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# Industry Insight

## Accounting Services

# Contents



**INDUSTRY INSIGHT**
Accounting Services


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# Summary

**This report focuses on New Zealand's accounting services industry which is concerned with a range of activities, from bookkeeping and the preparation of financial statements and tax returns, to the provision of auditing, assurance and advisory services. The term advisory services is a catch-all term which includes financial advisory, business planning, business development and management consultancy services.**

The accounting services industry in New Zealand is not particularly large. Turnover in 2017 was just under $3bn, making it smaller than the pulp and paper manufacturing industry. About two-thirds of this came from the preparation of financial statements and tax returns, while revenues from auditing and assurance services accounted for just over a tenth of the total. Fee income from providing advisory services is the fastest growing contributor to the industry's bottom line, but still only contributes slightly more than auditing.

The industry is not much of an export earner, although revenues generated from services provided to offshore accounting firms have grown quite strongly in recent years. Imports of accounting services are somewhat larger, but despite a pickup, remain insignificant.

Despite being relatively small, the industry is incredibly complex. It's made up of a diverse range of firms, serving very different, but sometimes overlapping markets, with an ever expanding range of services, an increasing proportion of which have a tenuous link with accounting.

Firms operating in this industry range from very small standalone sole proprietors that offer a limited range of accounting services to individuals and small concerns, to the branch offices of some really large corporations that span the world providing "globally integrated business solutions" to large corporates/financial institutions and government organisations. In between these two extremes are a large number of firms of differing sizes, some of whom are members of large, loosely knitted "referral" associations that operate across the world.

Irrespective of who these service providers are and what markets they compete in, the factors that drive demand for their services are essentially the same.

Three key drivers stand out.

The first is that firms in New Zealand must comply with statutory reporting requirements. This means that they have to produce financial reports that give an accurate picture of their financial standing. Reasons vary, but for most firms it's about confirming how much tax they need to pay. For larger firms that meet stipulated turnover thresholds and/or operate in a particular industry, these reports also have to be independently audited.

Firms, and for that matter individuals can either produce these reports in-house or they can outsource this non-core function to accounting services providers who are well versed in preparing financial statements/reports and tax returns. This is the main reason why traditional accounting services are the largest contributor to the industry's bottom line.

The second is that firms in New Zealand operate in an increasingly complex environment and need their accounting services providers to deliver insights that help them compete more effectively. This is the main reason why revenues from advisory services have grown strongly in recent years. It might also explain why the scope of advisory services has expanded over the years.

The third is the impact of technology, and more specifically the advent of cloud computing which has helped to automate many of the time consuming tasks involved in preparing financial statements and tax returns. Easy to use cloud based accounting software that provides real time information has not only reduced the amount of work that accountants have to do, in some cases it has almost eliminated it as firms have begun to opt for the DIY option by using the software themselves. This might explain why revenues from traditional accounting services have grown slowly in recent years

These dynamics have prompted a range of responses from accounting services providers. Some smaller outfits have effectively buried their head in the sand, ignoring the impact that technology is having on traditional accounting work. In part this is because a lot of these firms are still able to extract a price premium from the close relationships that

they have developed with their clients over many years. But, this can only last so long, and as the differential between what they charge their clients and the market price widens, so they will lose business.

Others, however, have embraced this new paradigm and are increasingly leveraging off cloud based technologies to provide their customers with unique insights about their business. They still provide traditional accounting services as far as they can, but are increasingly moving into higher margin advisory services. This in turn is blurring the lines of distinction between the accounting services industry and other industries.

Some firms, especially the really large ones, are going further, making large-scale investments in other technologies which not only enable them to extract extra value through data mining, analytics and exception reporting, but to do so at lowest cost. Investment areas include machine learning/artificial intelligence, robotic process automation and blockchain data structures.

They are also investing in people. The accountant, for so long simply a numbers person, is now becoming a people person, with a broader range of softer relationship skills to complement already well developed technical and ethical competencies and problem solving abilities. Being entrepreneurial, having a strong business acumen and being able to think strategically are additional sought after competencies. As a result, accounting services firms are increasingly hiring people from disciplines other than accounting (although accounting graduates still make up the largest component of new hires).

And they are also investing in other firms, especially those which have skills and competencies that they don't have. In this regard it is not unusual for larger players to acquire smaller firms in order to expand their capabilities. Mergers of equals are also possible, except perhaps for the really big firms. Alternative approaches include joint ventures and alliances with other firms. Affiliations within "referral" associations also help.

# Outlook

The factors that are currently shaping the accounting services industry are likely to continue to do so for some time to come. In fact, they are likely to become much more prevalent.

Technology will be the key driver of change. Cloud based accounting software is still not the norm, but will become so, completely replacing traditional desktop technology.

It will also eliminate the role of accountants in all aspects of traditional accounting work. Advances in machine learning/artificial intelligence and process robotics automation will mean that even the reduced level of tasks that accounting services providers currently undertake because of the adoption of cloud based accounting software, will disappear. Software, easily accessible, cost effective and payable on a subscription basis, will effectively replace accountants that deliver traditional accounting services.

Furthermore, this situation could happen sooner rather than later – cloud based accounting software is already here and is being adopted in leaps and bounds. Machine learning is in its infancy, but gains are being made and are likely to be incorporated in future software updates. Blockchain is already here. The global parents of the large firms that operate in New Zealand are also making significant investments in this area. So too, software developers.

These developments are likely to have significant consequences for accounting services providers in New Zealand that still cling to the tried and trusted. Simply put, they are just not going to be able to compete with new-fangled software that can prepare financial statements and tax returns quicker and at a fraction of the cost than they are able to do. Hardest hit are likely to be smaller firms that either lack the resources to change how they operate or the will to do so. Eventually most will go out of business or be acquired by other firms looking for specific competencies. So called "across the kitchen table" providers will be similarly affected, although arguably some might survive because they operate in such a niche area.

The impact of technology won't stop there. Indeed, the advances in technology mentioned above could have implications for auditing and assurance services.

Medium term, advances in technology could well result in a situation where auditing is largely automated, but still requires human intervention, much like traditional accounting is today. Further out, the situation could be even more extreme with integration between fully automated accounting systems run by firms and those operated by the authorities resulting in a situation where there is no need for auditing services, or human intervention for that matter. In essence, the systems would run themselves. This would not be good news for those larger firms that have traditionally dominated the provision of auditing services.

It also wouldn't be good news for the accounting services industry, which to all intents and purposes is likely to disappear or find itself merged within a broader professional/advisory services industry. That doesn't mean that demand for accounting services would disappear, but who delivers them and how they are delivered is likely to change. In fact, it's highly probable that demand for accounting services will continue to increase as the New Zealand economy expands and the number of firms having to meeting statutory requirements grows. It's just that the software companies, rather than the accounting services industry, will be generating the revenue. Changes in the labour market, evidenced by the growth in casual or freelance work, will support this trend. So too, higher reporting requirements, which could well increase in a fully automated environment.

The likely demise of the accounting services industry as we know it will not mean the end of accountants. It just means that the role of accountants will change and that they won't be "bean counters" anymore. The next generation of accountants will know how to use numbers rather than create them. That's not to say there are no accountants that operate this way at present – there are; it is just that many more of these will be required in the future. They will be able to handle people, be able think outside of the box to solve complex financial and non-financial problems, be adaptable to changing circumstances and provide operational, tactical and strategic advice and council to their clients.

The ability to provide unique insights will form the basis for competition in a new industry where "accounting service providers" will compete head-on with other providers of advisory services. This is already happening, but will become even more evident in the years ahead. Technology which allows the interrogation of unstructured and structured data, data mining, analytics and exception reporting, will be critical for creating a point of difference. However the investment here will be massive, so it's likely to be the industry's biggest firms that will lead the charge. Software developers are also likely to be fully engaged and it is these that smaller firms will turn to.

So the accounting services industry of the future is likely to look dramatically different from what it looks like today. Larger firms will continue to dominate, providing a "one stop" shop for all advisory services. They will be joined by other large firms from other professional services industries. There will also be a large number of smaller firms that provide a narrower range of advisory services, focusing on specific geographic, industry and subject matter areas where they have the necessary skills and competencies. While these are likely to be larger in number, there are also likely to be fewer of them than there are today. Some will have disappeared because of the large seismic shifts in the industry referred to above. Others will have been acquired by larger players and not just by those that came from the accounting services industry. There will be very few really small accounting services firms remaining.

