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HOW ACCOUNTING FIRMS CAN HELP THE SMALL BUSINESS OWNER[1]

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ABSTRACT

This paper discusses the types of services that are offered by public accounting firms to the small business client. Some items to consider when choosing an accounting firm, or deciding which type of service would be most appropriate, are also examined. The changing market for the services of public accounting firms is addressed, along with how accounting firms are actively pursuing small businesses as clients.

INTRODUCTION

Until recently, large industrial companies were considered the engine for economic growth in the United States. Today, while many of the country's largest corporations are busy downsizing to improve their competitive advantage, small and mid-size companies are busy creating jobs--almost six million new jobs between 1987 and 1992 (Byrne, 1993). Business Week (Byrne, 1993) reported that, in 1993, "small business [was] expected to generate an additional 1.7 million jobs, while companies with 25,000 or more employees [would] shed 300,000 people" (p. 12).

A growing appreciation for the opportunities afforded by smaller companies has not eluded the attention of public accounting firms. Whereas in the past, accounting firms sometimes focused their marketing efforts on larger corporations, accounting firms today are actively pursuing small businesses as clients.

This article addresses three issues related to accounting firms and small business. First, the range of public accounting services available to the small business is discussed. Second, major factors to consider when choosing an individual accounting firm or specific services are reviewed. And finally, some of the issues in the consultant/client relationship are addressed. Previous research (e.g., Gobeli & Seville, 1989) has indicated that the relationship between an accounting firm (or any consultant) and a small business client should be an interface. That is, the small business owner must make the accounting firm aware of its goals and the services it needs. In turn, the accounting firm must strive to help the small business

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achieve these goals and ensure that the small business remains competitive. This idea is expanded throughout the article.

WHY DOES A SMALL BUSINESS NEED AN ACCOUNTING FIRM?

About two million new businesses are started each year in the United States. Of these, about 20% are one or two person operations (O'Reilly, 1994). Although studies of small business failure rates come up with somewhat different findings, all agree that the failure rate is very high (e.g., Versper, 1990; Phillips & Kirchhoff, 1988; O'Neil & Duker, 1986). A widely quoted rule of thumb is that about half of the new businesses formed each year will cease to exist in three years.

While a variety of reasons exist for business failures, "one important root cause is a lack of good management information--especially financial information" (Gobeli & Seville, 1991, p. 17). The importance of financial information was shown in a study of small business failures conducted by Gaskill, Van Auken, and Manning (1993). Specifically, 71% of small business owners discontinued their business due to financial difficulties, compared to 29% that discontinued for personal reasons (health, conflicts, retirement).

An important issue to many businesses, therefore, is how to obtain the financial information that would help them avoid being one of the casualties. With limited resources available to produce the quality information necessary to attain success, many small businesses turn to outside consultants for assistance. Often, small businesses rely on accounting firms to fill this role. In fact, over 40% of small business owners in a recent survey (Hock, 1993) listed accountants as their most trusted outside source for business advice.

Consulting or advisory services can be of great benefit to the small business--but only if understood and used appropriately. The role of, and services provided by, the public accounting firm should grow and change as the small business grows and changes. Initially, if the company is quite small, without a full-time controller and accounting personnel, the public accounting firm can be called upon to serve as business advisor or part-time controller, handling bank and other financing arrangements, giving input into management decisions, and providing projections (Person, 1993). It should be emphasized that while the accountant serves as a consultant, final decisions on all matters must be made by management. This initial consulting role can be very important to getting a new business off the ground. Dirsmith and Kunitake (1988) reported, for example, that in a study of 5,000 private companies, 69% of the chief operating officers (who often were the owners) had no financial or accounting background.

As the business grows and a full-time controller and accounting personnel are hired, the public accounting firm takes on a different role. More specifically, the accounting firm's role may involve a wide array of services and supports for the expanding small business.

Most large and many smaller accounting firms have developed separate components of their practices to serve smaller clients, with personnel specifically dedicated to meet the unique needs of small businesses. Much of the personnel's training is directed toward developing small business specialists with the understanding necessary to help the small business client in all facets of the business. Upon completion of training, these small business specialists are assigned to an area often referred to by the accounting firm as the Emerging Market, Mid-Market, or Middle Market Area whose purpose is to attract and provide services to small business clients.

