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Where Is the Accounting Profession Heading?

Executive Summary and Part 1

What you need to be thinking about and doing now to be a serious contender in the emerging competitive space …

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Executive Summary

The accounting profession has a rich tradition extending back over 100 years. It has provided a noble service to society and its members deservedly enjoy a high level of trust. That trust is being drawn into sharp focus at this time because of the actions of a small number of individuals and firms and there is no doubt that the industry will change as a consequence.

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The profession is comprised of two distinct groups of firms. The very large ones account for close to 50% of industry revenue and number less than 50. The remainder of the industry is made up of nearly 43,000 firms only 5% of which employ more than 20 people. The very large firms are so different from the rest of the industry in terms the type of services they offer and the clients they serve that they are better considered to be in a different industry.

The rest of industry is highly fragmented and its economics are such that it is likely to remain that way. However, it is an industry that has matured and there is limited opportunity for growth in either revenue or profit as long as it continues to offer the same suite of services that it has in the past.

While there are pockets of prosperity within the industry (and they can be found in both large and small firms) the vast majority of firms are making more or less the same profit per owner. This is understandable because they are all doing the same thing, for the same clients, with the same skill sets, at the same price, using the same technology.

The intensity of competition is likely to increase and place further pressure on margins. This will be exacerbated by a serious shortage of talent and its impact on professional salaries (the major industry expense) in coming years. This is going to be a major challenge for small firms that have limited growth prospects because of the strategic choices they make today.

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If the firm down the road was a formidable competitor you would have already lost the battle …

Typically when accountants think about their competitors they think of the firm down the road. It is true that they are competing for local market share but it is totally wrong to believe that's where the greatest threat lies. If the firm down the road was a formidable competitor you would have already lost the battle. The real competition is going to come from adjacent industries particularly in the technology and broader financial services sectors. The Florida landmark case involving American Express Tax and Business Services paved the way for this to happen but the major driver of change will be technology operating within a de-regulated environment.

The profession has long been aware that technology has caused a displacement of labor by taking over much of the routine work and enabling clients to do a significant amount of their own accounting, but that is not the real issue.

Whereas in the past technology has led to improvements in the productivity of data processing and financial report generation, the future will be marked by much greater focus on the intelligent interpretation of information and decision making support. The view will shift more to the future than the past. In an environment of rapid change the past is a very poor predictor of the future and there is plenty of evidence to support the notion that the past financial performance of an enterprise is a very poor indicator of its future prospects.

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Key indicators of future performance will be measures of “corporate culture”, the “quality and depth of management”, the “integrity” of the business strategy in the context of the emerging competitive landscape, the value of intangible assets such as “brand equity”, “know how”, “innovative capacity” and “execution ability” which reflect the “quality” of the organization’s workforce and its ability to use, retain and expand its experiential knowledge, it’s collaborative capability and perhaps most important, it’s willingness and ability to deal with change. All of these things will ultimately be reflected in bottom line financial results but those results are lag indicators of success or failure. What people need is lead indicators to allow them to make informed decisions and take calculated risks.

Measures of this type are not addressed in GAAP. If accountants are going to play a valuable role in providing information for internal and external decision making, they will need to broaden the scope of their measurement system (perhaps based on Generally Accepted Measurement Principles—GAMP may become the acronym) because if they don’t, someone else will and whoever does will be at a much higher position in the information value chain.

Technology is going to re-define the total value proposition in the context of a rapidly emerging knowledge economy. We are already seeing accounting systems be renamed (and positioned) as Business Managers. These systems are being linked to broader knowledge bases and management tools with names like Enterprise Digital Dashboards.

In the fullness of time there is no doubt that these tools will become mainstream and any accountant who is not thinking about this now is already one day behind those who are. The scenario painted by these developments is one of disintermediation in which accountants who focus on compilations and reviews and low level tax preparation will find themselves very much marginalized at the bottom end of the industry value chain if they survive at all.

The reputation of the profession has not been well served by the Enron scandal. However, something like this has been waiting to happen for a long time and it is unfair to lay all the blame at the feet of the profession …

The reputation of the profession has not been well served by the Enron scandal. However, something like this has been waiting to happen for a long time and I believe that it is unfair to lay all the blame at the feet of the profession. Nonetheless, the consequences of Enron (and other big failures) for the profession will be far reaching. It is highly likely that it will split into two faculties, which is already reflected in what the consolidators are doing through the acquisition of the non-attest part of acquired firms and the consulting business spin-offs undertaken by some of the Big 5 in recent years.

There will be auditors and there will be the rest of the profession.

In the long haul, the latter group will morph into generalist business advisors linked together through a global network.

Today's CPAs who fail to make this transition will probably disappear.

There will be auditors who, through the impact of supply and demand, will significantly increase their prices and there will be the rest of the profession who do the things accountants can do as advisors to businesses and individuals. In the long haul I expect the latter group will morph into generalist business advisors linked together through one of many global networks that will provide backroom support for high cost research and development. That's where they will bring the greatest value to the table and it will become the mainstream of their practice within a decade. Today's CPAs who fail to make this transition will probably disappear.

