11-1981

Practicing CPA, vol. 5 no. 11, November 1981

American Institute of Certified Public Accountants (AICPA)

The Practicing CPA

NOVEMBER 1981

An AICPA publication for the local firm

PERFORMANCE STANDARDS FOR SUCCESS

Do you think your firm is growing faster than other CPA firms in your area? Are you sure of your answer? It is too easy to be misled by deceptive measures of growth and productivity. Increased activity is not necessarily progress and adding people to the payroll does not necessarily mean growth.

In order to appraise your firm's comparative performance, as well as its actual health and vitality, you need specific financial standards. You need to be able to compare, say, the rate of growth in chargeable hours to the rate of growth in fee revenue to see how your firm stacks up. You need records to be able to see whether the firm is being managed well and if it has the capability of doing better. In short, you need good reports to get good results.

The maintenance of financial standards and compliance with professional standards can be expensive. Peer reviews, for example, cost about 1 percent of revenues. No doubt, you probably could make more money for a while if you cut a few corners here and there. But such action could jeopardize your firm's reputation, even survival, over time. Besides, there are definite benefits to be derived from having specified standards.

To begin with, you can nearly always achieve better-than-average results if you set objectives. These goals should be definable, attainable and measurable. Reporting is the beginning of control because you obviously can't control the performance if you don't know what the performance is. You should know the chargeable hours monthly, or even more frequently, of everyone in the firm. Peer pressure will make people strive to achieve the standards.

In order to set performance standards, you will need some financial ratios with which to compare your firm's current statistics and to help you set objectives. In this regard, you might find that the surveys made of participants at management of an accounting practice conferences yield useful statistics as do the surveys made by several state societies (see "Practice Management Profile" in the June issue).

You can get a perspective on your firm through these ratios if the measurements are continuous and comparable. For example, we determine how many people our firm needs by dividing total hours by 2,300 (the average total hours per staff member). You can find out other things about your firm such as its having too many partners for the fees produced (or that partners are not doing partner work) or that there are too many expensive people for the fees generated. In this case, either the fees should be increased or the staff reduced. You can also determine if the ratio of support staff to professional staff is too high. (Support staff should account for roughly 6 percent of fees.)

Some firms tend to make people partners for the wrong reasons and in reality only a limited number of accountants are worth the price. Still, sometimes firms don't have enough partners. This

What's Inside . . .

may be more profitable in the short run but over time, quality will suffer. So, take a look at the number of staff people, the fee income and the billable hours per partner. (The firm should produce 6,200 to 7,000 billable hours per partner.) Two other areas that should be looked into are the average net profit per partner and methods of distributing profit. The previously mentioned surveys and the AICPA's *Management of an Accounting Practice Handbook* can be of help here.

Staff accountants represent the greatest cost and the greatest opportunity to the firm in producing billable hours. You should reasonably expect 1,600 to 1,800 billable hours and annual fees in the region of $60,000 to $75,000 per staff accountant. The profit potential lies in partner supervision of staff accountants' efforts and in the sale of more billable hours. This takes planning and organization.

The support staff is an unappreciated resource in most firms. It is well worthwhile to take a broader view of people's capabilities and to organize the support functions better. (Those crash jobs just cost the firm more.) The statistics to aim for are revenues of $125,000 to $225,000 and 400 to 600 chargeable hours per support staff person. You should keep in mind too that, in the future, the support staff will need increased skills in order to operate the more sophisticated office equipment that will be available. It is essential to get the staff's cooperation and participation if your reorganizational efforts are to be successful.

Generally speaking, the reasons for the disparities in the ratios between the most profitable firms and others (see "Practice Management Profile" in the June issue) is that the most profitable firms in all size categories have more staff per partner and more billable hours per partner. Most firms average 1,200 to 1,300 billable hours per partner but the most profitable firms have about 150 hours more and 40 to 50 percent greater partner income.

In the management of engagements, partners must be accountable to the firm as well as to clients. A partner must get an engagement at a rate that is right for the firm. Not only should a partner be responsible for billing the firm's standard rates and reviewing them frequently, but also for making sure that they are realized. Many firms only realize at about the rate they pay three- to five-year seniors. (Thirty dollars per hour is a good average.) Partners are also responsible for the condition of work-in-process—for seeing that expensive engagements are billed and collected with dispatch—and for accounts receivable.