PUBLIC ACCOUNTING SERVICES AVAILABLE TO SMALL BUSINESSES

In a survey designed to identify the major problems faced by small business owners, Franklin and Goodwin (1983) classified problem areas into three types: external factors, internal factors, and financial factors. Eight of the top ten major problems reported by small business owners were related to external factors: inflation, government regulations, costs, taxes. Several financial factors were also perceived by small business owners to be major problem areas: cash flow, operating capital, and debt collection problems. Important internal problem areas for small businesses included: employee motivation, personnel training, and fringe benefits packages.

Gobeli and Seville (1989), in an examination of the interface between small businesses and CPAs, asked small business owners/managers what services they needed from accounting firms. Nearly 100% of the respondents stated they needed help with tax returns. Ninety percent wanted tax planning services while 85% wanted help with the preparation of financial statements. Seventy-five percent wanted financial planning services.

The following sections discuss specific accounting services that can help the small business owner address many of these problem areas. The discussion is based on input from (as well as marketing information provided by) national, regional, and local accounting firms, in addition to a review of previous studies dealing with accounting firms and small businesses. Potential issues that may impact the consultant/client relationship are presented in a later section.

Accounting and Auditing Services

Table 1 lists some of the common accounting and auditing services provided by public accounting firms. The service area that has traditionally provided the foundation for a relationship between the accounting firm and the small business owner relates to the company's financial statements. It is often a request for financial statements by a bank or other lender that prompts a small business to first seek the services of an accounting firm.

There are three levels of financial statement related services: audit, review, and compilation. It is important for the small business client to understand the differences between the three types of service as well as some of the factors that should be considered in deciding what level of service is most appropriate in the circumstances. Choosing an inappropriate level of service can be a costly lesson for the small business owner.

An **audit** represents the highest level of service. Only an independent (not associated with the business) Certified Public Accountant can audit financial statement and issue an opinion on them. An audit involves the auditors collecting sufficient evidence to support their opinion that the financial statements are fairly presented (free of material misstatements) and follow generally accepted accounting principles. The end product of an audit is the independent auditor's report that states what the auditors did and the conclusion they reached. Although it is sometimes assumed by the general public, an audit does <u>not</u> guarantee or certify 100% accuracy of the financial statements. Moreover, an audit's major purpose is not to detect fraud, although the auditor is required to plan the audit in such a manner as to assess the possibility of material fraud.

Table 1

<u>Auditing & Accounting Services</u>

Audits
Reviews & Compilations
Assistance With Accounting Functions
Development Of Accounting & Control Systems
Specialized Internal Audits
Regulatory Requirements Compliance & Tax Planning
Implementation Of Accounting Systems
General Ledger Preparation
Personnel Training In Accounting Or Bookkeeping
Depreciation & Amortization Schedules
Bank Reconciliations
Payroll Preparation

An audit of its financial statements can be a time consuming and expensive undertaking for a small business. However, an audit may not be required. In many cases a creditor or lender will be satisfied with a lower level of financial statement related service. Two other levels of service, a compilation or a review, are designed for smaller, nonpublic companies.

A review of financial statements involves procedures which are substantially less in scope than those required for an audit, but more extensive than those required for a compilation. The accountant must understand the client's business and nature of its transactions. In addition, a review involves making inquiries of management and performing analytical procedures to determine if anything in the financial statements looks "out of line." The review report gives what is known as "negative assurance"--stating that nothing came to the accountant's attention which would indicate that any material modifications should be made to the statements for them to conform with generally accepted accounting principles.

A **compilation** simply involves an accounting firm presenting the client's financial information in financial statement form. In a compilation report, the accounting firm does not express any opinion or assurance on the financial statements. The accountant should understand the client's business and nature of its transactions and should be alert for (and follow through on) any obvious omissions or errors.

As a general rule of thumb, public accounting firms estimate that a review takes about half the time of an audit, and a compilation takes about a third the time of an audit (Dirsmith & Kunitake, 1988). If the small business can get by with a level of service below a full audit, it is certainly cost beneficial to do so. However, the small business owner should consult with prospective lenders before contracting for compilation or review services to verify these services will be adequate.