# Introducing the industry

## Defining the industry

This report focuses on activities undertaken by firms that operate in the accounting services industry. They include:

**Bookkeeping:** Bookkeeping refers to the recording of financial transactions and forms part of the accounting process. Transactions recorded include purchases, sales, receipts and payments by made by a range of different entities, from individuals and firms to non-profit making organisations.

**Preparing financial statements:** Financial statements, such as balance sheets, income statements, cashflow statements and statement of changes in equity, are prepared by accountants in accordance with generally accepted accounting principles from recorded transactions. They provide information about a firm's financial position and its performance to a range of users, from owners and employees to investors and lenders.

**Preparing tax returns:** Tax returns are prepared from financial statements. They are statements of income, expenses and other information, which are used by the Inland Revenue Department (IRD) to assess tax liabilities. Tax preparation may be done by the taxpayer with or without the help of tax preparation software and online services. Tax preparation may also be done by a licensed professional such as an attorney, certified public accountant or enrolled agent, or by an unlicensed tax preparation business.

**Audit and assurance:** An audit is a systematic and independent examination of financial accounts, statutory records and other documents to ascertain how far the financial statements as well as non-financial disclosures of a firm present a true and fair view of the concern. Assurance refers to the assessment of the processes and controls that are in place to ensure that financial records are being kept properly, policies are being adhered to, and financial practices help to support business goals. Its purpose is to check the accuracy of the accounting information and records and provide an assurance that there are no misrepresentations or irregularities.

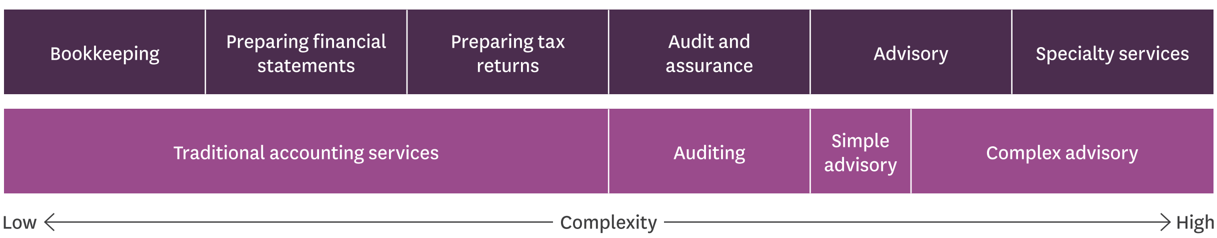
**Advisory:** Advisory services refer to the practical application of financial and accounting data to assess and shape strategy, tactical and operational performance. Accounting firms use knowledge of their client's business environment, tax situation and financial standing to help develop business plans, evaluate current operations, identify new opportunities for growth, highlight changes in the business or regulatory environment, and offer practical advice to make the business more efficient.

Advisory includes a wide range of services of differing levels of complexity and sophistication, from tax and financial advisory to enterprise strategy, succession planning, marketing and sales, corporate finance, mergers and acquisitions, legal, risk management (including financial, insurance, IT and human resources) and consulting.

**Specialty services:** Specialty services are highly specialised services which vary by firm. They are diverse and can include business valuation services, information system services (which examine the integrity and security of computer systems and employed data practices), as well as fraud and forensic accounting services ,which investigate complicated financial documents to uncover any illegal or fraudulent activity.

This report refers to the preparation of financial statements and tax returns as traditional accounting services. It also refers to audit and assurance as auditing and for the sake of simplicity, does not distinguish between specialty and advisory services.

**Figure 1: Services provided by firms operating in the accounting services industry**




Source: Westpac

# Shape of the industry

The industry is characterised by a preponderance of small firms, a large number of whom are sole proprietors, and a handful of really big firms that essentially operate in different market segments.

**Number of firms**

There are about 5,200 firms that provide bookkeeping and accounting services in New Zealand.

Of these, an estimated 3,200 are bookkeeping firms, often freelancers, concerned with the recording of day-to-day financial transactions. Although some of these firms might refer to themselves as accounting firms, only a few prepare financial statements and/or tax returns for submission to the Inland Revenue Department (IRD).

According to industry sources, approximately 2,000 firms in New Zealand provide traditional accounting, auditing and assurance, and advisory services. These firms service the accounting requirements of a range of entities, from individuals and trusts, to companies, non-profit public sector entities and the Government.

**Structure**

Firms operating in the accounting services industry in New Zealand are either a) local branches of large global professional services conglomerates or networks with offices located mostly in New Zealand's major metropolitan centres; b) independent firms located in a single location that are members of larger associations operating within New Zealand and/or across the world; and c) completely standalone firms.

Across these different configurations, firms in New Zealand can be categorised by their size; i.e. the turnover they generate and the size of their staff complement.

As is the case in other professional service industries, it is also normal practice to group firms according to the number of partners they have. A partner in an accounting firm is a highly ranked position that traditionally indicates co-ownership and an entitlement to a share of the profits as an "equity partner". This is certainly true for smaller firms operating in New Zealand where there might only be a couple of partners. Not so for larger firms, which have more partners, but these are typically senior salaried employees.

**Tier 1**

Tier 1 firms operating in New Zealand are the branch offices of Pricewaterhouse Coopers (PWC), Deloitte Touche Tohmatsu Limited (Deloitte's), Ernst & Young (EY) and Klynveld Peat Marwick Goerdeler (KPMG). These companies are the world's largest accounting firms, with unparalleled global scope and scale of expertise, providing a full range of services from traditional accounting to highly complex advisory and management consultancy services. They are not really accounting firms in the strictest sense of the word, but are instead multidisciplinary professional service firms that provide "globally integrated business solutions" to their clients.

Tier 1 firms operate within a network structure. A network is a formal, cohesive, tightly integrated, and highly branded organisation that tends to be comprised of larger firms that serve clients requiring cross-border accounting services.

**Tier 2**

Tier 2 firms operating in New Zealand are either branch offices of global accounting companies or are independent firms that operate within broader associations spanning the world.

The Tier 2 global accounting firms that have branch offices in New Zealand are BDO, Grant Thornton, Crowe Horwarth (part of the financial services company, Findex). Although

**Table 1: Structure of the accounting services industry**

| Category | Number of firms | Size | Organisation |
|---|---|---|---|
| Tier 1 | 4 | Large: >800 staff; >50 partners | Networks |
| Tier 2 | 8 | Medium to large: >100 staff; >20 partners | Networks and associations |
| Tier 3 | 800 | Small to medium: >10 staff; >2 partners | Associations and standalone |
| Tier 4 | 800 | Sole proprietors to small | Standalone |
| Across the kitchen table | 400 | Sole proprietors | Standalone |
| Bookkeepers | 3200 | Sole proprietors to small: Up to 15 staff; and 2 partners | Franchisee & standalone |

Source: Stats NZ, Westpac estimates

large in their own right, these firms are dwarfed by their much bigger Tier 1 counterparts.

Independent Tier 2 firms that are members of broader associations in New Zealand and across the world would include Staples Rodway, a New Zealand wide association of independent accounting and business advisory firms and part of Baker Tilly International, one of the world's largest associations of accounting firms. Other examples include Moore Stephen Markham, PKF New Zealand and Nexia New Zealand.

**Members of associations have access to international specialists, are able to refer clients to firms that offer specialist services, can receive referrals from firms in other countries, and can use the association's branding to increase overall credibility.**

#### Tier 3

Tier 3 firms operating in New Zealand are relatively small when compared to their Tier 2 counterparts. However, much like their larger counterparts, some are members of much larger global associations. Notable examples include firms like William Buck, which although relatively small in New Zealand, is part of the global Praxity alliance of firms. Similarly, Walker Wayland Australasia Limited, part of BKR international, a global association of accounting firms, is represented as a network of independent firms in Australia, New Zealand and Indonesia. Representation in New Zealand, however, is limited to Auckland, Hamilton and Wellington.

Some Tier 3 firms are home grown and just operate in New Zealand. They may have broad regional representation, although most are limited to operating in a few locations. Some are part of broader global associations, but most are not, and as such are standalone. Some of the larger Tier 3 standalone firms operating in New Zealand, which include BHW, Bellingham Wallace and Graham Brown & Co, are almost as large as some of the local branches of some Tier 2 firms.

#### Tier 4

Tier 4 firms are small service providers. They are dominated by sole proprietorships and by definition operate on a standalone basis. Sometimes these firms are part of local associations sharing a brand name with others, but operating totally independently. Tier 4 firms are usually locally focused, often specialise in particular industries and provide a limited range of accounting services to small businesses and individuals. They also provide advisory services, but these are quite limited in terms of scope and scale.