These changes will pose serious challenges for professional organizations responsible for the delicate balance between the interests of society and those of their members who also include the 40+% of CPAs who are not in the public practice arena. In my simple mind, it is an almost impossible challenge.

The rate of change coming from so many different directions must lead us to the conclusion that the future will be nothing like the past. We're seeing, for example; globalization of businesses (including an increasing number of small enterprises), pressure to change taxation systems, changes in demographics and its impact on consumer demand not to mention shifting political clout, the impact of telecommuting and teleservicing on work preferences and patterns, emerging centers of economic power such as China and India and with that the massive market potential that will evolve as the middle-classes in those countries grow, but at the same time, the enormous challenges still faced by under-developed countries in South America, Central Asia and parts of the Middle East will widen the gap between the haves and the have-nots contributing to the potential for global instability.

The questions that the leaders of today's accounting enterprises need to be asking include:

- What is the vision I have for my firm 10 years from now? In framing that vision I need to be thinking about the following issues.
- In what ways are my clients' businesses changing and what does that mean for the services I should be offering now and in the future?
- Who are my future competitors from within and outside the industry going to be? What am I doing today that will help me really stand out from these competitors?
- What technologies should I be using now to better service my clients, in particular how well appraised am I of what initiatives are being introduced or offered by firms in adjacent industries?

In what ways are my clients' businesses changing and what does that mean for the services I should be offering now and in the future?

- What process or product innovations have we introduced in the past three years to better service clients and offer a more valuable business value proposition? Do we lead or follow the pack when it comes to introducing new ideas?

To what extent am I really adding value to my clients? Is their business performing better as a direct result of my firm's involvement or are we simply providing a service any CPA could do for them?

- To what extent am I really adding value to my clients, by that I mean, is their business performing better as a direct result of my firm's involvement or are we simply providing a service that any CPA could do for them?
- To what extent am I being held captive by some of my clients who, for their own reasons, do not see any need to change their service requirements but who I allow to consume my valuable resources for fear of losing some short term revenue that has little or no growth potential?
- In what ways am I attempting to change the culture of my organization to better accommodate the work preferences and environment needed to attract and retain talented people?
- What am I doing now to implement re-training of my people to equip them with the skills that are going to be needed in the future?
- What are my plans to align with a network that will be able to provide back office research and development support, global reach and a source of colleagues I can collaborate with to quickly and effectively offer affordable solutions to my clients without risking them being lured away from my firm?
- How adaptive is my firm to change? Specifically, based on our past behavior, have we been willing to cast aside legacy ideas and systems so that we are better equipped to accommodate new opportunities?
- And the final but critical question: what resources in the form of time and money am I willing to invest to ensure that my firm not only transitions successfully to a new service model but takes rank with the top performers in the industry?

"If the rate of change inside an organization is less than the rate of change outside … the end is in sight."

Jack Welch,
General Electric

The background environmental changes that are driving the need for the leaders of all firms in the accounting industry to re-think their future operating model are discussed fully in the white paper.

In that context, today's leaders need to reflect on what Charles Darwin concluded: "It's not the strongest nor most intelligent of the species that survive; it is the one most adaptable to change." This is a conclusion also reached by General Electric's, Jack Welch, and which he articulated clearly when he said, "If the rate of change inside an organization is less than the rate of change outside …. the end is in sight."

I hope there is no end in sight for this profession.

Introduction

No industry is excluded from the impact of environmental change. As the forces of change inexorably exert their influence on industries, the shape of the competitive landscape changes. Old ideas and ways of doing things become irrelevant and die. New ones emerge and dominate.

In practically any industry you care to look at, significant change comes not from within, but from outside.

In practically every industry you care to look at, significant change comes not from within but from outside. People and organizations from outside who refuse to accept the traditional paradigm rewrite the rules and a new industry emerges with different participants and a totally new value creating potential. The new value proposition and the industry wealth it represents does not come from innovation at the margin and incremental improvements in efficiency, it comes from a dramatically different industry servicing old customers in new ways.

In new environments, traditional industry boundaries blur (or disappear). Some firms grow rapidly and prosper while others languish as their leaders grope around trying to understand what is happening and why the economic rewards from their traditional franchise seem to be disappearing. These so-called leaders draw comfort from rationalizing what is rather than exploring what might be. Denial is the order of the day. Mediocrity and/or failure is the inevitable consequence.

In his book *Only the Paranoid Survive,* Andy Grove introduces the concept of a point of strategic inflection to define that point in time when the drivers of change radically alter the way business is done. He defines it as:

> "…a time in the life of a business when its fundamentals are about to change. That 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 a new technology or fighting the competition as you used to may be insufficient. They build up so insidiously that you may have a hard time even putting a finger on what has changed, yet you know that something *has*." [1]

In new environments, traditional industry boundaries blur (or disappear altogether).

