Schwartz & Co. LLP: The Accounting Services Industry

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ABSTRACT

In September of 2001, a major scandal involving the Enron Corporation brought about drastic changes within the accounting profession. Schwartz & Co, LLP, a small accounting firm based in Long Island, had been forced to make adjustments to the way it did business in the same way that the Big Four had. The key decision makers of the company were the two partners: Michael J. Schwartz, CPA, and Joseph Boyce, CPA. They employed 14 other people full time as well as 3 interns. The company provided both audit and tax services to over 1,000 clients, which included individuals, partnerships, corporations, and trusts, with a specialization in investment partnerships. The task here was to develop an effective differentiating enterprise-wide strategy if Schwartz & Co. was to survive and prosper against aggressive competition in the face of a rapidly changing environment over the intermediate and long-term future. The focus was on which type of client Schwartz should concentrate on.

OVERALL INDUSTRY AND COMPETITIVE MARKET: THE PROFESSIONAL SERVICES INDUSTRY

Accounting firms could divide their operations into three major areas: Tax, Audit, and Consulting. Each area could then be further divided into smaller areas. Although not every firm had operations in every area, accounting firms would traditionally perform services in any of those shown. The major factor that would determine whether a firm provided more or less services would be the size. Naturally, a larger firm would be able to provide more services than a smaller one.

Tax

Many accounting firms would prepare taxes for their clients. While a great deal of money was made by actually preparing the actual tax returns for clients, this was not the only source of income for firms in the tax area. Firms could meet with their clients for discussions regarding tax planning. For example, a firm might recommend a client to invest in certain types of bonds that might offer a tax break. Or, accountants might explain the different consequences that could result depending on whether a firm wanted to buy a piece of residential or non-residential property. The tax code was very large and very diverse, and providing clients with people who were familiar with it and could use it to help save them money was an important source of income for many accounting practices.

Audit

Audit services provided by firms could be further broken down, just as tax services could. An audit, by definition, consisted of an accounting firm testing the financial statements of a company to ensure that the five basic assumptions of management (namely existence and occurrence, completeness, rights and obligations, valuation, and financial statement presentation and disclosure) were all fairly presented in the financial statements. After performing various tests of transactions and balances, the auditors would then sign an opinion statement.

This opinion might be unqualified if the financial statements were presented fairly in accordance with Generally Accepted Accounting Principals (GAAP), qualified if they were presented with certain departures from GAAP that did not result in information being presented that was misleading or altogether incorrect, or adverse if the financial statements were not presented fairly. In certain instances auditors might also sign a disclaimer, stating that they were not making an opinion on the financial statements of a company. Audit services were very important for firms because in order to trade on the New York Stock Exchange, it was required that they issued annual reports with audited financial statements. Even if a firm did not trade publicly, finding investors willing to put money into a company that had not been audited would be very difficult. Cheaper and less in-depth than an audit was a review. The idea behind this service provided was the same, however. An accounting firm would go over the financial statements of the client searching for misstatements. However, in a review no official opinion would be issued.

And where in an audit the accounting firm would say that in their opinion the financial statements were presented fairly (called positive assurance), in a review the assurance given would be negative. This meant that the accountants only said that, based on what they had seen, there did not appear to be any material misstatements in the financial statements of the company. Review services were not permitted in place of an audit, but for smaller companies that were not publicly traded this might be acceptable for investors to place their trust in them. The lower assurance level also resulted in a lower cost, which made it desirable for those who might not have been able to afford an in-depth audit. Financial statement compilation was slightly different from audit and review services in that here the accounting firm issued no statements at all as to the reliability of the client's financial statements. Rather, they collected information from the client and actually organized it into financial statements themselves. The firm preparing these compilations could not issue an opinion on them because a firm could not legally give an opinion on its own work because of independence issues. Another firm might still audit these statements as usual, however.

Consulting

The strength of accounting firms had always rested primarily with their employees. Besides being able to simply prepare a tax return or audit financial statements, they could also take advantage of their knowledge to assist in the management of certain clients. Legal issues forbade a firm from auditing and providing consultation for the same client, but provided the accountants did not participate in the audit, they would then be permitted to assist in the management of other companies. One important aspect of management was budgeting. Various regulations in GAAP could make it difficult to determine exactly what effect a certain project might have on net income.

