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The Impact of Technology on The Structure of the Accounting Profession and What the Firm of The Future Will Look Like

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Background

In 1997, Clayton Christensen published his book: "The Innovator's Dilemma: When New Technologies Cause Great Companies to Fail." He revealed how common it is for companies that adjust to change by incremental improvement and continuous innovation to almost always fail to embrace the next major wave of technology and either disappear or become mediocre.

Christensen's work serves as a sober reminder that simply getting a bit better will not work when a major technology shift is underway. He alerts us to the fact that that memories of past success, taking too much for granted and refusing to let go of legacy systems, legacy mindsets and legacy assets kills businesses and redefines industries.

What we are seeing today would have been considered to be science fiction 5 years ago. At that time, mention of the word "browser" would have conjured up a notion of someone aimlessly wandering around a store looking at merchandise. Today it is your link to the world and can be used to buy anything from cars to coffee, to entertain and inform, to communicate and, of course, to work.

The value that accountants have traditionally created has been based on their knowledge and experience and in that sense they are knowledge workers. But their method of delivery has essentially been built on an analog model. What we are seeing today is the rapid deployment of a digital model.

What distinguishes the analog model is that it is cumbersome, discontinuous and requires an intermediary (middleman) to effect convergence. That is, a professional accountant for example, will intermediate in the process of brining an analysis of a situation together with past experience and knowledge of options to form advice on an appropriate course of action.

In contrast, a digital model is characterized by continuity and natural convergence of systems which include not just the digital appliances that we are all familiar with but also the convergence of, for example, a business performance measurement system with a knowledge management system that is independent of the business itself. In this model the intermediary becomes disintermediated. Or to put that in crude terms, those of us who want to reside in the analog world won't be needed any more at least in relation to many of the things we now do.

In the analog economy there is typically a manufacturer, a distributor, a retailer and an end user consumer. In the digital economy the economic function of the distributor and the retailer are under threat. They will not necessarily be eliminated totally (there are few successful models of total disinternmediation, Dell Computer being a classic example.)

The economic function that intermediaries once performed is seriously under threat. In their place will be a different type of intermediary, one that provides customers with information that will help them make the exact purchase they want, at the best price available from the most reputable supplier at the lowest possible cost to effect the transaction. Whereas a traditional intermediary represented a limited product or service line and was only able or willing to provide a buyer with information about that line, the new intermediary, called a metamediary, has no such allegiance.

Emerge the transaction per click phenomenon. Information is money in this model. In fact, information about things (products and services) is fast becoming more valuable than the things themselves.

Each time a user clicks a link, some value is created and therefore potential to generate revenue is created. At a penny a click the user will be indifferent to the cost if it leads to what s/he's looking for. An individual business could never make any money charging people a penny for information but when you put billions of clicks together there is a lot at stake.

So what has all this got to do with CPAs? Lots.

As we speak, the e-economy is well and truly starting to take hold but I'd suggest we have not seen anything yet. This is a classic disruptive technology. Historically, the impact of disruptive technologies (e.g. the internal combustion engine, the personal computer) has been seriously underestimated because of what appear to be the initial barriers and their limitations. But this ignores their innovators' motivation to move from the fringe to the mainstream of business.

Every one of your clients' businesses and your business itself will be turned on its head in the next 5 years. In the past 5 years there has been massive investment in building the infrastructure that forms the backbone of the Internet. In the next 5 years we will see that infrastructure deployed.

The first wave of industry restructuring that arose from this deployment can be seen in the so-called B2C markets: Amazon.com is attacking traditional booksellers (and other retail categories), E-Trade is attacking traditional stock brokers, eToys is attacking the category–owning Toys-R-Us, Autobytel is attacking traditional vehicle dealers, Webvan is attacking traditional supermarkets.

What is singularly significant about these developments is that in no cases have the "new" business models been designed and built by the businesses that dominated the categories in the "old" economy.

The reason for this, I suggest, is that in order to re-invent an industry along the lines that the successful dotcoms have done mandates a willingness to abandon the existing model, a model that has served the company well in the past. In these circumstances, having nothing to lose is the key strategic strength of the new players. As I mentioned earlier, the incumbents are shackled by the weakness of. legacy systems, legacy mindsets and legacy assets that they are either unwilling or unable to abandon.

Of course the game is far from over. Many dotcoms have already fallen over and others will follow. Some of the incumbents (e.g. Schwab and Barnes & Noble) have reacted strongly to the insurgents and they may well emerge the ultimate winners but importantly, for that to happen they have realized that their business model must radically change. They will not win by relying on their traditional model.

In the fullness of time the revolution in the B2C space may be seen as a mere ripple in a pond. The tidal wave will come from the B2B space. In 1998 Forrester Research predicted that Internet-based business relationships would account for $1.3 trillion by 2003. By 1998 the Boston Consulting Group placed the number even higher at $2.8

trillion based on trends at the time. More recently, the Gartner Group is predicting $7.2 trillion by 2003.

B2B marketplaces are commerce sites on the public Internet that allow large communities of buyers and sellers to meet and trade. They are extremely flexible marketplaces that have the potential to serve the entire supply chain of practically any industry and are not limited to trading in materials but include service trading as well.

It is highly likely that in due course all businesses will buy on an online market, sell through and online market or be marginalized by an online market.

Never before has it been so important for every business to quickly embrace technology and draw its customers or clients closer. Let me be even more blunt than that, you must create a situation where they are not only dependent on you but they love you to the core.

Relationships with clients in e-space will be transitory at best. If you don't give them reason to appoint you their premier advisor you are dead. They are just one click away from another accounting firm or some other provider of the service they want today, meaning now, this minute! You are in the information business and information, unlike physical products, can be digitized and also unlike physical products the experience of shopping for information is not an inherent part of the value proposition.

