximum corporate tax rate now exceeds the maximum individual rate. Corporations that meet the qualifications can elect S-corporate status, which, while maintaining the corporate veil, can result in tax savings. However, for tax and accounting purposes, most S-corporations will now be on a calendar year. The increased workload for the practitioner resulting from S-corporation status will therefore occur in the busy season.

REPEAL OF "GENERAL UTILITIES" DOCTRINE

Repeal of the General Utilities Doctrine has a significant impact on corporate liquidations. The general rule under TRA is that gain or loss is now recognized by the liquidating corporation on a distribution of net assets as if such assets were sold at fair market value to the distributee shareholders.

Example. Assume a client formed a corporation in 1950 to buy land. He contributed $1,000 of capital, and the corporation bought land for $1,000.

In 1980, the land was worth $10,000 and your client decided to sell it. However, the buyer did not want to purchase the corporation's stock. Your client liquidated the corporation and sold the land. Therefore, the corporation's basis in the land of $1,000 flowed through to your client on liquidation, and he recognized a $9,000 personal gain on the sale.

Under TRA, the liquidating corporation's basis in the land is increased to $10,000 (its fair market value), and the corporation is treated as if it had sold the asset to the distributee shareholder. The liquidating corporation incurs a gain of $9,000 on which it must pay tax, necessitating a cash infusion by your client. After the corporation is liquidated, your client must pay tax on the profit distributed.

	Gain	Tax Rate	Tax	After Tax Net Profit
Prior law				
—individual gain	$9,000	28%	$2,520	$6,480

	Gain	Tax Rate	Tax	After Tax Net Profit
TRA				
—corporate gain	$9,000	34%	$3,060	
—individual gain	$5,940	28%	$1,663	
			$4,723	$4,277

Another impact of repeal of the General Utilities Doctrine is that any C-corporation that converts to an S-corporation after 1986 is considered to be a liquidating corporation. Consequently, it is subject to a corporate-level tax (as described above) on any built-in unrealized gains at the time of conversion that are subsequently realized during the ten-year period following the conversion. As described earlier, there are tax-rate benefits to be obtained in converting to S-corporations. However, the decision to change status for the tax-rate benefits must be carefully weighed against the corporate-level tax burden.

ALTERNATIVE MINIMUM TAX

More individual taxpayers are now subject to the alternative minimum tax than ever before. This situation requires more time for preparation of tax returns, more time for preparation of quarterly estimated returns, and additional record keeping. Essentially, clients must keep two sets of books for tax purposes and an additional third set for financial statement purposes. When clients need assistance in preparing or maintaining these schedules, the practitioner will be required to invest additional time.

C-corporations are now subject to an alternative minimum tax. This requires more time to prepare tax returns and quarterly estimated returns and more time to reconcile financial-statement income to taxable income. Record keeping is also becoming more complex. For example, a corporation may be required to keep different depreciation schedules for Federal taxes, Federal AMT calculations, state taxes, and GAAP financial statements.

PASSIVE LOSS LIMITATIONS

TRA imposes limitations on the deductibility of net losses from "passive" activities. The purpose of this legislation was to reduce

Federal income tax benefits derived from tax shelter investments and to encourage investments for sound economic reasons. These limitations on deductions are causing taxpayers to change investments, and they may seek advice from their CPA. Additional tax planning time will be required for most practitioners.

LIMITS ON USE OF CASH METHOD

Certain entities are now prohibited from using the cash method of accounting for Federal income tax purposes. Some clients may require assistance in converting from a cash basis to an accrual basis of accounting.

* * *

The **short**-term effect of TRA on a typical CPA practice is to—

- Put more entities on a calendar-year basis this year.
- Convert more C-corporations to S-corporations.
- Increase the need for tax planning for both individuals and corporations.
- Increase clients' recordkeeping requirements.
- Change clients' accounting methods.
- Increase the need for review of "passive" investments.

The practitioner must consider not only the short-term impact of TRA, but also the **long**-term impact. The number of calendar-year clients is increasing. Most clients who are required to change their taxable year will also change their financial reporting year. Tax returns can be extended, but most of your audit, review, and compilation work cannot be extended— increasing the busy-season burden.

This burden will affect **all** staff and management levels. Shifting personnel from one functional area to another during the busy season may be exceedingly difficult. The normal, now expanded, tax crunch occurs at the same time that more clients need their financial statements.

The profession expended a significant effort over the years to convert clients from calendar years to fiscal years to smooth out the workload and provide better service. With a stroke of the pen, Congress wiped out years of effort!

IMPACT OF TRA ON WORKLOAD

The most noticeable effect of TRA on practitioners will be the shift in workload, increasing the time "crunch" during the busy season.

The most obvious (but not necessarily the most important) impact of TRA will be on your tax practice. The tax season time crunch will increase for preparation of both individual and corporate tax returns and extensions.

More important, TRA will also have a domino effect on other areas of your practice. Not only is the busy season congested with more tax returns, but more of your accounting and auditing work will also be pushed into the busy season.

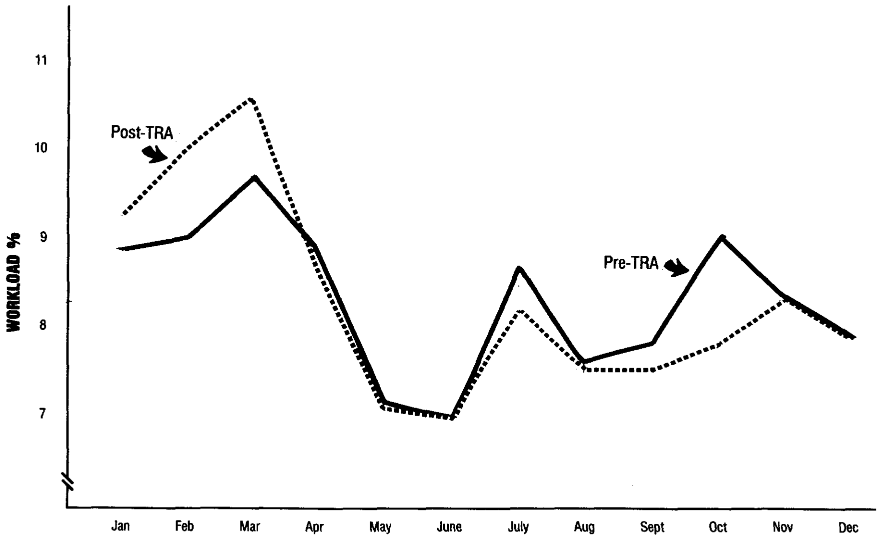
As clients change from fiscal years to calendar years for tax purposes, they will also want to change for financial reporting purposes to avoid multiple year-end closings. Thus, more of your accounting and auditing services are moved into the already busier busy season, effectively eliminating your ability to shift personnel from one functional area of your practice to another. In fact, you may be "short handed" simultaneously in both of your two largest functional areas.