In this white paper I will address the issue of the point of strategic inflection from the perspective of the accounting profession. I'll do that by first examining the current structure of the profession and the fundamental economic forces that have shaped the competitive landscape. I'll then examine the impact that major drivers of change are having on the profession and adjacent industries and postulate what that may mean for the firm of the future. I'll conclude with some suggestions as to what the leaders of today's firms should be doing now to ensure the relevance and success of their business in the future.

The Structure of the Competitive Landscape

The accounting services sector in the USA[2] is a $60+ billion industry if all firms that provide the services typically associated with the accounting profession are included.[3] Of this revenue base, CPA firms account for approximately $38 billion with the balance being attributable to non-CPA businesses.[4]

Industry Structure

Table 1 summarizes data from the 1997 Economic Census for CPA firms and provides us with a picture of the industry's structure.

Of the 43,000 CPA firms at census date, 95% employed less than 20 people

For the purpose of this analysis, small firms are defined as being those employing less than 20 people, mid-sized firms as those employing between 20 and 249 people and large firms are those with more than 250 employees.

Of the 43,000 CPA firms at census date, 95% employed less than 20 people. These firms account for only 35% of total industry revenue but employ 45% of total industry employment. Even within the small firm group, 64% of firms employ less than 5 people but account for only 13% of industry revenue. This is a highly fragmented segment of the profession, and competition for clients is intense.

In contrast, according to the definition given above, there are only 40-50 large firms in the large category representing about one tenth of 1% of the total number of firms. However, they account for over 46% of industry revenue and 33% of sector employment.

Large firms with more than 250 employees have strong affiliations with similarly placed firms abroad and for all practical purposes have the same depth and breadth of firepower possessed by the Big 5. But they lack the brand equity enjoyed by the Big 5, and this excludes them from a significant portion of the very large global company market serviced by that group.

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In the aftermath of the Enron scandal, the value of the brand equity possessed by the Big 5, and the profession in general, is now being called into question—more will be said about that and its impact on the profession later.

In most industries, firms that feel the greatest pressure tend to be those in the middle because they neither have large-scale dominance nor small-scale flexibility. They have competition from below and above and they tend to have difficulty defining their true identity and primary market focus.

Firms at the upper end of that group pitch against a Big 5 firm for a $200 million revenue client one day and the next day they're pitching against a national or regional firm for an engagement with a closely held company doing $5 million in revenues and 20 employees.

Table 1 Revenue and Employment in US CPA Firms (1997)

Firm size by # employees	Firms		Revenue		Revenue Per Firm	Revenue Per Employee	Employees	
	Number	% of Total	$'000	% of Total	$	$	Number	% of Total
Small Firms								
1 to 4	27,279	63.54%	4,762,396	12.58%	174,581	81,989	58,086	15.25%
5 to 9	9,529	22.20%	4,369,942	11.54%	458,594	71,103	61,459	16.13%
10 to19	4,044	9.42%	4,057,477	10.72%	1,003,333	77,331	52,469	13.77%
Small Firm Total	**40,852**	**95.16%**	**13,189,815**	**34.85%**	**322,868**	**76,679**	**172,014**	**45.16%**
Mid Size Firms								
20 to 49	1,630	3.80%	3,994,250	10.55%	2,450,460	84,841	47,079	12.36%
50 to 99	302	0.70%	1,847,831	4.88%	6,118,646	90,776	20,356	5.34%
100 to 249	107	0.25%	1,331,615	3.52%	12,445,000	89,774	14,833	3.89%
Mid Firm Total	**2,039**	**4.75%**	**7,173,696**	**18.95%**	**3,518,242**	**87,199**	**82,268**	**21.60%**
Large Firms								
250 to 499	19	0.04%	558,183	1.47%	29,378,053	91,028	6,132	1.61%
500 to 999	13	0.03%	742,335	1.96%	57,102,692	81,809	9,074	2.38%
> 999	9	0.02%	16,187,987	42.77%	1,798,665,222	145,271	111,433	29.25%
Large Firm Total	**41**	**0.10%**	**17,488,505**	**46.20%**	**426,548,902**	**138,097**	**126,639**	**33.25%**
Total	**42,932**	**100.00%**	**37,852,016**	**100.00%**	**881,674**	**99,370**	**380,921**	**100.00%**

Source: US Economic Census, 1997 US Bureau of Census.

Firms at the bottom of the middle group meet small local firms in the market on a daily basis but are also going head-to-head with the other firms in the mid-size firm category.

The average revenue for the small number of large firms is significantly higher than the rest of the profession and a good case can be made that large firms are not in the same industry as small firms and most mid-sized firms. This is clearly shown in Table 1.

