White Paper

Client Selection

A Major Key for Profitable Firm Growth

Abstract

Businesses exist to create value for their customers. Accounting businesses are no different. The more value they create, the more clients they will attract and retain. But not all clients are a good fit for the firm. When there is a disconnect between a firm's value adding capacity and a client's willingness and ability to benefit, both parties lose. In this White Paper, a case is made for accounting firms to develop and apply client selection criteria that will increase the likelihood of a mutually beneficial long term relationship between the parties.

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The Setting

It was a beautiful crisp, sunny Autumn day at Lake Taupo which is a stunningly beautiful place in the center of the North Island of New Zealand. I was presenting at a post-Boot Camp business development implementation program when one of the delegates shared her experience using our protocols and tools to deliver Business Development (BD) services to her clients.

Here's my recollection of the essence of what she said.

> "This all made so much sense when I was at Boot Camp. I couldn't wait to get back to the office and introduce my clients to my new BD service line. I got some early traction but before too long I hit a brick wall when I realized that the clients I had "sold" the service to just weren't implementing anything and were questioning the value of the process.
>
> My first thought was the location of my practice was such that the type of clients I had access to were just not BD candidates. I re-listened to the Boot Camp tapes and reviewed my notes and then it hit me—Ric said "the absolute key to growing a quality practice is client selection." Once I focused on taking more care in selecting the people I chose to work with everything changed. It turned out to be a slower process than I had hoped but the foundation I built was strong and my practice never looked back."

This story plays out over and over again.

An ideal client for any service is one whose needs fit with a firm's value proposition. For example, suppose your firm's value proposition is represented in your Mission Statement (or Brand Promise) that you proudly publish on your website and in all you marketing collateral says something like this:

> *"Our mission is to make ABC & Co the accounting practice of choice for our community's growth orientated businesses by consistently delivering outstanding, proactive service value, continuous innovation, and an awesome service experience so that we fulfill our brand promise of Better Business results in a Better Life and a Better and more Secure Community."*

Suppose further that this is not a mere motherhood statement but, unlike 50% of businesses,(1) your firm lives the promise it makes and you have implemented processes to achieve that. Given the fact that in order to become a "firm of choice by growth orientated businesses" it seems obvious that you need to have a clear picture in mind about the type of person who has a business that meets that definition i.e. you need to have an idea of the characteristics of your ideal client.

I like to describe an ideal BD client as being a person (representing a business) in respect of whom you can create demonstrable value over a significant period of time and who acknowledges the contribution you have made by being willing to share a fair proportion of that incremental value with you.

For BD services, this client avatar would be someone who meets all or most of the following 11 selection criteria:

1. Has been in business for at least three years and preferably longer
2. Has a pleasant, outgoing personality
3. Is willing to listen to advice
4. Has a positive disposition
5. Is technically competent – experienced in the industry and/or role
6. The business is profitable
7. The business is not chronically undercapitalized
8. The business is not dominated by a small number of customers or suppliers

9. There is a clearly established demand for the product or service
10. The business has scope for product or service differentiation through innovative marketing or activity re-alignment
11. The business has scope for improved productivity through innovative management planning, control or business model re-design

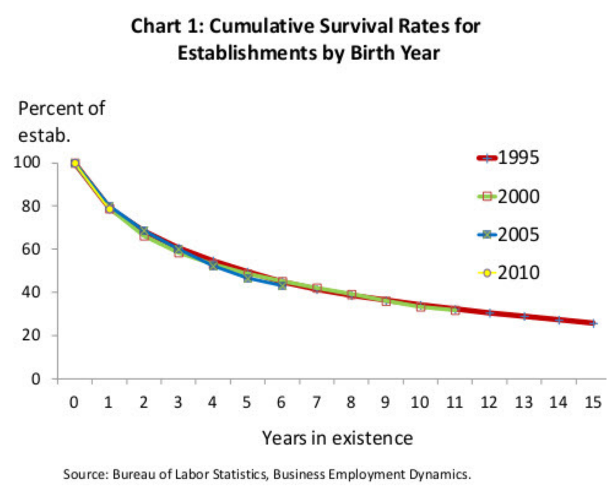
Risk and Return in Business

In this post I want to focus on the economic rationale for the first of these criteria—the prospect must have been in business for at least 3 years and preferably longer. When I was in practice I avoided start-ups for BD work. Here's why.