Different valuation standards or accounting estimates were just two difficulties that might arise. Accountants could assist in setting up budgets for any task that required one, including production, labor, and inventory purchases. Accountants could show managers how to most effectively and efficiently meet financial goals over time. Compliance was another aspect of consulting that tied in closely with many other areas. It could take on a legal viewpoint. For example, an item might need to be allocated over several years or it might need to be expensed immediately. Compliance could also take on a tax viewpoint. For example, a client might have unknowingly claimed a larger deduction than they were allowed to, which the accountants would point out, potentially saving the client thousands of dollars in interest and penalties if they were audited by the government.

Accountants could also provide compliance testing on behalf of investors. For example, many investors required firms in which they had an investment to keep their debt financing below a certain percentage. It would be up to the accountants to monitor this percentage and make sure the company's debt was where the investors required it to be.

As shown in Figure 1 (next page), the accounting segment of the professional services industry had several different facets: services provided, types of clients serviced, staff characteristics, industry regulation, geographical regions, and competition. Each area could be further broken down as shown in the model.

COMPETITION

Competition within the accounting sector could be best divided into three distinct classes: The Big Four, small and mid-sized firms, and sole practitioners. Each of these three areas had its own set of strengths and weaknesses in each of the key to success areas.

Big Four

The Big Four accounting firms were Price Waterhouse Coopers, Ernst & Young, Deloitte & Touche, and KPMG. Their main offices were in New York, but they had offices all over the world. They provided all kinds of services for their clients, and as mentioned earlier, they performed the audits for over 75% of the publicly traded companies in the US. They worked with all types of clients and employed full-time staff as well as a great deal of interns right out of college. The smallest of the Big Four firms had over 20,000 employees in the US alone. No matter where their clients were located, they either already had an office close by or were able to easily get employees to that client. They also had offices in and employees from over 90 countries worldwide [Accounting Jobs, 2006].

This allowed any of the Big Four firms as a whole to be familiar with languages and customs of nearly every major area in the world. This also gave each of the Big Four recognition internationally as well as locally. Naturally, their size alone allowed them to offer very high salaries to students coming out of college, so their college recruiting programs were very successful. However, the long hours created a stressful work environment, and many private companies hired accountants out of Big Four firms for an even higher salary, so employee turnover was high. This high turnover made it difficult for interpersonal relations to flourish within the firm. The Big Four accounting firms all offered services in tax, audit, and consulting, and due to the number of people they employed, it was a safe assumption to make that for any of these areas they had several employees both knowledgeable and experienced. They also serviced all types of clients: individuals, partnerships, corporations, and trusts. The Big Four firms were also able to take advantage of economies of scale due to their size, and were therefore able to service the biggest clients at the best prices.

