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The Analysis of Accounting Firms’ Organization Types and Reasons for Switching the Organization Types

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Abstract: *In this paper, we applied the agency theory and corporate governance theory to analyze the different organization types of accounting firms. There are increasing switches between the LLP and LLC of accounting firms. We are interested in the reasons why accounting firms made a such switch of organization types. We assumed that the switch organization types of accounting firms directly affect the accounting firms' company governance and business performance. We applied the cost-benefit perspectives of agency theory to analyze the economic benefit of switching organization types. We also used Wiseman and Gomez-Mejia’s behavior agency model to analyze the accounting company governance on risk-bearing and risk-taking. The financial data that we used to analyze the CPA firms are based on S&P Capital IQ. We concluded that the switch organization types of accounting firms directly affect the accounting firms' company governance and business performance. The switch of organization types increases business performance and decreases company governance from LLP to LLC. The switch will generate lower costs in operation and management and CPA firms are willing to become more risk-taking to issue modified audit opinions.*

Keywords: *Accounting, Company types, LLC, LLP, Agency theory, Corporate governance, Wiseman & Gomez-Mejia, CPA firms, Risk-bearing, Risk-taking*

1. Introduction

With today’s fast-changing of business environment and high competition that accounting firms face in today’s business environment, in both national and international ways, CPA firms are also under such pressures of economic performance, lawful liabilities, and even social responsibilities. We found that there is an increasing trend of switching CPA firms’ organization types from LLP to LLC these days. Therefore, we started to think about the fundamental reasons for CPA firms to switch their organization types and what the business performance is after the switch from LLP to LLC.

To generate a more accurate and applicable result, we did literature research based on agency theory and corporate governance. As an accounting firm, it provides auditing, taxation, and consulting services to client companies and also issued auditing opinions to SEC. Accounting firms and CPA firms would be able to be considered as an agency behaving on the client companies’ authority and also take certain legal and social responsibility to the client companies, shareholders and investors publicly. Jensen and Meckling[1] viewed an agency relationship as a contract between a principal and an agent. Therefore, applied the agency theory and corporate governance theory to analyze the different organization types of accounting firms. We assumed that the switch organization types of accounting firms directly affect the accounting firms' company governance and business performance. We applied the cost-benefit perspectives of agency theory to analyze the economic benefit of switching organization types. We also used Wiseman and Gomez-Mejia’s behavior[2] agency model to analyze the accounting company governance on risk-bearing and risk-taking[2]. If the cost and expenditure for the work of accounting firms will be cheaper the organization form of LLC. Then there is a great possibility that the accounting firms will switch their organization type from LLP to LLC or Inc., etc. For accounting firms, the change in the organization types could directly affect the company governance on risk-taking behavior. The financial data that we used to analyze the CPA firms are based on the New York Stock Market and AICPA websites. We have the 2020 IPA top 400 CPA firms’ list and we searched the audit firms’ peer reviews and quality control documents on the AICPA websites to evaluate the CPA firms’ business performance before and after the organization type switch, from the company’s revenue perspective and service performance perspective. We concluded that the switch organization types of accounting firms directly affect the accounting firms' company governance and business performance. The switch of

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organization types increases business performance and decreases company governance from LLP to LLC. The switch will generate lower costs in operation and management and CPA firms are willing to become more risk-taking to issue modified audit opinions.

2. Literature Review and Related Work

The organization type of accounting firm is an agency. Jensen and Meckling[1] viewed an agency relationship as a contract between a principal and an agent. A principal is a company or person who hired another company or person to provide services based on the principal's needs. An agent is a company or person who provides such services. The cost of the contract might increase if the agency relationship is agreed on by both parties. The cost could also be increased as the management or CEOs become more independent from the owners of the companies.

Bebchuk[3] researched several provisions and analyze how these provisions affected corporate governance and their relationships. For example, these provisions are limits to amend bylaws, limits to amend the charter, director liability, unequal vote, director duties, etc. The research discovered that with more provisions the result would not benefit corporate governance. Also, the key provisions matter more than the number of provisions to corporate governance. Furthermore, too many provisions would cause companies to be less productive and waste resources.

