

CPA INCORPORATION—WHY NOT?

LeRoy J. Neider*

Francis Budd Tims**

The purpose of this article is to explore the incorporation potential for certified public accountants in public practice. Most state laws do not provide for their incorporation, either directly by name or indirectly through rules and regulations of the various state boards of accountancy. The code of professional ethics of the American Institute of Certified Public Accounts (AICPA) currently prohibits incorporation,¹ as do the rules of professional conduct of most state accounting societies. The recent overwhelming trend of various state legislative enactments permitting certain professionals, primarily lawyers and physicians, to incorporate and the collapse of opposition² to these types of corporations by the Internal Revenue Service creates a favorable climate for such permissive legislation involving CPA's.

The traditional professional opposition to incorporation is now changing. Certain professional occupations—lawyers and doctors—are now marching in time with the rest of society and are “finding better ways” to reduce their personal income taxes. The Internal Revenue Code of 1954 has allowed “better tax benefits” to an economic entity in the corporate form than one in the partnership or proprietorship form.³ The difficulty was, however, that many professions (attorneys, doctors, and CPA's) could not heretofore incorporate because of either an enforced code of professional ethics or state law prohibition.⁴ The lawyers and doctors found a better way—they changed the state laws and their codes of professional ethics. Over one-half of the states now, by statute, have enacted

* B.S. 1960, University of Idaho; LL.B. 1965, Stanford University; Certified Public Accountant in California and Idaho; Member, American Institute of Certified Public Accountants, California Society of Certified Public Accountants, California State Bar.

** B.S. 1950, University of California, Berkeley; Certified Public Accountant in California; Member, American Institute of Certified Public Accountants, California Society of Certified Public Accountants, Professor of Accounting at the Menlo School of Business Administration. The opinions and conclusions expressed in the article are solely those of the authors.

¹ AICPA CODE OF PROFESSIONAL ETHICS, RULE 4.06 (1965).

² IRS TECHNICAL INFORMATION RELEASE No. 1019 (Aug. 8, 1969).

³ The case that gave impetus for incorporation is *United States v. Kinter*, 216 F.2d 418 (9th Cir. 1954).

⁴ AICPA CODE OF PROFESSIONAL ETHICS, RULE 4.06 (1965).

some type of professional incorporation statute.⁵ Yet, in California and other states, CPA's were not included within these statutes. Undoubtedly, there are far more than just tax consequences that follow from allowing a professional to incorporate. In the authors' opinion, the major drive for incorporation is primarily to achieve tax benefits. This drive, of course, is very difficult if not impossible to document. We are not so concerned with the tax ramifications of incorporation since this area is well explored, but rather to analyze from a professional viewpoint, the rationale of professional incorporation. Thus, the scope of this article will center on whether or not there is a rational, professional, non-tax justification for the incorporation of CPA's.

THE ANATOMY OF THE CPA PROFESSION

Just as there is more than one way to analyze any problem, there is more than one way to analyze a profession. Our analysis of the profession will encompass the two viewpoints we think most important relating to the question of incorporation. One is the *purpose a CPA firm fulfills* and the other is the *purpose of the CPA certificate*.

Traditionally, the primary purpose of a CPA firm was to audit the books and records of a business concern and then to express an opinion on the examination. The people who need and rely most upon this audit and opinion are creditors and stockholders of the business concern.

CPA's in public practice operate as entities in a very confidential manner, and little is known about their internal modus operandi. They are emerging as a profession in mixed subject areas. Their traditional role is as auditors of financial statements. Other major areas of responsibility include taxation and business advisory services. Their role in the economic society is both unique and common. As auditors they form the single professional authoritative body; as tax and business advisors they do not claim this uniqueness. There are no professionally licensed tax advisors or management consultants.