Also included in this tier are about 400 so-called "across the kitchen table" service providers who are sole proprietors that offer a range of low cost services to individuals on a casual basis. These providers are not necessarily qualified accountants but have knowledge of accounting and tax related matters.

**The term "accountant" is not protected in New Zealand and as a result anyone can use this designation.**

#### Bookkeepers

Most of the 3,200 bookkeeping firms that operate in New Zealand are sole proprietors, and often freelancers. An estimated 80% of the firms that operate in this industry employ less than 4 people, with a further 10% employing less than 10 people. Firms either operate as independent entities or as part of a franchise arrangement under a well-known brand name.

**Almost 70% of firms operating in this industry have a presence in New Zealand's three main metropolitan areas. Almost 50% of these are located in Auckland. Most of the large firms have head offices either in Auckland and or Wellington.**

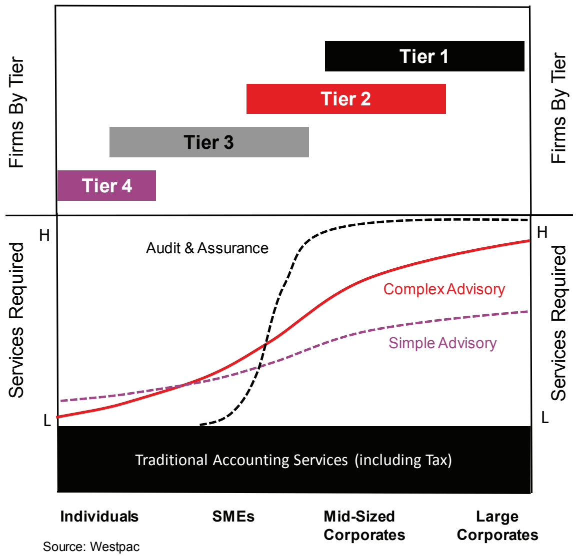
# Markets serviced

Each tier of accounting firms effectively service different market segments, although there is some overlap.

Tier 1 firms are "one stop" shops that have the scale and scope of expertise to provide a full range of services, from the relatively simple, such as the preparation of financial statements and tax returns, to the delivery of highly complex tax and business advisory, management consultancy, and specialty services.

Tier 1 firms focus on the mid- to large corporate market. They service most of New Zealand's biggest firms and public sector entities and dominate the provision of auditing services to this market.

**Figure 2: Service segmentation**




Source: Westpac

Tier 2 firms are also "one stop" shops, although they are much smaller than their Tier 1 counterparts on the global stage. Collectively, Tier 2 firms operating globally are still smaller than KPMG, the smallest of the Tier 1 firms. In New Zealand, the gap between Tier 1 and Tier 2 firms is a bit closer, although there is still a clear line of distinction.

Tier 2 firms also offer a large range of services, from the relatively basic to the highly complex. They tend to focus on the mid-sized corporates that have sophisticated requirements, although not quite as complex or extensive as those of large corporates. They also compete for the business of large corporates in direct competition with Tier 1 firms, although they tend to play second fiddle, especially in areas such as audit. Tier 2 firms also compete in the Small Medium Enterprise (SME) market, targeting those with more sophisticated needs.

Large Tier 1 and Tier 2 firms have advantages in providing a wider range of services to large corporate clients and having the resources to serve customers in many locations across the world.

Tier 3 firms are not "one stop" shops. While all deliver traditional accounting services, they tend to focus on areas of advisory work where they have specific skills and competencies.

Tier 3 firms focus largely on servicing the SME market and so will compete with Tier 2 firms. They will also compete with Tier 2 firms for the business of mid-sized corporates, especially those that have less sophisticated needs. Tier 3 firms will also compete for the business of individuals/ families/trusts.

Tier 4 firms are also not "one stop" shops. They focus heavily on providing traditional accounting services, although some have the capacity to provide simple advisory services. Firms operating within this tier typically target the bottom end of the SME market, mostly very small companies, often sole proprietors, individuals and families with whom they have developed relationships with over a long period of time. They also compete with larger Tier 4 and Tier 3 firms who might be active in this market segment.

"Across the kitchen table" firms provide the most basic of accounting services. They mostly service individuals looking for inexpensive accounting services. These typically focus on compliance related activities, such as the submitting of tax returns to the IRD.

Tier 3 and Tier 4 firms compete effectively by specialising in selected areas, providing superior levels of service and/ or leveraging off other members of the organisations that they belong to.

# Turnover

The accounting services industry operating in New Zealand is small. The large Tier 1 and Tier 2 firms generate most of the turnover in this industry, with traditional accounting services being the biggest revenue generator.

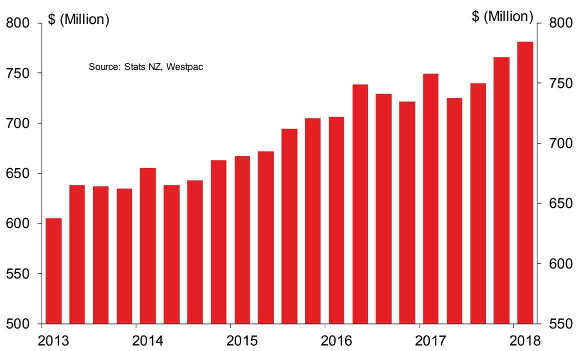
### Summary

Total industry turnover was estimated to be in the region of $2.9bn for the year ending March 2018, about 2.4% higher than the previous year. This is slower than the growth rate of the New Zealand economy over the same period.

The industry accounts for just under 4.5% of the turnover of all industries in New Zealand and is smaller than the pulp and paper manufacturing industry, which generated sales of $3.2bn in 2017. It also smaller than the legal profession, which it is often bracketed with, generating about $3.5bn in the same year.

The local industry is minute when compared to its global counterpart. The global accounting services industry generated revenues of about US$500bn in 2017, about US$150m of which came from simple and complex advisory services. Tier 1 firms accounted for roughly 31% of total revenues and about 35% of revenue generated from providing advisory services.

### Figure 3: Industry turnover

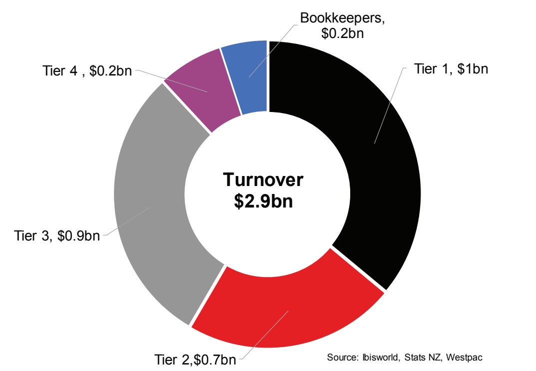



### Turnover by tier

Tier 1 firms accounted for about 36% of industry turnover revenues in 2017 – slightly more than their contribution globally. PWC is estimated to have generated just over $300m, followed by Deloitte's at about $290m, EY, $260m and KPMG, $170m.

Tier 2 firms are estimated to have contributed about 22% to industry revenues. Smaller Tier 3 firms collectively generated almost 30% of industry revenues, while sole trading Tier 4 firms are judged to have earned about 7%. The remaining 5% of industry revenue was estimated to have been generated by bookkeeping firms.

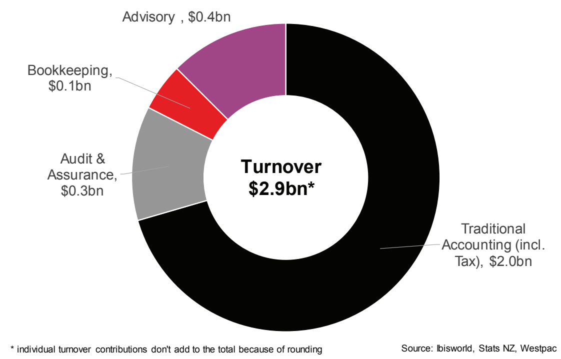
### Figure 4: Revenue by industry tier




### Turnover by service segment

Traditional accounting or compliance related services accounted for just under 70% of industry turnover. Fees generated from advisory services accounted for about 13% of industry revenue (which is roughly in line with the global norm), while audit and assurance services, typically provided by the large Tier 1 firms to New Zealand's largest corporates, accounted for a further 12%.