The vast majority of firms are employing people with similar skills and experience – this has implications for one of the big issues facing the profession – the war for talent …

That said, there is unquestionably competition at the margin between each of the firm size cohorts. The data suggests that most of them have a similar look and feel. They compete for the same types of clients and offer the same services. Support for this proposition can be found by looking at the average revenue per establishment and the average payroll per employee shown in Table 2.

When we look at the revenue per office location it can be seen that firms with 20 – 49 employees are not that much smaller than firms with 100 – 249 employees. One senses that the only difference will be the amount of space used. Similarly, when we look at payroll per employee there is very little difference. This indicates that the vast majority of firms are employing people with similar skills and experience. This of course has implications for one of the big issues facing the profession — namely the war for talent, and we will discuss that issue later.

Table 2. Selected Data on Firm Size for US CPA Firms (1997)

	Firms	Offices	Offices Per Firm	Revenue Per Office	Employees Per Office	Payroll Per Employee
Firm size by # employees	Number	Number	Number	$	Number	$
Small Firms						
1 to 4	27,279	27,290	1.0	174,511	2.13	26,697
5 to 9	9,529	9,633	1.0	453,643	6.38	30,776
10 to19	4,044	4,399	1.1	922,363	11.93	38,240
Small Firm Total	**40,852**	**41,322**	**1.0**	**319,196**	**4.16**	**31,676**
Mid Size Firms						
20 to 49	1,630	2,215	1.4	1,803,273	21.25	43,437
50 to 99	302	621	2.1	2,975,573	32.78	45,311
100 to 249	107	413	3.9	3,224,249	35.92	43,351
Mid Firm Total	**2,039**	**3,249**	**1.6**	**2,207,970**	**25.32**	**36,069**
Large Firms						
250 to 499	19	117	6.2	4,770,795	52.41	41,757
500 to 999	13	124	9.5	5,986,573	73.18	31,616*
> 999	9	649	72.1	24,942,969	171.70	47,600
Large Firm Total	**41**	**890**	**21.7**	**19,650,006**	**142.29**	**46,171**
Total	**42,932**	**45,461**	**1.1**	**832,626**	**8.38**	**39,147**

Source: US Economic Census, 1997 US Bureau of Census.
* The average payroll per employee for firms in the 500 to 999 employee cohort seems to be an anomaly when compared to the adjacent cohorts. It may be that this group employs relatively more lower paid people than the others, other than that we can't explain what appears to be a significant difference.

Profitability and Firm Size.

The available data does not allow a detailed analysis to be done on profitability. However, we can draw a couple of general conclusions.

Table 3 shows the contribution margin, defined here as the difference between average revenue and average payroll per employee. Very small firms have a higher margin because the owners do most of the billable work and their salary is not considered in the total payroll. If proper allowance was made for the opportunity cost of the owners' labor, small firms would generally have a very low level of profitability. As margins for low-end work continue to be squeezed, I believe that these firms face serious, and possibly existence-threatening, challenges in the future.

Table 3

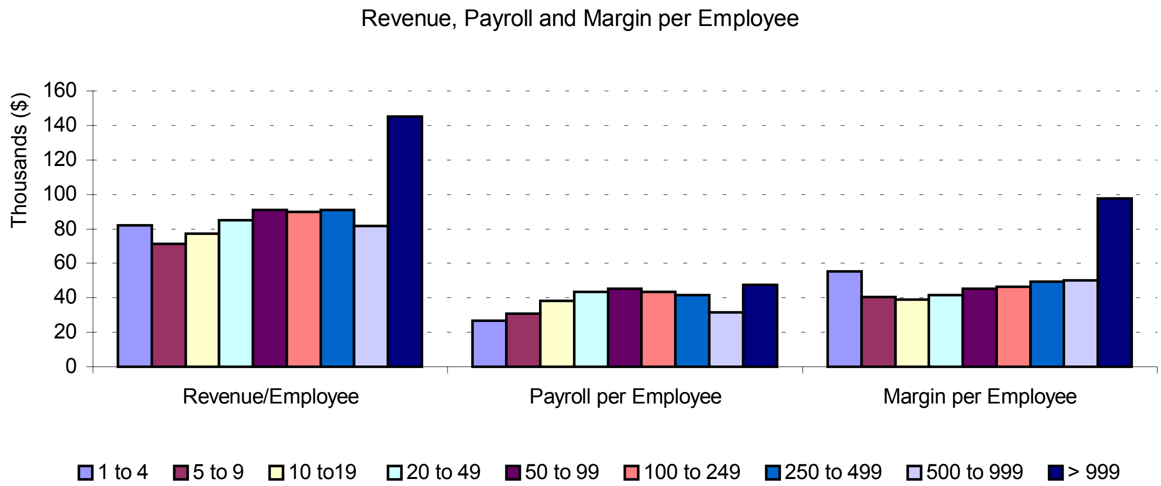
Firm size by # employees	Payroll Total $'000	Payroll Per Person $	Payroll % Revenue	Contribution Margin** Per Employee $	Contribution Margin** % Revenue
Small Firms					
1 to 4	1,550,750	26,697	32.56%	55,291	67.44%
5 to 9	1,891,468	30,776	43.28%	40,327	56.72%
10 to19	2,006,430	38,240	49.45%	39,091	50.55%
Small Firm Total	**5,448,648**	**31,676**	**41.31%**	**45,003**	**58.69%**
Mid Size Firms					
20 to 49	2,044,984	43,437	51.20%	41,404	48.80%
50 to 99	922,344	45,311	49.91%	45,465	50.09%
100 to 249	643,025	43,351	48.29%	46,423	51.71%
Mid Firm Total	**2,967,328**	**36,069**	**41.36%**	**51,130**	**58.64%**
Large Firms					
250 to 499	256,051	41,757	45.87%	49,271	54.13%
500 to 999	286,886	31,616*	38.65%	50,193	61.35%
> 999	5,304,158	47,600	32.77%	97,672	67.23%
Large Firm Total	**5,847,095**	**46,171**	**33.43%**	**91,926**	**66.57%**
Total	**14,912,096**	**39,147**	**39.40%**	**60,222**	**60.60%**