Dirsmith and Kunitake (1988) asked sixteen commercial bank lending officers to report on the level of "comfort" they derived from each of these three levels of service. Using a scale of 1 to 10 (with 10 being the highest comfort), the average score was 4.0 for compiled statements, 6.3 for reviewed statements, and 9.5 for audits. So, the requirements of users of the financial statements will tend to dictate the required level of assurance preferred. Often a new business is small enough that a lender or other user is satisfied with compiled financial statements, but as the business grows, reviewed and then audited statements will be required. The reason for this is that as the business grows, its records and internal controls become more complex, and its investment in inventories and plant assets becomes more substantial, such that a more thorough examination (such as an audit) of the company is necessary.

There are three other considerations in regard to the audit: (1) auditors assume the most legal liability for audited financial statements, (2) in addition to the audit report, auditors will provide a management letter, which makes suggestions for improvements, and (3) audited financial statements for the prior three years are required if the company decides to go public.

In addition to the preceding services, a small business may use an accounting firm to review its internal control procedures and help it to implement or revise its accounting system. As small companies grow, it is not uncommon for them to outgrow their accounting system or their system of internal control. While auditors assess a client's internal control structure as part of the audit, the emphasis of this assessment is on risk and on how the system will impact the type of evidence that will be gathered, and when it will be gathered. Small businesses therefore often find it helpful to engage the accounting firm to report specifically on their internal control structures from time to time. Here, the accountants will test and evaluate the whole system and offer suggestions for improvement.

It is quite common for a new small business to contract with an accounting firm to keep its books and prepare its financial statements. Nearly all accounting firms, regardless of size, have service divisions that will prepare payroll, reconcile the bank statements, prepare and post general ledger entries, as well as prepare the financial statements for the company. In this way, a small business can avoid the cost of establishing an accounting department and help ensure that it will meet the filing deadlines of state and federal regulatory bodies.

Tax Services

Today, most small businesses employ accounting firms to help them with preparation of their federal, state, and local tax returns. This assistance can range from answering specific questions on a complex tax issue to the actual preparation of the tax return itself. Table 2 summarizes some popular tax-related services offered by accounting firms.

Table 2

Tax Services

Preparation Of Federal & State Income Tax Returns
Family & Estate Tax Planning
Comprehensive Business Tax Planning
Compensation & Retirement Tax Planning
Acquisition & Disposition Tax Planning
IRS Ruling Requests
Compliance Assistance
Flexible Spending Cafeteria Plans
Deferred Compensation Plans

Family and estate tax planning is an important area in which small businesses should seek tax advice from their accounting firm, tax attorney, insurance agent, or banker, for the vast majority of small businesses are partnerships or closely held corporations. In fact, 90% of all U.S. businesses are family controlled (Francis, 1993). In these cases, the death of an owner of the business can result in an immediate and often massive tax liability to the estate. Therefore, business owners should ensure they have minimized their estate's future tax liability when the business is organized. Periodic reviews and updates of these tax plans should be undertaken to reflect changes in the tax codes.

Accounting firms also can help the small business owner in the area of employee compensation. As tax laws become more complex and tax rates increase, proper compensation plans for employees can mean tax savings for both the employee and employer. Many accounting firms can help a small business establish its own 401(k) or similar retirement plan. One tax service area in which many firms offer help to small businesses is in establishing flexible cafeteria plans for their employees. These plans provide employees more flexibility in deciding how their tax-free income is spent. Small businesses often use accounting firms for comprehensive tax planning for the business itself as well as for its top executives. Accounting firms can assist in all aspects of compliance assistance, as well as preparing Ruling Requests from the Internal Revenue Service, in which the small business requests the IRS's opinion on the tax implications of a prospective transaction.

Management Advisory Services

The service area that has provided the greatest growth for accounting firms in recent years is management advisory services (MAS). Many of the more popular services offered are listed in Table 3. Today, most accounting firms provide a wide variety of MAS services to small businesses. These small business services normally fall into four categories: (1) information and technology consulting, (2) financial consulting, (3) operational and productivity consulting, and (4) human resource consulting.

