How to Prosper during an Economic Downturn

Strategies and Opportunities for Accounting Firms

By James Byrd, Douglas Smith, and Marilyn M. Helms

Although economic times have occurred periodically throughout history; according to the National Bureau of Economic Research, there have been 10 recognized U.S. recessions that covered approximately nine years in a nearly sixty-year period (1953, 1958, 1960–61, 1969–70, 1973–75, 1980, 1981–82, 1990–91, 2001, and 2007–09). A recession, or even an economic slump, is not an unusual event; for one quarter of the twentieth century, the United States was in an economic downturn.

Responses to a Downturn

The primary response to reduced revenues is to cut costs by a proportionate, or even greater, amount. Typical retrenchment responses include delaying expansions; deferring maintenance and special projects; freezing training, business travel, and nonessential spending for supplies and services; and decreasing expenses. Other tactics include eliminating waste, monitoring receivables with more frequent billing, or offering discounts for immediate payment. Some hard-hit industries are also limiting or eliminating raises for employees. Others are using unpaid days off, or furloughs, as a short-term solution.

Although variety of cost centers can be affected, depending upon a business’s type or industry, personnel reductions are typically part of an overall response in a downturn. But because businesses need accountants for compliance filings, the accounting departments of corporations do not usually reduce staff at the same rate as other functional areas of the organization. Maintaining morale and productivity becomes an added responsibility for managers. According to Lindsay Blakely in “How to Manage in a Recession,” employees are under increased pressure to produce more with...
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fewer resources (CBS News, June 23, 2008, http://www.cbsnews.com/8301-505125_162-51208896/how-to-manage-in-a-recession/). Productivity is critical, but continuing to increase productivity at the same rate as before a recession is not feasible.

Public accounting firms might find themselves with fewer clients as their business customers retrench. In an article on cross-discipline training, Max Messmer suggested that cross-training employees to perform multiple job functions can be an option even during retrenchment (“Cross-Discipline Training: A Strategic Method to Do More with Less,” Management Review, vol. 81, no. 5, 1992). This approach has an additional benefit: it allows workers to understand how different functions in a company fit together.

Understanding how the entire company operates can improve functioning, reduce duplication, and increase satisfaction among workers. Increased knowledge among workers can lead to more efficient operations that will strengthen the company through cost reductions, making it more resilient in a downturn. This can also improve competitiveness and profitability as the economy improves. If reducing the workforce becomes necessary, a multifunctional group of employees will be better able to cope with the new environment. Cutting prices is typically not recommended for accounting practices, because clients equate price with the quality of such expert services.

Stability with Minor Changes

Accounting functions are better protected from the level of employee cuts experienced by line operations because more information is often needed in challenging times. Accounting groups are needed to retrieve the data used for decision making and for fulfilling several functions, including financial transparency, financial reporting, and business accountability. If business fluctuates wildly, accounting firms can utilize a mixture of both full-time and temporary employees. A large pool of talented workers is usually available for temporary and part-time employment.

Accounting firms should focus on the basic organizational goals of operating efficiently, providing high-quality products and services, satisfying customers so that they return, converting cash quickly, and maximizing profits, while maintaining customer service and quality. Demonstrating concern for employees during these times will result in employee loyalty, both in the present and in the long term, and can increase the capability of the accounting staff. Strategic goals remain important, and top management should be careful not to engage in reactionary decision making; instead, management should consider the long-term needs of the organization because managing the accounting practice efficiently is paramount. Just as accounting firms advise businesses about cost control, accounting organizations must use good budgeting strategies as well. Maintaining the firm’s bookkeeping and monitoring cash flows closely is essential. Strong internal controls should be firmly in place to manage assets, particularly cash. An alternative to cutting expenses is to focus on building revenue. Debt should be controlled and used only as necessary. Adjusting compensation to the current market for new hires, particularly as market salaries might have fallen, is also important. Reactivating dormant accounts and calling on old leads can be a stability strategy to generate new business to replace lost customers. Postponing fee increases and improving work flow and efficient routing can also be important.