For accounting firms, the organization types could be LLC, LLP, Inc., etc. Most accounting firms are providing auditing, tax, or consulting services to companies and clients, therefore accounting firms fulfill the definition of agency. When we applied the agency theory and the key problems that agency theory solves, it could give us a better perspective on why companies switch their organization types and how the switch would affect corporate governance and company performance. There are some agency problems that accounting companies could come across. For example, the conflicts of benefits between client companies and accounting firms will be discussed and it is also expensive and challenging for client companies to know what accounting firms are doing or how the work process would be[4]. The propositions that Eisenhardt[4] made in his research are information system, outcome uncertainty, risk aversion, goal conflict, task programmability, outcome measurability, and the length of the agency relationship. These propositions could also be taken into consideration when evaluating corporate governance and company performance when accounting firms changed the organization types. Grossman[5] and Hart tested the factors that influence the companies' profit beyond managers' control. And they assumed that the principals, the client companies are not able to know what the agent companies are doing[5]. Jensen and Meckling[1] discussed that the agency theory could also be used to analyze the organizations' ownership structure. In this paper, we also will use the agency theory to analyze the accounting firms' ownership structure and the results of changing the organization types[1]. However, Jensen and Meckling[1] are more concerned about cost-benefit issues when making business decisions. They believed that the expenditure and cost of the agency's work will most significantly influence the organizational structure of the agent companies. For example, if the cost and expenditure for the work of accounting firms will be cheaper the organization form of LLC. Then there is a great possibility that the accounting firms will switch their organization type from LLP to LLC or Inc., etc. Besides the accounting expenditure of the agency companies. Jensen and Meckling[1] also take the law and sophistication of contracts as a reason why both parties would like to lower the agency cost. For example, the cost of hiring qualified employees is higher than before, and the taxes paid for doing business is changeable, therefore there is a great motivation for accounting firms to switch to other organization firms if such a switch could lower the cost and fees. Wiseman and Gomez-Mejia[2] applied the behavior agency model to analyze corporate governance on risk-bearing and risk-taking[2]. The behavioral agency model they built is considering the following elements: internal/external performance indicators, compensation mix, stock options design, behavioral evaluation criteria, performance history, problem framing, risk bearing, risk-taking, direct supervision, and target difficulty. Therefore, for accounting firms, the change in the organization types could directly affect the company governance on risk-taking behavior. There are some scholars also used the cost-benefit theory to illustrate the agency cost. There are two costs they said are mostly concerned: the cost that monitoring the agent companies' behavior and the cost that agency expensed on through persuading the principal companies, that is, the agent company behaves for the benefit of the principal companies and not intend to harm the principle companies[6]. They also found that German and Japanese companies lowered the cost of these two conflicts by concentrated ownership of the company, which means a strong connection between owners, clients, co-works, etc. [6]. However, they also mentioned that lowering the cost and solving these two conflicts would not benefit the company's performance in general and even cause the company's performance to become low business profit. These discussions are a case-by-case issue and different countries or different business

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environments might require different solutions. For accounting firms. Whether to organize in LLC or LLP or other types depends on the particular issues they faced and the business environment overall.

CPA firms today also have pressures on company social responsibilities. Stakeholder theory and social responsibility are important issues. There are always disagreements among the views of corporate social responsibilities (CSR) and the theories of stakeholders. Such disagreement includes the boundary that how much companies should devote themselves to society, how much responsibility the companies should be taken to society, etc. CSR theorists believe that business is always expected to play much more important roles in society, and such a role is the ethical and moral obligation of the companies[7].

In the article written by Brown and Forster[8], they talked about from the stakeholders' view, how the business should make the decisions as to the number of activities that should be related to CSR or how priority these activities are. However, there is always a tension between sacrificing CSR to increasing business performance. This tension has been largely discussed in many kinds of literature. This article also demonstrates the theory of Adam Smith's concepts. When businessmen are facing challenges and making business decisions, how they could decide the issues related to CSR, meanwhile considering the business performance in general, the economic results, and ethical issues as well? The balance among those elements to make business decisions have been discussed as a real challenge that managers come across most of the time.

When talking about elements to define CSR-related issues. There is usually more than one dimension. For example, Schwartz and Carroll[7] defined a three-domain CSR. The three fundamental domains that defined CSR are the economic dimension, legal dimension, and ethical obligation dimension. Philanthropy has been included in the ethical obligation dimension.

However, Kurucz[9] pointed to another conclusion of the arguments among all the theories either for or against the CSR conceptual theory. They are the level of organization, the logic of economic, ethical, political, and social, the grounds or positivist, and others.

Before the discussion of CSR, it is better to identify two key concepts. We should first understand what are the stakeholders' responsibility and their roles, and if any stakes are owned by managers. Secondly, we could also identify the roles of managers and CEOs in the organizations and what function managers are supposed to have. Thirdly, these two identification and concepts are correlated to each other[10]. To further demonstrate the correlations between the roles of stakeholders and the roles of managers, there are some examples to think about. For example, one of the managers' functions in the companies is to make business decisions in the favor of stakeholders and increase business performance in general. Managers would also choose the economic resources which would benefit stakeholders as well[10].

Further research shows that there are many benefits and advantages for companies to engage in CSR activities. For example, it can increase firms' competitive value, and brand images and even enhance the marking power. When there are firms who devote themselves to CSR activities. They will be easily distinguished from their competitors. However, there could be some disagreements as to whether to engage in CSR activities or not. From the perspectives of stakeholders, stakeholders might think such CSR activities and social issues would not bring much competitive value or advantages.

Hillman[10], in his later findings, discussed that CSR activities related to stakeholders could not only be beneficial to stakeholders but also would be a benefit to shareholders. However, if firms decided to not engage in CSR activities related to stakeholders, which might also in turn harm the wealth of shareholders.

The largest discussion about CSR is its relation to business financial performance, whether it increases firms' net wealth or not. Studies show that there could be a mixed level of relations in general. McWilliams[11] suggested no relationship. Waddock and Graves[12] suggested a positive relationship and Wright and Ferris[13] believed in a negative relationship.