The MAS area that has been demanded most consistently by small business in recent years has involved information and technology issues. Thousands of small businesses have relied on accounting firms to assess the adequacy of their present computer systems and/or to recommend a new one. In addition, accounting firms often install and activate these computer systems.

Accounting firms are very involved with small businesses in hardware and software selection. Several firms have developed their own specialized payroll or accounting packages that they make available to smaller businesses. Moreover, many firms conduct on-site personnel training programs for small businesses on the use of computers and software.

Small businesses that employ accounting firms traditionally have used these firms to help them develop long-range financial forecasts. As these businesses increase in size, accounting firms often are employed to develop a pension and/or profit sharing plan for them. A growing service area that several firms provide involves helping small businesses identify sources of financing. Accounting firms can provide the initial contact with banks or investment companies that are potential sources of capital. Furthermore, they can help small businesses put together a business plan (including financial statements and growth forecasts) to present to potential lenders.

Along with management consulting firms, many accounting firms furnish consulting services related to the production phase of the business. They are hired by smaller businesses to conduct production and efficiency studies of their operations. Often, these firms are involved in developing and implementing an appropriate cost accounting system for a specific production process. And as computers become crucial to the production process, accounting firms can analyze and recommend appropriate equipment for computer assisted manufacturing.

Table 3

<u>Management Advisory Services</u>

Information & Technology Consulting

- Microcomputers & Networking
- Management Information Systems
- Hardware & Software Selection
- Implementation Of Computer System
- Personnel Training On Computers & Software
- Analysis Of Computer & Information Systems

Financial Consulting

- Identification Of Sources Of Capital
- Financial Forecasts & Budgeting
- Cash Management
- Credit & Collection Policies
- Pension & Profit Sharing Plans
- Appraisals & Valuations
- Investment & Risk Management
- Bankruptcy & Troubled Company Assistance

Operational & Productivity Consulting

- Production & Inventory Control
- Production & Efficiency Studies
- Cost Accounting Systems
- Marketing & Distribution Plans
- Computer Assisted Manufacturing
- Productivity Improvement Plans
- Implementation Of Production Processes

Human Resource Consulting

- Organization Planning & Analysis
- Management Development
- Executive Search & Staffing Assistance
- Personnel Policies
- Succession & Strategic Planning
- Compensation Programs
- Performance Evaluations
- Organization Efficiencies Studies

Of the four MAS areas, the one in which businesses may be the most reluctant to utilize accounting firms is human resource management. Business owners tend to think of accounting firms as providers of numbers or technical support. However, over the last few years, many accounting firms have developed an array of human resource services they can provide to the small business. Today, businesses rely on accounting firms to find needed personnel for their company, especially when technical expertise is required.[2] Other small businesses rely on accounting firms to establish training and performance evaluation programs for their employees.

THE RELATIONSHIP BETWEEN ACCOUNTING FIRMS AND SMALL BUSINESS CLIENTS

Accounting firms are only one of many sources available to help the small business owner. Accounting firms can provide a strategic benefit, however, in the array of services provided. Specifically, if the accounting firm helps the small business develop an effective accounting system, that firm is probably in a better position--through its knowledge of the client's financial information needs--to expand into other areas, such as tax planning and the implementation of a new computer system. Accounting firms often employ personnel other than accountants (EDP specialists, tax attorneys, etc.) to provide the breadth of talent necessary for service beyond traditional accounting. Strategic use of accounting firms, as with any consultants, involves the small business owner taking an active part in communicating his or her needs, and in providing inputs into the decision at hand as well as feedback to the consultant.

Accounting firms have been consistently ranked by small businesses as their most frequently used external consultant (Fields, 1993; Smeltzer, Van Hook, & Hutt, 1991; Arnold, Cherry, Diamond, & Walker, 1984) and often cited as their most trusted advisor (Hock, 1993; Fields, 1993). Recently, however, there have been some major criticisms leveled at the service provided to small business by accounting firms, especially the Big Six firms. In a widely cited front page article in The Wall Street Journal, Berton (1994) reported that an increasing number of smaller clients were complaining about the decline in the level of service they were receiving from the Big Six accounting firms. Many of these businesses were turning to non Big Six firms for their accounting needs. Among the complaints were rising accounting fees, frequent turnover among the accounting personnel assigned to work with them, and a belief that the major accounting firms were concentrating on their larger clients at their expense. Moreover, in a 1994 study of the responsiveness of major industries (e.g., airlines, banks, telecommunications) to the needs of small business, accounting firms ranked ninth among the twelve industries surveyed ("Big Firms," 1994).