### Figure 5: Revenues by service segment

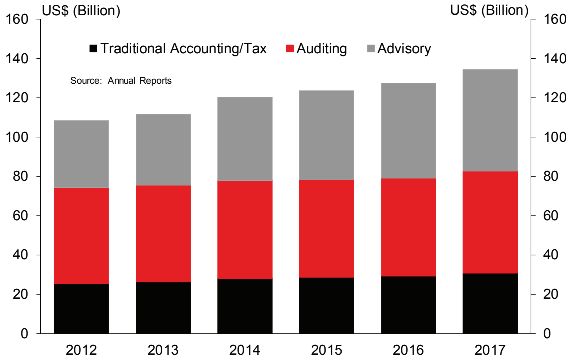



### Turnover growth by service segment

The fastest growing market is for advisory services, which generate higher margins – the reasons for which are discussed below. Globally, revenues generated by Tier 1 firms from lower margin traditional accounting services, grew by 21% between 2012 and 2017, while fees from auditing and assurance activities increased by a more modest 6%. By contrast, revenues generated globally from advisory services (both simple and complex) rose a whopping 52%.

Although this breakdown is not available for accounting services firms operating in New Zealand, it seems that this trend is also evident here. Indeed, 85% of firms in New Zealand surveyed by the Sunday Star Times in 2017 indicated that most of their revenue growth came from advisory services in the previous year and they expected this to continue.

**Figure 6: Global Tier 1 revenue growth by service type**




Growth in revenues from advisory services reflects a blurring of the lines of distinction between the accounting services, management consultancy, and legal and financial services industries.

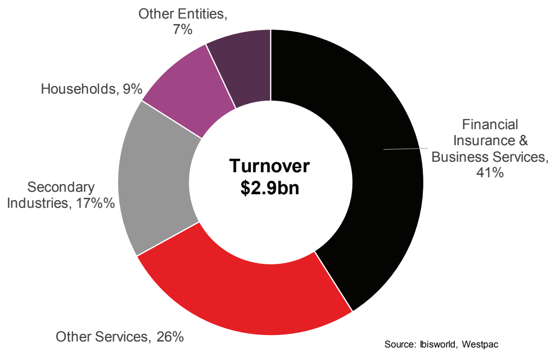
### Turnover by client industry

Firms in the services sector, and in particular financial services, are the key clients of the accounting services industry in New Zealand. This includes commercial and investment banks, asset management, insurance and private equity firms as well as other lending institutions. The reason for this is that firms in the financial sector are required by law to provide a high level of transparency, and so require audits and financial statement services in order to comply with relevant legislation and stipulated reporting requirements.

Firms operating in the secondary sector, which include manufacturing, construction and utilities, are also key clients, although their contribution to industry turnover has declined over time as their contributions to New Zealand economy has fallen. The opposite is true for fast growing "other services" such as wholesale, retail trade, hospitality and accommodation and ICT.

Public benefit entities and charities are also clients of the industry because they have to meet new stipulated reporting requirements covering the preparation, auditing and filing of financial statements.

**Figure 7: Industry revenues by client segment**



# External trade

Exports of accounting services to other accounting firms and clients located offshore are negligible but increasing. So too imports, where locally based firms, mostly accounting services firms, are starting to outsource back office work to low cost providers abroad. As accounting services become internationalised, imports have grown faster than exports.

### Exports

Exports of accounting services, mostly to other accounting firms located offshore, are negligible.

For the year ending June 2017, accounting services firms domiciled in New Zealand generated about $102m from providing traditional accounting, auditing, bookkeeping and tax consulting services to offshore entities. This amounts to about 0.5% of total service exports. This excludes a further $60m generated from specialised management consultancy and public relations services to offshore firms. Industry sources suggest that management consultancy services accounted for about 50% of this total.

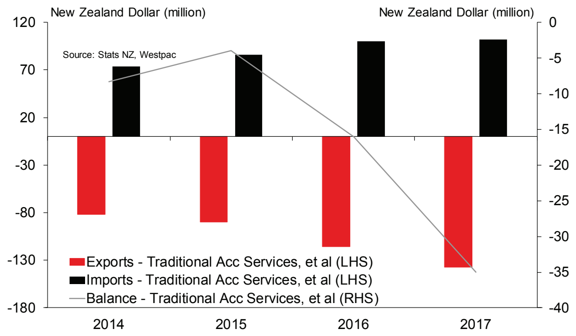
Exports have, however, grown sharply in recent years. Since 2014, exports of traditional accounting services, auditing, bookkeeping and tax consulting services have risen by about 38%. The key driver has been the impact of technology which has helped to facilitate two-way trade in accounting services. By contrast, the export of management consultancy services has seemingly flat-lined over the same period.

According to the Ministry of Business Innovation and Enterprise there about 500 accounting and bookkeeper firms in New Zealand providing services to over 10,000 small business customers in other countries.

### Imports

Imports of accounting services largely relate to the outsourcing of non-core work to low cost service providers abroad by accounting firms located in New Zealand. These service providers typically do most of the “grunt” work associated with traditional accounting services, allowing local accounting firms to focus more on higher value work.

**Figure 8: External trade in accounting services**




For the year ending June 2017, accounting firms in New Zealand paid just under $140m for traditional accounting services provided by offshore providers. This amounts to about 0.8% of total service imports. Again, this excludes a further $185m estimated to have been paid to offshore providers of management consultancy and public relations services during the same year.

Imports have grown more strongly than exports. Since 2014, imports of traditional accounting services have grown by about 67%. This reflects the degree to which local accounting firms have outsourced what are increasingly regarded as being non-core activities. By contrast, imports from management consultancy and public relations services have declined by just over 17% over the period.

The insignificance of exports and imports reflects the fact that the industry is characterised by many small firms who service small domestic clients. Trade in accounting services is also inhibited by different accounting reporting standards and regulations that apply in different countries.

# Value chain model

**The value chain model describes the range of activities that are required to move a product or service from conception, through the intermediary phases of production, to delivery to final consumers.**

For the accounting services industry, value chain activities are largely initiated by firms, organisations and individuals that need to comply with prevailing tax legislation and/or disclosure requirements, or to improve their competitiveness in the markets that they operate in.

Figure 9 summarises the value of inputs and outputs produced by the accounting services industry using basic price data from Stats NZ 2013 Input-Output tables. Because they are expressed in basic price terms they exclude taxes payable, any subsidies received and transport charges that are invoiced separately by suppliers.

The inputs used by the industry differ by firm depending on their size, the range of services that they provide and the infrastructure they need in order to provide them. They can be categorised as either services, materials or labour.

The industry uses a wide range of services from various industries. It relies heavily on commercial property services to provide suitable premises for client facing meetings and it needs space to accommodate staff. Some service suppliers, such as the telecommunication industry and utility providers are large and are likely to exert some pricing power over the accounting services industry. However, most suppliers are small and the ability of these firms to negotiate higher prices is limited.

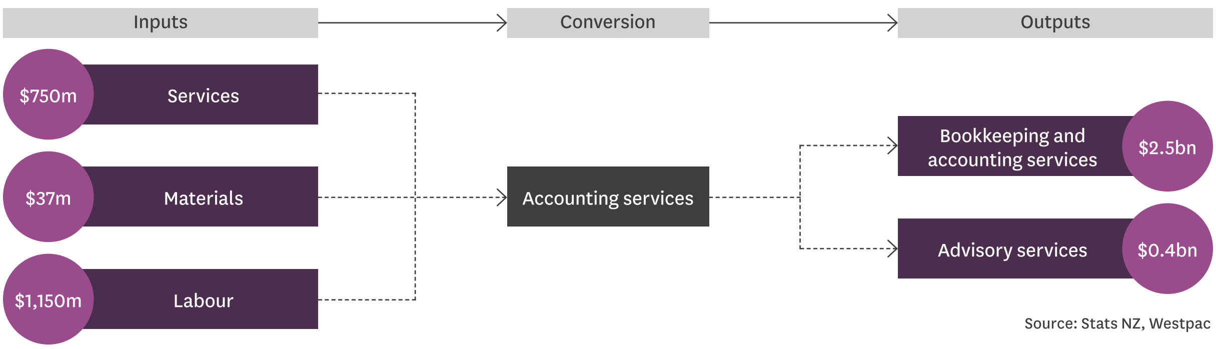
In total, services cost the industry about $750m per year, with commercial property leases/rents accounting for estimated $139m. The accounting services industry also depends heavily on independent legal opinion, especially when providing complex auditing and advisory services, and this costs an estimated $98m per year. It should be noted that some larger accounting firms provide legal services in their own right (and some law firms are also shifting into accounting services). Personnel recruitment services are also a major service item, costing the industry in the region of $67m. Other major service costs include equipment hire, which costs the industry about $39m per year, insurance services ($32m), computer software and services ($32m), and other education services ($31m).