Although tax returns can be extended, in most cases it will not be practical to defer audit, review, and compilation services. Your clients need **timely** financial information for management control and planning purposes as well as for creditors. Clients rely on their CPA for this information. Receipt cannot be delayed without a major impact on their businesses. No matter what your workload is, timely service will continue to be a major condition of client retention.

As a result of TRA, most firms will incur a peak workload when as much as 40 percent or more of the firm's billable hours will occur during a three-month period. For many firms, the change in workload may resemble the graph shown in exhibit 1.

Exhibit 1

SAMPLE CPA FIRM: Projected 1988 Workload



The impact on each firm will vary depending on the nature of its practice and its client mix. Sample CPA Firm is impacted less dramatically than many firms will be.

To ease this time crunch, many practitioners will be filing more extensions for tax returns. This action will have two impacts: 1) an overall increase in hours expended to prepare both the extensions and the tax returns; and 2) an extended "tax season" perhaps stretching as long as ten months of the year.

How filing more extensions impacts your overall practice will have to be determined. Although it may be helpful to shift your workload by freeing more time for accounting services, will clients pay for the increased tax hours?

Your support and administrative staff and related facilities will also be affected by the peak workload. Some areas to consider are the following:

- Can your existing secretarial staff handle the peak workload?
- Can your existing data-entry staff handle the peak workload?
- Can your computer system and hardware handle the peak workload?
- If you have to hire additional personnel for the peak season, do you have sufficient office space?

The biggest effect of TRA on your practice is to **shift** your workload from various times of the year to one peak period.

However, TRA will also **increase** your workload in some ways, particularly in the tax planning area. The effect may be short term, decreasing as clients become accustomed to the new provisions. In the short term, however, the impact will not affect your staff equally. Tax planning work will fall predominantly on management and senior staff members who have the comprehensive technical expertise to do the tax planning—and who may also be the same personnel with increased burdens in planning your accounting and auditing engagements.

These varying impacts on your workload can be very depressing. How do you cope with it? One of the key factors is better management of your practice. Better management may increase the administrative burden for partners in the firm, but it is time you can**not** afford **not** to invest. Profitability is directly related to the way in which a practice is managed.

We will be discussing ways to better manage your practice; but first, we need to discuss the economics of managing a practice. Understanding the underlying economics is essential to implementing useful management techniques tailored for your practice.

ECONOMICS OF PRACTICE

On the surface, additional chargeable time required by practitioners to implement the TRA provisions appears to be a "gold mine" for accountants. Time is money, right? The actual effect, however, could be quite different.

As a practitioner, you are not only a professional but also a business person. You are in business to make a profit—a fair return on your investment of time and capital.

Practitioners, however, frequently forget this basic concept. Consumed with their efforts to provide quality professional services to clients, they fail to manage their practices as businesses. A clear signal of this situation arises when a practitioner finds himself working harder for his growing practice, but making less.

TRA has a fundamental impact not only on your workload, but also on your profitability.

PEAK CAPACITY, PEAK DEMAND

Your firm's "capacity" to deliver professional services is its total number of chargeable hours available—partner, management, and staff hours combined. The "demand" for services is the amount of hours required to meet clients' needs.

If the demand for services were evenly spread throughout the year, it would be very easy to balance your firm's capacity. When all personnel became as fully chargeable as possible, you would simply hire more personnel as demand increases. In the real world, however, demand and capacity are not balanced. Peaks occur in demand (during tax season) and valleys occur in capacity (during summer vacations).

In the past, most practitioners were able to balance their demand and capacity fairly well. For example, they managed "demand" by encouraging some clients to change to fiscal years. They managed "capacity" by working overtime in the busy season and taking vacations and training in the slow season.

Exhibit 2, below, can be used to show the impact of TRA "demand" on current capacity.

Without making any changes in capacity (that is, without hiring additional people), the peak demand caused by TRA creates a significant shortfall during the busy season (January through April). The area in the curve between current capacity and the new demand is the

Exhibit 2

SAMPLE CPA FIRM: Comparison of TRA Demand and Pre-TRA Capacity

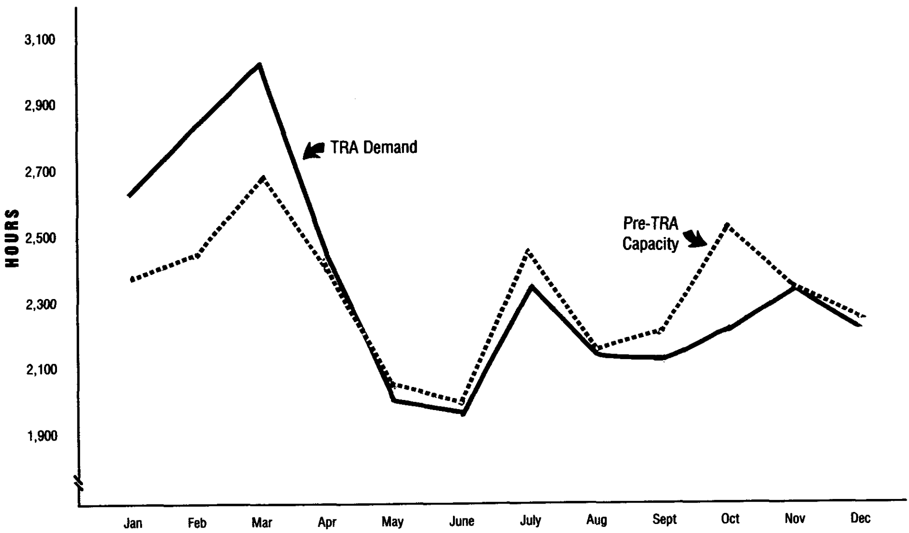
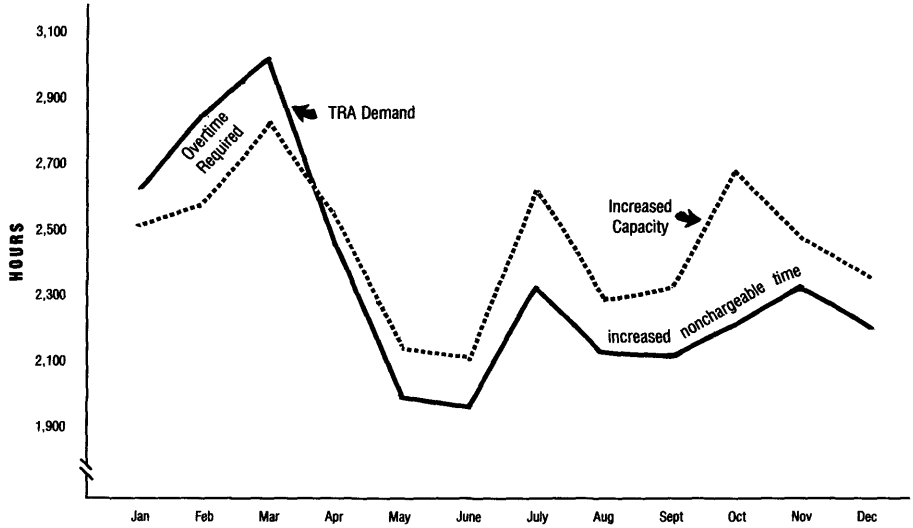


Exhibit 3

SAMPLE CPA FIRM: Comparison of TRA Demand and Increased Capacity



amount of extra hours that someone will have to work. However, before TRA, personnel were already working overtime. How much overtime can they work? In other words, what is your firm's peak capacity? Can the shortfall in capacity shown in the graph be covered by overtime without "burning out" personnel, increasing errors, and so on?