Employees often work longer and retire later during a downturn to compensate for the loss in their own investment portfolios. Retaining these senior members can present an opportunity for a business to benefit from their knowledge in mentoring junior employees or managing college interns. Leading the implementation of new software and upgrades can be another effective use of senior employees’ leadership and expertise. Area businesses may also benefit from the consulting expertise of senior staff.

Increased online work can be a cost-saving measure for employers. In fact, many tax returns are done offshore in India; such outsourcing can help shrink labor costs. Automating processes through technology is another way to save money and improve both worker efficiency and business processes. If businesses want to retain current local employees, telecommuting can be a perk, as well as a way to reduce variable overhead costs. Many accounting functions can be done from home, or anywhere that an employee has access to a secure computer.

Firms should increase their value to clients during tough times by becoming a strategic business partner that helps clients solve their financial problems. Successfully surviving the economic downturn is possible, as is creating new opportunities for the future. Some accounting firms believe that they have a responsibility to keep their employees employed, and this belief prompts them to create new lines of business. Keeping the employee pool intact ensures that the firm will not have to compete for talent once the recession ends. Firms—especially neighbor-
hood-based accounting practices—should also enhance their reputations within the community.

Proponents of an increased social consciousness in corporations present arguments that community involvement is a form of marketing—that is, building a relationship and reputation with the community and customers translates into increased profitability. One of the important aspects of a business’s responsibility is to make a profit; profitable businesses increase the value of a community and allow it to accomplish its other responsibilities, such as providing jobs and engaging in community service and leadership. In an economic downturn, accounting firms might have more difficulty fulfilling this responsibility, but it can be supplanted by exceptional performance in other areas: for example, the personnel and resources made available in the firm by reduced business demand can be assigned to improve the community and the economic environment by following a heightened external social responsibility strategy for the organization.

Developing unique expertise can also benefit a public accounting practice. If there is a business cluster or if the firm has a high concentration of clients in a particular industry, it should work to develop additional skills in this industry. Moreover, the firm should recruit competitors, suppliers, and even vendors and other entities in the industry’s supply chain as clients.

Some accounting firms have grown—or at least remained steady—in the slow economy as a result of recurring annual tax and audit work; even though clients are cautious about requesting additional services, assurance and tax services remain necessary. Firms could offer more value-added services for clients in order to dissuade them from trading down in an attempt to reduce costs; these added services would give customers a reason to remain loyal to the firm. Lastly, although hiring at accounting firms has been less aggressive than in the past, more firms are balancing employment needs and workloads by relying on college internships and part-time staff.

Strategies for Growth

Tough times precipitate dramatic challenges for all organizations, including accounting firms; however, there are opportunities to be seized. Although cost control and reductions are a normal first response, they are not always the appropriate one. Both public and corporate accounting organizations can provide valuable advice during times of economic hardship. Diversifying into new, related areas might be one option, along with serving smaller clients and repackaging fees for them.

In addition, rather than reducing staff, redeploying newly available staff to such development yields opportunities to create new lines of business that could become substantial sources of revenue even after the economy recovers. Hiring in carefully targeted areas of current or future strategic need is one growth option; even in times of high unemployment, it can take time to find the right employee with a specialized skill set. Another idea for growth, tailored for public accountants, is to include additional personnel in visits to job sites and in sales calls to potential customers. This can help a firm gain a better understanding of its customers, their needs, and the types of reports that would better serve users of accounting information.

Inevitably, the economy will rebound, so continuing to invest in the future is important. Companies should continue doing the things that made them successful in the first place, while acknowledging the mismatch between the timing of investments and the resulting cash flow improvements.

In the area of corporate and management accounting, most corporate operating departments need more information to manage during tough times. Accounting organizations need to be responsive to these requests. In addition, accounting organizations should be proactive in collaborating with operating departments to recognize user needs, identify costs, and work with other units and departments to come up with improvements.

Public accounting firms should use tough times as an opportunity to assist clients in dealing with costs. Unique corporate challenges, which clients might be unfamiliar with, present opportunities for consulting services. In addition, the lingering effects of the economy can present opportunities for employment related to accountability and compliance in many industries. Sometimes, organizations facing a downturn must trim their staffs to the bone in order to survive; however, much compliance work does not disappear, and staff with expertise in areas of annual reporting or other seasonal regulatory or compliance reporting can easily be deployed as temporary staff to complete special projects for clients like insurance companies, telecommunications firms, and healthcare organizations. Public accounting firms can even improve their bottom line by generating additional income.

