

Small Medium Practice Project

Best Practice – Statistical & Performance Analysis

July 2005



**Chartered
Accountants**

NUMBER ONE IN NUMBERS

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Foreword

It gives us great pleasure to release this report.

Founded on the detailed interviews undertaken with 30 small to medium practices in 2004, the report takes a practical approach to providing a wealth of information on:

Practice management issues
Performance metrics
Habits and actions of best performing small and medium practices

No one practice is the same but we are sure you will find items of inspiration within the report, which we hope, assists you on your journey in practice.

Rest assured PPAC and the Institute have gathered much valuable information from the project, which is contributing, to future initiatives enabling us to partner more effectively with you.

In closing we offer our sincere thanks to all the members that willingly gave up a considerable amount of time to participate in this project.

We commend the report to all those committed to growing their practice into a profitable successful enterprise and providing a first class service to clients.

Craig Farrow FCA
Chairman
Public Practice Advisory Committee
ICAA

July 2005

- Introduction
- Statistical analysis
- Performance analysis
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- Information for this report was gathered during structured interviews with Partners/Practice Leaders of 30 small and medium practices (“SMP”).
- The interview notes were documented and returned to Practices for confirmation and any additional comments
- Some 83 variables were identified from the interview questionnaires and data sheets
- This information was entered into a data base which was then analysed through a formal statistical process using SPSS software package
- The analysis provided correlations between the data collected and highlighted important insights into the characteristics of the SMPs that took part in the market research
- There has been no work to establish the reliability of those sources by reference to evidence independent of Principals comments at interviews

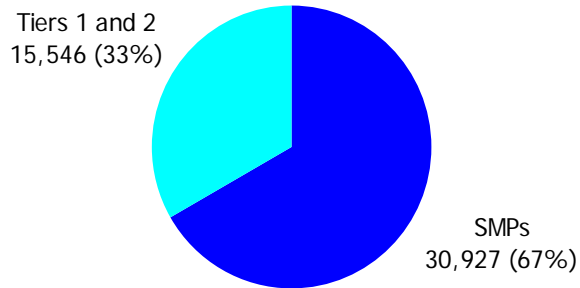
The purpose of the study was to provide statistical proven insights into what are the key factors that determine best practices in SMPs including:

- Providing correlations between the data collected and highlighted important insights into the characteristics of the SMPs that took part in the market research
- Testing for key correlations and what are the underlying drivers/characteristics of best practice firms and the key premises that lead to improved profitability, higher growth rates, better client management, better people management
- Identifying opportunities to improve practices
- Providing a sound basis for the Institute developing strategies and underlying new products and services

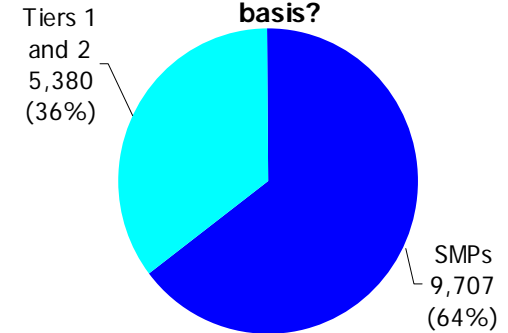
While the study focussed on best practice some comparative analysis of key performance measures have been included as they relate to and support best practices

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Where do all Public Practice Accountants work on a national basis?



Where do ICAA Public Accountants work on a national basis?



Key Points

- Public Practices generate annual fees of \$7,708 million a year¹:
 - > \$4,410 million (SMPs)
 - > \$3,298 Million (Tiers 1 & 2)

- Public practices generate annual operating profit before tax of \$1,446 million a year¹:
 - > \$963 million (SMPs)
 - > \$483 Million (Tiers 1 & 2)

- SMPs are of key importance in the ICAA membership profile

Now :

In order of importance:

- Finding and retaining quality staff is the number 1 issue for 50% of Practices
- Improving people management
 - > The supply shortfall of appropriate human resources is evident and high on the agenda of the Institute firms.
 - > It is noted that Accountants are now back on the immigration list, however there are many other macro and micro issues in this space e.g.
 - University intakes
 - Commerce graduates going elsewhere for employment
 - Global demand and ease of transferability
 - Changing hire profiles
 - > TAFE graduates
 - > School leavers
 - > Dissatisfaction with Human Resource Placement firms
 - Cost
 - Integrity / Ethics
 - Quality/mis-representation
 - > Generation X / Y attitudes
 - > Increasing female participation
- Maintaining growth, profit and cash flow
- Members are feeling
 - > Increased cost pressures
 - PI
 - Remuneration
 - > Increased 'non-chargeable' / 'non-recoverable' work in complying with complex legislation which clients don't understand
 - > Managing working capital challenges