The Structure of the Accounting Profession

Deregulation is lowering the protective walls that surrounded the profession for most of last century, technology is totally changing not only the way accountants communicate with their clients but also the nature of business generally with a consequential impact on the services accountants can now offer, it is becoming increasingly hard to attract and retain quality people in public practice, we're seeing talk of the accounting and legal professions to converge, we're seeing parts of the industry consolidate and public company ownership of accounting practices (which are being systematically re-positioned as financial, or professional, service firms), we're witnessing traditional accounting organizations move to admit non-accountants to membership and at the same time considering the introduction of a new designation for their members, we're seeing these same professional organizations planning to move into for-profit dotcom businesses.

The traditional core services of accounting, audit and tax preparation are increasingly being seen as commodities. There is very little evidence of real growth in these areas and margins are thinning.

In a survey of accounting practices in the US for year end 1999 there was practically no improvement in net profit per partner from traditional services despite the enormous strength of US economy. In contrast, growth in non-core services, notably general business consulting and IT consulting has been huge. Sadly, for most firms in the profession, this growth is not being experienced across the board but with few exceptions is restricted to larger practices that are offering their clients access to multi-disciplinary services.

Smaller practices, and in particular those that rely heavily on personal income tax preparation, are looking down the gun barrel of lean times I believe. In the1999 US tax

year for example, 922,000 income tax returns were filed with the IRS by individuals using tax preparation software. In the1999 tax season, 2.4 million returns were filed this way. That is a 160% increase over the previous year and is indicative of things to come. Unless small firms look for other ways to create value for their clients they are going to have a very difficult time ahead.

But it is not just the smaller firms that are in for some difficult times. The most commonly cited problem amongst accounting firms around the world is attracting and retaining talented people. This is placing pressure on personnel costs which, in the face of downward pressure on prices for core services, is driving margins from those services into the ground.

Let's face it, preparing tax returns, doing audits and reviewing financial statements is not the sexiest pastime. Young talented people have so many more options and even those that decide to study accounting are most likely to be attracted to firms that are growing rapidly, offer equity option plans, possibilities for overseas travel, assistance with and encouragement for further study, and do interesting and varied work for clients where the value created is obvious and appreciated. Most accounting practices could not lay claim to these characteristics.

If you are in practice today, it is sobering to ask yourself what would happen to your bottom line if you experienced a 50% increase in professional salaries (this number is seriously being touted around the US as a realistic expectation over the next 5 years), you were unable to increase the prices of your core services and you lost the top 5-10% of your clients to more aggressive multi-disciplinary practices or possibly through their own failure in the emerging e-economy.

These questions are what is driving more and more firms to think about consolidating. In the US the three major consolidators (see Table 1) who have attracted the limelight are American Express, H&R Block – RSM McGladrey and Century Business Services. These are the big players in the consolidation space but they are by no means the only organizations building, or contemplating building, market share through acquisition or merger.

Table 1: Major US Consolidators

	Revenue $US million	**Offices**	**Employees**
American Express	280	63	3,405
H&R Block – RSM McGladrey	1,648	8,988	88,979
Century Business Services	460	798	8,234

Source: Accounting Today, Supplement to March 13 – April 2, 2000 Edition.

It is useful to looks at the structure of the US accounting profession as consisting of five segments. Table 2 shows the five segments and the type of clients they each service.

Table 2: Distribution of US Firms by Revenue and Type of Clients Serviced

	No. of Firms	Revenue Range	Median Revenue	Clients Serviced
Big 5	5	> $2 billion	$6.4 billion	Major international public corporations and governments
Next 95	95	$13 million to $2 billion	$21 million	Some very large corporations but primarily privately owned businesses with revenues in the $25 million to $500 million range. High net worth individuals also serviced by this group.
Regional firms	1,800	$3 million to $13 million	$5 million	Privately owned businesses with revenues in the $5 million to $50 million range. High net worth individuals.
Local firms	12,000	$750k to $3 million	$1.5 million	Privately owned businesses with revenues in the $1 million to $20 million range. Relatively high net worth individuals who prefer to work with a local firm.
The others – mainly Sole Practitioners	33,000	< $750k	$295k	Some quality business clients but primarily tax preparation for individuals and low level assistance and advice to very small businesses.

There is an intensity of competitive pressure at the margin for each of these segments which is causing the constituent firms some considerable anxiety. For example, the Big 5 and the top end (in particular) of the next 95 often see each other in the market place. Clients of the top 95 firms are generally sophisticated buyers of financial and business services and they have no qualms seeking the best advice available. A number of firms in the top 95 cohort are known to be talking about merging to give them critical mass and access to specialist services as well as a wider geographic spread to better service their clients who are also expanding nationally and globally.

As well as fending off the Big 5, these firms also compete head to head with the regional firms that number about 1,800 units in the US. Many of the regional firms have exceptional talent and the loss of these people is one of their biggest worries. In addition to this, they are not quite big enough to be able to boast a wide range of professional services and therefore be able to lay claim to be a true multidisciplinary practice.

A large number of these firms have already been acquired by consolidators or are in negotiations either with them or other firms in the same position. Over the next year or two I expect to see a significant reduction in the number of firms in this cohort as a result of merges or acquisitions. Perhaps as high as 20-30% could disappear with most of those joining the firms now in the top 100 and the rest either merging with their peers or absorbing their smaller regional colleagues.

The regional firms have always competed with smaller, but more nimble, local firms. There are about 12,000 local firms in the US with median fess of about $1.5 million. They are well entrenched and enjoy a good reputation in their community. They primarily service small privately owned businesses but tend to focus on core services

centered on compliance. They have enjoyed quite respectable levels of profitability in the past and the "lifestyle" that has given the partners has tended to keep them local.

