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Practice of Accountancy by Partnerships and Corporations; State legislation Research Study No. 3

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THE PRACTICE OF ACCOUNTANCY

by

PARTNERSHIPS AND CORPORATIONS

STATE LEGISLATION RESEARCH STUDY NO. 3

1955

Prepared by the Committee on State Legislation

American Institute of Accountants
270 Madison Avenue
New York 16, New York

This is the third in a series of studies to be prepared by the state legislation committee of the American Institute of Accountants. It is submitted for the consideration of officers and legislation committees of state societies, and the extent of its use is to be determined by them.

This study was approved by the 1954-55 committee on state legislation comprising:

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Thornton G. Douglas, Chairman

THE PRACTICE OF ACCOUNTANCY BY PARTNERSHIPS AND CORPORATIONS

This study analyzes the two following questions:

1. Should state laws include provisions permitting partnerships to practice under the title "certified public accountants"?

2. Should practice by corporations be prohibited?

In the hope of being helpful to the state societies, the committee offers answers to these questions, but it feels that, in the final analysis, these problems should be considered in the light of local conditions.

Practice by Partnerships

Most states now forbid firms to use the designation "certified public accountants" unless all members of the partnership are certified public accountants. Some require each partner to possess a local certificate; others require only resident partners to have a local certificate and non-resident partners to be certified in any state or territory. Only nine states and one territory have no provisions for the use of the CPA title by firms within their borders. They are Alabama, Arkansas, Idaho, Mississippi, Montana, Nebraska, Ohio, Utah, Wyoming and the Virgin Islands.

The Institute's Position

The Institute has consistently maintained that state laws should cover this question. The following is excerpted from the May 14, 1940 report of the committee on state legislation:

> It is the opinion of the committee that accounting firms be permitted under state law to designate themselves as certified public accountants, provided each partner of the firm holds a CPA certificate in good standing, issued by the state or territory of the United States in which he practices.

In the "Form of Regulatory Public Accounting Bill", approved by the committee on state legislation in April 1945, the subject of partnerships of CPAs is treated in section 5, which reads as follows:

PARTNERSHIPS COMPOSED OF CERTIFIED PUBLIC ACCOUNTANTS--REGISTRATION THEREOF. A partnership engaged in this State in the practice of public accounting may register with the Board as a partnership of certified public accountants provided it meets the following requirements:

(a) At least one general partner thereof must be a certified public accountant of this State in good standing.

(b) Each partner thereof personally engaged within this State in the practice of public accounting as a member thereof must be a certified public accountant of this State in good standing.

(c) Each partner thereof must be a certified public accountant of some state in good standing.

(d) Each resident manager in charge of an office of the firm in this State must be a certified public accountant of this State in good standing.

Application for such registration must be made upon the affidavit of a general partner of such partnership who is a certified public accountant of this state in good standing. The Board shall in each case determine whether the applicant is eligible for registration. A partnership which is so registered and which holds a permit issued under Sec. 8 of this Act may use the words "certified public accountants" or the abbreviation "C.P.A.'s" in connection with its partnership name. Notification shall be given the Board, within one month, after the admission to or withdrawal of a partner from any partnership so registered.

Although the bill from which this excerpt is taken no longer has the approval of the American Institute's Council--since 1948 the official policy on regulatory legislation has been neutral--the principles of this section were incorporated in a report to Council by the interstate practice committee, March 30, 1953. Since Council approved the committee's report, the statement has again become official. The relevant portion of the committee's report reads as follows:

An accounting firm should be permitted under the state law to designate itself as certified public accountants if all of its partners hold valid CPA certificates of some state and its local representative is a CPA of the state in which his office is located. Because wide use of the title "certified public accountant" is desirable, state laws should

> not require that all non-resident partners must hold certificates of a state in which the firm wishes to practice as CPAs.

This position still seems eminently reasonable and practical. Spelling it out in the law would eliminate doubt and contention and would ease the administrative burden of state boards.

A non-resident partner has no need for a local certificate, for he would perform no services for local clients. State boards would be interested in the activities of, and have authority over, only the resident representatives of a CPA firm with offices in other states.