Source: Interview notes

- Improving productivity and workflow management
 - > Some sources say general productivity has not changed in over 100 years – it sits around 60% of available time.
 - > While there has been the advent of computers, electronic media etc, there has also been :
 - Increasing complexities of legislation changes and compliance demands
 - Workforce changes
 - > While tools have aided productivity, other challenges have affected work flow management.
 - ATO, ASIC and other regulator attitudes/expectations have presented inhibitors to gains.
 - Where human resources are scarce, efficiency gains are paramount.
- Keeping up to date on professional matters and the pace and complexity of legislative changes

The rate of legislative change and the volume of required knowledge presents significant challenges to the SMP sector.

This, combined with the frustration of legislative administration (ATO, ASIC etc), contributes to professional dissatisfaction outcomes.

- Improving client relationships and winning new clients

This is at the heart of Practices wanting to grow their businesses and feel the satisfaction of success.

Place this against the background of

- > human resource availability challenges in performing the work
 - > external legislative compliance impacts
- and it is relatively easy to understand the challenges members feel.

Source: Interview notes

Next 5 years :

■ Retirement and succession planning

Discussions with Practices reveal:

- > Generation X & Y members not wanting to be equity partners in firms
- > Sole practitioners at or near retirement age not knowing where to turn
- > Changing to no goodwill models for Practice succession.

This mindset is significantly challenging the Australian business community.

- > Will there be the right resources leading into the future?
- > How will Practices look and operate?
- > What is the future of public practice?

■ Vision and future for the Practice

With the challenges the firms feel now, stepping back to be strategic about the future of their Practice is a challenge many firms don't pay enough attention to : "Too much IN, not enough ON"

■ Generalist vs Specialists

Legislative complexities and compliance requirements drive specialisation – but the market demands generalists as well.

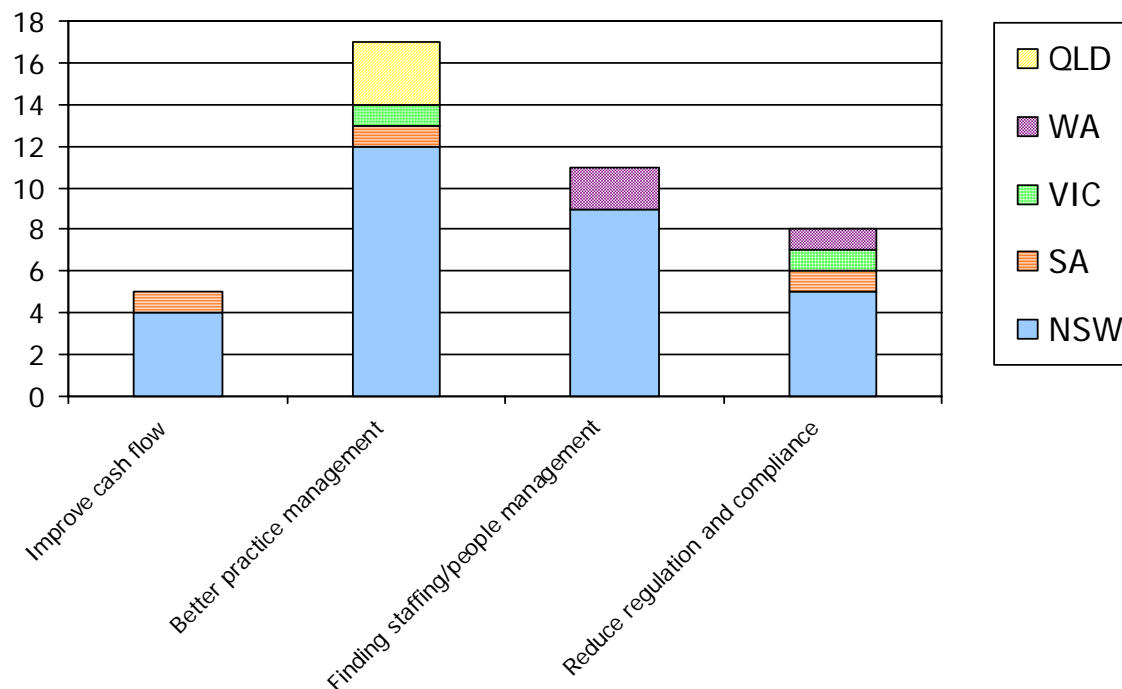
■ Keeping up to date technically

Obviously members see no change of pace in this area. Technical expertise at the leading edge is a necessity.

