Results Revisited

Reno, May 1998

And partly revisited again 23 years later
January 2021

Some Foundational Issues

The 3 Key Problems

1. We allow our clients to dictate the terms of our relationship.
2. We fail to articulate the value of the work we do.
3. We try to be all things to all people.

Why have we allowed this to happen?

4. We are in a mature industry.
5. The way business is done in our industry is 'settled'
6. We follow the pack because we grew up in the pack – it's comfortable there.
7. We refuse (or are unable) to acknowledge the forces of change.

This leads us to embrace the traditional practice growth paradigm:

MORE OF WHAT WE DO
X
MORE CLIENTS
=
More Fees and More Profit

But it also equals . . .

More competition for a finite number of clients which in turn leads to price and promise marketing and lower margins.

As an industry we are at, what Andy Grove (when CEO of Intel), describes as the Point of Strategic Inflection.

> "The point in the life of a business [or an industry] when its fundamentals are about to change. The change can mean an opportunity to rise to new heights. But it may just as likely signal the beginning of the end.
>
> Strategic inflection points can be caused by technological change but they are more than technological change. They can be caused by competitors but they are more than just competition. They are full-scale changes in the way business is conducted, so that simply adopting new technology or fighting competition as you used to is no longer sufficient.

> They build up force so insidiously that you may have a hard time even putting a finger on what has changed, yet you know something has.
>
> [It's that time] when something is changing in a big way, when something is different, yet when you're so busy trying to survive that the signals of change only become clear in retrospect."
>
> Andrew S. Grove, Only the Paranoid Survive, Doubleday, 1996.

My Fundamental Proposition is that

As practicing accountants we can . . .

- Build on our skills and existing client relationships
- And harness technology
- To provide clients with knowledge-based support using smart systems and rich networks
- That will be significantly more valuable than the generic, product-look, un-differentiable, compliance services we now offer
- And for this reason our clients will be willing to pay significantly for access to that service
- And because most of our competitors will not embrace change we will have a source of sustainable and defendable competitive advantage

Some Brief Comments on Strategy and Value Creation

In future, historians may look upon the 20th century as the period in time when the free enterprise system was established as the most efficient mechanism to direct resource allocation to maximize wealth creation. Whether it is remembered for its efficiency on the issue of wealth distribution is another matter.

When competitive forces are at work in a free enterprise system any industry that exhibits a capacity for superior wealth creation will attract investment from other players. As the forces of competition intensify, industry margins inevitably decline while at the same time the quality of industry output improves. This phenomenon reflects the inevitable, inexorable shift in value from producer to consumer. Ultimately it will occur in every industry. Indeed it is a characteristic of a mature industry.

The accounting services sector is a mature industry. Many of its existing firms will not survive as the process of consolidation continues and competition from firms outside the industry continue to drive margins down and clients away from the traditional service providers.

The firms that do survive will be those who can see and understand the forces of change and the competitive opportunities they present. They will be firms in which managers understand that the value they create for their firm is directly linked to the value they create for their clients because only in those circumstances will clients be willing to pay premium prices: the necessary ingredient to maintain margin.

They will also be firms in which their managers understand that the clients for whom they can create value are those who are in attractive industries and/or they can build and maintain a competitive advantage.

The fundamental purpose of a business is to create value for its owners. For a business to create value for its owners in the sense of increasing their wealth the measure of value must be a positive economic profit.

Economic profit is defined as net operating profit after allowing for arms length compensation for working owners and the cost of capital employed. In most industries, and in particular in mature industries, the average firm does not yield an economic profit. In other words, most industries are unattractive industries.

However, in all industries there are firms that consistently yield a positive economic profit. These firms have adopted a superior business strategy which is reflected in a competitive advantage in relation to their co-competitors and a positive value alliance in relation to their customers.