Source: Source: US Economic Census, 1997 US Bureau of Census.
* Please refer to the comment below Table 2 in relation to this statistic. There seems to be an anomaly in the data.
** Contribution margin is defined as revenue per employee less payroll per employee.

As firms get bigger, the contribution margin declines and settles around 50% of revenue. The very large firm cohort (>999 employees) has the highest contribution margin when measured on a per employee basis and also as a percentage of revenue (refer to Table 3 and Figure 1). Firms in that group also have the highest level of employee leverage (that is, the number of employees per owner). However, for all practical purposes very large firms are in a "different" industry than the rest of the profession. They don't even refer to themselves as CPA firms, so comparing them with the rest of the industry makes little sense.

For all practical purposes, very large firms are in a 'different' industry than the rest of the profession

Figure 1



When we exclude large firms a remarkable picture of consistency emerges. This can be expected when we consider that they do the same things, with the same people, for the same clients using the same technology and more or less at the same prices. However, census data for an entire industry disguises wide differences in performance that a smaller sample of firms will reveal.

The two main drivers of profit per owner in the accounting service sector are leverage (employees per owner) and charge rate (net realization per charged hour).

When we take a close look at a smaller cross section of the profession we can more clearly see the characteristics of the top performers. For example, data from various industry surveys (e.g. The Texas Society of CPAs National MAP Survey) indicates that larger firms tend to have a slightly lower level of hourly productivity than smaller firms indicating some (weak) evidence of diseconomies of scale. On the other hand, they exhibit a significantly higher average revenue per employee indicating <u>a higher average hourly realization rate</u> which, when accompanied by <u>a higher degree of leverage</u>, more than compensates for higher payroll costs and slightly lower productivity.

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The two main drivers of profit per owner in the accounting service sector are leverage (employees per owner) and charge rate (net realization per charged hour). It is not the number of hours worked, the level of productivity or even firm size that drives profit. Although larger firms do tend to have higher average hours worked, higher leverage and higher net realization, there are many small firms that have leverage of more than 10 people per owner and achieve an average hourly realization that matches the highest in the industry.

This is clearly shown in Table 4, which summarizes the results of an analysis I have done on 298 US firms based on data for the year ended December 1997.

Table 4

	People/Owner (incl. owner) People Leverage	Average Time Available per Person	Average Productivity (%)	Average Hours Realized per Person	Realization Rate ($/hour)	Net Profit per Owner ($)
Average	5.60	1,774	64.92	1,152	$82.97	$146,737
Median	4.00	1,873	63.47	1,189	$77.74	$111,791
Highest 5%	11.56	1,898	61.45	1,166	$112.48	$312,542
Lowest 5%	1.70	1,438	72.18	1,038	$64.12	$52.314

Table 4 tells the story. In this sample of 298 firms, the net profit per owner in firms with high leverage is slightly more than twice the industry average. Notice that there is practically no difference in productivity or hours available and therefore in the total time realized per person. The performance difference between the top performers and the rest of the industry comes down to two things: realization rate and leverage. In other words, more people doing more valuable work.

Many of the people who rise to the 'top of the letterhead', while probably excellent accountants, are not necessarily excellent business builders. In short, the industry lacks entrepreneurial talent.

This fact has never been a secret, so why is it that firms in this industry do not seem to understand it and manage themselves to achieve it? There seem to be two plausible reasons. First, many of the people who rise to the "top of the letterhead," while quite probably being excellent accountants, are not necessarily excellent business builders. In short, the industry lacks entrepreneurial talent.

Secondly, the environment in which the industry has evolved and the fundamental economics of the industry tend to favor many small firms operating in much the same way to exhibit remarkably similar levels of profitability.

CPA as Innovator and Entrepreneur

In a famous Monty Python sketch, Michael Palin, plays the role of an accountant who wants to be a lion tamer, and visits career counselor John Cleese, who advises against it.