What seems to be called for is an appreciation of the appropriate "fit" between the accounting firm and the small business client. The responsiveness of accounting firms as well

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[2] It should be noted that a CPA firm is required to refrain from performing the following MAS for its SEC audit clients: executive recruitment, psychological testing, public opinion polls, merger and acquisition assistance for a finder's fee and actuarial services to insurance companies. Similarly, a CPA firm cannot provide bookkeeping services and conduct an audit for the same SEC client.

as the quality and mix of services they provide varies. As with any commodity or service, the business owner needs to shop around to find the accounting firm that supplies the mix of services and personnel that most directly matches the need of his or her small business. There are over 45,000 accounting firms and sole practitioners in the United States (AICPA, 1994), so some general guidelines to narrow the search are provided.

FACTORS TO CONSIDER IN SELECTING AN ACCOUNTING FIRM

There are different sizes of accounting firms: Big Six, national, large regional, small regional, as well as local firms and sole practitioners. The Big Six firms (Ernst & Young; Deloitte & Touche; KPMG Peat Marwick; Arthur Andersen; Price Waterhouse; and Coopers & Lybrand) are international firms who count their revenues in the billions. National firms have offices in most major cities throughout the United States. Large regional firms have offices in major cities in several states. Small regional and local firms have one or a few offices employing relatively few professionals.

There are several factors to consider before deciding whether to go with a large or a small accounting firm. First of all, the smaller firm will tend to charge lower fees. For example, Accounting Today (Fraser, 1991b), reported a 1990 survey which indicated that the average hourly billing rates for partners were as follows: $235 for Big Six, $202 for national, $150 for large regional, and $142 and $117 for medium and small local, respectively. Remember, these are estimated billing rates for partners. Most accounting services are handled by non partners, so actual billing rates usually are lower.

While smaller firms may have a lower fee structure, they sometimes may not be able to provide the full range of services required by the small business. Many smaller accounting firms have established management advisory services fairly recently, and some firms do not have the personnel (or want to take on the potential legal liability) required for conducting financial statement audits. Some of the very small accounting firms may, therefore, restrict the services they offer to tax and bookkeeping services.

The American Institute of CPA's (AICPA) has developed an MAS data base, which provides smaller accounting firms the opportunity to exchange management consulting information and services. This may help bridge the gap between the range of services offered by small and large accounting firms. Also, some smaller firms are actively specializing in restricted services (i.e., carving out a "niche" that gives them a competitive advantage with certain types of clients or certain types of services).

Some small businesses prefer a smaller accounting firm because of perceptions of more personalized service. As previously mentioned, there have been instances where small business clients felt that increased competition among the Big Six firms had resulted in a decline in the level of service provided (Berton, 1994). Overall, however, these major firms have made a concerted effort to overcome perceptions that they pay less attention to their small clients. Moreover, many large firms have focused their marketing strategy on the concept of personalized service and ready access to personnel at the partner level.

Some small businesses like to start out with a smaller accounting firm, where they feel more valued, and then change to a larger firm when they need a more comprehensive array of services. Others feel that changing accounting firms as they grow is not cost beneficial because of the "start-up costs" of bringing new accountants up to speed in familiarizing them with their business.

In addition to size considerations, it is very important that the small business owner use an accounting firm that is knowledgeable in his or her industry. In a survey of more than 500 owner/managers, Arnold et al. (1984) found that the expertise of the accounting firm was cited by the owners as the most important factor in their selection of an accounting firm. Word-of-mouth references from members of the business community, especially those in the same industry, are an important method of locating high-quality firms with specific industry expertise. Local bankers and attorneys are also good sources for recommendations.