CPA firms operate either individually or as partnerships. They hire both CPA and non-CPA professional and clerical staffs. Professionals such as lawyers, psychologists, educators and engineers, are often employed to assist the CPA. The firms operate intrastate,

⁵ Ray, *Outlook for Professional Corporations and Associations*, 44 TAXES 464 (1966).

interstate and internationally. American firms are either local, regional, semi-national, or national. While few in number, the national CPA firms are very large. One writer estimated in 1966 that the largest firm had 345 partners, \$100 million in gross billings and over 6,000 employees.⁶ Opinions or certificates are the product of the firm and are so indicated. Many individuals, licensed and non-licensed, assist in the completion of audits and the result is the firm's product. Due to differences in competence of participants, in territorial scope, in relative firm size, and in professional responsibility, incorporation may require different criteria than are presently contemplated.

Since the end of World War II, there has been a voluminous growth of federal and state tax statutes, federal and state blue-sky laws and regulations, local government tax ordinances, federal and state employer-employee statutes, and consolidations, mergers and reorganizations of businesses. The CPA has played a vital and front line role in administering and interpreting this growth of business regulation. Therefore, the scope of his professional responsibility has expanded from that of primarily an auditor to one of an auditor, tax counselor, informal controller and business consultant. For any particular business concern, the CPA firm now might audit the books and records, prepare the various tax returns, issue letters of opinion on the tax and financial consequences of a pending transaction, review the accounting system, evaluate business opportunities, help resolve internal financial problems and assist in the preparation of the budget. Management relies as much upon the CPA as do the creditor and stockholder.

Do any of these functions prohibit the CPA firm from incorporating? Should they? The answer would seem to be—it depends on whether or not the fact of incorporation would materially alter these functions or reduce the reliance that these same creditors, stockholders and managements can place in the "CPA Corporation."

The AICPA and the accounting profession as a whole have placed a great deal of emphasis upon the auditor being "independent" when he conducts his audit.⁷ The AICPA has stated that "independence is not susceptible of precise definition, but is an expression of the *professional integrity* of the individual."⁸ Just as lawyers and physicians have maintained their professional integrity in the corporate form, we see no reason why CPA's cannot do the same. For example, the creditors, stockholders and management of Zip-Top

⁶ Wise, *The Very Private World of Peat, Marwick, Mitchell*, FORTUNE MAGAZINE, July 1, 1966, at 88, 89.

⁷ AICPA CODE OF PROFESSIONAL ETHICS, RULE 1.01 (1965).

⁸ *Id.*

Corporation *assume* the utmost professional integrity in Able, Baker and Conway CPA's, the auditors of Zip-Top. We think that these same creditors, stockholders and management should still be able to assume the same professional integrity in Able, Baker and Conway CPA's, Inc.

Professional integrity is, on the part of the CPA, an attitude of the mind and heart; on the part of the creditors, stockholders and management, a feeling of confidence and trust in the work performed. This is in a large part a personal relationship. This personal relationship should exist just as much and just as professionally with the officers of Able, Baker and Conway CPA's, Inc. as it would with the partners of Able, Baker and Conway CPA's.

Nor do we think that the auditor's independence would be impaired by incorporation of the firm. The AICPA has correctly said that "independence is an attitude of mind, much deeper than the surface display of visible standards."⁹ Able, Baker and Conway are just as capable and should be expected to display just as much of an attitude of independence as *officers* of their professional corporation as they were capable of and did display as *partners*. These questions of independence and professional integrity are matters of substance and mind and not of legal form.

The situation is not so clear in other areas that fall within the professional practice of public accounting. In the broadening scope of public accountancy, services are being performed which do not require licensing. The business community decides who is best qualified and whose services are sought. In the area of management services CPA firms are advising on plant layout and location, statistical quality control, public relations, pricing determination, personnel training, and 25 other areas unrelated to 24 areas which have been identified, and which are traditionally considered to be accounting related.¹⁰ CPA's are not suggesting that they are the only qualified professionals in these business oriented but not necessarily accounting oriented areas. They do say that the public practice of accounting can and does encompass these areas; hence the dilemma. Can a licensed professional CPA firm be said to be performing professional services, other than auditing, which include many functions performed by others equally qualified who are not licensed CPA's? Or, since the legislation is permissive, does this mean that the CPA's articles of incorporation will be revoked if its services are not limited strictly to auditing?