**Table 2: Inputs used by the accounting services industry**

| Input | $m (2013 Prices) | % of Input Cost |
|---|---|---|
| **Services** | | |
| Leased commercial property services | 139.0 | 18.7 |
| Legal services | 97.5 | 13.1 |
| Placement and supply of personnel | 66.5 | 9.0 |
| Equipment hire | 39.0 | 5.3 |
| Other insurance services | 31.5 | 4.2 |
| Computer software services | 31.5 | 4.2 |
| Other education services | 31.0 | 4.2 |
| Maintenance of equipment & machinery | 29.0 | 3.9 |
| Telecommunications & internet services | 26.0 | 3.5 |
| Other personal and community services | 26.0 | 3.5 |
| Advertising and marketing | 24.0 | 3.2 |
| Higher education | 23.5 | 3.2 |
| Publishing, printing, and reproduction | 23.0 | 3.1 |
| **Materials** | | |
| Computers, parts, and office machinery | 25.0 | 68.5 |
| Books, printed materials, newspapers and journals | 5.5 | 15.1 |
| Basic chemicals; other paper & paperboard | 2.0 | 5.5 |
| Spirits, beer, other drinks & tobacco | 1.5 | 4.1 |
| Petrol & diesel | 1.0 | 2.7 |
| Motor Vehicles, trailers, & semi-trailers | 1.0 | 2.7 |

Source: Stats NZ, Westpac estimates

**Figure 9: Simplified value chain mapping of the accounting services industry**




Source: Stats NZ, Westpac

Note: Inputs and Outputs are shown in basic prices for the year ended March 2013. The basic price of an input or output is the monetary amount received by a supplier plus any subsidies received less any taxes payable. It excludes transport charges invoiced separately by a supplier.

Expenditure on materials that are used to deliver traditional accounting and advisory services is small. In total, materials cost the industry about $37m per year. This reflects the fact that this is a knowledge intensive industry that relies heavily on the intellectual capability of people. Not surprisingly the largest material cost item is computer equipment and office machinery, which accounts for an estimated $25m. Other major material input costs include books, other printed material, newspapers and journals, which collectively account for about $6m.

Labour costs in this industry are significant, costing in the region of $1.15bn a year. This industry is highly labour intensive, and depends heavily on skilled and educated staff. Although the requirement for accounting, taxation and auditing skills continues to predominate, the changing nature of the industry means that there is increasing demand for a broader range of business related skills, from strategy, tactical and operational expertise to legal, information technology (IT) and human resources (HR).

It is very difficult for firms in this industry to cut labour costs given that they depends heavily on human capital to generate revenues. Without skilled labour, there are no revenues. Similar to other service based industries, firms operating in this industry have low fixed costs but high variable costs, which makes it really difficult for firms to generate economies of scale. Because of this, firms within this industry have to focus on increasing revenues to boost profitability.

Labour costs have been tempered by a growing reliance on cheap cloud based accounting software, which has a reduced skills requirement.

That said profitability tends to be higher in this industry than most others. This is because there are large number of small firms operating in this industry and they have a higher proportion of partners whose income is derived from the profitability of the firm rather than from a salary.

# Industry representation

Unlike most other industries, industry representation seems to be focused at the accounting practitioner rather than at the firm level. This reflects the nature of firms operating in this industry and the fact that many are owned by equity partners who are practitioners.

That said, there are a few professional bodies that represent firms operating in this industry in New Zealand. NZ CA Limited, which was established in 2001, is the largest of these, representing 29 independent chartered accountant firms that employ more than 400 professional accounting staff with 200+ support staff. These firms provide a wide range of accounting, tax, audit and business advisory services.

Accountants, however, are represented by a number of different professional bodies within New Zealand. That doesn't mean that all accountants are represented by a professional body. An industry source has suggested that there are a large number of people in New Zealand that call themselves accountants, but they are not members of any professional body. Some of these do not hold a bachelor's degree in accountancy. Others still are practicing, but do not have any relevant education or experience. Most will be Tier 4 sole proprietors that provide "across the kitchen table" services.

At the other end of the scale are Chartered Accountants (CAs) and Chartered Public Accountants. These are highly qualified professional accountants able to take on a number of specific accounting activities, including the auditing of financial statements, the filing of corporate tax returns and advising on financial and business matters. To become a CA in New Zealand a candidate must have completed highly challenging and rigorous post graduate study and practical experience administered by the Chartered Accountant Australia and New Zealand (CAANZ).

CAANZ is a professional accounting body which was formed when the New Zealand Institute of Chartered Accountants (NZICA) amalgamated with the Institute of Chartered Accountants of Australia (ICAA) on 1 January 2015. Its purpose is to provide education services to those looking qualify as a CA as well as ongoing learning opportunities to already qualified CAs. CAANZ ensures that its members comply with best practice professional and ethical conduct standards. It also provides a forum for the exchange of ideas and networking opportunities. It is one of two bodies that are able to licence and regulate audit firms in New Zealand. Each year CAANZ reviews a selection of member practices to determine whether they have the appropriate quality controls in place to meet relevant professional, technical and legislative requirements.

All CAs operating in New Zealand must be members of CAANZ. However, not all members of CAANZ are CAs. CAANZ has about 117,000 members, most of whom operate in Australia. Of the 29, 000 members that reside in New Zealand, about 24,500 are CAs, 16,000 of whom work for firms that operate outside of the accounting services industry. About 2,800 members of CAANZ are mid-level associate CAs, and 1,800 are accounting technicians. Of the CAs that operate in the accounting services industry, an estimated 1,200 work for Tier 1 firms with another 5,700 in private practice.

CAs that have their own practice and provide services to the public for reward are required to hold a certificate of public practice (CPP). This requires the completion of the Public Practice Program at CAANZ.

Chartered Public Accountants (CPAs) are similar to CAs in that they are also highly qualified accounting professionals able to provide a wide-range of service to the public, subject to having gained a CPP. Unlike CAs, however, CPAs do not to specialise in specific areas like auditing, but focus on broader set of accounting skills, such as costing, production, marketing and planning.

In order to become a CPA, candidates have to undertake rigorous post graduate study and gain relevant practical experience under the auspices of the Certified Public Accountants of Australia (CPA Australia).

CPAs and CAs in public practice must have policies and procedures in place to cover quality control, complaints and disciplinary procedures. Both have regular independent practice reviews to monitor compliance and quality within the practice.

CPA Australia is one of the largest, most recognized and respected accounting bodies in the world, with over

150,000 members in 120 countries. It was established in 1886 and opened its New Zealand office in 1992. Core services include the education and training of members, technical support and advocacy. Much like CAANZ, CPA Australia also looks to uphold the professional standards and ethics of its members, who are predominantly CPAs or have some associate level qualification. CPA Australia currently has about 3,000 members residing in New Zealand.

Other professional bodies include the Accountants and Tax Agents Institute of New Zealand (ATAINZ), which has over 365 members that provide a range of services from traditional accounting to business and tax advice. Members are not CAs or CPAs and as such have not met the same academic standards. They have either earned a recognised accounting qualification or have the required work experience in accounting and/or tax matters.

The New Zealand Bookkeepers Association (NZBAI) provides advocacy on behalf of bookkeepers in New Zealand. Core services include the upholding of the reputation of the bookkeeping industry in this country through a code of ethics and practice, the provision of avenues to education and training, and the certification of bookkeepers operating in New Zealand.

# Legislative and regulatory framework

The accounting services industry is subject to a strict regulatory regime that reflects the importance of accurate financial reporting.

**Financial reporting framework**

The underlying principle of the New Zealand's financial reporting system is to provide information to a wide range of different interest groups that have a need for an entity's financial statements, but cannot demand them.

The financial reporting framework that operates in New Zealand consists of two parts:

The first is the statutory financial reporting framework, which sets out which entities must prepare General Purpose Financial Reports (GPFR) and which ones may adopt lower reporting standards and instead prepare Special Purpose Financial Reports (SPFR).

The Financial Reporting Act 2013 and the Financial Reporting (Amendments to Other Enactments) Act 2013 prescribes who has to report, and what type of entities are required by law to prepare GPFR, have them audited and filed with the Companies Office. The financial reporting requirements for specific entities are contained in the statutes that govern those entities. For example, the financial reporting obligations for financial services firms or "FMC reporting entities" are included in the Financial Markets Conduct Act 2013. For companies which are not "FMC reporting entities", the financial reporting obligations are included in the Companies Act 1993.