Other types of consulting that could become lucrative revenue sources, both in the present and in the future, can be developed during a downturn and be ready to take off when the economy improves. For example, project management is a natural fit for many accountants. Certification in project management is available through the Project Management Institute (www.pmi.org). Searching the broader environment for regulatory changes can benefit public accounting firms.

While not related to the economy, the implementation of SOX provides a parallel. Requirements of the act include stronger internal controls and increased responsibilities of senior management for accuracy of corporate filings. Implementation of these new requirements was arduous and expensive for publicly traded companies; thus, public accounting firms experienced a tremendous increase in audit fees due to SOX requirements. The Patient Protection and Affordable Care Act of 2010 provided opportunities for additional fraud auditing and the implementation of medical records and billing systems (www.healthcare.gov). The Dodd-Frank Act of 2010 also provided opportunities for professionals with financial backgrounds.

Building Relationships

Developing and maintaining business relationships is an important part of public accounting firms’ success. Sometimes the pressures of getting the work done today can cause busy accountants to focus more on their current tasks than on developing new potential client relationships. A great time to pursue and nurture new business relationships is when business is slow. When the economy improves,
these relationships can result in new business. Thus, a firm that has focused on developing such new business during a downturn will be poised to rapidly grow revenues when the economy improves—and such a firm will do so more rapidly than competing firms that have cut staff to reduce costs.

Marketing is another overlooked area. In one CPA Journal article, Mary Kay Copeland outlines for CPAs management ideas related to marketing, advertising, and customer relationships that are relevant in growing a practice (“Marketing and Advertising for CPAs: Leading-Edge Strategies,” Aug. 2010, pp. 58–62). Marketing a practice can be accomplished by writing an accounting column for a local newspaper or business journal or by posting white papers about current topics on firm websites for added client benefit, as well as a potential way to attract new clients. Professional social networking sites, such as LinkedIn, are good avenues for accounting practices to establish a broader Internet presence. Conducting seminars for the business community is another suggestion. Firms can recruit new clients from current entrepreneurial businesses by speaking to small business development centers, business incubators, chamber of commerce groups, college business classes, and professional organizations. These activities can all increase professional visibility in the business community with little or no cost, and they are a good use of the time of senior managers and partners. Newsletters, sent either by postal mail or electronically, can help firms stay connected to clients and improve retention—and retaining current customers is always less expensive than soliciting new clients.

**Looking to the Future**

Developing new capabilities in the midst of a downturn can prove to be profitable in the long run. For example, forensic accounting has been growing despite—or perhaps as a result of—the current economy. The membership of the Association of Certified Fraud Examiners (ACFE) grew by almost 10% during 2010 and now includes nearly 55,000 members (2010 Report to Members, ACFE). According to ACFE’s 2010 Report to the Nation, fraud costs businesses collectively about 5% of their revenue. Despite SOX regulations and efforts by many agencies and organizations (e.g., the Government Accountability Office, the ACFE), fraud is not subsiding. A recession can contribute to an increase in fraud, and with business slow, staff members and partners would have time to train in a new specialty field. Forensic accounting could be a great new service opportunity for many firms. (More information regarding the ACFE and certification in this specialty can be found at www.acfe.com.) Although other firms might cut training during a weak economy, it can be a smart business move to be ready for the upswing.

The impending convergence of U.S. GAAP with IFRS provides another opportunity for firms. Developing expertise in the convergence area would enable a firm to provide consulting and training on the new standards to other firms and to corporate accounting departments. Not only can providing this training be a new source of revenue, but demonstrating expertise in teaching IFRS could be a productive business-development strategy. Clients could have time to implement new software, and accounting firms can help. Year-end reviews earlier in the fourth quarter might help clients (including S corporations) plan the timing of expenditures that have flow-through tax implications for owners. Some accounting firms are more involved with cash flow and budgeting issues. In some cases, the role of an accountant as a counselor has grown in importance, and firms are working with clients to develop ways to help their businesses.