Staff management is of growing importance nowadays and the managing partner must devote sufficient time to this job, if the firm is to achieve the standards set. And other partners must be supportive over such things as hiring enough staff members, paying attention to billed and unbilled services, being aware of needed changes in the type of services offered and of the need to update office equipment. With established standards to aid in the setting of goals and a staff that is motivated to attain them, your firm's performance should indeed be better-than-average.

—by James M. Arnett, CPA
Charleston, West Virginia

We're All Shook Up

Did you see that cartoon on page 5 of last month's issue? By the time we give the go-ahead to print this publication, we often feel swamped by letters and numbers too. We don't know whether that is the reason we got shook up, but, at any rate, we hit a wrong key on our typewriter last month. The AICPA library's toll-free number for the United States (except New York State) is (800) 223-4155. The New York State number was correctly reported as (800) 522-5434.

The Practicing CPA, November 1981, Volume 5, Number 11. Publication and editorial office: 1211 Avenue of the Americas, New York, N.Y.

Highlights of Recent Pronouncements

FASB Statements of Financial Accounting Standards (SFASs)

No. 49 (June 1981), *Accounting for Product Financing Arrangements*
- ☐ Extracts the specialized principles and practices from SOP 78-8, *Accounting for Product Financing Arrangements.*
- ☐ Specifies criteria for determining when an arrangement involving the sale of inventory is in substance a financing arrangement.
- ☐ Requires product financing arrangements to be accounted for as borrowings rather than as sales.
- ☐ Applies prospectively to product financing arrangements entered into after June 15, 1981.

No. 48 (June 1981), *Revenue Recognition When Right of Return Exists*
- ☐ Extracts the specialized principles and practices from SOP 75-1, *Revenue Recognition When Right of Return Exists.*
- ☐ Specifies how an enterprise should account for sales of its product when the buyer has a right to return it.
- ☐ Revenue shall be recognized at time of sale only if all the conditions specified by the statement are met.
- ☐ Effective for fiscal years beginning after June 15, 1981. Accounting changes to conform to the statement are to be applied retroactively.

No. 47 (March 1981), *Disclosure of Long-Term Obligations*
- ☐ Requires disclosure of commitments under unconditional purchase obligations that are associated with suppliers' financing arrangements; identifies information to be disclosed.
- ☐ Requires disclosure of future payments on long-term borrowings and redeemable stock.
- ☐ Effective for fiscal years ending after June 15, 1981.

No. 46 (March 1981), *Financial Reporting and Changing Prices: Motion Picture Films*
- ☐ Supplements SFAS no. 33 regarding motion picture films.

No. 45 (March 1981), *Accounting for Franchise Fee Revenue*
- ☐ Extracts the specialized accounting principles and practices from the AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue,* and establishes accounting and reporting standards for franchisors.
- ☐ Requires that franchise fee revenue from individual and area franchise sales be recognized only when all material services or conditions related to the sale have been substantially performed or satisfied by the franchisor.
- ☐ Establishes accounting standards for continuing franchise fees, continuing product sales, agency sales, repossessed franchises, franchising costs, commingled revenue, and relationships between a franchisor and a franchisee.
- ☐ Effective for fiscal years beginning after June 15, 1981.

No. 44 (December 1980), *Accounting for Intangible Assets of Motor Carriers*
- ☐ Amends Chapter 5 of ARB no. 43 and interprets APB Opinions nos. 17 and 30 to address questions raised by enactment of the Motor Carrier Act of 1980.
- ☐ Requires unamortized costs of motor carrier intangible assets representing interstate rights to transport goods with limited competition be charged to income and, if material, reported as an extraordinary item.
- ☐ Does not affect accounting for other intangible assets of motor carriers.
- ☐ Effective on December 19, 1980, for periods ending after December 15, 1980.

No. 43 (November 1980), *Accounting for Compensated Absences*
- ☐ Requires accrual of employees' rights to receive compensation for future absences when certain conditions are met.
- ☐ Effective for fiscal years beginning after December 15, 1980. Accounting changes to conform to the statement are to be applied retroactively.

No. 42 (November 1980), *Determining Materiality for Capitalization of Interest Cost*
- ☐ Amends FASB Statement no. 34 to clarify that Statement no. 34 does not establish new tests for materiality.
- ☐ Effective for fiscal years beginning after December 15, 1979.