"You are an appallingly dull fellow, unimaginative, timid, lacking in initiative, spineless, easily dominated, no sense of humor and irrepressibly drab," Cleese says. "In most professions, these would be considered drawbacks. In chartered accountancy, they are a positive boon."

"You're an appallingly dull fellow, unimaginative, timid, lacking in initiative, spineless, easily dominated, no sense of humor and irrepressibly drab."

Accountants have long been the butt of jokes. Unfortunately there is some truth in them. The accounting profession is an old, largely self-regulated, industry which has a strong service ethic but restricts entry through a rigid certification process and exhibits a fortress mentality. The only path to leadership is through the ranks. This means the people who are leading and managing its constituent enterprises have been mentored by those who went before them, and with that comes an acceptance of legacy ideas that may not have contemporary relevance and almost certainly a more inward than outward focus.

The rules of our game are well known. Most everyone has more or less the same insular mindset and is reluctant (or perhaps not permitted by their colleagues or their professional organizations) to step too far outside their comfort zone. This, coupled with the fact that the owners of accounting firms have been making a very good to reasonable living from their current business model for a long time and are, by nature, reasonably conservative people does not create the setting for what might be called an aggressively innovative outward-looking profession.

Leaders of accounting enterprises have developed habits in the context of a paradigm based on doing, rather than discovering and developing new initiatives.

Leaders of accounting enterprises have developed habits in the context of a paradigm based on *doing*, rather than discovering and developing new initiatives. Perhaps more to the point, most people have not really been taught how to grow a business. Their training, experience and compensation has focused on doing what the business does day-in-day-out rather than creating an organization that seeks and takes opportunities or different ways of doing things. Efficiency rather than innovation is the cornerstone of the management psyche.

There is, therefore, little wonder that most firms look and behave the same. Furthermore, as Jim Collins points out in *Good to Great: Why Some Companies Make the Leap and Others Don't*, most businesses (and I'm certain this includes accounting firms) never achieve "great" status because they are all pretty good and therefore do not see any real need to change what they are doing.

While it is easy to assert a lack of entrepreneurial flair, it's also important to realize that the people who have been responsible for managing accounting enterprises have simply responded to market signals issued by the prevailing socio-economic environment and within the permitted regulatory framework. It is to a discussion of those external forces that we now turn.

Industry Economics and the Evolution of the Profession

In his seminal work, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, Michael Porter provides a useful framework for analyzing the evolution of an industry. Porter reminds us that all industries are constantly evolving because there will always be "some forces in motion that create incentives or pressures for change."

All industries are constantly evolving because there will always be "some forces in motion that create incentives or pressure for change."

Firms from within, and often from outside, the industry make investment decisions in response to these pressures or incentives which in turn reshape the industry by changing the power of sellers relative to buyers, the nature and extent of inter-firm rivalry and the ease of mobility into and out of the industry. By understanding how the forces of change have worked to shape the industry we have today, we can develop insights into what it might look like going forward.

Porter notes that while there is always potential for change in industry structure, there may in fact be very little change for a variety of reasons such as no firm being able (either because of a lack of initiative or resources) to introduce an innovation that has the disruptive force to elicit a response from other firms.

It is dangerous to make the assumption that the future will be a replay of the past.

There are forces of change now in play that will change the profession dramatically

Considering the relative stability of the accounting industry over the past 100 years it would seem that Porter's observation applies. However, it is dangerous to make the assumption that the future will be a replay of the past. There are a number of changes that I will discuss later in this white paper that are now in play that will change the profession dramatically in my view, and firms that do not prepare for them will have a serious competitive challenge going forward.

One of the main drivers of industry structure is the growth for the industry's products or services. The modern accounting industry developed during a millennium in which, for the most part, the US economy (and most other western economies) grew strongly, and increasingly complex tax legislation created wonderful opportunities for the profession, as did the general level of business activity.

Government and professional association regulation created a protected environment in which the industry was able to flourish more or less without fear of non-accounting firms invading its franchise. In this environment most accountants did well and many firms contributed to even greater industry growth through extending their service lines and innovations in marketing and service delivery. However, only a handful of firms grew to be very large and that occurred primarily because their very large corporate clients pulled them to that size.

To some people it may be an unfair comment, but I believe it is close to the truth that the Big 5 (at one time the Big 8 and perhaps soon to become the Remaining 4) got to be there not because they were necessarily the best or because they were highly innovative. They got there because they were the only game in town.

We should note that in the past decade, the Top 100 firms, led by the Big5, have demonstrated a willingness to focus on new services and have dramatically grown their non-traditional businesses.

We should also note however, that in the past decade the Top 100 firms, led by the Big5, have demonstrated a willingness to focus on new services and have dramatically grown their non-traditional businesses. Data from Accounting Today surveys reveal that Management Advisory Services for the large firms have grown at about 20% per year and now represent close to 50% of total firm revenues. Their traditional services on the other hand have grown at about 5% in the same time. There can be no doubt that this has contributed significantly to the Enron scandal but it should also serve as notice to smaller firms that growth in mature industries is always come from new service lines and new markets.

