A juicier model

Small practitioners may be fearful of what the future holds in a changing market, but segmentation is key to a successful business model, as Keith Underwood explains

A presentation by a consultant in 1986 identified the following key issues for small firms, some of which might sound familiar: increased IT, training and retaining staff, additional services that can be developed for sale to clients, increasing regulation, client acquisition, and succession.

Many of these challenges continue to be just as relevant to small practices today. But while the issues are the bedrock for the business plan of an accountancy firm, the profession has now entered a period of significant change, which may well affect the list of key issues outlined in any similar presentation in five years' time.

Although small firms are facing a set of challenges that might seem to be the straw that breaks the camel's back, there are opportunities that can be exploited by firms adopting new methods and models and a flexible approach.

Small firms are normally defined as those with between one and three partners, with annual fees up to £2m. In previous articles, we have looked at larger firms and their challenges, but small firms with fees under £2m are going to face increasing regulation, and will need to change the services they offer clients, be flexible with their internal structures, and commit to IT investment.

The future for these firms is dynamic. If you look across the UK at the various components of business models, you will find a whole range of practices that can maintain or improve their profitability albeit by changing their business model. Some of those components are:

* geography
* number of partners
* partner aspirations
* source of clients and the pipeline
* lifestyle ethos of the firm
* advisory and volume-based service lines.

All accounting and professional service businesses are fundamentally about clients and skillsets. As a result, combinations of the six components listed above will provide opportunities for aspiring small firm owners. To demonstrate this, let's first consider the following small firm models.

Small firms: model 1

This small firm is a sole practitioner that has no senior qualified second-tier staff, but employs individuals with tax qualifications and good-quality accounts preparation skills, who carry out mainly compliance work for loyal clients. It has fees of £300,000–£400,000, mostly recurring, and limited call for advisory work. The practice is likely to be located in a market town or outside the main UK conurbations. The partner is inevitably undertaking a significant share of the compliance work. The charge-out rates for partner time are likely to be between £100 and £150 an hour, and the practitioner is full-time – ie, generating 1,000 hours or more of chargeable time per year. There may also be a lifestyle issue, in that EBITDA (earnings before interest, tax, depreciation and amortisation) is around £60,000 (15%–25% of fees) after a notional charge of, say, £100,000 for the principal's time. In the right environment, this model could provide a reasonable living and offer a strongly lifestyled profile to the firm, although there would be no investment in succession on exit.

Small firms: model 2

This small firm is a boutique tax practice owned by one party (sole practitioner) with three or four qualified staff and a pipeline of tax planning clients. Let's assume the practice has annual fees of £700,000–£800,000, with charge-outs of over £200 an hour. This business model could generate significant profits for the equity owner. It is a strongly advisory business and after applying a notional charge for the proprietor's time a super profit EBITDA of perhaps 35%–40% of fees could be expected.

Implications

The following conclusions can be drawn from the first firm model described above:

* The business is exposed to serious competition from IT-based providers of management accounts, payroll and homogenous client services.
* The age profile of clients is usually similar to the age profile of the equity owner. Although that may be seen as a negative, it also provides a strong loyalty factor.
* The ability to attract larger family-owned SME clients is very limited. Unless there is a good website and a robust marketing plan, targeting the startups of younger clients is unlikely to bring in much new business.
* It is typical of a considerable number of practices throughout the UK.

The second model is an example of a specialist practice – rarely adopted by sole practitioners. Individual practitioners can exploit the considerable variations and models between the two extremes.

Market forces

There is a continuing contraction in the number of sole practitioner firms adopting the second model described earlier. Too few individuals are coming into this environment to replace those retiring. Therefore most deals are not done on a one-to-one basis, but on an upward consolidation basis with a larger firm.

Being a sole practitioner just isn't attractive enough for those considering a career in accountancy. Although there are examples where it works, increased compliance takes time away from client work, investment in IT is becoming costly, ever more time is needed to integrate new IT systems, and training staff and optimising workflow is becoming harder as IT investment requires scale. In addition, second-tier technical staff are becoming administrators of a process rather than applying their skill and knowledge to client service. These roles lend themselves better, to a certain extent, to younger tech-savvy individuals.

Many firms face the prospect of seeing their commercial clients within a few years being capable of producing quarterly accounts themselves in the cloud or with in-house systems – just as larger clients with accounting departments and financial controller or FD functions do. It is a potential outcome of a major change in reporting predicated on digital tax and the requirements of HMRC.

Small firms with two or three partners similarly reflect the range of opportunity and challenges faced by a sole practitioner. In such a firm it is often difficult to maintain clear objectives over a longer period of time. Many such firms have never become integrated single-brand operations but have remained as two or three sole practitioners working together under the same identity but with clearly defined roles and client portfolios.

The level of £1.5m–£2m of annual fees is often seen as the hurdle above which firms should start looking at specialisation, single brand and succession. Many firms with just two or three partners do not have a succession regime in place because they operate in individual partner silos; as a consequence, they can exit only through a sale to a larger practice.

Towards a viable model

Where the future looks strong for two/three-partner firms is for those with strong, viable operations that can present high levels of personal satisfaction by concentrating partner services on the top quartile of advisory work and ensuring that qualified second-tier staff take care of compliance support and some advisory.

This model should be more widely promoted. There is still a good living to be made out of a two/three-partner firm, particularly those that develop a distinctive service line or specialisation, are valued by clients, and encourage and recognise success within the practice, motivating staff and partners to meet transparent and commonly held goals.

Unfortunately, these models often fall apart as the personal situations and objectives of the individual owners/partners change and move away from what was originally agreed, perhaps only five or 10 years before. However, a successful business should be able to leap over the £2m hurdle and grow to an integrated firm at the £3m–£5m fee level. It is a healthy practice that chooses to grow annually and develop new clients while being able to retain a partner-client relationship style.

Those without the ambition to grow, develop and change may seek to keep the status quo, but this is going to be increasingly difficult to maintain due to the challenges of the marketplace. ■

Keith Underwood is managing director of Foulger Underwood Associates

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0161 798 2121 norman@maximiti.co.uk