Nos. 41 and 40 (November 1980) and no. 39 (October 1980), Supplements to SFAS no. 33 (September 1979), *Financial Reporting and Changing Prices*
- ☐ Provide guidance to companies in the real-estate, forest-products and oil and gas industries on implementation of SFAS no. 33.

No. 38 (September 1980), *Accounting for Preacquisition Contingencies of Purchased Enterprises*

- ☐ Amends APB Opinion no. 16 to specify how an acquiring enterprise should account for contingencies of an acquired enterprise that were in existence at the purchase date and for subsequent adjustments resulting from those contingencies.

FASB Interpretations

No. 36 (October 1981), *Accounting for Exploratory Wells in Progress at the End of a Period* (interprets SFAS no. 19)

No. 35 (May 1981), *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock* (interprets APB Opinion no. 18)

No. 34 (March 1981), *Disclosure of Indirect Guarantees of Indebtedness of Others* (interprets SFAS no. 5)

Statements on Auditing Standards

No. 39 (June 1981), *Audit Sampling*

- ☐ Supersedes SAS no. 1, sections 320A and 320B.
- ☐ Provides guidance on nonstatistical and statistical sampling; sampling for substantive tests of details and sampling for compliance tests of internal accounting controls.
- ☐ Effective for examinations of financial statements for periods ended on or after June 25, 1982.

No. 38 (April 1981), *Letters for Underwriters*

- ☐ Supersedes SAS no. 1, section 630.
- ☐ Changes are in response to SEC revisions of reporting requirements and changes in professional standards relating primarily to reviews of interim financial information.

No. 37 (April 1981), *Filings Under Federal Securities Statutes*

- ☐ Supersedes SAS no. 1, section 710.
- ☐ Provides guidance for the accountant when his report based on a review of interim financial information is presented or incorporated by reference in a filing under the Securities Act of 1933.

No. 36 (April 1981), *Review of Interim Financial Information*

- ☐ Supersedes SAS no. 24.
- ☐ Changes are in response to the SEC's revisions to Regulation S-K and deal with the effects on the auditor's report when interim financial information accompanies audited financial statements.
- ☐ Guidance in SAS no. 24 on the accountant's procedures for a review of interim financial information and the form of the accountant's review report are unchanged.

No. 35 (April 1981), *Special Reports — Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*

- ☐ Amends SAS no. 14, paragraphs 15-17 to permit an accountant's report to be accompanied by an entity's financial statements and amends the language of the illustrative reports.

No. 34 (March 1981), *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*

- ☐ Provides guidance on the auditor's considerations when information comes to his attention that raises a question about an entity's ability to continue to exist.
- ☐ Discusses the effects on the auditor's report and presents illustrative reporting language.

No. 33 (October 1980), *Supplementary Oil and Gas Reserve Information*

- ☐ Provides guidance in implementing procedures specified in SAS no. 27 regarding SFAS nos. 19 and 25 and disclosure of oil and gas reserve information required by the SEC.

No. 32 (October 1980), *Adequacy of Disclosure in Financial Statements*

- ☐ Supersedes SAS no. 1, section 430. Retains basic concepts of section 430. However, updates guidance to achieve consistency with authoritative pronouncements issued subsequent to section 430 (e.g., SAS nos. 12 and 17, and FASB Statement no. 5).

No. 31 (August 1980), *Evidential Matter*

- ☐ Discusses the nature of assertions by management that are embodied in financial statement components and the use of assertions in developing audit objectives and designing substantive tests.
- ☐ Discusses the nature, competence, sufficiency and evaluation of evidential matter.
- ☐ Supersedes SAS no. 1, section 330.

Statements on Standards for Accounting and Review Services

No. 2 (October 1979), *Reporting on Comparative Financial Statements*

MAP for All

Have you ever returned from a management of an accounting practice conference all fired-up about things you had learned, people you had met, experiences you had shared, etc., only to find that your partners, who are not involved in the management side of things and who have never attended a MAP conference, just could not see what all the excitement was about? If only, you may have thought, it were possible for all of your partners to attend such a conference with you. Then, how much easier it would be to put into effect some of those great ideas.

Many firms, of course, do have several partners attend the same conference. Nevertheless, we were still rather surprised when looking through the roster of participants at the AICPA MAP conference on firm management and administration in Denver last July to see that one firm, McDermott & Miller of Grand Island, Nebraska, had 11 people there.