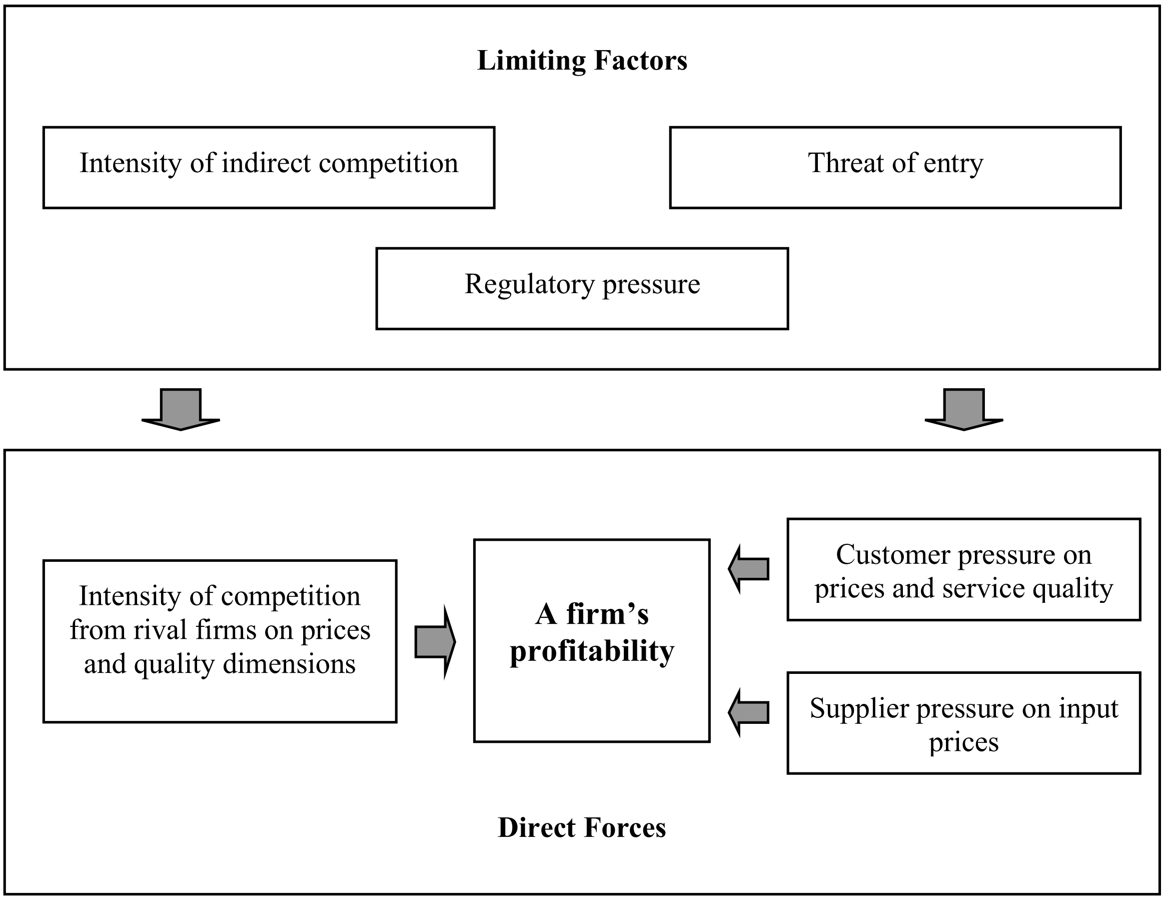
A firm is said to have a positive value alliance with its customers when both the firm and the customers realize value from the transactional relationship. The key to competitive advantage therefore is to create a business model that provides products and/or services to customers at a price that creates value for both the firm and its customers. It is a business model that other firms in the industry (or outside the industry) do not or can not replicate.

Competitive Forces and their Impact on Market Economics

There are six forces of competition that determine fundamental industry or market economics. That is, they determine industry cost structure and prices and therefore profitability.

The six forces of competition are:

1. Intensity of indirect competition
2. Threat of entry
3. Regulatory pressures
4. Intensity of direct competition
5. Customer pressure
6. Supplier pressure



It is useful to break these into two groups: those that act as limiting forces and those that represent direct forces. The limiting forces are the intensity of indirect competition, the threat of entry by other firms and regulatory pressures. The direct forces on economic profitability are the intensity of direct competition, customer pressure and supplier pressure.