During the last millennium the accounting industry evolved into many small- and medium-sized firms servicing many small- and medium-sized businesses and individuals. In addition to legislative protection and self-regulation of the industry, the main reason for this was that the barriers to entry were relatively low and the opportunity for the owners of small firms to make a very comfortable income were high, given the long-term industry growth rate.

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Entry barriers in this industry are low for many reasons including: there is little opportunity to achieve significant economies of scale; technology is pervasive and affordable; clients have low switching costs; there is limited opportunity for service line differentiation (although there are enormous opportunities for process differentiation, most of which are overlooked); and there is a continuous diffusion of proprietary knowledge and experience throughout the industry as people change jobs or establish their own accountancy practices. All of these things encourage a high degree of fragmentation.

The significance of the diffusion of experience is one of the most important reasons for the industry remaining so highly fragmented and why industry consolidation is unlikely to be an evolutionary outcome in my opinion. Basically, the value created in this industry comes from the heads of the people who are facing clients. It is difficult, if not impossible, for a firm to "own" that knowledge and experience and thereby prevent it from escaping. It leaves the building at 5pm each day and sometimes never returns because it walks across the road to a competing firm or becomes the foundation of a new firm.

In other industries where knowledge and experience can be captured and protected through patents, trademarks and other forms of property rights, an existing firm's accumulation of experience may represent not only a formidable barrier to new industry entrants (either because it gives cost leadership and/or a strong brand position) but will also confer on it the power to grow market share through aggressive acquisitions as well as through aggressive pricing. This simply does not exist to any significant extent in professional service firms generally and the accounting services industry in particular.

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In addition to the circumstances I have described above, the industry is also one in which exit barriers are quite high. Essentially, the owners of public accounting practices have experience that is generally only valuable in a public practice arena. Even during difficult economic times these people are reluctant to move out of the industry because there are few places for them to go and the value of their "business" as a going concern is not high enough for them to sell and retire.

When high exit barriers are accompanied by low entry barriers there tends be a high degree of price competition—particularly where there is limited opportunity for product differentiation, and that is certainly the case in the accounting industry. The intensity of price competition is one of the main reasons why the huge productivity improvements that have been realized from the introduction of technology have not been translated into higher bottom line results. Instead, we have seen flatter organizations reflected by lower employee/owner (leverage) ratios and lower prices (in real terms) paid by clients.

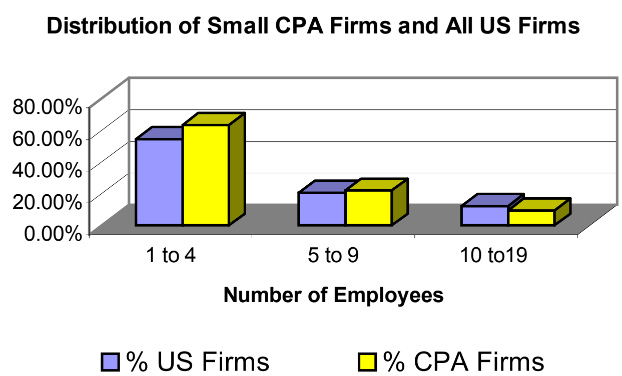
I mentioned above that a strong force that gave rise to the emergence of the Big 5 was the mandate from its large clients to expand or lose their business. A similar case can be advanced as one of the reasons for the fragmentation of the rest of the industry.

In every town and city there will be small-and-medium-sized businesses (SMEs) that require the services of local professional service firms

In every town and city there will be small- and medium-sized businesses (SMEs) that require the services of local professional service firms. In the past, the owners of these businesses have not been prepared to travel to buy accounting and tax services because there is a definite benefit in having your CPA, whom you know and have dealt with for many years, located down the road.

Furthermore, the cost that a non-local firm would incur in attempting to service these clients would put them at a decided cost disadvantage relative to local firms. For this reason it is understandable that as long as there are SMEs and individuals who need the services of CPAs there will always be a natural demand for small CPA firms to provide them. The correlation between the size distribution of all US businesses and the size distribution of CPA firms is remarkably high as shown in Figure 2.

Figure 2



SMEs are not sophisticated buyers of accounting services. They do not generally require the breadth of services that are available from large firms and they are not willing to pay what they consider to be very high prices for the services they do require. Furthermore, local knowledge and the close personal relationship built on trust between service provider and client have always been extremely important elements of a CPA's value proposition. They do not like to be switched from one client service manager to the next every year as usually happens in larger firms. It's really an issue of buyer-supplier fit.

Small and medium sized business owners are not sophisticated buyers of accounting services …

If a CPA firm gets "too" big in the minds of at least some of its clients they seek out a smaller one. In other words, small CPA firms fit well with small enterprises, mid-sized firms fit well with mid-sized enterprises and large firms fit well with large enterprises.