In addition to the competitive pressure from bigger firms the local firm cohort is very vulnerable to losing their top talent unless they can't give those people comfort that they have an assured future with the firm. And to make it even worse, their clients, who are often at the bottom end of the commercial food chain, are also the most vulnerable to the impact of technology on their businesses.

At the bottom of the industry are the other firms, most of which are sole practitioners. By comparison with the other 30% of firms in the industry their individual revenue is tiny. But they nevertheless account for nearly $10 billion of revenue (approximately 15% of industry revenue) attributable to the accounting services sector. These firms do an enormous amount of relatively low level work for individuals and small business clients. They are involved in write-up work, reviews and compilations as well as tax preparation and are very vulnerable to the encroachment of technology on their traditional franchise. Furthermore, when their clients grow they often find it hard to retain them or if they do, a disproportionate percentage of their fees are generated from a very small number of clients and that exposes them to considerable risk.

Based on what appears to be happening in the US at this time I believe that over the next 2 to 5 years we are going to see a total restructuring of the profession. The very small firms will experience huge problems competing with technology as well as other suppliers of low level commoditized compliance work. For example, even now you can buy a tax return in many Wal-Mart stores while you shop for other commodities. This could potentially wipe out 30-50% of practice units quite quickly.

Whether the local firms survive will depend to a large extent on their ability to find a robust business model that makes sense in the new economy. Many of them will find valuable niches beyond the core services they now provide Others will continue to position themselves as general service firms but if they do that they will have to form strategic alliances with specialist service providers to ensure that they can match the firepower of the larger multidisciplinary firms.

The Economic Forces That Determine Industry Structure

An interesting observation that comes from the segmentation shown in Table 2 is that business clients tend to gravitate to professional advisors who are about the same size as themselves and to the extent that there are a very large number of small businesses with revenues in the $1 million to $20 million range there will be a natural demand for smaller accounting firms. This has been one of the main reasons why the profession has always been fragmented and unless there is a fundamental change in the underlying economics of the industry it is arguable that it will remain fragmented.

In "Competitive Strategy: Techniques for Analyzing Industries and Competitors", Michael Porter provides a useful framework for analyzing the accounting services sector. Using Porter's ideas as a basis there are 11 themes that will impact the degree of industry fragmentation.

Low barriers to entry. To establish an accounting practice does not require a large amount of capital. The technology needed to provide core accounting services is readily available and relatively inexpensive. Most of the value created by a small accounting firm comes from the "head" of the principal. When barriers to entry are low attempts to gain advantage through consolidation are thwarted by a continual stream on new entrants to replace those who are acquired or disappear for other reasons. This tends to keep prices and margins low which in itself discourages entry to the industry by sophisticated businesses.

Absence of economies of scale. Typically there are few scale economies in fragmented industries. Production processes are standardized and tend to utilize more or less the same technology available at relatively low cost to any organization that wishes to enter the industry. Furthermore, because the principal industry processes are not complex there is little experience curve effect that might otherwise give incumbents a cost advantage over new entrants. For these reasons the cost structure of firms in these industries is more or less the same.

Low levels of product or process innovation are required. If the product or service offered by an industry is generic and clearly defined and there is little if any need for investing in continual R&D to remain competitive small firms will tend to dominate the landscape. This is reflected in the absence of scale economies and is one of the reasons for low barriers to entry. Because professional service firms generally can't claim access to exclusive valuable proprietary technology their value proposition is built on 'personal' service and relationships and that is difficult for large firms to match.

High transport or transaction costs. If transport or transaction costs are high relative to the cost of providing a product or service it is unlikely that large scale operations will achieve sufficient cost savings to compensate for the cost of distribution and servicing clients. This will provide local firms with a natural cost advantage over larger national operators who do not have proximity to local customers.

Erratic sales fluctuations. Small firms are more adept at absorbing sales fluctuations than large scale operations. One reason for that is that small firms tend to have lower relative fixed costs in their total cost structure than large scale operations which means they have lower production break-even points. The accounting services sector is characterized by an intense "tax season" that lasts for about three months and the rest of the year for many firms is relatively quiet. Many of these firms hire part time people during their busy season and scale back their operations during the rest of the year – this type of capacity management is very difficult for large scale businesses to manage although it far from impossible for them to do so (e.g. H&R Block have been very successful at this.)

No competitive advantage to large firms in dealing with customers or suppliers. This is an interesting issue and impacts different industries in different ways. For example, if an industry's customers or suppliers are so large that even very big firms would have little economic strength in dealing with them there is no incentive for firms to get bigger. Furthermore, dominant customers or suppliers will often create the conditions for firms to remain small and the industry fragmented by spreading their business and encouraging entry for example, by providing finance, expertise and/or granting distribution territories and long term supply contracts to independent firms.

On the other hand, firms in fragmented industries often serve firms in other fragmented industries and these firms, while having the power of choice, will still prefer to deal with a firm of their own size than deal with a larger one. This gives small firms some measure of protection from competition from significantly bigger competitors but it does not remove the intensity of competition they face from others of their own approximate size.

The most important productive resource in accounting forms is skilled labor. It is also the main cost. One sure way to destroy an accounting business is to 'steal' its key people especially at the present time when there is a shortage of trained and experienced personnel. To the extent that large firms can offer better conditions and benefits to employees they represent a very real threat to small firms in the industry and this alone could be where the battle for market dominance takes place. And while it may not be sufficient to consolidate the industry it will certainly lead to a polarization of firm size and profitability—that is, we could see a larger number of very small practices where the owners are the only ones left to do the work and because of their inability to leverage people their profitability will be seriously impacted.