Peter Drucker suggests that the purpose of a business is to create and keep a customer. Far be it from me to "correct" Drucker but it I think he should have added " …. of the type who is a good fit for your business." And by that I mean there is a demonstrable mutuality of benefit for both parties.

An essential characteristic of business is that it involves placing bets with your money and/or your time. In this sense it embodies the characteristics of gambling. The objective of management in this context is to achieve an optimum balance between risk and return and this is more likely to be achieved if you have a good sense of what your risk exposure is and what you need to have in place to achieve a return on your intellectual capital.(2)

So with that idea in mind let's turn to the "3 year rule" of client selection. To start the conversation take a look at the graph below which shows the cumulative survival rates for start-ups by birth year (it's from the US Bureau of Labor Statistics but I'm certain the same pattern applies throughout the world.)



This graph highlights 4 things:

1. There is an amazingly consistent pattern of decline for each of the four birth year cohorts. This suggests that there is a natural law of business survival in play but most importantly it reminds us that other things being equal (which they aren't as I suggest below) the probability of a start-up surviving 10 years is almost certain to be about 33%. It's sobering to note that double zero roulette offers 46.37% odds for a Red/Black or Odds/Evens bets.
2. The probability of a business surviving 3-5 years lies in the range of 45-60% - let's say about 53%. For every client you lose during that time you'll need to pick up another just to stay where you

are. This means, amongst other inconveniences and costs, you'll incur a repeat of on-boarding costs as you familiarize yourself with the new client.

3. Once a business gets to year 5, the probability of it being around for at least 10 years rises to 62% - better odds than roulette. In other words if you start a professional relationship with a client who has been in business for 5 years there's a 62% chance the relationship can last for 10 years. It's therefore a better bet to invest your time and expertise with that client than a startup.
4. Once you get to year 10 the probability of lasting survival is very high. That's not to say these businesses will be highly profitable because most of them probably aren't but they are obviously profitable enough to survive.

That a business may survive 10 years does not mean it's going to be a good fit with your firm and that's where the other criteria come into play. For example a client might not be a nice person to deal with (which probably also means it's a business failure waiting to happen) so if you want your work life to be pleasurable you'd be better off without her.

She may also not be willing to seek or listen to your advice in which case you can't add value. So you're wasting your time because all you'll be doing is low value work, which is not the stuff you'll build a great firm on. This type of work is commonplace and is therefore incredibly hard to differentiate, and it's unbelievably boring for your team members so their level of engagement and loyalty is at risk.

I don't intend to go through all the criteria here but I hope you can see where I'm going with this. The first criterion deals with the probability of having a long-term relationship; the remainder of the criteria are about the quality of the relationship and in particular your ability to create value for the client. To put that another way, they define what you might describe as a *good-fit* client and a *bad-fit* client.

Good-Fit and Bad-Fit Clients

I define a *good-fit* client as being one where all or most of the criteria listed above apply. I define a *bad-fit* client as one where most of the criteria don't fit. You may not know whether a prospective client is a good or a bad fit at the time of an initial interview but you'll find out in the fullness of time.

I submit that the annual fee growth for a *good-fit* client will be significantly higher than that of a bad fit one. I further submit that a good fit client will be a much better referrer and more loyal than her *bad-fit* counterpart. Your team will get more value from working with her, she will push your firm to higher levels of performance because she will be more demanding and challenge you, this will give you the opportunity to be a stand-out performer in your market which is a powerful brand-builder and that will place you in a positive profit growth spiral, as a good-fit client she will enable you to value price simply because you are creating value whereas bad-fit client will continually be seeking "value" by expecting you to lower your price.