Additionally, without making any changes in capacity, nonchargeable time increases in the slow season (May through November). This is the area in the graph between current capacity (considering vacations and training time) and the new lower demand level.

Adding personnel to increase peak capacity during the busy season, as shown above in exhibit 3, also increases nonchargeable time in the slow season.

This example raises an important question. Does the increase in billings during the peak season pay for the increase in nonchargeable time in the slow season? In other words, can you afford to hire more personnel to meet the peak demand? Although there is no magic formula to answer this question (each situation depends on the practice and the available options), it should, nevertheless, be analyzed.

The potential impact on your profitability can be illustrated by an example. Assume a practitioner wants to generate an additional $100,000 of revenue. To do so, he must incur additional costs of approximately $67,000 (assuming a typical historical ratio where 1/3 of billings cover labor and 1/3 cover overhead). Therefore, it costs $.67 to produce $1 of service. If a client is served only during the peak season, and that client generates $1 of revenue at "standard," the practitioner incurs $.67 of costs to earn $.33 of profit. This is a 2-to-1 ratio of expenses to profit. Consequently, each month of profit earned during the busy season is consumed in excess costs in only fifteen days!

A key to effectively managing your practice—that is, to optimize profitability—is to balance **both** peak capacity and peak demand as much as possible. As previously shown, hiring more personnel increased capacity to meet peak demand during the busy season, but additional personnel also increased capacity during the slow season, hence there was more nonchargeable time. In this example, changing **one** variable (capacity) did not balance the situation. In most practices, to maintain or improve profitability, multiple variables will have to be changed.

BILLING RATES

Another significant factor affecting profitability is billing rates.

If your rates are set **too** low, the number of clients (your demand) may increase because of your bargain prices, but eventually you will reach a "break even" point where you begin to lose money. This is the point when costs (salaries and overhead) exceed revenue.

Conversely, if your rates are set **too** high, you will lose clients who can obtain comparable service elsewhere at a cheaper price.

However, these are extreme examples. A frequent misconception held by practitioners is that their services are extremely price sensitive. Services are price sensitive if rates are carried to the extreme, but services are not as price sensitive within a normal range as frequently imagined. Most clients do not select their CPA solely based on price considerations, but rather, are more concerned with the quality and timeliness of the CPA's service, confidence in the CPA's judgment and ability, and the CPA's expertise in specific areas. In other words, the CPA offers a personal service. Clients generally will pay a reasonable price for the right professional, yet personal, service.

No formula can magically determine how to set an optimum rate structure. Many different formulas are used by different practitioners, such as the "1/3 labor, 1/3 overhead, 1/3 profit" formula used in an earlier example. In the past, these formulas covered overhead costs and provided a reasonable profit to the partners/practitioner. However, as the profession changes, these formulas will become less useful and possibly dangerously misleading.

Much of the additional time that will now be incurred during the busy season is **not extra** chargeable time, but merely time that has been transferred from one time of the year to another. Consequently, **total** chargeable hours may not increase, though more overtime will be incurred.

If your firm pays professional staff at overtime rates, and bills clients at a constant billing rate, which includes a factor for **average** quantities of overtime, you may be losing money. An example illustrates the point. Assume standard billing rates are based on the 1/3-labor/1/3-overhead/1/3-profit theory, where hourly salary costs are multiplied by 3 to obtain billing rates. If the chargeable hours previously expended in September (at a labor cost of $10 per hour) are now expended in March at overtime rates (costing $15 per hour), overhead costs are increased by $5 per hour. If we continue to service this client at the same $30 billing rate that we used previously, we lose $5 of profit per hour on each of the hours transferred. Instead of 1/3 labor, 1/3 overhead, and 1/3 profit, we now have 1/3 labor ($10), 1/2 overhead ($15), and 1/6 profit ($5) (assuming overtime is classified as overhead). Consequently, to recover additional overtime costs, billing rates may need to be increased.

The same effect results from overtime for support staff. If you are paying secretaries and data-input clerks additional overtime, these costs should also be factored into the billing rates.

If a standard formula for calculating billing rates is used and overhead costs increase, profit decreases by default. The profession as a whole may, therefore, need to adopt a more sophisticated approach to establishing billing rates.

Key steps for calculating billing rates using a more business-like approach are as follows:

1. Estimate your firm's total chargeable hours. [You may want to refine the estimate by staff level.] Start by calculating standard hours per year (40 hours x 52 weeks = 2,080) for all billable personnel, add a realistic estimate of overtime hours to be worked, and subtract a realistic estimate of hours that will not be worked because of holidays, illness, vacation, etc. Your total available hours is the result. Because not all this time can be "sold" to clients, subtract a realistic estimate of nonchargeable hours for training, administration of the firm, business development, research, and so on. This is your inventory of chargeable (that is, billable) hours.

   Many firms use a standard of 1,600 to 1,700 billable hours per person. Test this standard against your historical average.
2. Prepare a budget of salary costs. Include an allowance for partners' salaries, which should be viewed as a fixed cost of doing business.
3. Prepare an expense budget. Overhead typically includes items such as rent, utilities, support staff salaries, fringe benefits, overtime pay, computer charges, and the like.
4. Divide your budgeted expenses (Step 3) by your estimate of chargeable hours (Step 1) to obtain an overhead rate per hour.
5. Calculate an average salary cost per hour by dividing your budgeted salary costs (Step 2) by your estimated chargeable hours (Step 1). Add your hourly rate for budgeted expenses (Step 4) to obtain your total cost per hour.
6. Estimate a reasonable profit. Each firm must decide its own amount, while considering return on invested capital, retirement plans for partners, interest rates, expertise of partners, and so on. Divide this by your estimate of chargeable hours (Step 1) to get an hourly rate.

7. Add your budgeted costs (Step 5) to your anticipated profit (Step 6) to obtain your average billing rate. If these calculations are done on an overall basis (rather than by staff level), distribute the overall average rate to obtain billing rates for each staff level.

Calculating billing rates as outlined above is a reasonable business approach. The process is not as complicated as it may first appear, and the expense budget produced in Step 3 is a useful management tool to help control actual expenses. You may find that the results are far different from the formulas (1/3-labor/ 1/3-overhead/ 1/3-profit) previously used.