In states with regulatory public accounting laws similar provisions should be made for the registration of partnerships of public accountants, who would then have the right to designate themselves "public accountants". In such states a public accountant might properly be admitted to a firm of CPAs, though the firm could no longer hold itself out as certified public accountants.

Partnership Names

About twenty years ago a bill was introduced in the general assembly of Pennsylvania the avowed purpose of which was to protect the public and prevent fraud by prohibiting the practice of accountancy under an assumed name. The proponents of the bill contended that if the name of a deceased or retired partner is continued in a firm name, the professional character of the practice is lost.

The following quotations from an editorial in The Journal of Accountancy sum up the profession's views of this and similar bills:

> --Many firms of lawyers, architects, engineers and other professional men carry, sometimes for a generation or more, the names of men who have died. Why accountants should be singled out for the peculiar exclusiveness which this bill indicates is beyond our comprehension.

--The goodwill attaching to a well-known firm name is the most valuable asset of the firm. That goodwill is a reflection of the years of work, the adherence to high standards and the development of an efficient staff.

--It may be argued that the client could be informed of every change in the firm name, but the client is not the only person to be considered. The statement bearing a certificate with a new firm name--which might in truth be the same firm--would not carry the weight with bankers and other grantors of credit which the long-established name would carry. [1]

Later, in October 1943, the Council of the American Institute of Accountants asserted that "neither the public interest nor the interest of the accounting profession as a whole would be served by legislation preventing the use by public accounting firms of firm names or titles which contain the names of partners who have died or withdrawn from the firm". Council instructed the committee on state legislation to oppose legislative proposals of this type.

Although the Institute's rules of professional conduct do not specifically prevent an individual CPA from practicing under a partnership name, the ethics committee has attempted to discourage the practice on the grounds that it might be misleading to the public. It would, however, be a violation if the plural description "Members American Institute of Accountants" were used by a sole practitioner. [2]

It is the opinion of the committee on state legislation that it is misleading for a sole practitioner to use plural designations.

In Section 2(e) of Circular 230, the Treasury Department maintains in effect that no enrolled agent may use a firm name indicating a partnership when in fact he is practicing as a sole proprietor. [3]

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1. The Journal of Accountancy, August 1935, vol. 60, pp. 86-7
2. John L. Carey, Professional Ethics of Public Accounting, American Institute of Accountants, New York, 1946, p. 116
3. Ibid., p. 114

Practice by Corporations

"The objection to incorporation of an accounting practice is based upon the fact that accountancy, like law, is a profession and there should be individual responsibilities not restricted by resort to the protection of limited liability." [4] The accountant's responsibility to a client is that of a professional man and hence personal. And professional responsibility should not come within the limited liability recognized for corporations.

The impersonal character of corporations makes the corporate practice of accountancy impractical on other grounds. "The public does not know who the principal stockholders are. The officers might be certified public accountants and the staff might consist entirely of experienced and able auditors, but the controlling stockholder might be a layman, whose major interest was financial gain." [5] Such a man would not be subject to the disciplinary power of professional accounting societies and state accountancy boards.

If he were to determine the policies of the corporate accounting firm, "the whole idea of accounting as a profession might as well be abandoned. In spite of all protestations the public would recognize it as a business, and rightly so." [6]

Measures Taken Against Corporate Practice

The American Institute of Accountants has taken steps designed to prevent corporate practice. Adopted in 1938, Rule 11 of the rules of professional conduct reads as follows: "A member shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the

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4. The Journal of Accountancy, August 1935, vol. 60, p. 87
5. Carey, op. cit., p. 72
6. Ibid., p. 73

practice of public accounting in any state or territory of the United States or the District of Columbia." In 1945 the Institute's committee on professional ethics held that "The name of a firm of practicing accountants should denote a personal association. Such a firm should not adopt for its name any nonpersonal or misleading title. A corporate form of name would not be appropriate as the name of a firm of professional accountants."

The Institute's model bill of 1945 provided that no one could sign the name of a corporation of accountants or auditors to any financial statement, unless the corporation was registered and practiced under such corporate name before the enactment of the law.

Some states merely prohibit the use of the CPA title by corporations, some prohibit the formation of new corporations after a specified time, and others prohibit corporate practice altogether.