My basic argument here is that if you focus on working with clients who only want basic accounting and tax work done that's all you'll ever get really good at doing and you'll always "look like" the firm next door that's offering exactly the same service.

Need I say more?

Ron Baker, the author of several books including *Implementing Value Pricing* (which I consider to be required reading for anyone serious about managing a contemporary professional services/knowledge firm) suggests that "bad clients drive out good clients." He calls this Baker's Law and I agree with him that it deserves the status of a law. The most serious factor that limits profitable firm growth is the issue of client selection.

To get a sense of what value the concept of rigorous client selection has on the value of your accounting business let's put some numbers on this.

Bill, Ben and Mary: Three Client Prospects

Suppose for the sake of discussion three prospects walk into your office. We'll call them Bill, Ben, and Mary.

Bill is starting a new business. He seems to be a nice guy and he wants some advice about entity structure to minimize his tax and help with setting up an accounting system taking care of his taxes. Bill is a start-up client and would fail my 3-5 year test.

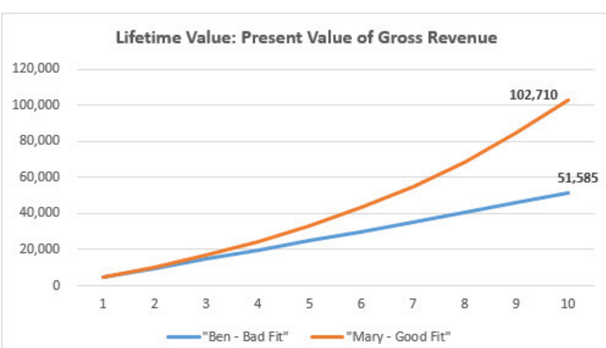
Ben has also been in business for 3 years. And he is unhappy with his previous accountant because "he charges like a wounded bull and doesn't return phone calls." He is looking for a new accountant to take care of his compliance needs – "nothing more" he says because "I've got a good handle on how to run my business." We'll assume Ben turns out to be a *bad-fit* client but one of the early warning signs is his criticism of his previous accountant (refer to criteria 3, 4 and possibly 2.)

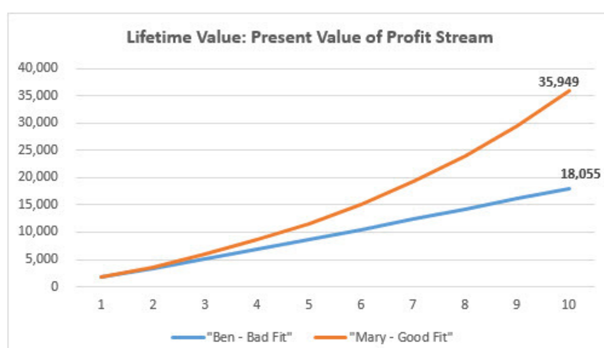
Mary has been in business for 3 years and she heard you specialized in business growth advisory services in addition to taking care of your clients' compliance work. Her business is profitable and she's keen to have your assistance to take it to the next level. We'll assume Mary is a *good-fit* client, which you'll pick up from the conversation you have with her.

To simplify the mathematics I'll make the following assumptions:

1. The fee for each of these people in year 1 is $5,000, which they all accept.
2. The fee for the *bad-fit* clients will grow at 5% per year
3. The fee for the *good-fit* client grows at 20% per year.
4. Bill goes out of business at the end of year 3.
5. Mary and Ben both survive and remain with your firm for 10 years.
6. I assume the net profit margin to be 35%
7. I use a discount rate of 3.5% to calculate the present value of the revenue and profit streams.