Changes introduced by the Financial Reporting Act 2013 effectively reduced the number of firms required to prepare GPFRs from 460,000 to less than 10,000, cutting compliance costs by $90m per year.

The Tax Administration Act 1994 requires all firms and organisations not required to file a GPFR to prepare a SPFR that meets the minimum requirements set out by the IRD. Firms and organisations that are not required to prepare a GPFR under the Financial Report Act 2013 can still opt to do so if they wish. Firms and organisations that are exempt from preparing financial reports are either not active, are part of a bigger group, or have not generated an income or incurred expenditure of more than $30,000 in a given year.

The second part to the financial reporting framework is the accounting standards framework. Having decided whether or not an entity must prepare a GPFR, the next decision is which standards need to apply for those that do.

The External Reporting Board (XRB) is the Crown Entity responsible for developing and issuing accounting and auditing and assurance standards for entities that are required by law to prepare GPFR. The XRB was established under the Financial Reporting Act 1993, and is subject to the Financial Reporting Act 2013 and the Crown Entities Act 2004.

The New Zealand Accounting Standards Board (NZASB) and the New Zealand Auditing and Assurance Standards Board (NZAuASB) have delegated authority from the XRB Board to develop and issue New Zealand's accounting, auditing and assurance standards.

The accounting standards framework in New Zealand uses international Financial Reporting Standards (IFRS) adopted in 2004 for "for-profit" firms required to prepare GPFR and International Public Sector Accounting standards (IPSAS) for "public benefit" entities that have the same reporting requirement. Firms that prepare SPFR are exempt from IFRS reporting. The framework adopts a multi-tier approach for "for-profit" and "public benefit" entities, with different accounting standards applying to each tier.

The establishment of a multi-tier approach for GPFR reporting has created new complexities and additional work for accounting service providers.

**Financial Reporting Amendment Act 2014**

The Financial Reporting Amendment Act 2014 came into force on 1 July 2015 and supersedes the Financial Reporting Act 2013. This later act allows members of accredited professional bodies to perform most statutory audits if they are recognised by their professional body as being qualified to do so.

**Financial Market Conduct Act 2013**

The Financial Markets Authority (FMA), established in 2011, is an independent Crown entity tasked with regulating a range of different financial service providers under the Financial Market Conduct Act 2013. Its objective is to work with financial markets participants to raise standards of good conduct, ethics and integrity, and to achieve best standards of practice and compliance.

The purpose of the Financial Market Conduct Act is to promote and facilitate the development of fair, efficient, and transparent financial markets by regulating financial conduct, as well as governing the way financial products are offered, promoted, issued and sold.

From an accounting perspective this Act focuses on ensuring more concise and timely financial reporting with about 2,300 financial service providers and schemes in New Zealand being subject to regulatory oversight by the FMA.

**Auditor Regulation Act 2011/Auditor Regulation Amendment Act 2014**

The Auditor Regulation Act sets out the licensing and registration requirements for auditors and audit firms in New Zealand.

Among other things, the Act requires that the FMA monitor and ensure that audit regulatory systems and processes used by accredited bodies are adequate and effective. The FMA has accredited the New Zealand Institute of Chartered Accountants (NZICA) and CPA Australia as the only accounting professional bodies that can now license and regulate auditors and audit firms in New Zealand with oversight from the FMA. NZICA's regulatory functions are set out in section 6 of the Auditor Regulation Act 2011 and in section 3 of the Auditor Regulation Act (Prescribed Minimum Standards for Accredited Bodies) Notice 2012.

A key objective of the Auditor Regulation Act is to ensure that New Zealand's audit oversight framework is recognised internationally as being best practice. Such recognition contributes to investor confidence in New Zealand markets.

Despite having amalgamated with the Institute of Chartered Accountants of Australia (ICAA) to form CAANZ, NZICA, rather confusingly, continues to regulate the accountancy profession for CAANZ members resident in New Zealand (who by virtue of their residence continue to be NZICA members).

The Auditor Regulation Amendment Act 2014 allows audit firms to incorporate as companies provided they are able to meet specific requirements aimed at protecting auditor independence. For owners of auditing firms, this offers the promise of having limited liability and the protection of personal assets (which are not tied to the firms in which they have invested) from legal action.

The Act also allows certain incorporated overseas audit firms to operate in New Zealand. Standards relating to ownership, governance and professional indemnity insurance are set in accompanying regulations.

Auditing in New Zealand is generally an area in which Tier 1 and Tier 2 firms operate. An industry source suggested that one of the reasons for this is the strict review regime that auditors are subject to and the associated costs of compliance.

**Anti-Money Laundering and Countering Financing of Terrorism Act 2009**

The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 came into force on the 30 June 2013. The Act requires that financial institutions and casinos operating in New Zealand take appropriate measures to detect and deter money laundering and terrorism financing. The purpose of the Act is to enhance the reputation of New Zealand as a safe place in which to do business.

From 1 October 2018, all accounting services providers operating in New Zealand will be required, under this Act, to collect personal information from clients to verify their identities and, in some circumstances, the source of their funds for transactions.

The Anti-Money Laundering and Countering Financing of Terrorism Act is expected to drive up compliance costs, especially for smaller accounting firms.

# Summary of competitive forces

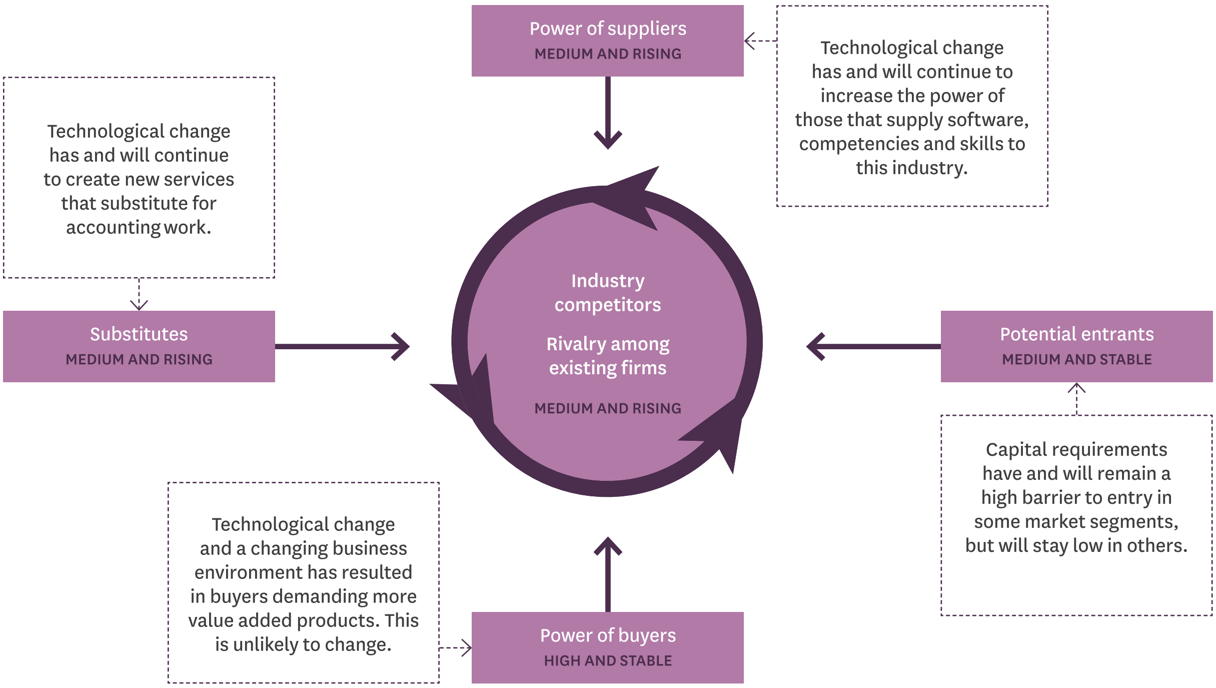
The intense competitive forces buffeting the accounting services industry suggest that in the long-term profitability is likely to come under pressure. Competitive differentiation through the adoption of technology will be the key to ensuring future prosperity.

Figure 10 below summarises the magnitude of competitive forces currently at play in the accounting services industry and provides an assessment of where they are headed in the future. Specifically, it assesses whether a competitive force currently has a "high", "medium", or "low" impact on industry participants and whether this impact will be "rising", "stable" or "falling" in the future.

The figure below uses a framework developed by Professor Michael E Porter from Harvard Business School. It includes three forces that relate to "'horizontal" competition: the threat of substitute products or services, the threat of industry competitors, and the threat of potential entrants. It also includes two other forces that relate to "vertical" competition, namely the relative negotiating position of those that supply inputs to the industry and the bargaining power of clients that purchase its outputs.