Cost accounting is growing in importance as businesses work to determine their most profitable products lines, services, or customers, and accountants can assist in this analysis. Clients often need accounting firms and their services more than ever in periods of uncertainty, but accountants might have to initiate the call and spend more time in the field listening to clients before proposing new avenues of consulting.

Although tough economic times certainly are not appealing to anyone, including accounting organizations, the profession can play a major role in a weak and recovering economy, allowing it to not only survive, but thrive.

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Evaluating the AICPA’s CPA Horizons 2025

A “Road Map for the Future” or a More Socially Responsible Path?

By Richard H. Kravitz

In late November 2011, the AICPA released the results of CPA Horizons 2025: A Road Map for the Future, a strategic look into the next 15 years of the CPA profession that built on its 1998 Vision Project. With more than 5,600 CPAs participating through over 75,000 comments, in-person and online forums, focus groups, interactive surveys, and discussions led by a 21-member advisory body, the objective of this monumental study was to examine “the current and future relevance of our Core Purpose, Values, Competencies, and Services” over the next 15 years (http://www.aicpa.org/Research/CPAHorizons2025/DownloadableDocuments/cpa-horizons-report-web.pdf).

The report provided many positive and meaningful observations, recommendations on education and training, pride in the knowledge required to be a CPA, and pride in the CPA profession that builds on the Vision Project. It also defined the profession’s core purpose as “making sense of a changing and complex world,” which is relevant today and will remain relevant in the future.” The core values and competencies identified in the report are shown in Exhibit 1.

In the spirit of open dialogue and intellectual honesty as this 15-year journey begins, this author must say that, unfortunately, CPA Horizon 2025 failed to address the most fundamental issue facing CPAs today: our role in society and the changes that we will need to make in order to remain relevant in the future.

The CPA profession faced almost exactly the same issue 100 years ago, when George May assumed legendary leadership of the accounting profession as head of Price Waterhouse in 1911. Should we follow in May’s footsteps and in his “zeal to protect the public trust”? Should we take this on as our principal obligation, our responsibility to protect the public? As May put it: “...the high-minded accountant who undertakes to practice in this field assumes high ethical obligations. ... Of all the groups of professions ... there is none in which the practitioner is under a greater ethical obligation to persons who are not his immediate clients” (Twenty-five Years of Accounting Responsibility, 1911-1936, Price Waterhouse, 1936, p. 173). Should we employ accounting as a “social force” or continue the status quo and place client service over public service? (See Mike Brewster, Unaccountable: How the Accounting Profession Forfeited a Public Trust, Wiley, 2003, p. 98.)

Among investors, employees, shareholders, and the general public, the CPA brand is still the most trusted financial professional brand in America. But we are now at a crossroads. The question we need to ask is whether we should allow this franchise to be continually diluted by abdicating all responsibility over financial reporting and auditing practices to the federal government and those bodies authorized to carry out its statutory authority—the SEC, the Public Company Accounting Oversight Board (PCAOB), and FASB. Is there not something more that a CPA should embrace? Unfortunately, these critical, pivotal issues were not addressed in the AICPA’s CPA Horizons 2025 report.

The Economic Realities of Recession

CPA Horizons 2025 was issued against the backdrop of the current prolonged recession and the accompanying unprecedented wealth destruction; between 2004 and 2010, the median wealth of the average American declined by 8% (“Economic Downturn took a Detour at Capitol Hill,” New York Times, Dec. 27, 2011). Absent from the AICPA report is a discussion of the frequent revelations during the past four years of enterprise fraud, misstated or materially misrepresented financials, and an explosion of suspicious fraudulent activities. (According to the FBI, 1,700 pending corporate, securities, commodities, and investment fraud cases are under investigation, an increase of 37% since 2001 [http://www.fbi.gov/stats-services/publications/facts-and-figures-2010-2011/investigative-programs/]).

Bankruptcies, insolvencies, and forced mergers over the past four years have meant frequent disclosures about Federal National Mortgage Agency, Federal Home Loan Mortgage Corporation, and MF Global—not to mention American International Group (the largest corporate failure in history), Lehman Brothers, Bear Steams, Merrill Lynch, Washington Mutual (the largest bank failure in U.S. history), Countrywide Financial, Olympus, Westridge Capital, Sky Capital, and the disgraced financiers Bernie Madoff and Allen Stanford, and lawyer Marc Dreier.

