The Practicing CPA

THE NEWSLETTER OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION

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March/April 2006

Understand the Impact of Your Client Account Relationships

By William R. Pirolli, CPA

Most CPA firms know with some certainty how many personal tax returns they prepare and how many entities they represent. In fact, most of us track these statistics as a measure of firm growth. All well and good, but do you really know how your business is concentrated? Can you consolidate your client list into relationships?

Recently, we did this in our office and were quite surprised by—and a bit concerned about—the results.

Our firm profile

First some facts: We are a typical local accounting firm, with three partners, two staff people, and one support person. The firm is about 35 years old. We consider ourselves both traditional and nontraditional in the services we provide: We try to avoid providing certain services like auditing, nonprofit, and write-up while we favor offering services such as performance measurement and management consulting. Our commitment to staying focused on a narrow range of services means we rely on providing consulting rather than compliance services. In fact, a large percentage of our invoicing is for nonrecurring projects.

An in-depth look at relationships

From time to time, we undertake a self-prepared SWOT (Strengths, Weaknesses, Opportunity, and Threats) analysis. Most recently, we decided to include an in-depth analysis of our client base. We started by simply compiling a list of the names and amounts appearing in the year's invoices. We then assigned unique numbers to the names and combined accounts with relationships.

We defined a relationship as a network of accounts that included a key account, meaning that, if we lost the key account, we would lose all the others as well. Such relationships are common; for instance, our firm typically represents a business client, which leads to the preparation of personal and family returns, as well as the returns for real estate entities and related business ventures.

In our analysis, we also considered unrelated accounts and projects that arise from a single referral. Our firm represents several law firms that refer to us not only their related entities but also a great deal of unrelated estate, trust, and other consulting work. Obviously, if we lose the law firm as a referral source, we also lose some referral dollars.

Good news and bad news

Here is what we learned from our analysis. In 2005, we prepared about 725 returns, not counting "family freebies" and pro bono work. This number includes personal, entity, estate, and trust returns. The 725 returns, however, arose from a mere 262 relationships, a number that both surprised and concerned us. Could it be that our firm's clientele was actually made up of only 262 relationships? On the positive side, this fact is a testament to our commitment to provide a wide range of services to our major clients, leverage our professional referral sources, and avoid having a large compliance-only prac-

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tice. Of course, the flip side is that the firm's client base is not as broad as we had hoped.

When we started to attribute dollars to the relationships, the problems became clearer. Our top ten client relationships, ranked by total dollars, produced 35% of our billings, our top 50 relationships produced 77% of billings, and our top 100 relationships produced a whopping 85% of our total billings.

We then sorted the database another way. We found that 50% of our annual billings were concentrated in only 19 relationships, 75% were represented in 46 relationships, and 90% were tied up in only 100 relationships. We were so surprised by the statistics that we analyzed the invoices from the preceding five years to see whether the results from all years would be consistent. They were.

On the positive side, the names at the top of the list change often, given the firm's specialization in consulting, and very rarely does one relationship exceed 5% of our total billing. We have always been aware of the old 80/20 rule, according to which 80% of a firm's revenue is tied to 20% of its clients. Still, it was eye-opening to see the truth of the rule on paper and distill the results even further by analyzing relationships, rather than total clients.

What we learned

So what can we take from this? The following are the conclusions we drew from the SWOT analysis of our firm demographic:

- ***Strength.*** We have a good ability to sell services and expand major client and professional relationships on a consistent basis.
- ***Weakness.*** We lack a broad base of clients.
- ***Opportunity.*** We should try to expand the client base by seeking to provide more services to the bottom 50 clients.
- ***Threat.*** The loss of a major client relationship would place the firm at risk.

In addition to addressing the above SWOT analysis conclusions, we have to face some other questions. If 85% of our invoicing is tied to 100 relationships, can we live without some of the remaining 162? Are we better off with more or fewer relationships? It is certainly easier to manage fewer relationships and provide these clients with superior service, but a broader base might be more stable. From our standpoint, we would rather have fewer clients to whom we provide more services. Moreover, given that our firm has been profitable and growing for 35 years, it appears that our existing approach works. But does the analysis tell us more?