The five forces suggest that over time this industry could disappear and find itself absorbed within a broader professional/advisory services industry. This is already happening with a blurring of the lines of distinction between accounting services and other advisory services industries.

**Figure 10: Porter's 5 Forces Framework**




Source: Westpac

# Power of buyers

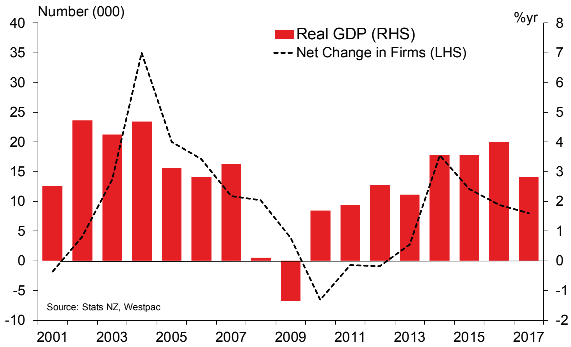
There are a range of factors that drive demand for accounting services, from the number of firms that exist at any one point in time to labour market practices and financial reporting requirements. The need for firms to improve their competitive positioning, the impact of technology and issues relating to trust also likely to be key factors that shape demand for accounting services.

### New firms and closure of existing ones

Demand for accounting services is partly a function of how many firms are in operation. Simply put, the more firms there are the bigger the market for accounting services.

While the number of firms in existence underpins demand for accounting services, the sophistication of these services tends to increase as firms get larger. Small firms, for example, often do not start out with in-house finance staff, instead relying on external practitioners for most professional services and day-to-day advice. However, as they grow, they build in-house capabilities and engage accounting services providers to support their finance operations.

**Figure 11: Net new firms in New Zealand**

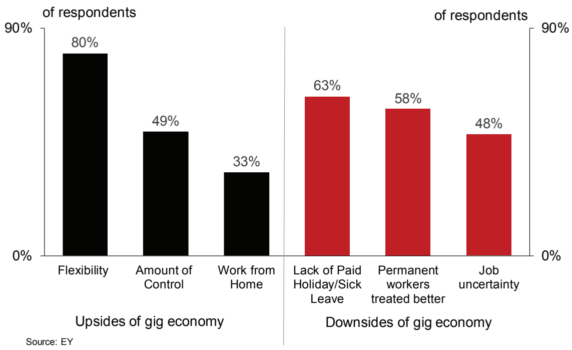



The management, operational and tax complications that accompany business growth often leads to increased demand for complex advisory services.

### Changes in the nature of employment

A related factor is the emergence of the so-called gig economy, which refers to the growing number of workers abandoning 9 to 5 employment in favour of working independently on a task-by-task basis for various employers. More people are signing up to work on casual and short-term contracts to take advantage of new technologies that reinvent and make business models more efficient.

**Figure 12: Gig economy – pros and cons**




Currently about 30% of the combined workforces of Europe and the US are engaged in freelancing work and this is expected to rise well over 40% within the next couple of years.

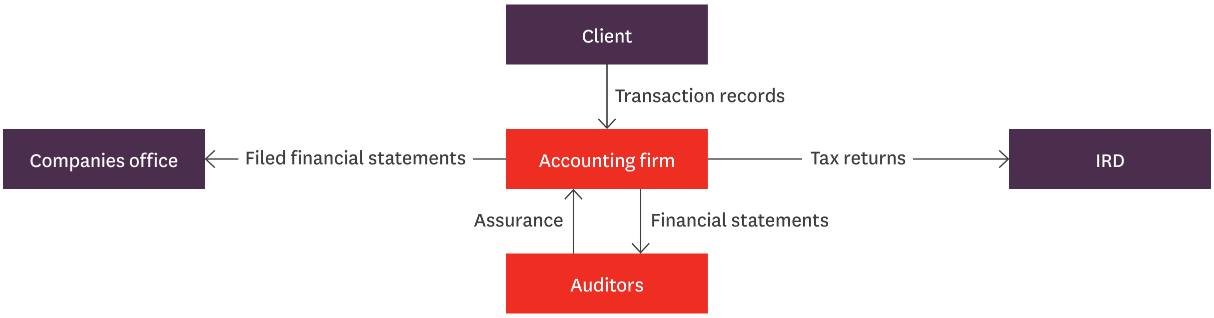
While in the past, most of these freelancers would have had their tax obligations covered by their employers, in the gig economy where they may have many different employers, they are more likely to need the services of an accountant to work though complex tax affairs.

The gig economy has emerged and is growing at a breakneck pace. The result is an increase in the number of taxpayers who must now face the tax realities of operating their own entrepreneurial businesses.

### Compliance with statutory requirements

Demand for traditional accounting and auditing/assurance services is also driven by a) the need to comply with statutory reporting requirements for the purposes of assessing tax liabilities (company/individual income tax returns, good and services tax returns); and b) the need to comply with financial reporting requirements to ensure that investors and regulators have the information they need to make informed investment and lending decisions as well as enforce regulations. Often regarded as a grudge purchase, firms will often turn to their accounting services providers for up-to-date advice on regulatory matters when there are significant changes to statutory reporting requirements.

## Figure 13: Simplified traditional accounting process



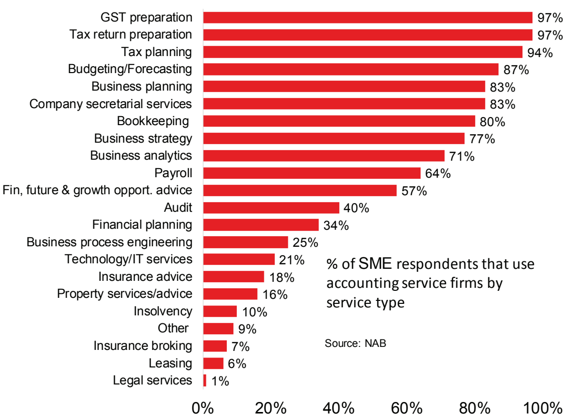

Source: Westpac

> Changes in statutory requirements can have a significant impact on industry revenues. For example, changes to the Financial Reporting Act 2013 resulted in a sharp drop in the number of firms having to submit detailed financial statements, effectively reducing demand for this service.

### Competitive positioning

Firms are increasingly looking to their accounting services providers to provide insights that inform the development of strategy, tactical decision making and operational improvements, to enable them to compete more effectively in an increasingly complex operating environment. Specifically, they are looking at services such as tax planning and advisory, business planning, business strategy, analytics and advice on growth opportunities.

## Figure 14: % of SMEs using accounting services

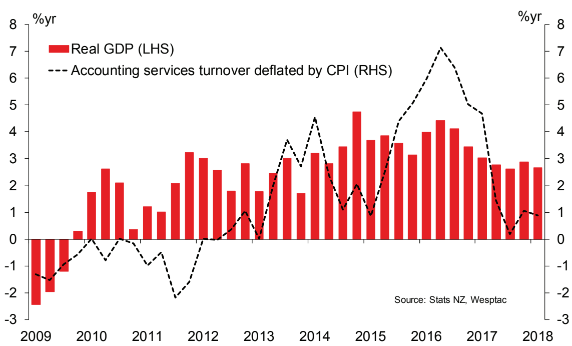



> According to industry sources, firms purchase accounting services so they can focus on their core business. Their motivation is simply to gain time, money and mind freedom.

### Economic cycle

Demand for accounting services is positively correlated to the economic cycle. Industry turnover tends to grow faster than the overall economy when growth picks up, but underperforms when it slows.

## Figure 15: Economic activity vs industry turnover




However, this is not the case for all accounting services. Demand for traditional accounting services, for example, is largely immune to the changes in the economy, mainly because most of these services are required for ensuring compliance with statutory obligations. Of course, some traditional services are not mandatory and firms will often look to cut back on these during an economic downturn. The same can be said for auditing services. Some firms, who may have no obligation to be audited but do so on a voluntarily basis, may opt out if the economy slows and the focus shifts towards reducing costs.

By contrast, demand for advice tends to increase in an economic upturn, but grows more slowly when the economy turns southwards and financial constraints start to bite. When the economy is growing, firms are much more likely to turn to their accounting services providers to deliver advisory services that help them exploit future growth opportunities. Areas of interest might include advice on merger and acquisitions, capital expenditure plans, offshore expansion, tax restructuring and the raising of equity through initial public offerings.