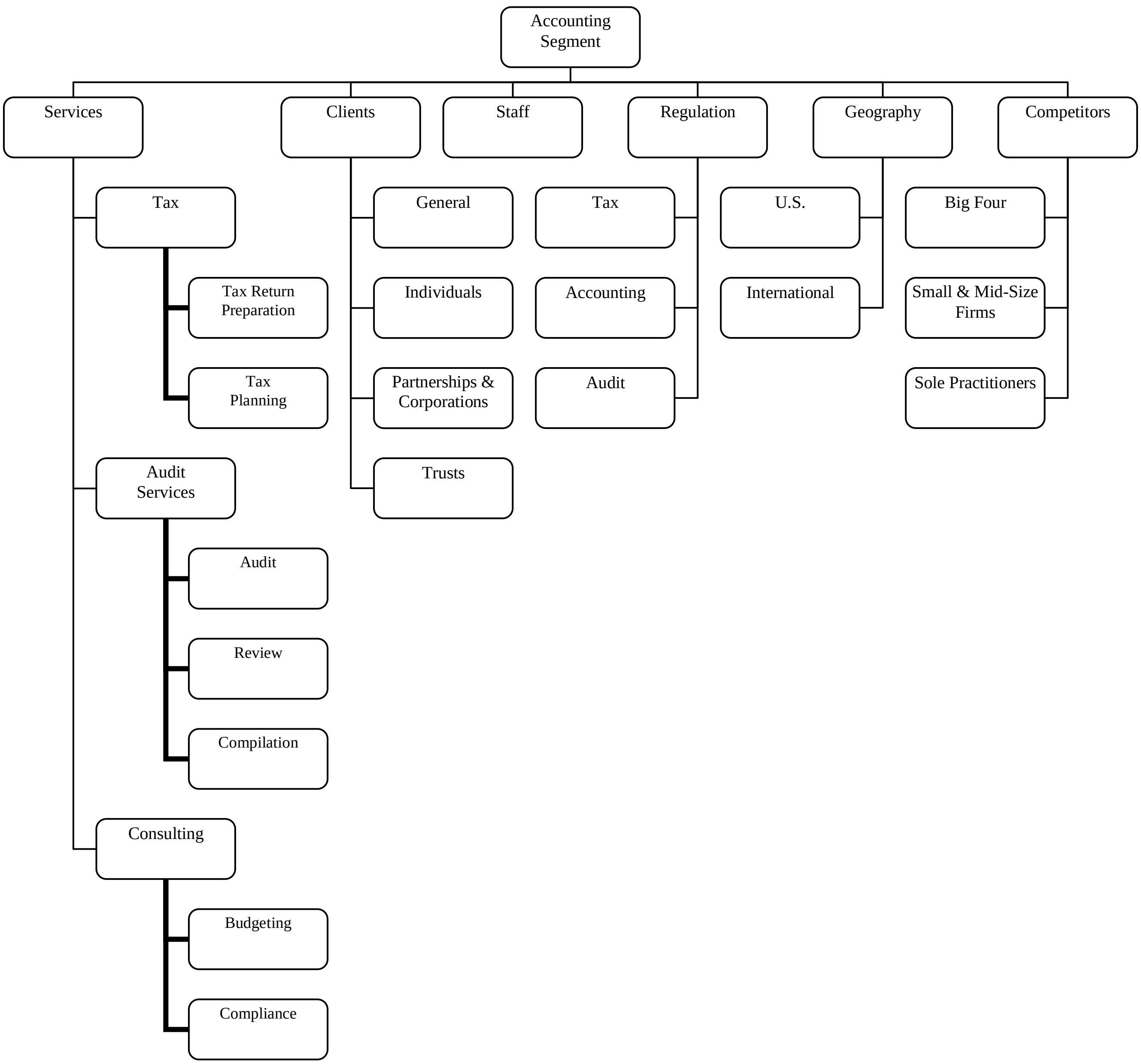

Figure 1: Accounting segment business model.

Small and Mid-Sized Firms

Smaller accounting firms might share many traits of the Big Four such as international offices and providing all types of services, but they fell short in terms of size. Mid-sized and smaller accounting firms were still present, however, in each segment of the industry. The biggest weakness of these smaller firms was that they had much less exposure than Big Four firms. While college students learned about the Big Four in class, it was the responsibility of the smaller firms to get their names recognized however they could. This weakness also extended to new acquiring new clients. Entities looking for an accounting firm already knew about the Big Four and what their merits were, but few knew of the qualities of smaller firms.

The impression given by the words "small firm" had never been a good one, as it seemed to imply a lower level of service. Depending on the size of the firm, it could offer all types of services to all types of clients, but it could also have been limited if it didn't have enough employees to diversify its client base. The increased costs associated with both making its name known to potential employees and clients, and with expanding into new areas if necessary, could flow down into higher costs for clients or a more stressful work environment for employees. Smaller accounting firms that were able to overcome this major weakness were then able to turn it into a major strength. That strength was that smaller firms' employees were generally much more loyal to the firm than employees of Big Four firms. Although smaller firms might not be able to pay as well as Big Four, and they might not have been as conveniently located in general, the fact remained that the environment tended to be one that promoted trust and teamwork by being free of internal office politics and that promoted growth among its employees.

Sole Practitioners

Sole practitioners were generally the smallest practices in the field, but their small size helped them to excel in their relationships with clients. The small number of clients made it easier for these practices to build personal relations with each one. They normally would have relatively few clients, and they would often specialize in one type of client, such as individuals or sole proprietorships. This could result in a greater level of knowledge in the fields of each of their clients. Because sole practitioners worked directly with their clients, the issue of friendly attitudes and respect was much easier to achieve than in larger firms. A weakness of sole practitioners was their limited recognition outside of their geographical area of operation. Because they had few employees, diversification was very difficult to achieve, and there would be virtually no team to develop trust within.