Further, this business approach of calculating billing rates shows you what clients must be billed to cover your overhead costs and still make a reasonable profit. As the profession encounters changes (through increased computerization, for example), using this approach becomes increasingly important. TRA is merely one of those changes. For most firms, TRA will increase costs. The practitioner using this budget approach will be able to automatically build the increased costs into his billing rates.

Although we will be exploring various alternatives to minimize costs, as a result of TRA, the profession may find that overall revenue (billing rates) will have to increase.

[Additional information on setting billing rates and managing the revenue cycle of a firm can be found in the AICPA's *Managing an Accounting Practice Handbook* (MAP Handbook). The AICPA also has training courses available, such as the home-study course on *Accountants' Fees*.]

INCREMENTAL REVENUES VS. INCREMENTAL COSTS

Before making changes in your practice to cope with the additional TRA burdens, an in-depth analysis of incremental revenues vs. incremental costs is needed. In other words, will the additional client billings more than offset the additional costs incurred in providing the service?

The cost of running a practice includes both fixed and variable costs, but for all practical purposes, most are variable. Rent, for example, is generally considered to be a fixed cost. However, as your practice grows, you may need additional space and your rent will increase accordingly. True variable costs, such as salaries, tend to change more frequently. For most firms, 70 percent to 80 percent of all costs are payroll related. Therefore, for practical purposes, essentially all costs are variable.

Costs tend to increase in steps. Hiring an additional person causes salary costs to step upward. In combination, total costs (including partners' salaries) can be depicted as a series of steps as shown below in exhibit 4.

If a revenue line is added to the graph (see exhibit 5 on page 19), the firm's profit can be seen in the area between the two lines. Revenue follows a more lineal relationship because client work tends to gradually change.

Exhibit 4
Increasing Cost

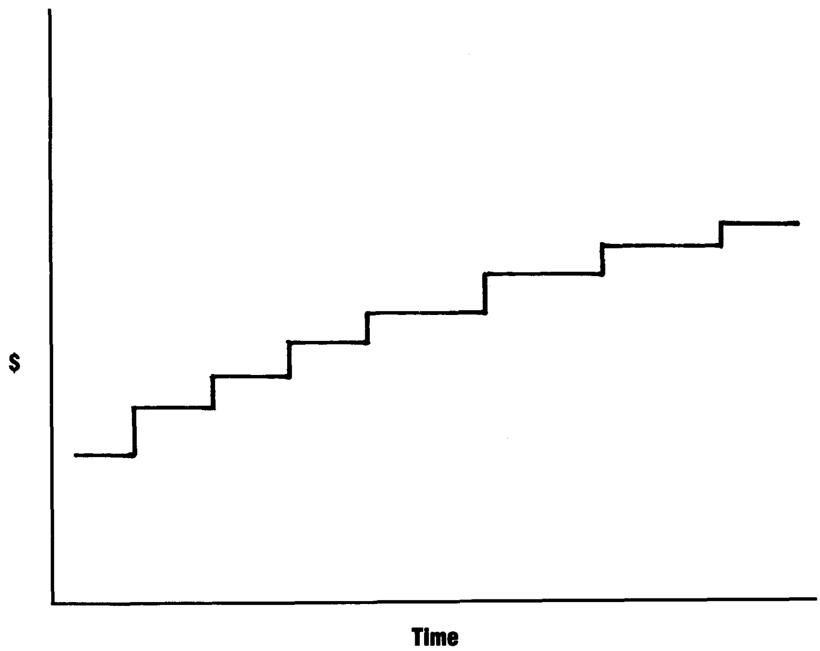
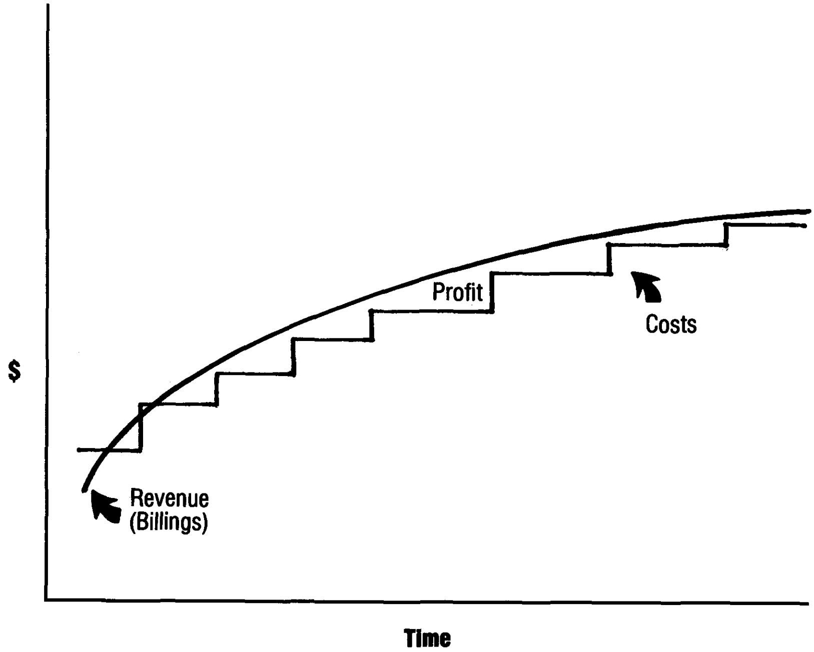


Exhibit 5

Cost and Revenue Increases



If the revenue line intersects the cost line, the incremental revenue is not sufficient to cover incremental costs, much less provide a profit to the firm.

Whenever a change in your practice results in an increase in costs (such as hiring additional personnel), the incremental cost—the step upward—must be weighed against the increased revenue that is generated by the investment.

Example. Assume an additional staff person is needed to handle the additional seasonal workload. What does this person cost? The practitioner must consider not only the salary cost, but also the overhead cost (fringe benefits; professional development; additional office space, if needed; and the like). For this example, assume the salary of the additional staff member is \$20,000 per year. As in the earlier example (the 1/3-1/3-1/3 theory), if salary costs increase by \$20,000, overhead also increases by \$20,000, for a total cost of \$40,000.

Assume the staff member will have approximately 1,600 hours of chargeable time available to clients (total available hours less nonchargeable time). The billing rate necessary to recover costs is $25 per hour ($40,000/1,600 hours). To generate a $20,000 profit, revenues of $60,000 are needed, or a billing rate of $37.50 ($60,000/1,600 hours) per hour.

Is this incremental investment worthwhile? The question can be restated. Will this additional staff person generate $60,000 of additional billings? Or, will he generate at least $40,000 of additional billings to recover the costs? If the person is needed only for the busy season (say, three months), the answer is no. Three months of 60-hour work weeks yield only 720 billable hours, which, at $37.50 per hour, is $27,000 of revenue. Compared to the incremental cost of $40,000, he generates a loss of $13,000.

Hence, the issue becomes whether there is sufficient work (or, whether it can be generated) during the remainder of the year to keep the staff person chargeable for another 350 hours simply to recover costs (or 880 hours to earn a reasonable profit). Or, can the practitioner increase the staff person's billing rate and still remain competitive? If not, the incremental cost outweighs the incremental benefit, and another solution to the busy season time crunch must be found.