⁹ AICPA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 12 (1965).

¹⁰ R. Roy & J. MacNeill, HORIZONS FOR A PROFESSION, 150-52 (1967).

With respect to these other functions, we see no impairment of the CPA's integrity. Throughout the nation there are numerous professional and nonprofessional *incorporated* concerns rendering tax, business and financial services and advice. The authors are not aware of any statistics or publications that have stated or concluded that such concerns, because they are incorporated, are any less competent, less professionally minded or lacking in professional integrity. Again, the important point is the quality and character of the individual CPA, and not the legal form he chooses in rendering his services.

While CPA firms do present their opinions or certificates under a firm license granted by the state, the staff members who prepare the opinion or certificate are not always licensed CPA's. In fact, in the larger firms, about 50% of the professionals preparing these reports are not CPA's.¹¹ When a lawyer renders an opinion or tries a case he may have secretarial and research assistance. A surgeon operates, and in so doing may utilize the assistance of one or more paramedical skills. Here, however, one is not considering secretaries to the attorney or nurses to the surgeon; rather, the CPA employs predominantly college graduates who have an undergraduate major in accounting, yet have not been licensed. The rendering of certain professional services by non-licensed staff, *does* create a problem.

Today we have extensive legislation regulating many occupations. For example, the California Business and Professions Code regulates outdoor advertising,¹² the size and weight of a standard bread loaf,¹³ the licensing of bedding renovators,¹⁴ antifreeze used in automobiles¹⁵ and a number of other products as well as professional callings.

The entire thrust of this regulation seems to legislate a *minimum* standard of quality or competence; so also with the statutes and regulations dealing with CPA's.¹⁶ Minimum educational¹⁷ and experience requirements¹⁸ are a prerequisite before a person can be titled a "Certified Public Accountant."

All states granting the certificate to the individual require the passing of a comprehensive written examination,¹⁹ and most also

¹¹ *Id.* at 150.

¹² CAL. BUS. & PROF. CODE §§ 5200 *et seq.* (West 1962).

¹³ *Id.* §§ 19800 *et seq.*

¹⁴ *Id.* §§ 19000 *et. seq.*

¹⁵ *Id.* § 21700.

¹⁶ *Id.* §§ 5000 *et. seq.*

¹⁷ *Id.* §§ 5081 *et. seq.*

¹⁸ *Id.* § 5083; 16 CAL. ADM. CODE § 11.5.

¹⁹ U.S. ARMY AUDIT AGENCY, PROVISIONS IN CPA LAWS AND REGULATIONS, 30-50 (rev. July 1, 1968).

require experience as a condition to the issuance of the license.²⁰ Illinois grants a certificate as a CPA, but precludes the certificate holder from public practice until he has spent a certain minimum time gaining experience.²¹ The experience requirement has been reduced to a relatively short period of time and may eventually, we feel, be eliminated. In short, it appears that the purpose of this voluminous legislation is to require that CPA's attain a minimum standard of educational competency in accounting and related fields.

Does this primary purpose of the CPA certificate prohibit the CPA firm from incorporating? Should it? Again, the answer would seem to be—it depends on whether or not the *fact of incorporation* would materially alter this purpose.

A frequently quoted definition of a corporation is the one by Chief Justice Marshall. "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of the law."²² If this definition is accurate, which we believe it to be, then it seems the best method to insure a minimum standard of quality and competence is to certify the accountants who will be doing the accounting work. Equally important, we should insist that only accountants are in control of the corporation and that each of these accountants be certified. In short (to fulfill the purpose of the CPA certificate) it seems desirable to establish a chain of competency and responsibility starting with CPA's in control of the corporation down to CPA's performing the actual work.