Diseconomies of scale in some important aspect of the business. Large firms are usually less nimble than small ones. This is particularly true where there is a need for overhead to remain low, where there is a diverse product line that requires a high level of customization and/or interface between the customer and the manufacturer (or personal service firm), where there is a high level of creative content, where there is a need for close local control or where local image and contacts are critical. All of these things tend to favor small business units.

Diverse market needs. If local or regional tastes are diverse small firms will tend to dominate because there is insufficient scale economies to favor a large scale producer given the variety of product and the high transportation costs involved.

Potential for high product differentiation. Where products or services are capable of being highly differentiated it is difficult for a large scale firm to assume a dominant position in the market. This is why differentiation is such an important strategy for small firms to adopt to compete effectively with larger firms.

High exit barriers. When exit barriers exist many marginal producers will stay in the industry and effectively bid down prices. This form of economic irrationality results in the industry being less attractive to consolidation because there will always be some firms that will not exit. Exit barriers may arise for a variety of reasons including: an owner not being able to apply his/her skills in other areas, not wishing to realize a loss of capital, desiring the lifestyle that self-employment represents, being attracted to the romantic characteristics of the industry (e.g. ranching, farming, fishing – and dare I say it, accounting!).

Regulatory control over industry structure. This may come from government or industry regulation. The accounting services sector for many years operated in an environment in which government and industry regulation favored fragmentation. This is no longer the case and whereas in the past it has almost guaranteed that the industry will remain fragmented, its absence today means that the rules of the game are changed in a way that would tend to favor large scale concentration.

What Does the Future Hold?

For most of the last century it is probably fair to say that the themes described above have, on balance, favored a fragmented industry. Within this framework some firms became relatively large through superior service, better marketing and acquisition. Natural growth in the demand for core accounting services from a robust industrialized economy together with regulatory protection of their franchise meant that most firms did quite well.

But those days are over. De-regulation of the industry and converging ubiquitous technologies are changing the rules about who can play in the accounting space and how they play in that space.

If we accept that the themes are responsible for the structure of the competitive landscape and therefore the way in which revenue is allocated between the constituents, then it follows that to change the landscape some fundamental changes need to be made to all or some of the critical themes.

For example, this might be done by powerful competitors from with in or outside the profession in any, or a combination, of the following ways:

- Increase the barriers to entry by, for example, by redefining the investment in technology required to meet clients' service expectations.
- Deploy technology in such a way that economies of scale are achieved.
- Utilize technology in such a way that proximity to the client is not a critical part of the service delivery protocol. This does not have to be a 'perfect' fit. For example, prior to the desktop PC there were dedicated word processors (e.g. Wang) that were a perfect fit for the WP function. With the wide scale introduction of the PC in the early 1980's WP applications became available that we nowhere near as good as the dedicated systems but they were "good enough" given all of the other functionality that was bundled into the PC. Very quickly, the dedicated WP disappeared from the scene. People are willing to accept "good enough" when the overall value proposition is expansive.
- Redefine the service and/or product offering to eliminate the erratic sales fluctuations. For example, by introducing service line extensions and additions that existing firms do not have access to.
- Engineer competitive advantage by competing for the industry's personnel by taking a long term view on building market share and being willing to make investments in people. Firms that are unable to attract professional talent will increasingly find themselves at a serious competitive disadvantage.
- Eliminate the impact of diseconomies of scale that tend to favor small firms (or live with them while market share is being built) by for example, using technology to engineer very high levels of customization in the service offering. Whereas in the past customization was only able to achieved by personal intervention of the professional today, convergent technologies are totally changing that. This incidentally also allows the accommodation of diverse client needs and offers remote suppliers a serious degree of product differentiation.
- Reduce exit barriers. For example, in the worst case scenario from the practitioner's point of view, create an environment in which the profit to be made from public practice is so low that the opportunity cost of remaining in practice is too high.

We are starting to see some of these things happening already.

One of the hottest areas (in the vernacular of the day, known as cool space) at the moment is the application service provider (ASP) sector. In simple terms an ASP provides software applications over the web that users rent rather than own and they do not have to worry about installation and maintenance etc.

Revenue from this sector is expected to grow from a tiny $US7 million this year to $US7 billion by 2004. Users will increase from 20,000 this year to 30 million in 2004. In my mind that is growth but more importantly, it points to some very significant changes that will occur in the way business people inter-relate with their professional advisors. In fact it brings into sharp focus the question of who in fact their advisors are going to be.

For growth of this magnitude to occur I believe we're going to see the telecoms play a major role because they not only have the infrastructure in place to deliver broadband services, they also have strong brand equity and the marketing muscle required.

If this prediction is correct, small and medium sized enterprises (SMEs) will soon be able to get all their applications from their telecom provider who will bundle local and long distance Internet and application services with broadband connections. This is something that will start to happen within the next couple of years and will totally redefine the competitive landscape.

Irrespective of the source of software applications there will still be a role for you to play but as communication infrastructure converges with critical business process applications you will be confronted by a situation where your clients now have a mission critical link with a powerful supplier that is well and truly out of your control.

Typically, an accounting firm would play a significant role in the selection, installation and operation of its clients' software applications, especially their accounting system. This serves to lock the client in to them because of the critical role they play. But if an ASP-telecom aligned organization steps into that role the link with the accounting firm is broken.

It is a small step for that organization to start to offer a client other services and in the process, erode the relationship accounting firms have with their clients. In an extreme case you might even ask whether a practicing accountant will have any role to play if the client is linked directly to an ASP-telecom service provider that can easily find other partners to service clients' broader needs. To put that another way, digital networks blow up the traditional relationship between rich information and its carrier.