■ Sustainability, especially for sole practitioners

Given issues associated with specialisation, human resource and career challenges, sustainability is a question increasingly asked.

Source: Interview notes



Key points

- > Better practice management was the most common area with specific comments focussing on better systems, reduction in work time, more strategic emphasis/focus and leadership/management skills
- > Finding quality staff and people management was the second most important issue with comments directed at finding, retaining and training issues
- > Improved cash flow was inter-related with practice management
- > Reduced regulation issues centred on the level and complexity of legislative change
- > 3 out of the 4 most mentioned changes are within SMP's own control and all 4 are within the scope of the ICAA to help

Source: Interview notes

Characteristic	Variable chosen for statistical analysis
Fastest growing revenue	Growth in billings
	High gross contribution margins
Increasing profitability	Increasing profitability
	High net contribution margins
Improving productivity and work flow management	Distinction between administration and practice management
	Concerned with maintaining and improving productivity and workflow management
Good liquidity and debtor management	WIP levels
	Debtor levels

Two variables were analysed in order to address this issue: high gross contribution margins and growth in billings. The correlations and findings are as follows:

■ Growth in billings

SMPs with high growth in billed fees had the following characteristics: high staff to partner leverage, higher ratio of client staff to total staff, had a strong vision, a marketing plan, a well articulated business strategy and plan, strategic planning and decision making systems, concerned with improving people management, strongly committed to maintaining growth, profit and cash flow, people trained in managing the practice, distinction between chargeable and non chargeable work, had a risk management plan, high non partner chargeability, cross sell and up sell strategy, HR strategy in place, partners with no definite retirement age, strong support for CA and CPE training, increasing profits, increasing debtor levels and larger proportion of average clients in the \$20,000 to \$50,000 profile

Take out: SMPs that have significant growth in billings focussed on strategic management, have high staff to partner leverage, have people trained in managing the business, manage workloads and flows to maximise chargeability and invest in their staff

■ High Gross Contribution Margins

SMPs with high net gross contribution margins had similar characteristics, including : had introduced strategic plans and decision making processes, had performance management systems which included financial and non financial KPIs, strongly supported CA training and CPE, had a positive outlook in terms of the practice business conditions, expected a high level of staff changes over the next 12 months, were concerned with improving productivity, work flow management and client relationships AND tended to be outside the CBD, had increased non partner charge out rates significantly in FY2003/4 and profit shared with staff and a higher proportion of average client fees between \$5,000 and \$10,000

Take out: SMPs that have high contribution margins had introduced performance management systems and had increased significantly non partner charge out rates and strongly supported CPE and CA training

Source: Interview notes

Two variables were analysed in order to address this issue: Expected increasing profits and high net profit contribution margins. The correlations and findings are as follows:

■ Increasing Profitability

SMPs that had increasing profits focused on improving client relationships and winning new clients, had a business strategy and strategies in place to cross-sell and up-sell to shift work from traditional to value-add. However, Practices with increasing profits also expected high levels of staff changes over the next 12 months but invested heavily in training of a soft/technical nature including CPE, had completed a training need analysis and had succession planning

Take out: SMPs that are increasing profits are client focussed, look for opportunities to sell more services to existing clients, have expanded their services from traditional areas and have invested heavily in training

■ High Net Contribution Margins

SMPs with high net gross contribution margins had the following characteristics: high staff to partner leverage, concerned with improving client relationships and winning new clients, were not overly concerned with distinguishing between chargeable and non chargeable time, had high staff retention and strongly support CPE, profits tended not to be re-invested in the practice, high contribution margins, low levels of average WIP, had increasing non partner charge out rates and a higher proportion of average clients fees were less than \$5000 followed closely with clients in the \$5,000 to \$10,000 fee bracket

Take out: SMPs that have high net profitability have also high staff to partner leverage, low levels of debt and have significantly increased charge out rates coupled with high staff retention and strong support for training

Two variables were analysed in order to address this issue: Concerned with maintaining and improving productivity and workflow management. The correlations and findings are as follows:

■ Distinction between administration and practice management

SMPs that distinguished between administration and practice management have high staff to partner leverage, had broad practice demographics, were strategically focussed in that they had a clearly identifiable leader, vision, marketing plan, people focussed culture, a business strategy and plan plus risk and HR management plans, a strategic decision making processes and concerned with improving people management, distinguish between chargeable and non chargeable time and resources have been trained in managing the practice

Take out: SMPs that are better managed have a clear leader, focus on both strategic and operational management and whose key resources have been trained in managing the practice