Although the California Business and Professions Code states that a person must complete some "public accounting experience,"²³ the California Legislature left the matter of "establishing the character and variety of experience necessary to fulfill the experience requirements" to the State Board of Accountancy.²⁴ The Board requires that the experience relate almost exclusively to the field of auditing and financial statement preparation.²⁵ In large part, there is no experience necessary in the fields of tax matters, controllership duties, accounting systems evaluations and budget preparation, to mention a few. Very possibly, these fields are ones which should not lie within the exclusive domain of the CPA profession because they are of a somewhat specialized nature apart from the mere rendering

²⁰ *Id.* at 5-37. States which do not require experience or substitute formal qualifying education include, Colorado, Florida, Illinois, Maryland, Montana, North Dakota, Oklahoma, Oregon, Vermont and West Virginia.

²¹ *Id.* at 14.

²² *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 517, 634 (1819).

²³ CAL. BUS. & PROF. CODE § 5083; 16 CAL. ADM. CODE § 11.5.

²⁴ *Id.*

²⁵ 16 CAL. ADM. CODE § 11.5.

of public accounting services. In fact, many CPA firms seem to have assimilated these specialists²⁶ rather than engage in direct competition with them. For example, the AICPA has stated that these non-CPA specialists may be "principals." In the absence of statutory restrictions, they may also be partners in the CPA firm and share in the firm's profits, because they are "employed in the practice of public accounting."²⁷

Still, the primary purpose of the CPA designation is to attest to audited financial statements, although the CPA may fulfill other functions. There is no real need or possibly even desirability that a person must be a CPA to engage in tax practice, to be a controller, to be an evaluator of accounting systems, or to be the preparer of a budget. A review of the California legislation and regulation seems to indicate that the purpose of the CPA certificate or designation is *specifically* to require a minimum standard of competency in accounting and auditing theory and practice,²⁸ with the emphasis in the field of auditing.²⁹ We think that these standards of competency should exist for each practitioner on an individual basis, whether or not he is technically employed by a corporation or by a partnership, with the final responsibility for the audit or financial statement preparation resting with a CPA. Under close examination, the fact of incorporation simply does not alter the basic purpose and reach of the CPA certificate. If Marshall's definition is correct, there is no need to fear the corporate form; rather, there is continuing need to monitor those who comprise the corporation.

We think that the proper fulfillment of these various functions of the CPA rests solidly upon a high level of professional integrity consisting of mental attitude, confidence, trust, and in the matter of auditing, independence. We do not think the fact of incorporation materially alters these functions and their proper fulfillment, or reduces in any respect the reliance that creditors, stockholders or management can and should place with the professional CPA firm.

It would seem that the key element in maintaining and improving the high level of professional conduct of CPA's lies in a sensible and enforced code of professional ethics. We seriously doubt that any present or future CPA who abides by the profession's code of ethics will automatically abandon these same ethics immediately upon incorporation. To believe otherwise completely ignores the historical growth of the profession, and expresses no trust or confidence in the future.

²⁶ This is a personal observation on the part of the authors. See note 6 *supra*.

²⁷ AICPA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 17 (1965).

²⁸ CAL. BUS. & PROF. CODE § 5082 (West 1962).

²⁹ 16 CAL. ADM. CODE § 11.5.

PRESENT LEGISLATION ON PROFESSIONAL INCORPORATION

California's professional corporation law³⁰ permits incorporation if:

- a) The Articles of Incorporation include a specific statement to this effect.
- b) The professional services being rendered are subject to a license, certification or regulation authorized by the Business and Professions Code.
- c) The professional services being rendered are that of a single profession and the appropriate governmental regulating agency has issued a certificate of registration.
- d) All employees who render professional services are licensed.
- e) Shares of stock are issued only to licensed persons.
- f) Shares are transferable only to another licensed person or to such professional corporation.
- g) Single shareholder professional corporations need have only one director, the sole shareholder, who shall also be the president and treasurer. The other officers need not be licensed persons. If there are only two shareholders, they need only two directors (the same shareholders) and between them they shall fill the offices of president, vice-president, secretary and treasurer.