The Financial Crisis Inquiry Report

In January 2011, Congress released The Financial Crisis Inquiry Report—an emotionally charged but formal response to the congressional investigation of the causes of the economic downturn. The report vilified the banking and financial service industry. It concluded: “The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. Theirs was a big miss, not a stumble. While the business cycle cannot be repealed, a crisis of this magnitude need not have occurred” (p. xvi, http://www.gov.pdf).[368x540]

But absent from this 600-page report was any reference to auditors, who have audited banks and financial service companies for almost 100 years, and are responsible for ensuring that the financial statements of the companies they audited were accurate, truthful, and presented fairly their operating results.

Socially Responsible Accounting

The question for the accounting profession—ignored by both the AICPA and the Financial Inquiry Commission Report—is: what is our responsibility as CPAs to act in the public interest and safeguard the public trust? Certainly, we owe our certificate to the public and our license to the state.
But as the most trusted advisors in the financial service industry, are we satisfied with our collective performance during these past four years? Are we not part of the chorus of discontent directed toward Wall Street over these abuses? Are we, as accounting professionals, unimpeachable? In 2009, Louis Grumet, former NYSSCPA executive director, asked, “When it comes to assigning blame, when do we stop looking elsewhere and start looking in the mirror?” (“Losing Our Moral and Ethical Compass,” The CPA Journal, May 2009, p. 7)

**The Expectations Gap: Is it Widening?**

Throughout the 20th century—and past the Millennium, driven by the scandals of Enron and WorldCom—government, the investment community, and the accounting industry debated the role and responsibility of the accounting firm in American society. Popularly termed the “expectations gap,” the profession continues to be burdened with this gap between what the public perceives as accountants’ role in society and what the profession perceives as its role in service to clients. Study after study defines and reaffirms this obligation:

We conducted our research over a decade after the release of the expectation gap SASs and also after the issuance of SAS No. 82 (AICPA 1997). Our findings indicate that an expectation gap exists; investors have higher expectations for various facets and/or assurances of the audit than do auditors in the following areas: disclosure, internal control, fraud, and illegal operations. We also find that investors expect auditors to act as “public watchdogs.” (John E. McEnroe and Stanley C. Martens, “Auditors’ and Investors’ Perceptions of the ‘Expectation Gap,’” Accounting Horizons, Dec. 1, 2001, pp. 345–358) In its simplest form, the public wants outside auditors and internal auditors to uncover fraud, and it wants CFOs not to bow under CEO pressure to commit it. CPA Horizons 2025 ignores this fundamental issue, our raison d’être; our unique value, and the contribution we make to postmodern capitalism:

CPAs need to be watchdogs of the public trust. As auditors and financial managers, our principal responsibility is to ensure that financial statements are not materially misleading or misstate the results of the profession, “no major fraud has ever been discovered by auditors … the reason why external auditors have a very poor record of uncovering fraud is that much of the auditors work and examination time is based on a faulty assumption that separation of duties within the corporation prevents fraud” (Seidler, as quoted in Forensic and Investigative Accounting, 4th ed., by D. Larry Crumbley, Lester E. Heitger, and G. Stevenson Smith, CCH, Aug. 2009). In fact, the “many disclosures of cooked books … proved Seidler correct” (Crumbley 2009).

The discussion in CPA Horizons 2025 focuses on outcomes; the expectations gap was not explicitly addressed, and one of the few times the subject is discussed is only to extend that “the profession must stay vigilant in defending its unique role as providers of audit and attest services” (p. 24). The issue, according to CPA Horizons 2025, appears to be one of self-protection rather than self-improvement.