Dan Skoog, partner-in-charge of the firm's Hastings office, tells us that all of their partners and two principals (partners-in-training) attended the conference. Mr. Skoog says that usually one or two partners go to such conferences but this time, Arlin Kiel, the firm's administrative partner, thought it was a good opportunity to combine the firm's annual away-from-the-office partner meeting with some exposure, for all partners, to various ideas on management. For the most part, the conference administrators were able to arrange the partners at different tables with partners in firms of comparable size from other areas of the country.

Concurrent sessions are a special feature of the AICPA MAP conferences. The presenters at these sessions usually focus on a particular aspect of the conference topic—specifically, how this particular function is handled in their firms. The conference is arranged so that participants can choose which two of the three sessions they wish to attend. At this conference, the concurrent sessions dealt with the duties of an office manager, managing a multioffice firm and the uses of word processing equipment in a CPA firm. (See the October issue for an article based on one such presentation.) The McDermott & Miller partners attended sessions of their own choosing, but with so many people there, the firm's coverage was complete.

Mr. Skoog says they held meetings after each day's sessions to discuss points they considered applicable to their firm and held their annual partners' meeting the day after the conference ended. They rented a room for this purpose although the Institute had arranged for several rooms to be available for such meetings.

Now, having 11 people attend one conference is obviously a very expensive proposition. Air fares, hotel accommodations and meals are not exactly given away these days. So was it all worth it? Mr. Skoog says that they certainly did not go home entirely united about what they wanted to do. However, they did come away with some ideas. Not all of the ideas were new but even the presentation of some ideas and methods that are already being used can be helpful in demonstrating that the firm is on the right track. Sometimes, when a firm is unsure of its existing practices, it is reassuring to know that other successful firms have adopted similar approaches to their management.

Forming Partnerships or Professional Associations with Non-CPAs

Members frequently ask whether it is permissible to form partnerships or professional associations with individuals who are not certified public accountants for the purpose of rendering accounting services.

Ethics Ruling no. 139 under section 591 of the AICPA Code of Professional Ethics provides in part that "while some state boards of accountancy and CPA societies have rules prohibiting mixed partnerships, the Institute's Code does not prohibit a member from forming a partnership with a noncertified public accountant." In the event that a state board or society does not permit mixed partnerships, the member is bound by the most restrictive rule to which he or she is subject.

However, section 92.03 of the code, "Applicability of Rules," provides that "A member may be held responsible for compliance with the Rules of Conduct by all persons associated with him in the practice of public accounting who are either under his supervision or are his partners or shareholders in the practice." Therefore, AICPA members may be held accountable for any violations of the Code of Professional Ethics by their noncertified partners or shareholders in a mixed partnership or professional corporation.

A related concern is how such a mixed partnership or professional association may be presented to the public. Obviously, if some members of the firm are not certified, it would be improper to use the term "certified public accountants" after the firm name.

Similarly, Rule 505 of the code, "Form of Practice and Name" provides that "a firm may not designate itself as 'Members of the American Institute of Certified Public Accountants' unless all of its partners or shareholders are members of the Institute." The same proscription would also apply regarding a designation implying membership in a state society of CPAs by all members of the firm when this is not the case.

Nevertheless, in mixed partnerships, members may show their CPA designation as well as AICPA or state CPA society membership by including a roster on the firm stationery with such information after each partner's name.

This article is based on the AICPA professional ethics division staff's responses to written inquiries from members and is not a pronouncement of the professional ethics executive committee nor does it purport to set forth an official position of the AICPA. In addition, the article does not address the requirements of other regulatory bodies.

Report Issued on A-102 Audits

A report recently issued by the single audit steering committee of the Joint Financial Management Improvement Program, formed by several governmental agencies, focuses on the participation of small and minority CPA firms in A-102 audits and certain concerns encountered by these firms in obtaining government contracts. One concern voiced was that small and minority firms, which have traditionally audited many contracts and grants for state and local governments, "would not have the resources at their disposal to perform the large organizationwide audits" envisioned under Attachment P of OMB Circular A-102.

The report describes the relevant federal and state regulations pertaining to small and/or minority businesses, highlights some of the significant concerns encountered by these firms in obtaining government contracts, and discusses what steps could be taken to increase participation in A-102 audits. The report contains various recommendations urging actions to be taken "to achieve the largest possible participation by small and minority CPA firms in the conduct of organizationwide audits."