THE COMPANY

Schwartz & Company, LLP was a small firm in terms of the number of professionals it employed, but was closer to a mid-sized firm in terms of revenues generated. Figure 4 (next page) shows areas that the firm was concerned with [Interview, 2006A].

Services

Although Schwartz & Company was a relatively small firm, it did not limit the services it provided because of its size. Just like mid-sized and larger firms, Schwartz & Company provided tax, audit, and consulting services.

Tax

Schwartz & Company's greatest strength in the tax field was the personalization of the services it provided. The staff worked closely with clients and stayed on top of tax issues from year to year. Tax projections were also provided at the end of the year, allowing major tax questions to be discussed months before tax deadlines in April.

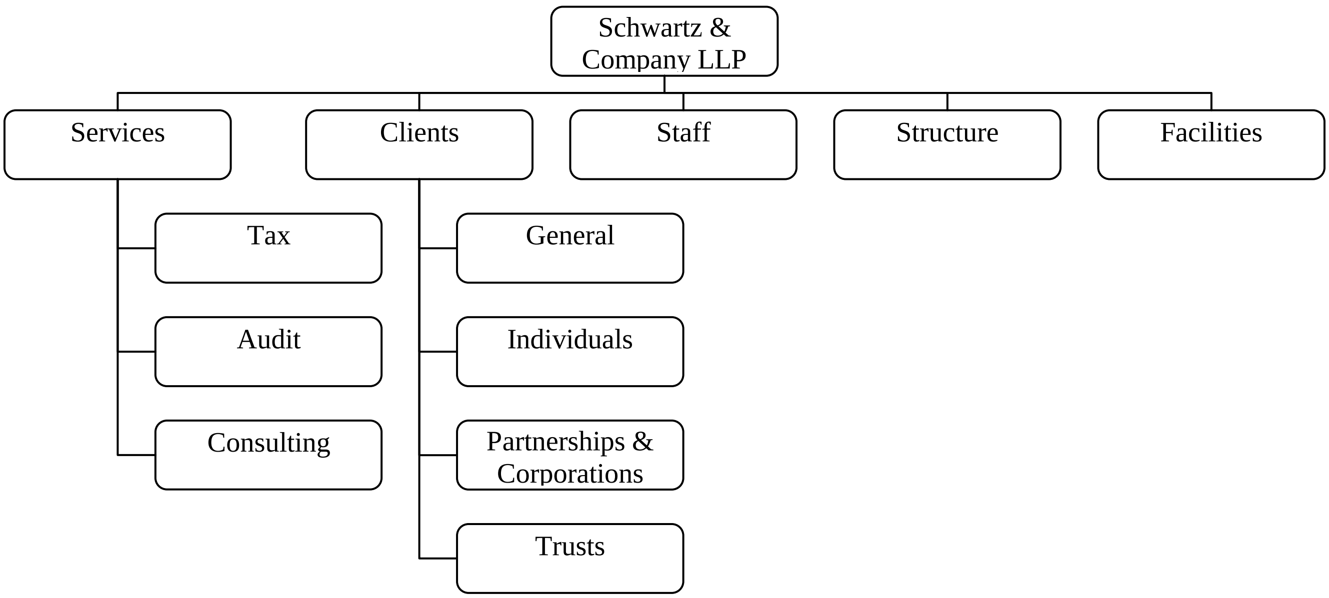

Figure 4. Schwartz & Company, LLP areas of operation.

Schwartz & Company was very helpful in that it kept its employees aware of current tax regulations. Meetings were held regularly regarding important tax issues to be aware of and how to work with them on the tax preparation software the firm used. Emails were sent out within the office, and contact between staff members was encouraged when any questions arose. The firm was also efficient in its organization of tax documents. Management made it clear what they were looking for, and those expectations remained consistent from year to year.

Audit

The greatest strength Schwartz & Company had in the audit department was its experienced staff. Before the formal process would start, management would sit down with staff and discuss with each of them what was expected and how to go about performing the audit. A large percentage of the firm worked with audits over time and was especially familiar with the way they were done at Schwartz & Company.