**Growing Loss of Trust**

The growing loss of trust in our institutions has been chronicled in public surveys over the past four years. But the surveys within the accounting profession are even more interesting:

- Of 221 CFOs surveyed, 62% believed that they could intentionally misstate financial statements, representing a 10% increase over the prior year (Financial News Network, Smart Pros, Aug. 2011; Alan Rappeport, “Is the Auditor the CFO’s Fool?” CFO.com, Nov. 15, 2007, http://www.cfo.com/article.cfm/10131484/c_10132205?f=TodayInFinance111507).
- More than 83% of the chief financial officers in the same survey believed it was not possible for outside auditors to detect fraud in all cases (Financial News Network 2011; Rappeport 2007).
- In 72% of fraud cases occurring over a 10-year period, the CEO was implicated; and in 23% of the cases, the outside auditors were implicated (Mark Beasly, Joe Carcello, and Dana Hermanson, “Fraudulent Financial Reporting: 1998–2007,” Committee of Sponsoring Organizations of the Treadway Commission (COSO), May 2010, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf).
- A 25-year study by the Conference Board of accounting and auditing enforcement actions revealed that CFOs who were implicated in the action had an even bigger risk of litigation in accounting manipulation cases than CEOs, yet did not have

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**EXHIBIT 1**

**CPA Horizons 2025: Core Values and Competencies**

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<th>Core Values</th>
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<td>Integrity</td>
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<td>Competence</td>
<td>Leadership skills</td>
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<tr>
<td>Lifelong learning</td>
<td>Critical-thinking and problem-solving skills</td>
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<td>Objectivity</td>
<td>Anticipating and serving evolving needs</td>
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<td>Commitment to excellence</td>
<td>Synthesizing intelligence to insight</td>
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<td>Relevance in the global marketplace</td>
<td>integration and collaboration</td>
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Source: AICPA, CPA Horizons 2025: A Road Map for the Future, AICPA, 2011
the immediate personal financial benefits of cooking the books (Universal Conduct: An Ethics and Compliance Benchmarking Survey, September 2006).

CPAs had the most to lose and the least to gain. Whether it is the revelations of the Bernard Madoff scheme, recent investigations of feeder funds, the disclosure of $1.2 billion missing in custodial accounts at Jon Corzine’s MF Global, or the SEC’s new civil and criminal investigations of alleged massive fraud in bundling mortgage obligations at Fannie Mae and Freddie Mac (Franklin Yu, “Former Fannie CEO takes Leave Amid SEC Charges,” Epoch Times, Dec. 21, 2011), it is undeniable that over the past four years, clean audits were rendered on enterprises that subsequently became insolvent, that practically seized up the global financial markets, or that were forced to merge (Merrill Lynch, Countrywide) or liquidate (Lehman Brothers). We should be better than this.

**Who Will Fill the Leadership Gap?**

It is said that abuse invites regulation. What might shape the accounting profession over the next 15 years, absent the advocacy of the AICPA, is sobering. Politically motivated solutions are usually not optimal; they lead to political overreaction; punitive government oversight; and substandard, politically motivated regulation. Just look at the Sarbanes-Oxley Act (SOX) of 2002 and at the PCAOB—the world’s largest frauds were committed under their watch.

If current direction is an indicator of future direction, look no further than PCAOB Chairman James R. Doty’s presentation at an NYSSCPA conference; he highlighted the fundamental conflict between a company and its auditor, and noted that in its roughly 3,000 audits, the PCAOB found hundreds of flaws that “cut to the heart of an audit’s fundamental objective of obtaining reasonable assurance that a financial statement is free of material misstatement” (Chris Gaetano, “Doty Seeks Shift in the ‘Culture of the Audit,’” The Trusted Professional, Dec. 2011, p. 8).

Would CPAs prefer their profession to be “restructured” as a service provider to the federal government? Would they prefer to be paid by a government trust fund that would hire outside auditors to audit publicly traded enterprises under strict regulatory oversight? Or, as some have suggested, would CPAs prefer that professional liability insurers hire the outside auditors in an attempt to reduce their own liability? Would this improve financial reporting and transparency for the public, or would it be self-serving for insurers? Would insurance companies and risk managers establish audit procedures and processes in the same way that they do for medical procedures? Would CPAs accept the legitimacy of nonauditor, third-party administrators to determine the necessity of certain audit procedures and eligibility for subsequent reimbursement?

**Why Accountants Need to Step Up to the Plate**

The practical reality is that there are many more accountants and auditors than there are PCAOB inspectors and SEC staff. Regulatory staff number in the hundreds of thousands, but there might be nearly 1 million CPAs and Chartered Accountants in the world. Public accountants work year-round in the offices of the largest corporations in the world. While Lehman Brothers was on the brink of destruction, at least three of the Big Four were allegedly working in the firm, performing tax preparation work, advisory (consulting) services, and auditing services. Because of their industry footprint, CPAs constitute the largest body of independent observers of corporate behavior.