Example. Assume the practitioner believes that buying a computer to assist in tax planning, preparing tax returns, and preparing audit schedules can significantly reduce staff time during the busy season. In addition to the front-end costs of purchasing the computer and software (or buying terminals and accessing a tax service), the practitioner will also have training time for personnel and, perhaps, the cost of additional office space for the computer. Added to the ongoing costs are supplies, hardware maintenance, software upgrades and, perhaps, a computer operator.

For simplicity, assume an outside service was elected with an up-front cost of $40,000 for equipment, system access charges of $20,000 per year, minimal ongoing cost of supplies, and training done during nonchargeable time. Assume the computer equipment has a useful life of four years. The cost is $30,000 per year [$20,000 + $10,000 ($40,000/four years)].

How does this affect the 1/3-labor/1/3-overhead theory? It has been already stated that the computer would be bought to reduce time. Consequently, overhead costs are increasing while labor costs are being minimized; hence, the 1/3-1/3-1/3 theory will no longer be true. The cost-analysis approach used earlier in determining billing rates is a better approach.

How does the practitioner charge his clients? Does he charge all clients, or only those that use services using the computer? The latter is preferable because direct charges, rather than overhead costs, are easier to explain to clients. Ideally, a direct-charge rate would be applied to the service provided; for example, $x per tax return processed or $x per computer hour used. If this is not administratively practical, then a factor can be added instead to the staff billing rates.

Assume the practice has been averaging 16,000 hours of chargeable time per year (ten people at 1,600 hours each). An increase in everyone's billing rate of $1.88 per hour ($30,000/16,000 hours) will recoup the annual investment in the example.

The purpose of getting the computer system is to reduce personnel hours, so increased billing rates should not increase total fees billed. However, spreading the costs to all clients through the billing rates (rather than directly charging users for the computer costs) may cause aberrations for some clients' fees.

In summary, before investing money, analyze and consider the cost/ benefit of alternatives.

PROFITABILITY OF CLIENTS— "BELOW STANDARD" RATES

If your practice has been expanding, but profitability does not seem to be keeping pace, perhaps certain clients are not as profitable as you think. Do you have long-standing clients who have always been charged the same fee? If so, then these clients may be hurting your profitability.

You should evaluate the rates clients are being charged. If there is no justification for continuing to service clients below the standard rate, you should increase your fees. At worst, you may lose an unprofitable client whose work demands attention during your peak period when you should be devoting greater hours to your more profitable clients as well as developing additional profitable clients.

However, in actuality, you probably will not lose the client. As the quality of service governs a client's choice of a CPA, you will most likely not lose a long-standing client by increasing fees.

VALUE OF SERVICES—EXPERTISE

Over a period of time, many firms develop one or more areas of expertise, either in special industries (such as, banking, insurance, or governmental entities) or in special fields (such as, foreign taxes or financial planning). Within certain areas of expertise, you probably have little competition in your area. In addition, these services are not particularly price sensitive. Consequently, because the market may bear higher than average billing rates (that is, higher profits), do not undervalue your services when setting fees.

MANAGEMENT VS. STAFF

Some of the time generated by TRA, particularly in tax planning, actually will result in additional chargeable hours. This time is predominantly management and senior time. Junior staff members generally have not yet acquired the expertise to handle the comprehensive technical aspects of tax planning. However, because many of the junior staff's hours were transferred to the busy season, you now have more nonchargeable time for them during the slow season. Consequently, you could have the unfortunate situation of senior personnel burdened with extra work while junior personnel are unassigned.

Therefore, review your upcoming workload. Specific tax areas may exist where junior staff members could be assigned. For example, one junior staff member could be assigned a specific tax area to research and then assist senior personnel in planning in that area. Another could scan clients' prior tax returns to identify potential tax planning possibilities that, if identified early, could eliminate unexpected problems. Another could assist clients in the mechanics of accounting changes required by TRA.

A better balance between management and staff chargeable time provides improved revenues as well as a happier and more productive work environment.

ANALYZING YOUR PRACTICE

TRA affects each firm differently, depending on the nature of its practice, the complexity of its clients, and the size and flexibility of its staff. To better manage your practice, you need to determine TRA's specific impact on your particular practice. If you do not know the impact, you can only guess at the best strategy.

The key to analyzing your practice is to calculate your over/under capacity. To do this, you first need to calculate your client workload (the demand) and then compare it to your available billable hours (your capacity). From this information, you can analyze the results and take appropriate courses of action.

SCHEDULE WORKLOAD

The first step is to schedule your client workload, which can be done in different ways. One approach is to merely schedule the prior year's billable hours by month and adjust for changes. A second approach is to use a spread sheet (computerized, if available) to list all of your clients, the work required for each, and an estimate of the hours required for each project during each time period (for example, week or month).

After totaling the hours in each time period, the schedule will clearly show the peaks and valleys in your workload.

[Depending on the size of your firm, you may want to use a separate schedule for each functional area (tax services, accounting and auditing services, and so on) to improve its usefulness. For added scheduling capabilities, again, depending on the size of your firm, you may want to separate management time from staff time.]

In preparing the workload schedule, start by reviewing your billing records for the actual hours expended on each client in the prior year. Then, adjust those hours for anticipated changes this year. Add estimates for new clients, and delete lost clients. Then, adjust the hours for anticipated complexities. For clients with a change in fiscal year, for example, the hours will have to be transferred to new time slots. It may be helpful for you to review clients in the following groups:

- Services to be provided to fiscal year C-corporations that have become S-corporations
- Services to be provided to fiscal year S-corporations and partnerships that must convert to a calendar year-end.

Now, schedule your firm's workload for the coming year. A brief example, which can be used as a pro forma workpaper, is shown as exhibit 6 on the following page. Tailor your schedule to meet your own individual needs and circumstances.

Exhibit 6

SAMPLE CPA FIRM: Workload Schedule—1988

Clients	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
ABCD Company:													
Tax—prior year	36									3		24	
—change to calendar year												(24)	63
and file extension	(36)				24	36				(3)		3	
Accntg—prior year										60	100		160
—change to calendar year	60	100								(60)	(100)		
≈													
P.L. Zamarillo:													
Tax—prior year	12												
—change to calendar year													12
and file extension	(12)					12							
Total	2,620	2,825	3,025	2,460	2,000	1,970	2,330	2,130	2,120	2,210	2,330	2,220	28,240

Summary	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Total—prior year	2,500	2,540	2,740	2,500	2,040	1,990	2,450	2,160	2,200	2,530	2,350	2,240	28,240
Percentage of work	8.9	9.0	9.7	8.9	7.2	7.0	8.7	7.6	7.8	9.0	8.3	7.9	100
Changes	120	285	285	(40)	(40)	(20)	(120)	(30)	(80)	(320)	(20)	(20)	0
Projected for 1988	2,620	2,825	3,025	2,460	2,000	1,970	2,330	2,130	2,120	2,210	2,330	2,220	28,240
Percentage of work	9.3	10.0	10.7	8.7	7.1	7.0	8.2	7.5	7.5	7.8	8.3	7.9	100

SCHEDULE TIME AVAILABLE

The next procedure is to schedule your available staff hours using the same time periods (and the same staff levels and functional areas, if applicable) as used in scheduling your workload.