Customers' experiences of changes in other industries, particularly towards consolidation, can also impact their preferences for a certain industry structure. For example, I suspect few customers would argue that consolidation and the associated depersonalization that has occurred in the banking and health care industries have been to their benefit. Whatever happened to the family doctor who used to make house calls or the friendly bank manager who knew the names of your children? Irrespective of whether there have been cost savings that have been passed onto customers from these changes, their perception is that the quality of service has diminished and they have no objective benchmark to judge whether the value/price trade off has been worth it.

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Having had that experience, I think it is going to be a big task for any organization to convince SMEs and individuals that they will be better off dealing with a large corporation at the end of a phone or website than they are with people from a small responsive local firm. To the extent that buyers have power over determining industry structure, I suspect that they will lean towards the current structure rather than a concentrated industry that might emerge from consolidation through merger and acquisition. But there is a caveat here, the small local firm is going to have to be able to match the services offered by other firms because at the end of the day "personalized service" alone will not be enough as small local retailers found when they thought they could compete against Wal-Mart and the category superstores.

However, while this may explain why large national firms have not been able (or desired) to enter many local markets, it does not explain why regional and local firms have been unable to dominate their own territory. This is because the forces we previously discussed have been at work even at the local level to keep the industry fragmented, and in this industry, for now anyway, the market definitely does not see *big* as *better*.

On the other hand, if one or more firms (or networks—about which I will say more later) come into the market with a demonstrably better service value proposition that is difficult for other firms to replicate they could end up dominating the industry, or a segment within it, and its structure, as well as the economic rewards for its present constituents, will change forever. The value migration that would occur in this case could be significant and rapid. Note what has happened in the health care industry.

If one or more firms (or networks) come into the market with a demonstrably better service value proposition that is difficult for other firms to replicate, they could end up dominating the industry …

In Part II of this white paper I address the question of whether the future will be an extension of the past. My answer is a categorical NO! I believe the point of strategic inflection that Andy Grove talked about occurred in the accounting services sector about 5-7 years ago and was signaled by two significant events.

In August1995 Netscape, a company that was 16 months old with a product it planned to give away, went public at an unheard of valuation. This brought to the surface a growing realization that the Internet had to be taken seriously and was most definitely going to redefine the way business would be done in the future. Many, many instant millionaires were created overnight and "blue sky" took on a whole new meaning. This laid the foundation for what was to become the ill-fated dot-com boom.

While history will show that greed coupled with inexperience and an abundance of capital ended in catastrophe for many, it will also show that the innovation burst that occurred would forever change people's lives …

While history will show that greed coupled with inexperience and an abundance of capital ended in catastrophe (for many), it will also show that the innovation burst that occurred would forever change people's lives and subsequently find its way into new business models built on technologies that are profoundly different from those of the past millennium.

The other significant event occurred in 1997-8. This was the landmark case of Florida Department of Business and Professional Regulation v American Express Tax and Business Services, Inc in which the U.S. Supreme Court allowed a lower court ruling to stand and in so doing, effectively redefined public accounting, which permitted public corporations to enter the non-attest public accounting space.

At the time, this decision caused considerable consternation amongst accountants who were worried that they would find themselves competing against financial services giants like Amex. There was a fear that the profession would experience a wave of consolidation and that small firms would be marginalized.

As it turned out, this fear was unfounded although there has been a lot of merger activity especially amongst mid-sized firms in recent years and there is reason for small independent firms to be concerned about the future. More importantly, the Florida decision signaled a far more significant change and that was the dismantling of the protected environment the profession has enjoyed for the past 110 years which in turn has led to other significant identity issues including the XYZ credential debate, the concern over the quantity and quality of people entering the profession, the on-going MDP debate and more recently, the issue of independence and self regulation brought to a head by the Enron scandal.

In Part II of this white paper I address the question of whether the future will be an extension of the past.

My answer is a categorical No!

Read it to find out why.

End Notes

[1] Andy Grove, *Only the Paranoid Survive,* Doubleday, 1996, pp 3-4.

[2] In this report I will be talking specifically of the US industry. However, having reviewed data from, and being very strongly involved with, accounting firms in Australia, the UK, Canada and New Zealand I feel quite comfortable in suggesting that my analysis and conclusions are universally applicable.

[3] 1997 Economic Census, U.S Census Bureau (October 2000). This includes the category defined as Accounting, Tax Preparation, Bookkeeping and payroll Services.

[4] The 1977 Economic Census is the latest full set of data available at the time of writing. Since that time the accounting services sector has grown strongly as reflected by the Annual Top 100 Survey conducted and published by Accounting Today. The 2001 publication of that survey revealed that the Top 100 firms alone had revenues of $34.7 billion (representing year 2000 revenues) an increase of about 16%-23% per year depending on whether the Accounting Today data or US Census revenue data is used for the 1997 base year.