The law as stated above does not apply to any corporation now in existence or hereafter organized which may lawfully render professional services outside the scope of this law. Various provisions of the Business and Professions Code have been added to permit professional services by medical, legal and dental corporations.

Does the present California Professional Corporation Legislation fit the CPA firm *modus operandi*? If CPA's were to incorporate would this require a change in professional corporation legislation and in the state control as exercised by the State Board of Accountancy? The answers are both, "Yes" and "No," as will be pointed out in the balance of this article.

SUGGESTED GUIDELINES PERMITTING CPA INCORPORATION

We do not pretend to possess perfect insight for a legislative or regulatory scheme. However, we think that the following guidelines are desirable to maintain the current typical operations of a CPA firm and at the same time to insure that the CPA corporation

³⁰ CAL. BUS. & PROF. CODE §§ 13400 *et. seq.* (West 1962).

properly fulfills its functions and serves the purpose of the CPA certificate.

- a) All officers, directors and professional staff should be licensed.

Comment: This agrees with the present legislation. It may require a change in the operation of the CPA firm since non-licensed professional staff would be eliminated. It may require new regulations by the State Board with regard to licensing, for example, substantial formal education could be substituted for the experience requirement in the case of persons who have passed the written examination and who wish to initiate their professional life with this entity. A "grandfather clause" may be required for those non-licensed staff who are currently employed, during the transition to incorporation.

Reason: The privilege of incorporation bears the weight of compliance with existing legislation. It is difficult to justify a lesser standard.

- b) Mandatory professional negligence insurance must be carried.

Comment: To maintain public confidence in the profession, the corporation should not be able to hide behind a shield of non-responsibility.

Reason: The corporate form may provide limited liability for acts other than those committed by the corporate CPA employee.

- c) The corporation and its staff should be required to abide by a code of professional ethics as promulgated by the State Board of Accountancy and the AICPA.

Comment: The AICPA leads the profession. Non-AICPA member CPA's are not now bound by the portions of the national society's code which have not been enacted by the State Board. For example, the AICPA code prohibits advertising;³¹ the rules of the State Board do not.³²

Reason: Ethics are best promulgated, strengthened, revised or eliminated by a strong national body which sets the tone and limits of a profession.

- d) Shareholders need not be licensed.

Comment: The thrust of this article has been that CPA professionalism is personal. The traditional fear against lay owners or lay profit sharers is that economic participation by lay members leads to control and dom-

³¹ AICPA CODE OF PROFESSIONAL ETHICS, RULE 3.01 (1965).

³² 16 CAL. ADM. CODE § 63.

ination by these members and that this control would emasculate professional standards. This conclusion cannot necessarily be valid if responsibility for professional services rests with licensed professionals via a wholly licensed board of directors, officers and staff. This does not agree with the present legislation.

Reason: Capital requirements, due to the expanding scope of this profession, may require a substantial investment in such equipment as computers which are beyond the personal means of the professional.³³

- e) The services rendered on behalf of the corporation may include any that are permitted by state law and the code of professional ethics.

Comment: This provision would comply with current legislation requiring that the services being rendered are that of a single profession; yet, the growth and flexibility of the profession can be maintained by allowing the State Board of Accountancy the ability to recognize new areas of public accounting to meet the needs of our changing society.

Reason: Since the "CPA Corporation" is holding itself out as licensed in one field, its activities should be limited to this representation. This would eliminate those activities completely foreign to traditional public accounting yet concurrently compatible with the public accounting practice.

³³ See note 6 *supra*. The author and others estimated this accounting firm's capital at \$30 million.