To determine available staff hours, include existing staff only; do not factor in any increases in personnel (unless you already planned to hire additional personnel for non-TRA work). Exclude lost hours for holidays, vacations, professional development, and other required nonchargeable items. If you have a historical basis for estimating personnel time lost to illness, factor that into the end of the schedule.

As long as it is done consistently, overtime hours can be scheduled in different ways. One method is to exclude overtime from the schedule. Later, when comparing available hours to your workload, it will be easy to see the total overtime that will be required. Alternatively, if you work a standard 6-day week or 10-hour days, for example, during the peak season, you may want to include those overtime hours as part of your standard time. Later, when comparing available hours to your workload, however, bear in mind that your staff may already be working at or near capacity.

Now, schedule your firm's available time for the coming year. A brief example, which can be used as a pro forma workpaper, is shown as exhibit 7 on the following page. It is a monthly schedule and includes no overtime.

Exhibit 7

SAMPLE CPA FIRM: Time Available—1988

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Number of business days (excluding holidays)	20	21	23	21	21	22	20	23	21	21	20	21	254
	x 8	x 8	x 8	x 8	x 8	x 8	x 8	x 8	x 8	x 8	x 8	x 8	x 8
Hours available per person	160	168	184	168	168	176	160	184	168	168	160	168	2,032
Number of personnel	x 18	x 18	x 18	x 18	x 18	x 18	x 18	x 18	x 18	x 18	x 18	x 18	x 18
Total hours available	2,880	3,024	3,312	3,024	3,024	3,168	2,880	3,312	3,024	3,024	2,880	3,024	36,576
Scheduled nonchargeable time:													
Partner # 1:													
Vacation					(40)			(40)				(20)	(100)
CPE						(20)	(20)						(40)
Business Development					(40)	(40)	(40)	(40)	(40)	(30)	(20)		(250)
Administration						(20)		(20)	(20)				(60)
Partner # 2:													
Vacation						(40)	(20)		(40)				(100)
CPE								(40)					(40)
Business Development					(10)	(10)		(10)	(10)				(40)
Administration	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(480)
≈													
Paraprofessional #6:													
Vacation					(40)	(40)							(80)
Illness, etc. (historical average)	(16)	(8)	(24)	(8)		(8)			(8)	(16)	(8)	(8)	
Chargeable Hours Available	2,375	2,440	2,665	2,400	2,040	1,990	2,450	2,160	2,200	2,530	2,350	2,240	27,840
Summary by Staff Level													
3 Partners	340	420	450	320	310	260	300	270	300	330	340	300	3,940
3 Managers	370	400	460	380	330	320	400	380	370	390	400	370	4,570
3 Seniors	415	440	505	390	300	300	420	360	360	420	420	390	4,720
3 Staff	350	330	350	310	300	310	330	350	370	390	390	380	4,160
6 Paraprofessionals	900	850	900	1,000	800	800	1,000	800	800	1,000	800	800	10,450
Total	2,375	2,440	2,665	2,400	2,040	1,990	2,450	2,160	2,200	2,530	2,350	2,240	27,840

MEASURE OVER/UNDER CAPACITY

Now compare your projected workload to your projected staff hours. This comparison will highlight problem areas—such as periods with insufficient available hours, regardless of overtime, to complete the work. If possible, make this comparison by staff level as well as in total, because hours are not necessarily interchangeable. Although management can substitute for staff, staff usually cannot substitute for management.

Consider critical deadlines when reviewing the schedules. For example, if your schedule is done on a monthly basis, but tax returns are due on the 15th of the month, do not erroneously think all of April's hours are available before the tax deadline.

With this information gathered above, you can begin to make preliminary changes. For example, you can plan to—

- File more extensions for tax returns.
- Perform more interim audit work.
- Hire additional temporary help.
- Delay financial statements for certain clients (if practical).
- Advise certain clients that you cannot do their tax returns this year.

The solution(s) for your firm will depend on your particular circumstances. However, if you take effective management action, you can solve, or at least minimize, the over/under capacity problem.

After preliminary decisions are made, enter the changes on the schedule (this is when the computer is helpful) to project both your revised workload and your revised staff availability. Then, measure again your over/under capacity as a result of the changes. Continue making additional revisions until your over/under capacity problem is solved.

The importance of advance planning cannot be emphasized enough. If appropriate action is not taken in advance, your firm will coast into the busy season where you will be forced to exercise "crisis management." Crisis management may be feasible on an occasional basis, for example, when the problem is short-term or a one-time event. However, the over/under capacity problems created by TRA are long-term, affecting your scheduling and workload and, inevitably, your firm's profitability.

PRACTICAL COURSES OF ACTION

As previously mentioned, the course(s) of action for your firm in handling its over/under capacity problems as well as maintaining or improving its profitability will be unique.

However, alternatives for solving over/under capacity problems with which other firms are experimenting may suggest ideas that can be used in your own practice.

PROFITABILITY OF CLIENTS

One alternative that many practitioners would consider almost treasonous is to consider foregoing work for certain clients. During the peak season, staff shortages require action, and most alternatives involve an incremental cost. Incremental cost, however, must be weighed against incremental revenue. As shown in an earlier example, the cost for additional personnel may not be offset by the incremental revenues generated for the work. Therefore, it may be more profitable (less costly) to decline the work.

Alternatively, perhaps you can improve profitability by carefully analyzing each of your clients. Client analysis involves considerations such as the following:

1. Do you perform other work (such as consulting, estate planning,

or repetitive compilation services) for the client during your slow season? (Slow season work is very profitable.)

2. Do you perform work for the client's affiliated companies or family members? (Is this work profitable?)
3. Is or has the client referred other business to you?
4. Are you billing the client at "below standard" rates?
5. Does the client pay promptly? (If not, the interest factor on your receivables essentially results in "below standard" rates.)

Clients that you see briefly, once per year, during the busy season, and whom you bill at "below standard" rates, may no longer be profitable for the firm. However, before declining the work, consider whether the client will pay standard (or even premium) rates to improve profitability of the account. Alternatively, perhaps the client can be encouraged either to close his books slightly ahead of your peak season or to file tax extensions and, thus, delay the work to your slow season.

SCHEDULING/SHIFTING PERSONNEL

Several alternatives, outlined below, are available to the practitioner in the areas of personnel and staffing. As shown in the earlier scheduling exercise, you must first obtain a clear picture of your firm's capacity, and then use that information to consider your various alternatives.