After the search has been narrowed to about a half a dozen possibilities, written proposals and in-person interviews should be requested from each firm before a decision is made. Six important issues to ask about are:

1. Qualifications of those who will be providing services

Most firms are willing to supply resumes of the partner and manager level personnel that will be providing services. These individuals should give some indication of their availability to answer questions throughout the year and how much time they will be spending, personally, on the specific engagement (having a well qualified partner in charge of your audit, for example, is of little value to you, if you rarely see that individual).

2. Types of support services available

The availability of support services is an important issue if you are considering going with a smaller accounting firm. It is helpful to try and project the types of services you think you might need over the next five years, and then make sure that you can obtain those services from the firm you are considering. Small businesses sometimes engage a firm initially to maintain their books and prepare periodic financial statements. However, it is not too long before they find they also need help with tax planning or assistance with a computer system analysis. If the accounting firm does not offer this variety of services, the company will need to consider changing firms or plan to work with different firms, which may not always be the most efficient alternative. However, some small businesses prefer to use two or more firms, with one accounting firm responsible for one area (e.g., the audit) and another firm responsible for another area (e.g., MAS).

3. Result of most recent peer review

The AICPA has established a Quality Review Program to monitor adherence to professional standards regarding audits, compilations, and reviews. In order to be a member of AICPA and practice public accounting, an individual must practice in a firm that is enrolled in this Quality Review Program. An accounting firm should be willing to disclose when their last peer review was performed, who the peer firm was, and whether the report of the review team was unqualified, qualified, or adverse. If the firm is not willing to share this information, it might indicate some problems with their procedures for assuring quality and adherence to professional standards.

4. Prior or pending legal actions

The popular and business press has done an excellent job at keeping the country informed about the liability crisis that is faced by public accounting firms. A record number of lawsuits have been filed, and many are still pending. Michael Knight in Inc. magazine (Fraser, 1991a), recommended that the small business owner should be sensitive to the financial viability of an accounting firm before entering into what is expected to be a long-term relationship. He suggests asking if the firm has ever been sued and what the outcome was and if there are any outstanding legal claims against the firm (especially any dealing with malpractice).

5. References

Ask the accounting firm for the names of some of their clients whom they consider comparable to you--especially the names of firms in your industry. Contact those references and ask about their satisfaction with the services they have received. Although all information provided to an accountant is confidential, a few businesses choose not to be audited by an accounting firm who audits a competitor.

6. Fees

It is important to get a good understanding of the fee structure of the firms that are under consideration. This avoids unpleasant surprises later. Ask for a detailed breakdown of the estimated hours and billing rates for the personnel that will be performing the required service. Pay particular attention to the amount of time that the accounting firm includes for partner and management level personnel. Inquire about other items that will be included in the fee structure, like the accountants' travel time, telephone expenses, and charges for advising and consultation throughout the year.

As mentioned previously, choosing an accounting firm, like many other business decisions, tends to come down to a "fit" of the personalities involved. The relationship between the small business and the accounting firm is most beneficial to both if the parties feel comfortable with one another.

Many small business owners recommend including key management personnel in the selection process (Fraser, 1991b). These are the people that will often be working most closely with the accountants. They will feel more comfortable, and be more cooperative, if they feel they had input into the decision.

CONCLUDING COMMENTS

Over the last half century, potential services offered by accounting firms to help the small businesses have expanded dramatically. From once offering only accounting and tax services, accounting firms now provide a full complement of management and financial services to small businesses. However, accounting firms are only one of several outside sources available to help small business owners. Other sources include: small business development centers, small business institutes, consulting firms, individual consultants, bankers, attorneys, stock brokerage firms, software specialists, insurance agencies, and college faculty members. Each of these outside resources offers a different mix of expertise that can give the small business owner a greater chance of success during the critical early years of operation.

Whichever type is preferred, it is important to engage the consultant before major problems arise. Quite often, small business owners feel they cannot afford an outside consultant in the early stages of their business. However, it is in the early years that failure is most likely to occur. Hiring someone after financial problems have developed is often too late. The good news is that as accounting firms and other consultants have focused on the small business client, the market has become significantly more competitive--which, hopefully, will drive down the cost of services.

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