Consulting

The higher level staff at Schwartz & Company gave specialized consulting services to clients in the areas of tax planning, financial planning, and wealth management, among others. The firm's greatest strength here was the staff's commitment to excellence. Staff at Schwartz & Company would always be proactive with clients, solving problems the client never even knew existed. This commitment to improving the client's position first helped Schwartz & Company grow completely through client referrals. A weakness of the firm in this field was its lack of access to information. While the staff was very knowledgeable in most areas, they had no large reference materials or Internet databases to go to in the event that staff did not already know something. Information was still available over the Internet, but was more difficult to navigate than a company database might be.

Clients

Schwartz & Company provided services for all types of entities. Just to name a few, the firm would prepare tax returns for individuals, perform audits and reviews of partnerships and corporations, and offer wealth management consulting services to trusts. However, as Michael J. Schwartz, general partner at Schwartz & Company put it, “We have no clients; we have lots of relationships” [Interview, 2006B].

The greatest strength of Schwartz & Company was always its relation to its clients. In the business world, there was any number of accounting firms a person could go to for the services they needed. What made them choose Schwartz & Company was the relations they built above and beyond the standard business relationship they could find anywhere else. Regarding the acquisition of new clients, the firm would ask certain questions regarding potential new clients before it accepted them. Namely, research would be done regarding the integrity of the client, whether the firm could provide a value-adding service for the client, whether the client would recognize the value that Schwartz & Co, LLP added, and whether the potential client wanted a relationship or not. These standards were the same, regardless of whether the potential client was an individual, partnership, firm, or trust.

General

One way Schwartz & Company was able to build such strong relations with its clients was its size. Where with a large firm clients could run the risk of being moved around between staff, clients with Schwartz & Company would deal with the same people every time. This continued contact helped create a friendly atmosphere for each client, no matter what they came looking for. Staff at Schwartz & Company also did their best to ensure that work for the client was done on time. Deadlines were set, and while office hours were set, the general mood of the firm was that the office closed when the work was finished. Therefore, whatever the actual amount of time needed to complete a project might be, the firm would ensure its clients that a certain date was reasonable and that the work would be finished by then. Although Schwartz & Company was a small firm, they were not generally difficult to contact as might be expected at a small firm.

There would almost always be someone in the office between 8:30 AM and 7 PM, and many staff were issued Blackberries so that clients could contact them outside of normal office hours in case of emergencies. Schwartz & Company was also careful with its selection of clients. The firm did not set up any restrictions on whether or not a client would be accepted based on industry or size; however, all potential clients would be interviewed before they were accepted, and an important point Schwartz & Company would look for in this interview was whether it could add value to this client. Only after this was determined would the client be accepted, and in this way the firm would be able to be sure that their clients would walk away satisfied.

Individuals

Because Schwartz & Company placed such an important emphasis on the importance of connecting with the individual, it was able to develop strong relations with clients there for individual services.

The priority of the firm was always the client. Therefore, clients would be assigned to employees that could best relate to them, and the firm operated around what the client needed first.

Partnerships and Corporations

What made partnerships and corporations different from individuals was that the services partnerships and corporations required was more extensive. It more often required knowledge of regulations in various states, which Schwartz & Company was able to handle. However, there were also various practices depending on the industry the client was in. A weakness of Schwartz & Company was that although it specialized in investment partnerships, its experience in other fields was more limited, and it had no clients at all in the construction and apparel industries.

Trusts

As mentioned earlier, the purpose of a trust was very straightforward, and did not differ between different trusts. Trusts therefore did not have any keys to success in addition to the ones basic to all clients. Schwartz & Company's strengths in the general field made it inherently strong with trusts as well.

Staff

Schwartz & Company's small size gave it certain advantages over its larger competitors, while at the same time its large size gave it certain advantages over its smaller competitors. The firm had less than 20 employees, all working in one office. The constant contact among team members helped an atmosphere of trust and friendship to grow within the firm. Because the firm was fairly large in comparison to sole proprietorships and other small firms, it was able to cater to the wants and needs of its employees. For example, if an employee working primarily on audits preferred to go into tax, then the firm was able to accommodate that employee. A smaller firm with fewer employees might not have been able to move the employee out of the audit field if nobody could fill the vacancy. Schwartz & Co's policy regarding employees was to settle for nothing less than the best. The way it went about achieving this was through its internship program.