The graphs below reflect the value that each of these three clients represent to the firm during a 10-year time frame. The first graph looks at lifetime value from the perspective of fee revenue and the second graph looks at it from the perspective of net profit contribution.





Clearly these measures of lifetime value are proxies only but they do serve as indicative metrics of what *good-fit* and *bad-fit* clients are worth to a firm. For example, we should be working with contribution margin not net profit margin and we should probably attempt to take into consideration other factors such as referral leads, etc.

Furthermore, it's worth noting that the longer the time frame you get to work with a client the greater the value disparity between a *good-fit* client and a *bad-fit*. I should add, that a *good-fit* client is more likely to be with you for a longer time than a bad-fit client so my guess is when you consider these things the *good-fit* client would be even more valuable to the firm than my analysis suggests.

The graphs tell an interesting story.(3)

In the first few years there isn't much difference between the value contributed to the firm by Ben and Mary. It's easy therefore to believe Ben and Mary are more or less the same client type. It's not until around 5-6 years that their respective contribution to revenue and profit starts to move apart. Whereas Ben is happy just to plod along , as she hits her straps Mary will be looking for more support from her professional advisers.

This is where many firms run the risk of losing Mary because they're so preoccupied with bringing on new clients, predominantly of the Bill and Ben type because they represent the majority of candidates, that they under-service her. The tragedy is that Mary is just beginning to be a really significant profit contributor and potentially very valuable referral source for the type of clients like her. Ben, on the other hand, may also refer some clients but invariably they will be his type not Mary's.

By the time 10 years comes along the present value of the revenue stream and net profit stream from Mary is approximately twice as great as that of Ben's. But it gets even more interesting when you look at a 20-year profile. Refer to the following Summary Table.

Summary Table

	PV of Revenue Stream			PV of Profit Stream			PV of Firm Value Impact		Combined Value
	3 Years	10 years	20 years	3 Years	10 years	20 years	10 years	20 years	20 Years
Bill	14,704	0		5,146	0		0	0	
Ben	14,704	51,585	111,152	5,146	18,055	38,903	5,499	6,350	45,253
Mary	16,926	102,710	553,551	5,924	35,949	193,743	18,289	80,280	274,023
Client Quality Premium	115%	199%	498%	115%	199%	498%	333%	1264%	606%

After 20 years Mary has generated a revenue stream with a present value of $554,000 compared with Ben's $194,000 – a premium of some 498% - we might call this a client quality premium. A similar picture emerges when you look at Mary's contribution to the firm's profit. At the 20 year mark she will have contributed close to 5 times the amount of profit compared to Ben.

Now if we assume that the firm's value is based on $1 per $1 of revenue the Present Value of the contribution to the firm's value by Mary would be $80,280 (her annual fee in year 20 based on 20% compound growth would be $159,740 with a present value of $80,280) compared to Ben's $6,350 (annual fee being $12,635 based on 5% growth) and the combined value contribution to the firm from the net profit stream together with the incremental goodwill value from Mary would be $274,000 against Ben's $45,000—a 6x difference.

To get a sense of the importance of this you'll need to have 6 Bens for each Mary you bring on board and while you may disagree with me I believe that once you get your value proposition right, your processes right, and your marketing and sales right it's no harder to win Mary-type clients than Ben-type clients.

Another way to appreciate the full impact of this conclusion is to consider what your firm would look like if it had 50 Marys or alternatively 300 Bens. In each case the revenue might be the same, the profit might even be the same (although I seriously doubt it) but your life would be totally different.

Oh and one more thing with a 20 year time frame, 50 Marys would represent $4.014 million contribution to firm value while 300 Bens would yield $1.905 million. Quite a difference! But I believe this will turn out to be a very conservative assumption in the future because I seriously doubt that in 20 years firms will be valued at 1 times revenue. Given the way technology is accelerating, firms with a preponderance of Ben-type clients will be the poor cousins in the industry and quite likely have little value at all. On the other hand emerging technologies will enable firms that take care of clients like Mary to create even more value than they can now and accordingly the value of those firms will be an order of magnitude higher that those that don't.