The limiting forces do not impact directly on industry economic profitability but their presence and intensity will prevent firms in the industry raising prices to levels that will encourage entry, attack or regulation. In that sense they impose a ceiling on prices and economic profit.

Whereas the limiting forces impose a ceiling on economic profit the direct forces determine how low the floor will be in the industry. These forces are what the average firm confronts every day in the market. There are four determinants of the strength of these forces. They are:

The amount of excess capacity in the industry.
If there is excess capacity it is likely that aggressive pricing will be adopted by firms in an attempt to win market share. This is particularly common in industries that are capital intensive and therefore have a high fixed cost structure. But it will also be seen in industries that have low barriers to entry because there will always be someone out there willing to enter irrespective of the economic profit.

The degree of standardization of the product or service.
If the product or service is essentially generic in nature and if customers are unable to base purchase decisions on anything other than price it is likely that margins will be low.

The number and concentration of rival firms.
If the industry is highly concentrated it is likely that it will have more mature and rational competition. In these circumstances, prices will tend to settle at a level that is high enough to yield an economic profit but low enough to act as a barrier to entry. This is one of the reasons we see industry concentration occur in traditionally fragmented industries as they reach maturity. The consolidators realize that low industry profits are transitory and once the process of consolidation is complete, margins will typically improve. Furthermore, to the extent that the concentrators are able to create value from, and for, the traditional customers of that industry by offering access to a broader product or service line there is further scope to enhance economic profit that would not be available to the smaller existing firms.

The growth in natural demand.
When demand is growing rapidly there is adequate profit for all firms without them resorting to price driven competitive strategies. In these circumstances, where there are also low barriers to entry, new firms will enter the industry almost unnoticed. If (or when) growth slows economic profits quickly disappear. There is then excess capacity. Firms typically interpret this as a slowdown rather than as a fundamental change in industry structure and the competitive landscape. This view is fed by the memory of past success and limited alternative options other than to remain in the industry.

The Forces of Competition Impact on ALL Industries

No industry and no firm within an industry can escape the forces of competition. Inevitably, they serve to drive down the economic profit of the average firm to a neutral or negative position.

The only strategy . . . that makes sense

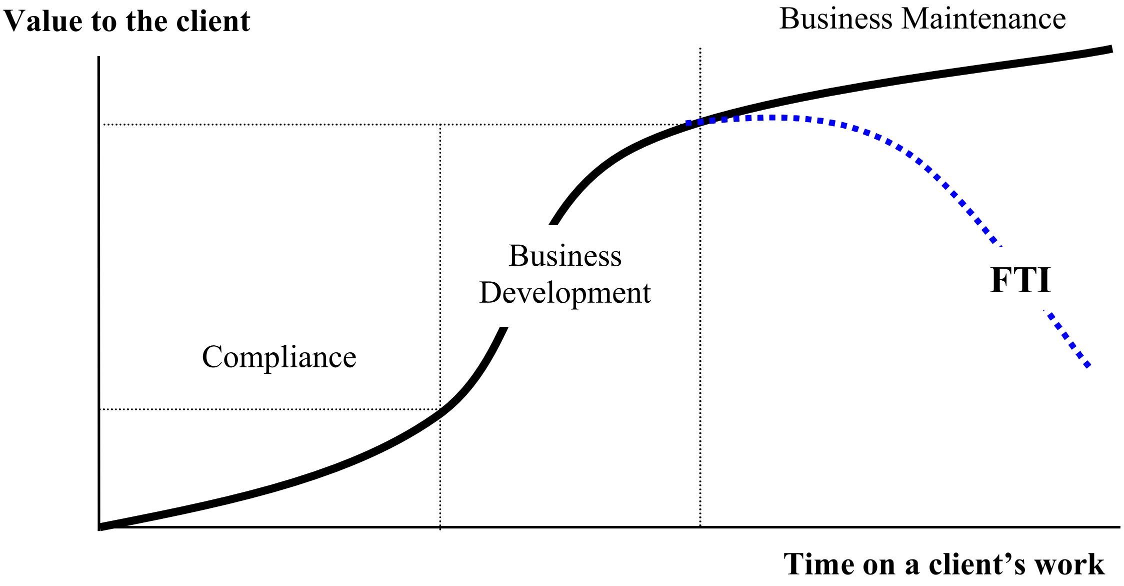
…… that will work for any firm in any industry is one based on differentiating and/or dominating a niche. To do that it must carefully select its customers and know how to create value for them by knowing precisely what products and services they need. It must do that efficiently so that its costs (including the cost of capital) are lower than the value (and hence prices) it creates. It must also select who its competitive rivals are going to be. If it elects to compete against firms that have the same strengths and characteristics, its success will be short lived. It must also build a strategy on initiatives that competitors will find difficult or impossible to replicate.