Next steps

It is clear that we now know which client relationships should be the focus of our attention. The top 20 will be receiving calls monthly, if for no other reason than to remind them that we are interested in them, and confirm that they are satisfied with our services, and have no unsatisfied demands or needs. We will also make sure that our law firms' referral sources are happy and fully aware of the range of services we provide. This relationship grouping disclosed that the work referred to us by these law firms was well in excess of the fees charged to them for their own services. Are we referring work back to them?

We are also recommitted to expanding our base to limit our overall risk exposure. We will stay true to our client selection process and the services in which we excel. Expanding our base by adding more work only makes sense if the work fits our firm's criteria. We will also examine the bottom of the list with the purpose of determining whether some clients can be eliminated without endangering the firm.

Our self-examination was meticulous and time-consuming, but worth the effort. Nevertheless, we have added a new procedure that will make the process easier in the future. Starting this year, we can track our realization with an ongoing analysis of client relationships, as well as individual clients, to ensure that all accounts meet our standards. With these additional statistics, the firm will be able to clearly identify the key client in a given relationship. For instance, a firm can ascertain that a key client is either up to or below standard, even though other clients in the relationship may be either closing or creating a performance gap. This kind of information may never come to light in an analysis that captures only the overall relationship.

CPA firms advise clients to become aware of these kinds of customer demographics, but rarely take their own advice and access this information about their own entities. Take the time to fully understand your

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business and you may find some strengths, weaknesses, opportunities, and threats.

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Peer Review Task Force Recommendations

The AICPA Peer Review Program has served the profession well since mandatory peer review was originally approved in 1988. In the past two decades, the world has changed dramatically, and the CPA profession has evolved to meet changing needs. The Peer Review Task Force believes that the peer review system should evolve, too. In today's era of increased accountability, peer review reports need to be more usable and transparent. The National Association of State Boards of Accountancy and other users are assertively calling for changes that would achieve transparency. The AICPA Board and Council believe the profession should demonstrate the leadership it has always shown in response to market and regulatory demands and step up to the call for transparency voluntarily and in a manner that helps ensure uniformity for the profession.

In May 2005, the AICPA Board of Directors established a task force to recommend changes to the profession's peer review programs that would advance the desire of both the AICPA Board and the AICPA Council for greater transparency of peer review results. The Task Force was chaired by Lee Wunschel, a member of the AICPA Board of Directors, and included representation from small, medium, and large CPA firms, business and industry, those involved with peer review, some who weren't, state CPA society leadership, and state regulators.

In response to the increased demand for peer review information by regulators and other users, the Task Force recommended the following enhancements to the transparency of the Institute's Peer Review Program

- Peer review reports should be as concise as possible and written in "plain English." The "grading" terminology should be simple and clear, and the report should be a stand-alone document that discloses the significant matters affecting the type of report issued.
- The current peer review administrative oversight processes should be made more transparent by communicating the objectives, procedures, and results of oversight to the public through annual, and in certain cases biannual, reports issued by the AICPA and the state CPA societies that administer the program.
- To ensure a level playing field for all practitioners, all state boards of accountancy should require peer review as a condition of licensure.
- The AICPA should conduct a comprehensive peer reviewer recruitment campaign to attract new, quality peer reviewers and educate firms on the benefits of having their owners and staff members involved in performing peer reviews.
- The AICPA should continue its peer review communications efforts to members and users of peer review.
- The AICPA's Peer Review Board should continue to ensure the high quality of peer reviewers, establishing additional minimum requirements to be a peer reviewer, and consider requiring additional minimum criteria such as the number of accounting and auditing hours spent by a reviewer in his or her own firm.
- The AICPA should provide a mechanism for members to comply with state board licensing requirements by allowing any AICPA firm to voluntarily post its peer review results in the AICPA's current public file regardless of membership in a specific AICPA section or audit quality center.
- For those firms that have received a second consecutive modified and any adverse peer review report, direct access to those reports should be provided. The AICPA Board will bring this recommendation to its March Council meeting for discussion.

The Task Force recommendations resulted from a great deal of deliberation, as well as the recognition that beneficiaries of the peer review process now include the broader regulatory community and even the public, not just the firm. Many of the recommendations are being submitted to the Peer Review Board for consideration, analysis, and possible execution. The Board decided that if the recommendations are successfully implemented, a broad base campaign to educate members and users about the significant changes would be warranted.

The full report is available online at *www.aicpa.org/transparency*.