Copies of the report are available from Nancy Myers at the Institute.

Letters to the Editor

The article, "The Benefits of Peer Review to a Local Firm" that was published in the July issue of the *Practicing CPA*, brought to mind the sense of accomplishment we felt at our firm of 18 people (9 professionals) on passing our peer review. Like that other firm, we derived significant benefits from the experience and also found it a great motivator.

When I first read about peer review, I immediately thought that it was just one more step in the ever-increasing regulation of small firms. But after joining the private companies practice section (PCPS) of the AICPA division for CPA firms and actually undergoing a review, I have completely changed my thinking on the subject.

We were early joiners of the PCPS—even before we really knew what was involved. So we began to list the various elements of change that the firm would have to undergo and even began to write our own auditing manual. We already had a personnel manual which included an organizational chart and which listed the various benefits, requirements and policies of the firm. But we soon realized that producing an auditing manual would be a larger task than we bargained for. The procedures needed for constant updating seemed particularly complicated.

Because of the potential updating problem, we began to investigate the manuals and technical updating services that the large national CPA firms were starting to make available to other firms. (This was the summer of 1979.) We concluded that a subscription to one of these services was the best route for our firm to take and have found the arrangement completely satisfactory.

In December 1980, we had our peer review which was performed by a firm of our choosing. The reviewers were knowledgeable and thorough and the experience was informative.

The benefits to our firm are numerous and not the least among them is the knowledge that we are maintaining the high standards of quality dictated by our profession. We have found that prospective clients are impressed by the fact that we have undergone an examination of our quality control policies and procedures while most firms have not. There was also a real boost in staff morale during the year and a half we spent planning and preparing for our peer review. During the actual review the staff's excitement was obvious, and when we received our "unqualified opinion" everyone proudly discussed the effort that went into establishing the firm's quality control system.

We take great pride in knowing that approximately only one hundred other local firms in the U.S. had undertaken a peer review by December 31, 1980. We believe that had we waited to have the review, the establishment of our quality control standards program would have been delayed.

The cost was not cheap. The reviewing firm's fee was $4,005 including expenses. (Indirect expenses are hard to measure because of the heavy involvement of partners and managers.) Still, there is no doubt in our minds that preparing for and passing peer review is one of the most rewarding experiences we have had in the twelve-year history of our firm.

–Jerrell A. Atkinson, CPA
Albuquerque, New Mexico

I read with interest the article, "Steps Toward More Efficient Billing" in the September issue of the *Practicing CPA*. While I basically believe that any system which produces the desired results is a good one, I would like to add a few comments on certain aspects of the article.

We CPAs hold our counsel and services in high esteem, but not high enough, it seems, to bill fairly and promptly. We tend to decide how our clients will react to bills before they have even seen them. And then we rationalize why perfectly valid bills should be marked down.

I agree that timing is imperative. Getting raw data in, getting the summaries back and then billing promptly are essential to the success of any system. However, I do not agree that a billing meeting is necessary. In most instances, billing is simply a discipline of standard rates accompanied by behavior modification. This last named activity can be a rather painful process at first, but it can end up, as it apparently has at Mr. Reardon's firm, being a pleasurable and profitable experience. In our firm, the same results were obtained in a somewhat different manner.

We require each PIC (partner- or principal-in-charge) to bill fairly and promptly. By fairly, we mean fair to the client and fair to the firm. The necessary discipline and peer pressure results from action taken by the three-member executive committee. Each month, when the time and recordkeeping report is received, this committee meets to review, authorize or reject the following items which must be submitted by all PICs:

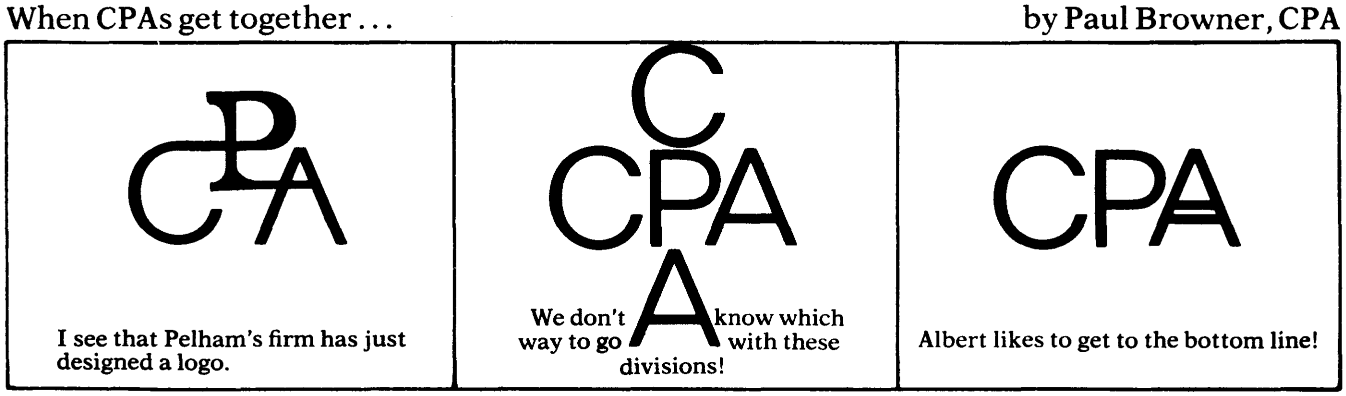
- ☐ A written explanation as to the status and the collection efforts being used on all accounts receivable over 60 days old.
- ☐ A written explanation as to why work-in-process over 60 days old has not been billed.
- ☐ A written request for approval to write off accounts receivable in excess of $200. This must cite the reason for the request and give the total amount billed to that client for the year.
- ☐ A written request for approval to write down work in process in excess of $200. This must cite the reason for the request and give the total amount billed after the write-down.

The executive committee is not a rubber stamp group. Requests are periodically rejected or instructions are given to a PIC to stop doing work for a client until some payment is made. It is amazing how having to write the requests motivates one into getting rid of old items and into handling others on a more timely basis. And even clients, knowing of a forthcoming meeting, are sometimes motivated into mailing their checks promptly.

In our best year after this policy was instituted, our cash basis income exceeded our accrual basis income. This made us aware of our lack of discipline in prior years. We realize, too, that if the policy is to continue being as effective, motivation and discipline must be maintained. If not, a fast deterioration will occur and dollar-flow rigor mortis will again be upon us.

–Sidney F. Jarrow, CPA
Chicago, Illinois

When CPAs get together . . . by Paul Browner, CPA



Lawsuits—They Could Happen to You

A nationwide study conducted by Rollins Burdick Hunter Co., administrators of the AICPA professional liability insurance plan, shows that clients are more prone to sue their CPAs over tax work than over any other type of professional service rendered. Out of a total of over fifteen hundred claims (amounting to approximately $23.3 million) since the inception of the plan in 1974, 526 ($4.0 million) were related to tax matters.

Most of the lawsuits over tax services result from the penalties assessed clients because of the late filing of returns and the underpayment of estimated tax—due, clients allege, to negligence on the part of the accountant. Other claims arise because of the disallowance of the treatment of items reported on the tax return prepared by the accountant.

Another area that gives rise to a lot of liability suits is accounting services. There were 253 claims (totaling $3.5 million) alleging failure of a CPA firm to properly discharge its obligations when engaged to provide nonaudit services, i.e., write-ups, compilations and reviews.

In terms of the number of lawsuits against firms (246), providing audit services is the third most hazardous way for a CPA to earn a living. However, there is an added twist. The total dollar amount of the claims ($7.0 million) far exceeds the totals in other categories. The claims usually allege that a CPA firm was engaged to examine books and records of a company in accordance with generally accepted auditing standards (GAAS) and to report on whether the financial statements are presented in conformity with generally accepted accounting principles (GAAP), and that the firm failed to properly discharge its obligations.

Now, what if you sue clients to collect fees? What is the result of that? Unfortunately, the study shows that clients have a propensity to countersue. There were 208 such claims totaling $685,000.

According to this study, other areas where CPA practices seem to be vulnerable to lawsuits involve defalcations, 105 claims ($4.0 million); business and investment advice, 70 claims ($800,000); claims by third parties not privy to the engagement contract, 48 claims ($2.1 million); claims involving fiduciary responsibilities, 42 claims ($350,000); management advisory services, 25 claims ($200,000).

American Institute of Certified Public Accountants, Inc.
1211 Avenue of the Americas
New York, N.Y. 10036

Non-Profit Org.
U.S. POSTAGE
PAID
New York, N.Y.
Permit No. 3681