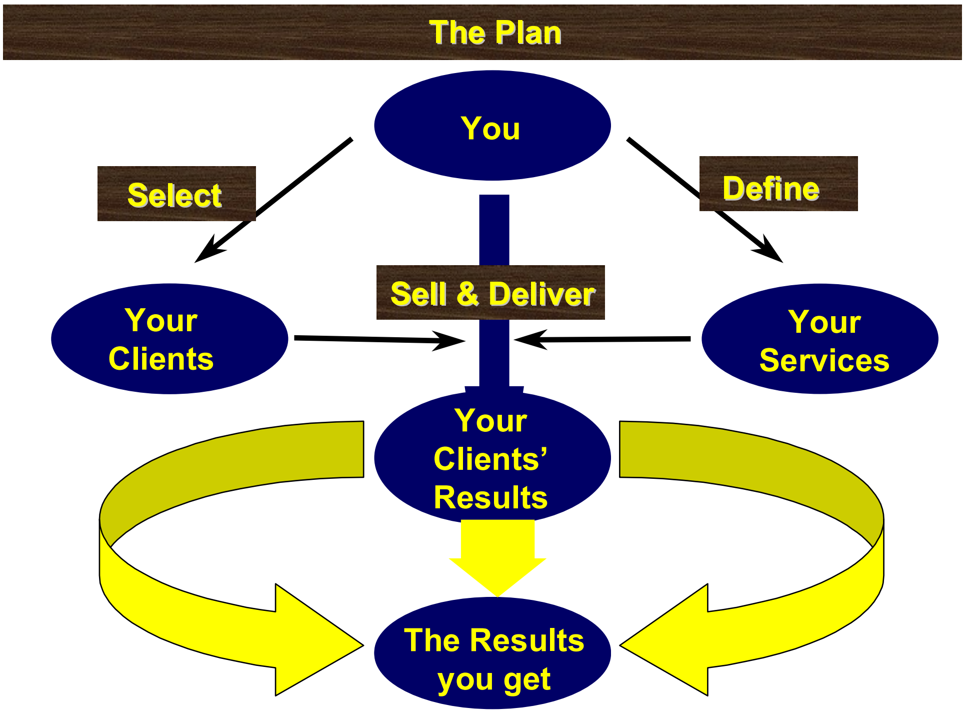
A Change in Paradigm is needed

(Where does your paradigm fit right now?)

From		To	
Volume		Focus	
Cost		Value	
Profit		Relationship	
Past		Future	
Reaction		Pro-action	
Expert		Facilitator	
Delivering		Selling	
Control		Empowerment	

From Compliance to Reliance





The focus of your attention needs to be on ……

You and Your Business

Your clients
Your services
Your Action Plan

Do you need (want) to change?

If you're happy with the way things are now you may not feel a sense of urgency.

If you are not happy then you should remember

> "… if you continue to do what you have always done you can expect to get what you've always got provided that the circumstances in which you operate do not change!"

If change is on your agenda. The question is, where do you start?

For there to be a beginning there must first be an end. Therefore, you must be willing to unshackle yourself from your existing paradigm.

If you're willing to change only if it :

- Carries no risk
- Produces quick results
- Is inexpensive
- Will not offend
- Does not consume your personal time
- Does not require a change in your behavior

Don't
Bother