Besides allowing the intern to get a feel for a smaller accounting firm as opposed to a Big Four firm, it would also gives the firm an opportunity to evaluate performance to decide whether it would be a good idea to keep the intern on as full time. This had been a very successful method of keeping only employees with a strong work ethic and that work very well together as a team. The small size of the firm, on the other hand, allowed for personal growth opportunities that would likely not be found in larger firms. Interns and new staff at Schwartz & Company were needed on projects right away, where in a Big Four environment newer staff would generally be used for the tasks not directly related to accounting, such as photocopying and mailing. Therefore, where personal growth would be delayed in larger firms, at Schwartz & Company challenges and growth were a daily occurrence. Management at the firm realized this, and was eager to have staff share what they learned and if they had any ideas as to how the firm could operate better. The firm offered incentives to its employees to achieve certain goals, whether they would result in the growth of the firm itself or the growth of the individual within the firm. For example, an employee might choose a self-improvement book to read, or might be asked to bring in a certain number of resumes in a given year. Each employee would be given a unique set of goals each year with progress evaluated quarterly.

The employee's progress towards achieving these goals would then be figured into that employee's bonus. Many members of the staff at Schwartz & Company were recently graduated from college. A familiarity with local campuses helped its college recruiting program greatly. Training for new staff members was mostly an informal process. There were no off-site meetings or formal processes that all new employees had to undergo. Rather, new employees would work closely with more experienced staff at first and would learn how the firm worked by actually doing the work. Additionally, each employee was assigned a mentor from higher level management to act as someone that he or she could go to with any questions, comments, complaints, or observations about any aspect of the firm. The one major weakness Schwartz & Company had with staff was a relatively small number of employees compared to clients. The high standards the firm set when hiring new employees led to a small rate in hiring new employees compared to the number of new clients acquired.

Structure

Schwartz & Company, LLP's organizational structure consisted of two partners at the top, followed by managers, staff, and interns moving down the chain. However, while the chain of command was very clear within the firm, responsibilities were not broken down into such clear areas. For example, a first year staff could still be in charge of performing an audit. Tasks were given to employees based on expectations built from previous work rather than simply based on number of years of experience. Because Schwartz & Company was a fairly small firm, and because all the staff would have experience in several areas, the firm was not broken down into distinct departments for different services or client types.

Facilities

Schwartz & Company, LLP had offices located in Bellmore, Manhattan, and Boca Raton, Florida. The Bellmore office served as the main office, while the other two offices had no permanent employees but were used when staff needed to be in the area.

LOOKING TOWARDS THE FUTURE

At a recent informal meeting at Schwartz & Company, various suggestions were made regarding how the firm could increase revenues among the services provided for individual clients. One staff member, Mark Lundin, suggested that the firm move into a new market, namely preparing returns for college students. Another staff member, Peter Costalas, suggested that the firm would be better off staying on its current course of catering to high net-worth individuals.

The first alternative, to expand into the college student market, would result mostly in an increase in the number of tax returns prepared by the firm, as college students generally did not own large businesses or have investments of millions of dollars in different ventures. The benefit of the first alternative would was that it would allow the firm to make its name known to college students without any additional costs besides that of implementing the change within the firm. Students would know about the firm because of the services it would provide for them, and the internship program could be promoted and explained to each individual student one-on-one. This alternative was feasible because the firm had very good relationships with several colleges on Long Island. Schwartz & Company could use these existing relationships and making these schools the first ones the new program was brought to. Once the program proved successful, Schwartz & Company could use these first schools as an example and expand into other schools in the area.

A <u>second alternative</u> would be to keep the firm focused on high net-worth individuals. Under this alternative, the only new individuals Schwartz & Company would take on as clients would be those with a net-worth of $1 million and over. The benefit of this alternative was that Schwartz & Company would be continuing to work with what it knew best. The firm had grown since 1991 serving individuals classified as high net-worth, so it would be able to continue working around its strength. This second alternative was feasible because the firm would not need to make any changes to its structure or existing practices. It would only need to continue what it had been doing since its foundation.

Both alternatives had to be examines carefully, especially in light of how each one would win against the competition, as well as each one's drawbacks. Michael Schwartz and Joseph Boyce would have to carefully consider each alternative and consider any additional possibilities thoroughly before committing to any single decision.

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