You might want to think about this in the context of "free websites" being offered to accounting practices by some of their service providers and others. Come on guys, who are you kidding? There is no such thing as a free lunch. Is this altruistic or strategic? Many people subscribe to the view that "you should never look a gift horse in the mouth" but as Shakespeare reminds us in Hamlet: "Rich gifts wax poor when givers prove unkind."

At least one scenario that plays out in my mind is a strategy designed to get well and truly into your client channel and once the relationship with your clients is established to systematically harvest it. This is known as the classic Trojan horse strategy. The only way to combat the Trojan horse strategy is not to open the gate and drag it in.

Amongst the hot applications that fit the ASP space will be a variety of e-commerce tools, accounting, tax preparation, customer contact and relationship management, productivity tools of every shape and size imaginable and of course, word processors and spreadsheets that form the core of bundled office applications. But it will most definitely not only be limited to the applications we are familiar with.

Incredible developments are occurring in the area of knowledge management and its interface with applications such as general ledger packages. Sophisticated knowledge management systems are out of the reach of the ordinary business when their IT system is built on traditional LAN client-server architecture.

However, when the application is provided by an ASP and the database resides outside of the business, a smart management system that is built on a link between actual performance and a web-enabled knowledge and experiential universe is both doable and cost-effective.

I have seen some AI (artificial intelligence) knowledge management systems that are nothing short of amazing and I believe they have the potential to dramatically change the way businesses are run and how people access the knowledge universe.

Imagine, if you will, your clients use an ASP platform for all their accounting, supply chain (procurement) and customer relationship management needs. From anywhere in the world and at any time of the day they can get a status report of how their business is tracking.

They can be advised how they compare against the best in their industry. They're told where their weaknesses are and are automatically pointed to a filtered list of documents containing suggestions on what can be done to fix the problem—not an endless list of articles that you now get when you do a word search using common search engines, but a very specific list that relates directly to the industry, business and issue at hand.

If they're not quite sure how to interpret the advice they can ask a question in natural language form and are presented with an even more refined advice set and possibly offered a multi-media online training program that will assist them better understand what they've just been told.

Because of the types of questions they've been asking they're automatically assigned a user profile that enables them to communicate with other people around the globe who have similar interests and/or are dealing with the same issues. They will also find that 3rd party service providers who have solutions to their problems will pass notices across their desktop for consideration.

Interesting thoughts you might say. Well, this technology is here today! This is not about the future, it is about the now. Again, I ask you to revisit the comments I made earlier in relation to the Trojan horse.

The next cool space will be taken by WAP (wireless applications protocol) we're told. This is simply where everything you (and your clients) want will be accessible through a mobile phone or PDA (personal digital assistant) which itself will converge with the phone system. Everything is going to get smaller, faster and cheaper.

In this context, it is appropriate for us to ask what your role might be? You won't be needed to install and support accounting systems or any other system for that matter. Tax preparation and advice won't have to be something that physical presence mandates. It would also seem that even management advice is not something that you can use to claim the high ground if you accept the scenario I have pointed to above.

Perhaps you could do some financial planning—well look at how the traditional brokers have fared to form a view about that, clearly this can be easily (as is enormously easy) for people to do themselves by accessing super-smart systems that possess all of the interrogation and experiential resources that any individual could possibly muster to assist in the planning process not to mention the placement and monitoring of the investments.

The point I'm trying to make is that information, in particular, and experience, to a lesser extent, is fast becoming a commodity. The technology required to deliver this in a form and at a time, place and price that meets user needs, 7 days a week, 24 hours a day, is available now and it will only get easier to use, more expansive in capability and of course, cheaper.

A Glimpse at The Firm of the Future

People need people. We are social animals and we will always want to confide in and seek the opinion of each other. No matter how sophisticated technology becomes, this need will always be present.

Someone is still going to have to help us map out business strategy and define the parameters for its execution. This will involve helping clients set goals and keeping them focused on those goals. It will be a mentoring and coaching function as well as a seriously valuable interpretive function through which, to paraphrase Peter Drucker, information will be endowed with relevance and purpose for without that it is merely data.

Most SME owners exhibit six fundamental characteristics:

1. They do not have a vision of what their business can, and does, stand for. They do not truly understand their governing commercial purpose and they have a very unclear definition of which customer segment(s) they can create value for. They tend to be willing to be all things to all people, with the inevitable consequence that they fail to meet the needs of anyone very well, and they are unable to define a service model that will WOW the customers who are potentially the most valuable to them. They exhibit all the problems associated with legacy systems, legacy mindset and legacy assets that I referred to at the beginning of this paper and consequentially, they are ill-prepared to accommodate change.
2. They are shocking at setting goals. Without goals, there is virtually nothing to aim for or to monitor progress against – there is no basis on which to manage, other than in the form of reactive crisis control. In these circumstances, the business lacks performance benchmarks and floats like a rudderless ship in an ocean of mediocrity. Business performance has virtually nothing to do with having a bad strategy, but everything to do with poor execution and a lack of goal-oriented activity.
3. They lack discipline and tend to allow themselves to be drawn into dealing with short-term problems and issues by treating the symptoms, rather than addressing the root causes. This also keeps them focused on the short term, rather than the long term.

4. They are cost-focused, rather than value-driven. This draws them towards a tendency to buy the cheapest inputs, to minimize expenditure on training and other business building investments, and to adopt marketing and pricing strategies that drive margins down in the (usually mistaken) belief that their customers are also narrowly cost-focused.
5. They are appalling managers of their own time and usually find it easier to "do it themselves", rather than investing time systematizing business processes and then delegating responsibility to trained team members.
6. They are very parochial and myopic in their view of the world and the changes that are taking place around them. They firmly believe that the problems they face are unique to them or their industry, and that they are doing as best as can be done given the circumstances. Because of this, they are unable (or unwilling) to adapt to change.