Improved scheduling. Improved scheduling of personnel can improve staff utilization. Review your current scheduling techniques to determine if enhancements could be beneficial. For example, the use of a computerized scheduling system might provide better data that would enable you to focus on problems more quickly. Alternatively, the assignment of specific management responsibility for scheduling to one person might eliminate inefficiencies.

One option that has been successful for other firms is to assign staff to specific clients in advance, which can provide the following benefits:

- You can match each person's time with client workloads and spread the overtime evenly, thus avoiding burnout. Each person is scheduled for the peak season, and you know in advance where the scheduling problems are.

- You can assign reviewers for complex financial statements or tax returns.
- You can match technical expertise and experience with the right clients, rather than randomly assigning at the last minute whoever is available. Efficiency is improved because the most qualified staff can rapidly complete the work and, thus, minimize both the "learning curve" for underqualified personnel and boredom for overqualified personnel.
- You can easily evaluate changes in workload (new clients, unexpected technical problems, and so on) to determine the impact on your staffing.
- You can assign personnel to business clients with whom they have already worked. In working closely with the client, personnel may be able to identify other efficiencies.

Shifting personnel and workload. If your firm has different functional areas (accounting and auditing, consulting, tax, financial planning, among others), personnel can perhaps be reassigned during the peak season. Although accounting and auditing services and tax services have the same peak period, tax services are easier to reschedule by filing additional extensions. Rescheduling tax work can free tax personnel for accounting work.

Accounting and auditing services are more difficult to reschedule because clients need the information. However, doing more interim audit work can improve your scheduling abilities. Asking certain clients for a delay of even a week or two on compilation services can also improve your schedule and provide more flexibility.

Temporary help. During peak periods, hiring temporary personnel is an option you may want to consider. Experienced professional personnel are difficult to find, but the following are some of the sources available:

- Retired persons
- Women temporarily out of the job market while having children
- Paraprofessionals
- College students (accounting majors) seeking part-time work

(An internship program, which provides college credit for the work, could perhaps be arranged with a local college.)

Hiring temporary personnel can reduce the number of full-time personnel that would otherwise be needed throughout the year.

Clerical support. Tasks, such as photocopying and answering telephones, can be performed by clerical personnel and relieve these time-consuming chores from the professional staff, thus improving their productivity. A review of your firm may indicate that hiring additional clerical personnel, rather than professional staff, could improve productivity and ease scheduling difficulties. Clerical personnel are also more readily available on a temporary basis.

Time bank. Establishing a time bank to minimize overtime costs can significantly improve profitability. During the peak season, instead of paying professional staff for overtime hours, perhaps at overtime rates, staff can accumulate overtime hours worked into a "time bank" (either hour for hour, or at 1½ hours for each hour worked). During the slow season, staff can then take the time accrued as additional vacation. Using a time bank reduces your non-utilization of staff during the slow season.

A time bank program can have varying impacts on staff morale. Overall morale may improve when personnel are not bored during the slow season. Some personnel may dislike the decrease in pay, while others may actually prefer the additional time off, particularly if it is scheduled in advance so they can make plans. Offering a time bank as a voluntary program can be a good compromise that improves everyone's morale.

Before establishing a time bank, consider the impact of wage-and-hour laws for non-exempt employees, particularly as they impact paraprofessionals.

CHANGING NATURE OF PRACTICE

Considering the impact of TRA on your practice, now may be the perfect time to consider long-term changes in your practice. Consider what type of practice you want to have.

The increased workload during the busy season can be reduced by gradually changing the nature of your practice. Certain types of work have become exceedingly difficult to manage because of the peaks and valleys caused by TRA. Unless you are able to meet peak demands by using temporary personnel, for example, you may have little choice but to work excessive overtime during the busy season. If this approach is not satisfying on a long-term basis, you should consider—

- Branching into other areas, such as estate planning or financial planning. This type of work can be very lucrative by filling in the valleys in your other practice areas and providing a more balanced workload. As new clients and/or work are obtained, you can gradually reduce your peaks by filtering out unprofitable clients.
- Helping clients upgrade their systems and records so your role becomes more of a consultant and less of a bookkeeper/controller.

PRICING

Pricing changes can also affect the nature of your practice. As previously discussed, public accounting work is not as price sensitive as many practitioners believe. Clients who seek professional advice are usually willing to pay for **quality** service. A client's degree of confidence in the CPA's abilities has more of a driving market force than the price of his services. However, pricing is more important for routine competitive work than it is for complicated work requiring special expertise. Tax compliance work and simple compilation work are probably the most price sensitive. A client who merely wants to file his tax return does not necessarily care who prepares it. If you do it for $50 while your competition charges $75, you will retain the work. In other words, you can structure your fees to encourage and discourage specific types of work.

Examine your billing rates by staff level. The "product mix" can impact the fees charged. While your firm's **average** billing rates may be the same as your competitors' rates, the mix may be quite different. For example, tax compliance work has a higher ratio of staff to management time than does tax planning work. If your staff rates are lower than competitors' and your management rates are higher, then your average fee for tax **compliance** work is going to be lower, while, conversely, your average fee for tax **planning** work will be higher. Consequently, by setting your billing rates, you may inadvertently attract compliance work and repel planning work. If this is not the type of practice you want, consider changing your billing rates to achieve the desired effect. The same principle also applies to accounting and auditing services and consulting services.

Raising your prices is an area that is often overlooked because of a "mind set" that "the client will never pay a higher fee." As previously discussed, clients are usually willing to pay for quality service. If you **really** feel they will not pay a higher fee, it may be worthwhile to review the quality of your service by asking the following questions:

- Are clients happy with your service? If not, why? For example, have you failed to meet important deadlines?
- Do you communicate with clients, or are the clients constantly surprised by unforeseen events?
- Do you discuss fees in **advance** with clients?
- Do you bill on a timely basis, or do you wait for several weeks until the client has forgotten the wonderful service you provided?

Many practitioners fear that if they increase fees, their firm will not be competitive. However, the effects of TRA are impacting **all** practitioners in one way or another. Most will reach the same conclusion—their costs are increasing, and in some way must be recovered. Improving efficiency helps, of course, as do many other alternatives already discussed. Changing the nature of your practice to obtain more off-season work helps, but in the end there is not enough off-season work for everyone. The profession as a whole has a peak demand period, and some firms have to do the work. All firms have to recover their costs and make a reasonable profit, otherwise there is no point in remaining in business. Consequently, the market demand for services will eventually create price increases. The question is when. If delays only postpone the inevitable, members of the profession can improve profitability by taking positive steps sooner, rather than later.

Assuming price increases are necessary, the following alternative approaches are available:

- Across-the-board rate increases. This method spreads the increase to all clients and, consequently, the overall increases to each client may be smaller than under other methods. However, this method also transfers higher fees to clients outside the peak season who did not cause the increased staffing costs.
- Premium rates during peak demand. This method allows you to charge your increased costs directly to the clients who are causing the peak demand.
- Discount rates during slow season. If applied across-the-board, this is really the same approach as charging premium rates during peak demand periods. However, it can be used in isolated situations to motivate clients who can move their work to the slow season to do so.
- Premium rates for certain services. This method can be used to change the nature of your practice by spreading the increase to the clients who are causing the peak demand.