Why Not Accept all Prospects?

You might look at the conclusion that Mary is a way better client to have than Ben and certainly Bill and say "of course she is, your assumptions obviously lead you to that conclusion. Tell me something I don't know."

That's a very fair point and you're right. You'd also be right to suggest that it's hard to identify client quality from an initial interview—although it's not as hard as you may think but that will be left for later discussion.

But the point I'm trying to make is the sooner you figure out who the Bills, the Bens and the Marys are and make the necessary adjustments to change the allocation of your resources to better fit the various clients you're dealing with or get rid of the Bills and possibly the Bens so that you can allocate your scarce resources to people in respect of whom you can create more value and consequently capture more value.

You might also, quite reasonably, argue that you should keep all of the client prospects and let natural selection play out while harvesting the profit contribution. The problem with this is that natural selection tends not to play out and relatively low contributing clients of the Ben type often hang around and consume resources that have a high opportunity cost. In some cases because of poor resource allocation you actually lose money on Ben if the full service cost is actually charged to him. Sure the Bills disappear but not before they have consumed valuable time that could have been put into building more relationships with people like Mary.

"The problem with this is that natural selection tends not to play out and relatively low contributing clients of the Ben type often hang around and consume resources that have a high opportunity cost."

The Virtuous Circle of Client Selection

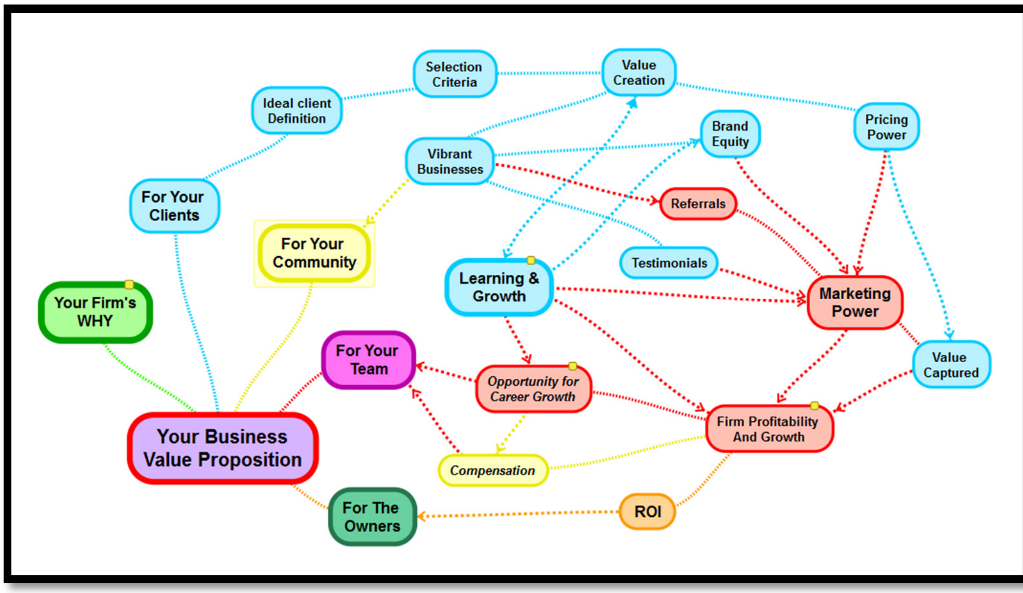
And that brings me to the comment I opened this White Paper with:

> *"… once I focused on taking more care in selecting the people I chose to work with everything changed. It turned out to be a slower process than I had hoped but the foundation I built was strong and my practice never looked back."*

Once you get client selection right a virtuous circle of firm performance improvements starts to take effect. The figure below summarizes how that takes place.