The firm of the future will help its selected business clients deal head on with these six generic issues. It will do that with a big dose of personal professional intervention, through the extensive use of technology and through its affiliation with a powerful knowledge network. The essence of the firm of the future will be the alignment of technology and its core client relationship strength. Refer to Figure 1.

The firm of the future will inject itself into, and be an essential element of, its selected clients' value chain. By that I mean it will be an indispensable part of the business and its value-creation process. It will attend to the contextual matters that its business clients need to deal with so that they can focus their energy and competencies on the core value creating activities they must excel at. SMEs that do not embrace technology and integrate it into the very fabric of their business will find it hard to survive.

The firm of the future will not be organized along traditional lines but will be a scalable model comprised of Client Service Units (CSU) of about 7-8 people who are all technology savvy. Each CSU will look after about 30 business clients who, in today's prices, will be paying at least $30,000 annually for a highly systematized, and customizable service. It will include traditional compliance services but will be primarily business development and business support focused. The CSU will become the client's administrative backbone and will perform both chief financial officer (CFO) and chief technology officer (CTO) functions. The one thing that technology will not be able to take away from the firm of the future is the relationship of trust it has with its clients. But the minute it loses that relationship it will lose its clients.

The people in these firms will be compensated on the basis of results and will probably have some skin in the game. Fees will be fixed by negotiation and will be closely tied to value created rather than the cost of resources used. Increasingly the revenue will be per-click based. Much more sophisticated and relevant systems than timesheets will be used to monitor performance. People in these firms will not necessarily hold accounting qualifications but will be an eclectic group with diverse backgrounds and skills. The firms will be organized and managed along the lines of a "corporate" as opposed to "partnership" model.

The firm of the future will be positioned in its community as a preeminent professional service provider. Its clients will be linked 24/7 to its extranet through which it will

channel best of breed applications, services, advice and assistance that it draws from the extensive support network (such as the Results Accountants' Network) that it is a member of. That alliance it will also give the firm of the future the muscle it needs to offer, on equitable terms, telecom delivered broadband services to its clients.

The firm of the future will look and feel like a business portal. It will dominate the real estate on its clients' desktop. In effect it will be a mini dotcom entity. Information that is uniquely relevant to each of its clients will be seamlessly and automatically channeled to them. It will be seen by its clients as their primary service provider. Through this it will achieve client lock-in.

The firm of the future will be independently owned and operated and will therefore be entrepreneurial and able to act nimbly and with purpose. It's cost structure will be much lower than its larger competitors and it will be a lot closer to its clients than its larger competitors can get. It will build unsurpassed client loyalty because it will be totally sensitive to their needs and its network affiliation will give it all the fire power it requires to be able to deliver any level of service sophistication required by its clients.

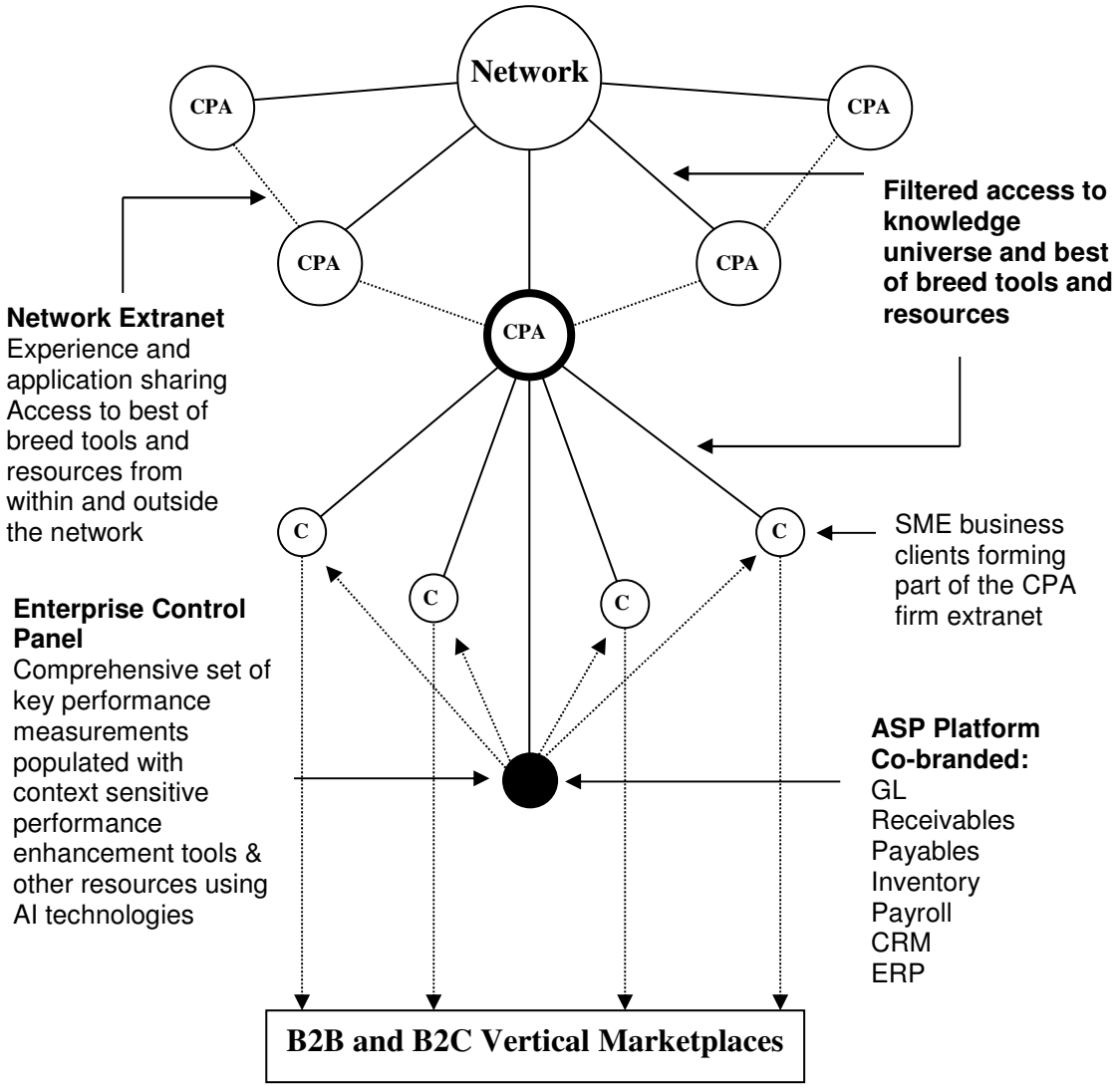
The competitive battle of the future will not be characterized by firm-to-firm combat but networks will compete for market space on behalf of their affiliates. The firm of the future will, however, through the support it gives to its affiliated network build the strength and market power of the network. It will participate as both buyer and vendor of knowledge and experience. In fact, the major value proposition it will offer its clients is access to a rich knowledge and experience network of consulting accountants who share a common service protocol, have a global reach and who bring world class applications and support to the table.