The services provided by public accounting firms to their clients are extensive. Ernst & Young, Lehman’s principal auditor that was recently charged with civil fraud, actually has a staff of 350 forensic accountants within the firm who “focus on fraud and investigations” (Jeff Stimpson, “Forensic Accounting: Exponential Growth,” Accounting Today, Feb. 1, 2007, p. 3). It also has a special advisory group in the financial services sector that handles financial risk management.

The SEC and similar state and governmental watchdogs lack not only the legal mandate to “live” in companies, but also the staff, depth, competency, organizational breadth, flexibility, and structural ability to provide this kind of coverage, which, when best employed, has the potential to preemptively uncover fraud before it gets out of hand and forces the entity to fail.

There are few alternatives. Seidler, one of the founding fathers of forensic accounting, remarked that:

- Internal auditors put disclaimers in their charts. Management looked to audit committees. Audit committees looked to independent auditors. Independent auditors looked to management. Were it not for the phenomenal amount of investment funds and jobs lost by innocent individuals, the whole business would remind one of the “who’s on first” classic comedy routine (Crumblly 2009).

The public accounting firm must therefore assume its role as a check-and-balance enterprise of the sort inherent in a democratic society in order to meet the needs of the public and to reduce the expectations gap. There are no other legitimate global institutions that can observe and or police corporate enterprise as effectively.

This author argues that now more than ever—in these politically, socially, and economically troubled times—CPAs, as the most trusted advisors and in conjunction with the profession’s most trusted institutions, must reassert their leadership, ethical guidance, and moral compass in order to protect the public interest and insures the public trust.

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Richard H. Kravitz, CPA, MBA, is a fellow of the American College of Forensic Examiners, and founding director of the Center for Socially Responsible Accounting. The above is adapted from Post Modern Capitalism: A Reassessment of the Institutions, Advisors, and Models in a Period of Unprecedented Wealth Destruction, slated to be published in 2012.
Five Steps to Grow Beyond the $5 Million Mark

Escaping the Black Hole of Business

By Greg Crabtree

A natural no-man’s land for privately owned businesses exists between $1 million and $5 million in annual revenues. But companies stuck in this “black hole of business” should be assured that there are reasons for this challenge. Moreover, there is hope for a successful escape, and the discussion below can act as a practical guide for businesses to grow beyond this zone.

Challenges for Business Owners

It is likely that a business owner who started a company from scratch not only managed all the functions of the business, but was its sole employee and executed all of its functions. As the owner learned to work “on” the business, rather than “in” the business, it climbed up to that symbolic $1 million in revenue and hit its first major transition point, where the owner most likely had to give up either sales (business development) or operations.

Most entrepreneurs are naturally gifted at either sales or operations, but rarely both. Those gifted in operational knowledge get stuck at $1 million because they have sold to all of the people they know or can easily contact; however, they are more likely to be profitable at this point. Those gifted in sales often blow through the $1 million mark as they make their way to the $5 million mark, but they will have likely depleted their funding resources—and they are also likely losing money while holding on to the belief that more sales will make them profitable.

Both entrepreneurial types need to begin by learning simple lessons: the operations-gifted entrepreneur needs to find a way to create sales, while the sales-gifted entrepreneur needs to get operations under control and exercise financial discipline (because not every sale is a good sale). The true challenge for both is recognizing that the $1 million sales mark is the first time in the business cycle when they must hire employees to create the business’s infrastructure without being able to easily afford it. This challenge is exacerbated because the owner has to truly delegate to this key hire. The newcomer might have experience, but the owner will still have a nagging thought: if new hires are so experienced, why were they available? If they show skill but have limited experience, the owner could be turning the business over to someone who might risk the owner’s reputation and limited capital.