It all starts with your business value proposition which sits at the heart of your business model. That has implications for your key stakeholders – team, clients, owners, and community. To create value for clients you must work with clients who have value growth potential. That mandates a selection process. Value creation ensues which has a multi-faceted impact on your brand, referrals, marketing effectiveness, pricing power, and profitability. The inter-connecting lines in the figure drives home the fact that the selection of clients is just one piece of the inter-connected fabric of the business but it's an essential element of your firm's business model—remember, a business model describes the way you create, deliver, and capture value.

The Virtuous Circle of Client Selection



At the center of the virtuous circle is learning and growth. This is a critical element of the process and stems directly from learning to do challenging work for *good-fit* clients. It is what enables you to differentiate your firm and earn premium profit because remember, you are in the knowledge industry and the better your knowledge compared to your competitors the stronger will be your competitive advantage. This will be reflected in premium profitability, which is both the cause and consequence of firm growth which means career growth and compensation growth for team members not to mention the obvious reward for owners.

You will realize this competitive advantage in several ways. For example, the type of work I'm talking about is inherently interesting while being challenging. This is the type of work that attracts and retains talented people because as positive psychologist Mihaly Csikszentmihalyi says, it sits at the interface between challenge and skill and creates an opportunity for team members to get into a state of flow—that state of being where you're totally absorbed in what you're doing and time just seems to fly.(4) Dan Pink says the same thing. If you want to attract and retain talent you need to create an environment that encourages intrinsic motivation and to do that you must provide an opportunity for autonomy, growth through learning, and a sense of purpose.(5)

At the end of the day your community is the beneficiary of a vibrant business scene. Any way in which a professional service firm can play a role to prevent business failure and contribute to business success has to be good for everyone. I believe technology is coming into play that will enable savvy accounting firms to play a dominant role in driving business success. The firms that embrace this opportunity will prosper, those that ignore it will be marginalized.

"Far and away the best prize life has to offer is the chance to work hard at work worth doing." Teddy Roosevelt

Notes

(1) A Gallup survey of almost 18 million customers revealed than only half of them strongly believe that companies they deal with deliver on their brand promise. The highest performing companies deliver on their brand promise 75% of the time according to their customers in other words doing what you say you'll do is good for business. There is a very strong message here for both having a Brand Promise (Mission Statement) and most importantly, delivering on it. The article includes several suggestions on how to address this issue. It is titled *Companies Only Deliver on Their Brand Promise Half the Time*. http://bit.ly/1dJ1OZv

(2) When reviewing an earlier draft of this paper Ron Baker suggested that business decisions, or "bets" as I have described them here, are not really gambling. He argued that gambling is paying to take a risk, without any gain in knowledge if one loses. A risk taken in business can result in profit or loss, plus a gain in knowledge. He also suggested that my reference to return on effort would be better stated as the return on intellectual capital. Both of his suggestions make sense but the message I am trying to convey is that businesses operate in an uncertain environment (uncertainty can't be measured) and management makes decisions that have the character of bets in the sense that there is a probability of certain outcomes (risk can be measured by means of probabilities based on observed experience). In the context of taking on board a new client, the risk is the client will not survive more than a certain period of time, and there is probabilistic data on that, during which the firm will have incurred on-boarding costs and will have invested time with that client that would have been better invested with a client who, based on conformity with criteria of the type I have suggested, has a greater probability of surviving for a longer period of time and a greater probability of receiving and therefor paying for value creating services.

(3) The Excel spreadsheet used in this analysis is available for download from a January 2016 post titled *Client Selection: Get it Right and You'll Do Your Banking in Cornsacks* on my blog site at www.theconsultingaccountant.com

(4) Mihaly Csikszentmihalyi, *Flow: The Psychology of Optimal Experience* ,Harper Perennial, (1990, 2008)

(5) Daniel Pink. *Drive: The Surprising Truth About What Motivates Us*, Riverhead (2009)