The size of the firm of the future will not be as important as the size and strength of the network it is affiliated with. In fact very few firms will be big enough to compete independently of a network. This will not be solely due to the magnitude of the capital pool that is required to develop and harness technology but there are inherent diseconomies of scale in professional service firms which make it extremely difficult for them to respond quickly enough to changing clients needs and economic circumstances.

Figure 1

CPA Firm of The Future

Network Structure



Should You be Considering a Merger or Sale?

Most practitioners I have talked to from around the world in the past 12 have expressed considerable anxiety about what the best course of action is for their firm in view of the changes that are taking place. Many are thinking about merging with other firms, some are hoping to be acquired by a consolidator, some are looking to establish niche practices and some believe that the changes we are now seeing is just a temporary aberration and that there is no need to alter what they are doing.

Before jumping into a merger or sale, you should stop and think about the consequences and whether it actually makes sense from the viewpoint of them offering a better quality or a broader range of services to their clients and/or whether it will improve their long term profitability or survival prospects through internal efficiencies.

Let's consider the issue of the quality and range of services first.

If two firms that offer the same suite of services to clients merge you end up with a bigger firm, but not one that offers a better breadth or quality of services. In these circumstances, clients are no better off than they were before the merger and often they feel that they are actually worse off.

For clients to be better off after a merger one or both of two things must happen. They must either see a reduction in their fees through greater efficiencies being passed on to them (which is so unusual I'd suggest it never happens) or they must have the opportunity to have access to services that were unavailable to them previously.

Typically, a merger of the same type of firms creates little, if any, value for either their clients or the partners and employees of the two entities. Furthermore, the difficulty in integrating different cultures and dealing with 'top dog' ego issues, not to mention getting uniformity in the way things are done in the practice, adds to the pain.

For a merger to make economic sense the condition precedent is that the two firms should have some different skill sets that, when made available to the combined group of clients, present an opportunity to create value that would otherwise not be created when they are operated as independent businesses.

I have heard suggestions that economic efficiencies will be achieved by getting bigger but the evidence runs counter to this. The fundamental economics of this industry are such that there is little evidence of scale economies. In fact the evidence is that there are diseconomies of scale.

Accounting businesses buy more or less the same inputs and pay more or less the same prices for them. Productivity is also more or less the same across the board so you don't have to be a rocket scientist to conclude that relative cost structure is going to be more or less the same as a consequence.

Inter-firm comparison data also indicates that prices charged for services offered by firms of different sizes are also are more or less the same when measured on the basis of average fee per hour. To the extent that larger firms achieve slightly higher average profit per partner than small firms (and it is only slightly higher) is because they tend to have a higher partner to team member ratio.

If a more highly leveraged firm acquires a lower leveraged firm the only way it will maintain its profitability will be to retire some partners, charge higher fees or generate more revenue either through improved productivity or by hiring more people accompanied by more effective marketing and sales. These matters should be at the top of the agenda in any merger (or acquisition) discussions.

We are hearing a lot of talk from firms that are in the process of buying accounting practices that they will engineer revenue growth through cross-selling additional services to the acquired client base. In the main, the services they are talking about revolve primarily around financial planning, insurance and the like. I'll believe that when I see it.

I have great difficulty coming to terms with the observation that if accountants are not cross-selling now why will they all of a sudden start doing that simply because they have been acquired by another company. Accountants have had the opportunity to build seriously good financial planning businesses during the past 20 years but few of them have stepped up to the plate and done it. And even those who have offered those services most of them have been mediocre at best.

The principals of financial planning businesses that I have spoken to repeatedly tell me that amongst their accounting firm associates, 80-90% of the business that is written can be attributed to 10-20% of their associated firms.

SMEs typically want to work with professional advisors who understand them and who will work with them over the long haul. Very large firms are always changing the people who are responsible for managing client relationships which negatively impacts their ability to win client loyalty. A very strong case can be made for the argument that as long as there are small and medium sized businesses there will be a similar size distribution of professional service firms.

It's all very well for the consolidators to say that they'll let their acquired firms continue to operate the way they always have but if that is the case in fact I can't see how anything will be different. To put that another way, the group will not achieve any synergy other than perhaps a bit more buying power but it's hard to see what inputs an accounting firm uses that additional buying power can impact given that more than 30% of their costs are labor related.