SHIFTING WORKLOAD

Because of the limits of TRA, shifting workload will be the most difficult alternative for most practitioners. However, some relief can be provided by using the suggestions below.

File as many extensions for tax returns as possible, for both corporate and individual clients. Although this frees personnel during the peak demand period, it frequently increases the overall time required for tax work because of the extra time required to prepare the extensions. Explaining the necessity for the increased time to each client and billing for the extra time can have a significant impact on your firm's profitability. You increase overall chargeable hours while delaying most of your tax work until the slow season when time might otherwise be nonchargeable.

As mentioned previously, encourage clients who can do so to change from a calendar year to a fiscal year. Offering reduced fees, or by foregoing a fee increase, can be a way to encourage them.

Propose to clients that they adapt different fiscal years for financial statement purposes than for tax purposes. In many cases, this may be a matter of clients retaining their existing fiscal year. If audit or compilation work can be postponed until the slow season, your staffing flexibility will improve during the peak season.

COMPUTERS

Most practitioners have long since discovered that computers are useful tools for preparing individual tax returns. Computers are also useful tools in tax planning, particularly in performing "what if" calculations. Projections can provide not only a valuable service to clients in tax planning, but they can also reduce your time during the busy season by resolving tax issues earlier.

If you are not already using a computerized tax preparation and/or planning service for corporate and partnership clients, this may be a way to ease part of your time burden. However, do not expect miracles immediately. There are pitfalls along the way, avoidance of which requires an investment of time. The primary problem is one of training personnel to use the software. In the short term, you may find the time you expected to save on tax work is more than consumed by both the training and the "learning curve" for staff to use the system. However, in the long term it may be a worthwhile investment.

If you are already using an outside computerized tax planning service, you may be tempted to bring the service in-house. Although this may improve flexibility, the pitfalls mentioned above also apply to conversions.

If you are not already doing so, consider using computers to assist in your accounting services. Numerous "spread sheet" and general ledger software packages are readily available on the market. These packages can be used to both expedite preparation of financial statements and improve your financial analysis capabilities. The latter can be an area in which to expand the range of services you offer, particularly during the slow season. For example, you could use the computer to assist clients in either budgeting expenses or in forecasting costs to decide between alternative courses of action.

Finally, do not overlook the management opportunities that computers offer in administering your own practice. For example, they can be used to improve your scheduling capabilities, expedite billing, tailor audit programs, and accelerate the typing of financial statements.

OTHER IDEAS

Brainstorming by MAP Committee members produced the following additional ideas that you might consider using for your own firm:

- Prepare "mini" manuals for clients' bookkeepers or controllers that contain "to do" lists, checklists, highlights of tax changes, planning ideas, and so forth.
- Provide training seminars for clients.
- Perform more interim work.
- Revert to doing more monthly work.
- File extensions that contain pre-year-end projections, rather than making year-end changes prior to April 15th.
- Improve training by using practice sets.
- Publicize to clients anticipated difficulties (such as, delayed K-1s).
- Discount fees charged to clients who either submit data early or close their books early.
- Educate clients on the need for timely start of year-end audit work, review work, and so on.
- Set dates for clients to submit data.
- Communicate with clients (for example, by using newsletters).
- Urge clients to contact their Congressmen if they think the new law is unreasonable.
- Watch for personnel problems (such as burnout) if staff are working longer hours. Consider the impact on administrative and support staff as well as professional staff.
- Hire personnel for a nine-month year (school-year calendar), rather than a full year.
- Consider the impact on utilization of firm resources (for example, in-house computers).
- Subcontract staff—
  —To clients during off season.

—From clients during peak season.
—From private contracting firms.

- Develop a state-of-the-art personnel system better equipped to monitor staff performance, detect shortcomings and technical deficiencies, and reward performance.
- Merge with a firm that has different peak periods.

CONCLUSION

TRA is undoubtedly having an impact on your practice. If you take positive action to cope with its effects, you can turn the apparent problems into a lucrative practice.

Neither identifying nor making the necessary changes will be easy. However, ignoring the problems is not an acceptable alternative.

The long-term impact of TRA on the entire profession is a significant shift in its workload. Higher staff levels will be required throughout the profession to meet the demand and, consequently, the profession will have more nonchargeable time during the slow season, thus increasing the cost of accounting services to society as a whole. Someone has to pay the price.

- In the short term, some practitioners may be tempted to pay the price—through decreased profits or burnout. This alternative is harmful, not only to the practitioner, but also to the profession. Decreased profits lead to "short cuts" and exhaustion causes errors, both of which discredit the entire profession.
- In the long term, society will have to pay the price through increased CPA fees—just as it already pays legislated cost increases for manufactured goods resulting from legislated pollution-control devices.

As a practitioner, you have to decide your own course of action. Improving efficiency within your firm by implementing some of the ideas in this guide may help your firm offset the cost increases generated by TRA. If operating efficiencies are not possible, you may have little choice but to either accept decreased profits or to increase your fees.

MANAGEMENT OF AN ACCOUNTING PRACTICE

Committee Roster—1986-87

Carl R. George,
Chairman
Clifton, Gunderson & Co.
Peoria, IL

Louis J. Barbich
Barbich, Longcrier & Co.
Bakersfield, CA

Robert J. Batson
Batson, Carnahan & Co.
Fort Myers, FL

Paul V. Breazeale
Breazeale, Saunders & O'Neil, Ltd.
Jackson, MS

Darold D. Brockhaus
Wipfli, Ullrich & Co.
Wausau, WI

Stanley Brownlee
Randall & Brownlee, Inc.
Enid, OK

Gary B. Carlson
Anderson, ZurMuehlen & Co.
Helena, MT

Ronald S. Cohen
Crowe, Chizek & Company
South Bend, IN

Walter G. Goerss
Goerss & Co.
Maryland Heights, MO

Irving B. Kroll
Kenneth Leventhal & Co.
Los Angeles, CA

David F. Metler
Metler & Co.
Albuquerque, NM

James R. Miller
Larson, Allen, Weishair & Co.
Minneapolis, MN

Emile P. Oestriecher, III
Oestriecher & Company
Alexandria, LA

Donald E. Parent
Parent, McLaughlin & Nangle
Boston, MA

Marvin P. Pechter
Connally, Pechter & Company
Marietta, GA

Ron D. Pittman
Gatson, Gay & Montgomery
Phoenix, AZ

Joseph A. Puleo
Puleo & Spitzbard, P.C.
Hamden, CT

David L. Swan
Presnell, Gage & Co.
Lewiston, ID

James A. Warren
Warren, Averett, Kimbrough & Marino
Birmingham, AL

Ronald G. Weiner
Weiner & Company
New York, NY

Albert S. Williams
Williams, Cohen, and Fike
Denver, CO

Nancy Myers, Director
Industry and Practice Management

889295