Five Steps to Success

Step 1: drive to 15% pretax profit by the time the business reaches $1 million in revenue. It always sounds great to glorify the success stories of those entrepreneurs who threw caution to the wind, grew their business exponentially, and only then figured out how to fund it. Unfortunately, the stories of how many more businesses failed by growing fast and unprofitably often remain unheard. Unless an investor or buyer can figure out how to make a fast-growing business profitable, the company will be of no interest to them, and the owner will be left picking up the pieces of the business’s bankruptcy.

Step 2: include the owner’s market-based wages in calculations of profit. If a business gets to a 15% pretax net income, it is only real if the owner is receiving a market-based wage and is able to meet his living expenses off of net pay. This means that there are no distributions being taken out of the business, except for covering the taxes on business profits (assuming that the business is an S corporation or a limited liability company [LLC]).

Step 3: take no distributions of after-tax profits until the business has met its growth goal. The easiest way to measure this is for a business owner to build the company’s cash balance up to at least two months of operating expenses without drawing on lines of credit; this is referred to as the “core capital target.”

Step 4: build the business using the “salary cap” concept. Once a business has reached a 15% pretax profit, the owner can make the next key hire and allow the company’s profit to drop, but to no less than a 10% pretax profit. Then, the owner should hold salaries constant until the business once again reaches a 15% pretax profit. After this, the owner should add another one or two key hires and repeat the process. The owner might not be able to fund the business’s growth completely out of pocket, but the owner’s line of credit balance should generally remain less than 50% of accounts receivable during this process.

Step 5: manage the “cash reward” when growth levels off. Once the business has had a period of three to six months of level sales and has maintained 10%–15% profitability during this growth cycle, the owner will experience a great cash reward—because she will not have to reinvest her profits. It is critical for an owner to not become a “professional consumer” at this point and develop obligations (e.g., a new house with a big mortgage) or bad spending habits (e.g., exotic cars, vacation homes, recurring expensive vacations). It is all too easy to fall into the habit of spending the early fruits of one’s labor rather than stockpiling to weather the inevitable down cycle of the business market. That’s not to say that business owners shouldn’t enjoy their success, but they must remember that, too often, this enjoyment gets in the way of good judgment.

Opportunities

When the silently successful entrepreneurs do to tell their stories, it is revealed that more of them followed a path similar to the one outlined above—rather than those portrayed in flashy stories of high risk and high return. Both methods can work, but there are many more business casualties using a method of high growth without steady profitability. Advisors who become familiar with the steps described above can guide business owners in becoming better equipped to escape from the black hole of business into a new universe of possibilities.

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The Importance of Education in Building the Profession

I was pleased to read Joanne Barry’s publisher’s column, “A Pathway for Access to the Profession,” in the September issue of The CPA Journal. It dealt with the need to teach accounting at the high school level and at the advanced placement (AP) level, and I am a long-time supporter of that view.

I am a full-time instructor at Berkeley College, a proprietary business college in the metropolitan New York/New Jersey area. I usually teach the basics of accounting and business law, both to students who plan on majoring in accounting and to those who don’t, because knowledge in these areas is required for most business-related degrees.

From time to time, I have been given the opportunity to speak and work with high school administrators and faculty, with regard to the teaching of accounting in high school. My own personal observation is that the offering of accounting courses to some students should be “broadened” at the high school level through the mandatory teaching of at least one basic bookkeeping course to all students.

Currently, only the better-qualified students are typically given this opportunity, and only if they prefer to learn accounting, especially at the AP level. In her column, Barry discusses offering accounting as an AP course. Many students today need to develop a better command of English—both spoken and written—and math. Clearly, advanced students who seek to learn accounting already have such a command, but these students are in the minority. This knowledge of English and math is needed by the majority of today’s students—and requiring all students to take bookkeeping courses is one way to achieve this goal, regardless of whether a student plans on becoming a business major.

Perhaps this idea is not perfect, but it is based on my recollection of the time when standardized tests began to incorporate questions that dealt with graphs of varying degrees of complexity, therefore intertwining English comprehension and math comprehension. To learn bookkeeping is to learn basic English and basic math. Many of my better students have indicated that it was their introduction to bookkeeping—whether because it was offered in their high school or in a part-time job they held while they attended school—that led them to major in accounting.

Thoughts like those expressed in Barry’s column help to further develop the accounting profession, and I thank her for them.

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P.S.