The consolidators claim that in addition to a broader service offering they will be able to bring more marketing grunt to the table. Spending on marketing is one thing, getting a return for the investment is quite another. Clients who are happy with the service their professional advisors are providing tend to be very loyal and will not be swayed by fancy marketing.

One of the relevant reasons for selling out to a consolidator is that it gives existing partners an opportunity to cash out without having to retire and if you are nearing retirement who cares who you sell to especially if you can do so at a premium. That is an appealing option but will do nothing in itself to lay the foundation for a better and more viable firm in the long run. It may benefit one generation of partners but younger partners and especially those with minority interests are likely to question the long term value to them from this option.

Furthermore, to the extent that shares are used to finance some or all of the acquisition there is downside as well as upside in the transaction.

Let me put some numbers on that. The 52 week high for CBIZ is $16.13 (July 99) and the low is $2.56 (April 00). If you sold out at the high and received 30% in cash and still hold the shares, your effective sale price is 41.12 cents in the dollar. The 3 year high for CBIZ is about $25 so if you'd sold at that valuation you'd be even worse off, to the tune of a 90% decline in value of the equity component to be exact. This reflects the market's assessment of consolidated accounting firms that do not appear to have a coherent strategy other than size. Even with some options to sweeten the deal unless and until the options are in the money they are worthless.

Irrespective of what price they may have received at the time of sale, sellers will inevitably become disillusioned if their future income is lower because of inefficiency elsewhere in the organization. Defections are starting to be experienced by some of the consolidators in the US for this reason. In the absence of return for personal effort the tendency is towards mediocrity which is one of the reasons for the relatively low margins exhibited by many larger firms in any industry.

As long as smaller independently owned firms are able to deliver all the services that their larger competitors can offer either directly themselves or, more likely through alliances, they will thrive in this environment and will carve out, and in my view retain, a very profitable business.

The key here can be found in the words "are able to deliver all the services that their larger competitors can offer." One way to do that is to align your firm with a network that gives you access to a broader range of services so that you can position yourself as a multi-disciplinary firm. In the future, I believe the most viable form of structure for professional service firms will be through formal networks. To put that another way, if you are not in a network you will be competing against one.

And if you are in a network you had better avail yourself of all the benefits that offers because simply offering your clients what you have provided them in the past will not cut it.

We also believe that business value in the accounting profession in the future will not be based on arbitrary rule-of-thumb measures such as a revenue multiple but instead will have regard to earnings and other valuable assets such as access to network intellectual property, average revenue and profit per person and per client and, of course, local and global brand equity.

Independently owned and operated firms that are members of a strong network will have all the firepower they need without any of the disadvantages of being part of a large enterprise and we believe that their owners will see much greater value growth in the future without any loss of effective control.

Importantly, the firm of the future will be able to attract and retain quality employees because of the brand equity it enjoys and the opportunity it offers for growth and development. Talented young professionals are not going to want to go to work for a corporation where the layers of management are deep and the prospect for an equity play

is a long way off. In contrast a small nimble, client focused, profitable and aggressive local firm with global reach is a very attractive alternative in my view.

It is obvious that my considered personal view is that you should not sell out to a consolidator. I'd add to that the suggestion that if you are considering merging with another firm do so only if you believe that you really have a shared vision and can achieve a cultural integration that will work for both groups.

Most firms that merge find this very hard to achieve and I doubt that will change. When professional firms get together there are rarely any significant scale economies achieved and if there are they tend to be lost in the management of a bigger entity.

Going Forward

Everyone in the profession at this time is faced with many decisions. It is a very difficult time because no-one really knows what lies ahead. In may respects the world seems to be out of control. There seems to be little rhyme or reason for dotcoms that have never looked like making a profit trading at the values they are commanding at this time and yet that very fact suggests that the "market" sees companies built on the dotcom model as defining the future.

In a very real sense the price:revenue multiples reflect the huge risk that the investors are taking. But it is a risk that must be taken because the factors that are playing out at the moment will not go away. First mover advantage is clearly very important and the stakes are high.

Entire industries, not to mention firms, are likely to be wiped out in the next decade. This has happened before when major shifts in technology have occurred. I am very optimistic about the future of the accounting profession but I fear for many of its present constituents. The future will be characterized by strong alliances and curious relationships. Businesses (including accounting firms) will find themselves working with their direct competitors as well as competing against them.

Relationships with clients will be different and there will be constant pressure on firms to deliver value or risk losing their clients. The same applies to their people. The traditional command and control structures that worked in the past will not longer be acceptable. Accounting businesses will need to be organized along corporate lines rather than traditional partnerships and will embrace a diverse range of talents only some of which will be in the core compliance and accounting areas.

However, technology offers the accounting profession an opportunity to create significant value for its clients. They will also have to compete at the highest levels of efficiency and will need to integrate extant technology into their own operations. Their survival will increasingly depend on the quality of information (and importantly, their understanding of its significance) they have access to and given that accountants have traditionally owned the business information franchise they will be the logical people to go to for assistance.

The questions you might want to ask yourself now are as follows.

If I were starting an accounting business today:

- What clients would I target?
- What services would I offer those clients?
- How would I service those clients and specifically how would I deploy technology in my service model?
- What type of people would I hire?
- What alliances would I form?

Having asked and answered those questions you might then ask yourself: why not set about creating such a firm now even if it means trashing a lot of what you already have. As Geoffrey Moore reminds us in "Living on the Fault Line: Managing for Shareholder Value in the Age of the Internet" (page 11), "It is in the gestation phase that market leaders and followers are determined—more or less permanently."