■ Concerned with maintaining and improving productivity and workflow management

SMPs concerned with maintaining and improving productivity and workflow management did not expect a high level of staff changes, had a marketing plan and people focussed culture, were inwards focussed in that they were not overly focused on client relationships and winning new clients, did not distinguish between chargeable and non chargeable time, low partner and non partner hours, no strategy for cross selling and up selling, had a work life balance including no week end work, decreasing partner profits and profit sharing arrangements with staff and declining billed fees

Take out: SMPs that are concerned with maintaining and improving productivity and workflow management are under stress and are looking for ways to improve both revenue and profits

Two variables were analysed in order to address this issue: Average WIP and Debtor levels. The correlations and findings are as follows:

■ WIP levels

SMPs that have low levels of WIP have high staff to partner leverage, a broad practice demographics (non specialised), positive practice outlook, have increased charge out rates for both partners and non partners and had greater proportion of client fee greater than \$10,000 and high net contribution margins. SMPs that have high WIP levels stated that they made a distinction between chargeable and non chargeable time, had large billed fee base and increasing average weekly billed time for partners and non partners

Take out: SMPs that have low WIP levels have high staff to partner leverage, not afraid to increase charge out rates and have high net contribution margins. Conversely, SMPs with high WIP levels have large billed fee base and increasing billed time that appears not be billed regularly

■ Debtor levels

SMPs that have high debt levels had significant increases in non partner billings, large billed fee base and high WIP levels, maintained a distinction between chargeable and non chargeable time

Take out: SMPs that had high debtor levels have high billed fee base but also the billing and collection processes have not improved in relation to increases in non partner billing

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Measures	Mean	Minimum	1 st Quartile	Median	3 rd Quartile	Maximum
Billed fee movements ¹	8.1%	-16.2%	1.0%	7.5%	15.4%	36.7%
Gross contribution margins	55.6%	39.0%	43.5%	55.0%	65.0%	78.0%
Net contribution margins	30.7%	6.5%	25.2%	32.0%	34.8%	55.0%
WIP days ²	64	20	76	64	38	162
Debtor days ²	69	17	88	71	60	101
Partner charge out rate movements ¹	4.3%	0.0%	0.0%	5.0%	7.6%	10.0%
Staff charge out rate movements ¹	4.9%	-3.6%	1.5%	5.0%	8.5%	14.0%
Partner billed hours ³	1,232	435	1,000	1,072	1,474	2,200
Staff billed hours ³	1,279	748	1,100	1,250	1,490	1,950
Partner workload ⁴	55	40	50	50	60	70
Staff work load ⁴	46	40	40	50	50	50

- Notes: (1) Movements between FY2003 and FY2004
 (2) Based on 365 days
 (3) Annual billed hours for FY2004
 (4) Average weekly work load FY2004

Source: Interview notes

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The more successful SMP focus on:

- **Improving leverage** – maintain a high staff to partner leverage
- **Planning and executing strategies** – have a vision and supporting business strategy, had introduced strategic plans and decision making processes, had performance management systems which included financial and non financial KPIs, had completed marketing, risk management and business plans (including detailed annual budgets)
- **Managing change** - have changed the practice away from a traditional compliance base to broader services, focussed on specific clients/industries and improved internal management practices including using new technology, regularly review charge out rates
- **Improving client relations and management** - improving relationships by better understanding of client businesses and by meeting these requirements by cross and up selling services and by actively pursuing/winning new clients, marketing and by forming business alliances to service clients
- **Improving people management** – developed a HR management strategy, completed a skills and training needs analysis and had a work life balance, managing workloads and actively monitoring staff satisfaction
- **Better practice management** – the Partners and senior staff have been trained in managing the practice had appointed a Practice Manager to take care of all back office functions, systemised processes, and constantly seeking ways of improving processes
- **Minimising WIP and Debtor levels** – actively manage billing and collection levels, have implemented fixed service/payment contracts with clients
- **Investing in personal development** – conducting training in soft skills (eg leadership, management, HR training) and technical skills including CPE

Practice management	Practices
<p>Strategic management</p>	<ul style="list-style-type: none"> ■ Utilise vision statements to communicate their objectives and to unite staff toward a common goal ■ Conduct strategy sessions off site with partners and staff ■ Expand their practices from traditional auditing/accounting introducing new higher value services ■ Leverage their client base by cross and up selling services either themselves or through alliances ■ Develop strategic relationships and alliances to leverage skills and maximise business development opportunities ■ Separate strategic and operational decision making processes ■ Document plans for marketing/business development, HR/capacity planning requirements and management tied together by financial plans (budgets for up to 3 years) ■ Consider the client base to be an asset in itself ■ Invest time and money in tomorrow's fee not just today's ■ Delegate responsibility for strategies and underlying actions and track their successful execution ■ Ensure strategies have measurable objectives/milestones and are linked to performance metrics ■ Maximise client average fees by knowing your clients, their businesses and their issues ■ Establish the appropriate mix/leverage of "finders", "minders" and "grinders" ■ Target people/clients who have "spheres of influence" to maximise the scope for referrals ■ Establish networks with likeminded practices to discuss practice management and development