Prohibiting Corporate Practice: Constitutionality

On August 16, 1949, the California Supreme Court handed down an important decision on legislation which would forbid the corporate practice of accountancy.

This case, Accounting Corporation of America v. State Board of Accountancy of the State of California, et al., involved the constitutionality of a provision in the accountancy statute which read as follows:

> Nothing contained in this chapter shall prevent any corporation which, at the effective date of this chapter,[7] has been legally organized in the State of California and engaged in the practice of public bookkeeping and accounting for a period of three years prior to such date from continuing such practice under its corporate form and arrangement.

The Accounting Corporation of America was incorporated two months

7. September 15, 1945

before the effective date of the law. It sought to enjoin the State Board from enforcing this provision on the grounds that it deprived the corporation of equal protection of the laws and that it established arbitrary classifications prohibited by the California Constitution.

The decision of the California Superior Court, which found for the defendant, was reversed by the California District Court of Appeal, which declared the provision unconstitutional. The California Supreme Court reversed the appellate court's judgment, asserting that "the entire proviso relating to corporate practice need not be nullified, but only the phrase which restricts such practice to those which had engaged in the practice 'for a period of three years'." [8]

The argument of the court may be summarized by the following quotations:

> --Since the Legislature decided that at least some corporations are not disqualified from practicing public accounting, the sole question presented is whether it was reasonable to declare that only those corporations which had engaged in the practice for three years prior to the statute's effective date, should be permitted to continue as public accountants.
>
> --Where a statute discriminates against individuals or corporations solely because they are new to the field and such discrimination does not appear to have any relation to the public interest, the legislation disregards constitutional protections against arbitrary classification.
>
> --The competence of a public accounting corporation depends... not upon the length of time the corporation has been engaged in the practice of accounting, but upon the experience, training and integrity of its personnel of the moment.
>
> --The evil of the proviso to section 5062 [9] is that it confers a privilege to remain in business upon a class of corporations arbitrarily selected from among those engaged in public accounting at the time the new accounting chapter became effective.

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8. The Accountancy Law Reporter, Commerce Clearing House, First Edition, "Court Decisions", p. 7141. The quotations which follow are from pp. 7130-41.
9. The excerpt from the law given above.

One kind of legislation forbidding the corporate practice of accountancy seems most likely to stand a court test. This is the "grandfather clause" type, which provides that all corporations in practice at the time of the enactment of the statute may remain in practice, but no new corporations will be formed after the effective date of the law.

It has been argued that since the public interest is involved, practice by corporations might be forbidden altogether. In support of this view the language of the court in the California case may again be cited:

> Public accountancy is in some respects comparable to the learned professions of law, medicine and dentistry in that a high degree of skill and integrity on the part of the practitioner is demanded. Proficiency in the examination, analysis and evaluation of financial records must be combined with a relationship of trust and confidence between an accountant and members of the public who consult him. This being the case, the Legislature might have, had it chosen, reasonably excluded corporations entirely from the practice of public accountancy.

Nevertheless, the committee feels that the "grandfather clause" type of legislation is preferable because in this kind of bill there can be no question of infringing the constitutional rights of any corporation.

Moreover, the accounting corporations still in existence are so few as to have little effect on the profession. Rather than run the risk of having a law excluding them from practice declared unconstitutional, perhaps on the ground that it is retroactive legislation, the committee recommends that a "grandfather clause" statute be enacted.

The most important thing to be remembered about legislation of this kind is that it must operate in a uniform manner upon all concerned and that arbitrary distinctions must not be made.

Conclusions

After evaluating all the ascertainable facts and weighing all the

proposed arguments, the committee has agreed on the following principles which it recommends should be incorporated into all state accountancy laws:

1. A public accounting firm should be permitted to practice under the title "certified public accountants" if all partners resident in the state (or resident manager of any office if there be no partner) hold certificates of that state and partners resident elsewhere hold valid CPA certificates of some state or territory of the United States, or of the District of Columbia.

2. Continuation of an existing partnership name should be permitted so long as there is in fact a partnership.

3. Plural designations should not be used by a sole practitioner.

4. Corporate practice should be prohibited, but care must be exercised not to violate the constitutional rights of corporations now in practice.