Some other scholars argued that since the decision to make whether or not to participate in CSR activities depends on whether such CSR activities will help to increase firms' net wealth and business performance, and usually firms will choose the decision to maximize the value. Therefore, the relationship between CSR activities and business financial performance is neutral[14].

Waldman[15] pointed out that leadership theory in the strategic field has direct relations with CSR. The strategic theory will be helpful for business decisions made related to CSR and firms could participate in CSR activities more strategically.

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Social activities could promote companies to engage in CSR activities by advertising consumers to buy products from firms dedicated to CSR activities (Fedderson & Gilligan, 2001).

McWilliams[14] and Siegel suggested that to maximize the financial performance of the firms, cost, and benefit scenarios could be helpful to achieve a suitable amount of CSR activities[14]. Meanwhile, some researchers argued that in the future only social and environmental issues would be counted as CSR activities (cf. also Roman et al. 1999). The definition and identification of stakeholders would be more restrictive[16].

Phillips[17] As to the structure of corporate governance, the CSR activities and stakeholder theory could not require a change of corporate governance[18]. The discussion of CSR activities is broadly discussed and scholars viewed these theories from more perspectives.

3. Methods and Proposed Measures

We made hypotheses: (1) Switch organization types of accounting firms directly affect the accounting firms' company governance and business performance. (2) The switch organization types increase the business performance (3) The switch organization types decrease company governance from LLP to LLC. (4) The switch will generate lower costs in operation and management and CPA firms are willing to become more risk-taking to issue modified audit opinions.

By applying the agency theory and company governance concept, our key variables to identify and used in the data analysis are: geographic locations, industry classifications, company status, company type, ownership status, advisory firm type, and total revenue. The financial data that we used to analyze the CPA firms are based on the S&P Capital IQ.

We generate two datasets. The first dataset has a sample of 89 CPA LLPs. 86 CPA LLPs are United States and Canadian companies. 25 CPA LLPs are industrials. 49 CPA LLPs' company status is acquired, 21 CPA LLPs are operating and 18 CPA LLPs are operating subsidiaries. 83 CPA LLPs are private companies (Table 1). 22 CPA LLPs are independent corporations. 89 CPA LLPs ownership status is never sponsor-backed. 45 CPA LLPs advisory firm types are either auditing or accounting. The mean of total revenue ($USDmm, Historical rate) is 21.9(Table 2).

The second dataset has 122 CPA LLCs. 50 CPA LLCs are industrials. 57 CPA LLCs are uncategorized. 39 CPA LLCs' company status is acquired. 51 CPA LLCs' company status is operating. 32 CPA LLCs' company status is operating subsidiary. 113 CPA LLCs are private companies (Table 1). 114 CPA LLCs ownership status is never sponsor-backed. 45 CPA LLCs ownership status is an independent corporation. 121 CPA LLCs investment firm types are uncategorized. 69 CPA LLCs advisory firm types are uncategorized. 52 CPA LLCs advisory firm types are auditing or accounting. The mean of total revenue ($USDmm, Historical rate) is 79.3 (Table 2).

Table 1: Industry Classification, Company Status, Company Type

Company Type	Industry Classifications	Company Status	Company Type
CPA LLP	25 industrials	49 acquired/21 operating/18 operating subsidiary	83 private
CPA LLC	50 industrials	39 acquired/51 operating/32 operating subsidiary	113 private

Table 2: Ownership Status, Advisory Film Type, Mean of Total

Company Type	Ownership Status	Advisory Firm Type	Mean of Total Revenue[LTM]($USDmm, Historical rate)
CPA LLP	22 independent/89 never sponsor-backed	45 auditing/accounting	21.9
CPA LLC	45 independent/114 never sponsor-backed	52 auditing/accounting	79.3

For the tables, the two dataset samples show that CPA LLCs have more industrial companies compared to CPA LLPs (Table 1, Table 2). CPA LLCs have more operating company status than CPA LLPs. CPA LLCs have a higher mean of total revenue than CPA LLPs.

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4. Conclusion

Based on our research and analysis, we concluded that switching organization types of accounting firms directly affects the accounting firms' company governance and business performance. The switch of organization types increases business performance. The switch of organization types decreases company governance from LLP to LLC. The switch will generate lower costs in operation and management and CPA firms are willing to become more risk-taking to issue modified audit opinions. We also found that the switch of CPA firm's organization types from LLP to LLC also increase the CPA firms' mean of total revenue.

However, our research is not perfect, there are still some limitations for further researchers and scholars to evaluate and discover. Our sample is mostly chosen from the 89 CPA LLPs and 122 CPA LLCs. It is not clear whether our conclusion could be generalized to the overall CPA firms, which are determined by more largely databases. However, collecting data from private CPA firms seems more difficult compared to collecting data from public CPA firms. Our research is based on US CPA firms and the taxation law is changing so we didn't consider this element. There could be more accurate and applicable theories or models to use and wait for further research and discussion. We believe this topic will be continued research in the future.

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