Practice management	Practices
Operational management	<ul style="list-style-type: none"> ■ Measure performance using financial and non financial metrics ■ Develop a continuous improvement culture including regularly redesigning and systemising processes and for work flow management ■ Appoint a Practice Manager not just an administrator (larger SMPs) ■ Introduce client service contracts that list the services to be provided ■ Segment clients into level of importance and/or relationship ownership perspective based on current /future fee potential but also from a strategic perspective using (A, AA, AAA) not (A, B, C) ■ Apply benchmarking to measure operational/process competitiveness in order to find better ways ■ Introduce new technology to reduce manual re-keying and transferring/storing information ■ Undergo continuous change via a series of small steps rather than one large “leap” change ■ Assess regularly existing practices to improve quality and costs ■ Introduce different business models such as a Client/resource model that has dedicated client staff and a shared service staff ■ Ensure that decision making information is available in structured and unstructured manner for further analysis ■ Identify, manage and optimise the return on non billable time ■ Active manage WIP and debtors and level of discounts/ write-offs plus expenses against targets

Practice management	Practices
<p>People management</p>	<ul style="list-style-type: none"> ■ Offer both financial and non financial incentives ■ Encourage cross functional and cross client/industry teams ■ Review performance against documented objectives (for Partners and Staff) ■ Link partners and staff compensation to performance ■ Cascade performance metrics from Partners to staff and support one another ■ Review regularly Partner and staff actuals versus target performance not just at appraisal time ■ Conduct regular appraisal/feedback sessions rather than relying on a once/twice a year appraisal process ■ Introduce grading and competency based systems ■ Hold Partners and staff accountable for strategic and non financial performance initiatives ■ Active management of work life balance and staff satisfaction ■ Delegate work and responsibilities to create a continuously changing/challenging work environment, balanced by appropriate training and supervision

Practice management	Practices
<p>Training and education</p>	<ul style="list-style-type: none"> ■ Train staff to maintain and enhance technical skills and for personal development ■ Use role playing to demonstrate the firm’s culture/way i.e. in dealing with clients that request a fee discount ■ Establish mentoring programs and coaching roles ■ Seek opportunities to add to the firm’s technical, personal, industry skills and knowledge ■ Provide opportunities for Partners and Staff to acquire not only technical skills but also personal and other commercial skills eg marketing ■ Rotate roles and tasks between Partners and between Staff ■ Introduce personal development plans for Partners and Staff including succession/promotion plans ■ Share knowledge and experience through engagement/client debriefings to staff group meetings

Measures	What does it measure?	What drives it?	Calculation approach
Billed fees	Level of potential cash flow	Hours available and sold, charge out rates, resources, utilisation and recovery rates	Total invoices raised over the financial period
Earned income	Actual level of expected cash flow	As above plus write-offs/ons to WIP	Billed fees after adjusting for movements in WIP, provisions for doubtful debt, disbursements not billed and bad debts
Gross contribution	Level of profitability prior to controllable expenses	Utilisation and recovery rates and payroll/labour costs including notional Equity Partner salaries	Earned income less labour costs
Net profit	Underlying profitability	All of the above	Gross contribution less expenses
Unit profit	Basic element of distributing net profit to Partners	Net profit and number of distribution units	Net profit divided by units issued
Utilisation rate	Level of resource usage chargeable to clients	Hours charged/sold to clients and having people with the right experience/skills	Total number of hours charged to clients divided by total number of hours available
Recovery rate	Extent to which chargeable time is being recovered from clients	Price and rate discounts and WIP adjustments	Billed fees against WIP at standard rate required to generate those fees (price variance and WIP write-offs/ons)
Efficiency	Overall resource usage plus the level of trade-off between hours sold and discounts to sell those hours	Utilisation and recovery rates	Utilisation times recovery rates
Cash collection	Cash banked by clients paying bills	Timely billing	Total value of cash collected over a financial period
Days lockup	Responsiveness to billing clients for work done and collecting the cash	Timely billing of clients, no “surprise bills” and following up/resolving outstanding accounts	Days invested in WIP and days invested in debtors