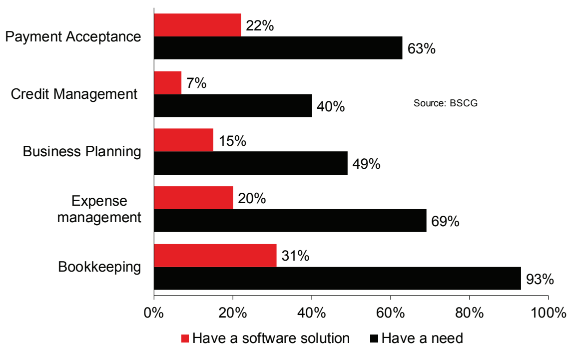
When the economy tanks, firms still demand advisory services, but these are more likely to focus on minimising costs in order to preserve margins with poor business performance, cash flow issues and market pressures being front of mind. Areas of interest might include consultancy advice on liquidations and insolvencies, the restructuring of operations, and how to optimise training and marketing.

**Assuming all else remains constant, an expected slowdown in the economy over the next couple of years should translate into slower turnover growth in the accounting services industry.**

### Technological change

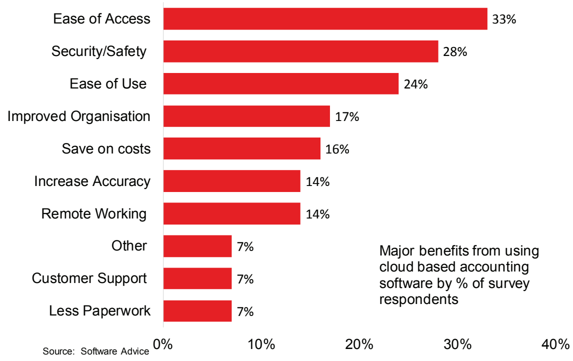
Advances in technology have led to the development of cost effective cloud based accounting software that is able to provide real time financial information tailored to individual needs. This information can be accessed at any time, even remotely on mobile devices. As opposed to traditional desktop accounting software, cloud based programmes are able to automate many of the accounting processes that have historically been undertaken by accounting service providers. Indeed, according to research by McKinsey, cloud based accounting software can fully automate about 42% of finance tasks at present with an additional 19% mostly automated. Greater automation means that more clients can spend more time focusing on their businesses, rather than on their accounts.

**Figure 16: Adoption of cloud based accounting software**




Given this, it's not surprising that firms have shifted to cloud based accounting software. According to Accounting Today 2018 "Year Ahead" Survey, the overall adoption of cloud accounting globally is currently between 45% and 58%, depending on the size of the firm. The study showed that 45% of SMEs, 57% of mid-sized companies and 58% of large corporates currently use online accounting software.

**Figure 17: Benefits of cloud accounting software**




Industry sources suggest similar splits are evident in New Zealand. They also suggest that firms in this country have been early adopters of cloud accounting software. A 2014 study by New Zealand based accounting software provider, Xero, found that 18% of New Zealand SMEs were already managing their accounts using cloud software compared to 11% globally. Not only that, of those that were not using the cloud for their accounting needs, about 42% of them were in the process or looking to convert within 12 months. By the end of 2015, roughly 40% of SMEs in New Zealand had shifted to using cloud based accounting software.

The adoption of cloud accounting software in New Zealand has effectively reduced demand for traditional accounting services. In most cases, an accountant is still needed to undertake necessary checks for accuracy and to make complex accounting adjustments where required. However, for some smaller firms, especially those with lower reporting requirements, cloud based software has enabled them to bypass their accounting service provider altogether.

The advent of cloud-based accounting software has not just reduced the amount of work that accountants have to undertake, but it has effectively commoditised much of what constitutes traditional accounting work. A lack of differentiation has not only capped the prices that can be charged for such work, but also lowered the costs of switching from one accounting service provider to the other – a key reason, perhaps, why so many accounting providers emphasise the quality of service that they are able to provide.

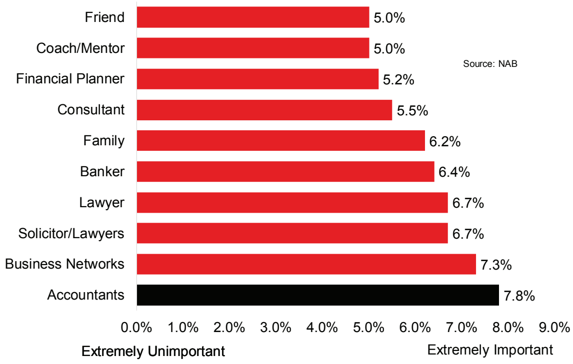
The adoption of cloud based software has also been underpinned by the changing face of the workplace, evidenced by the growth in the number of tech-savvy millennials (and the decline in working-age baby boomers) who are now business owners. Added to this, the growth in social media, web tutorials, YouTube videos, webinars and search engines has enabled these digital natives to access just about anything necessary to handle their own accounting and bookkeeping needs

**The new generation of business owners are looking to their accountants to tell them what their financial statements mean and to turn that into practical advice to drive business performance.**

### Role as trusted advisors

According to a 2016 survey by NAB of SMEs in Australia, accounting service firms are regarded as the most important and trusted providers of professional services. Just over half of respondents to the survey put them in top place. More specifically, accountants are the most trusted profession when it comes to financial services (47 %) and business planning (39%).

**Figure 18: Trust levels by professional service**




This is not surprising considering that so many critical decisions facing firms are entwined with their own financial circumstances, an area which accountants are very familiar with. This may also reflect the fact that small firms in particular, faced with ongoing challenges in their operating environment, often feel quite alone. This is not to say that other types of professionals are not consulted at various times. It's just that accountants are consulted more often and their opinions carry a great deal of weight.

**The trust and reliance that firms place on their accounting service providers is often a missed opportunity. Many accountants are happy to be bogged down with traditional accounting work, and are often uncomfortable helping firms make big moves to better themselves.**

# Power of suppliers

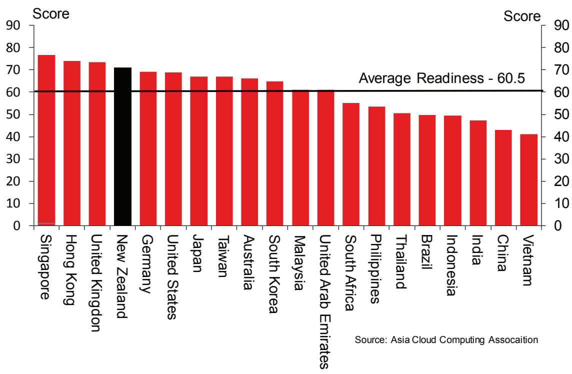
Technology has been the big disrupter, reducing barriers to entry while simultaneously creating new opportunities for accounting service providers. Pursuing these new opportunities, however, requires a not only a shift in mind-set but also in the skills and competencies not traditionally associated with the accounting services industry.

**Technology**

The last decade or so has marked a fundamental change in accounting software and this has created a significant shift in the accounting services industry.

Cloud based accounting software has revolutionised the industry by reducing the amount of work required to deliver traditional accounting services, limiting revenue growth from this source. However, it has also created the ability to deliver higher value-added advisory services.

**Figure 19: Cloud based readiness of firms by country**



Source: Asia Cloud Computing Assocaition

A Sunday Star-Times Top 30 Accounting firms Survey in 2016 revealed that 91% of accounting services providers in New Zealand were investing in cloud accounting software for their firms while 88% were investing in cloud accounting for clients.

However, not all accounting services providers have adopted cloud based accounting software. Indeed, according to industry sources there are a large number of mainly Tier 4 firms operating in New Zealand that prefer to stick to the tried and trusted. Ignoring new technologies, these firms rely instead on the close relationships that they have developed with clients over many years. By all accounts, the vast majority of these firms are small, mostly run by ageing sole proprietors whose thoughts are turning to sale and retirement rather than the next round of investment.

These firms are increasingly under threat because cloud based computing is commoditising traditional accounting work. A lack of differentiation means that competition for this type of work is largely based on price. In an environment where input costs are rising, mostly because of a limited availability of skills, and prices are effectively capped, the ability to charge on a cost plus basis becomes increasingly difficult, with squeezed margins being the final result. The ability to set higher prices on the basis of close relationships only delays the inevitable. As the differential between what these firms might charge and what the market says they should charge widens over time, so they will lose business. This is likely to be exacerbated by the fact that many of their clients, often ageing, will also be looking to wind down themselves or sell to the next generation who are likely to be more open to using online accounting software than their predecessors.

Limited potential for revenue growth from traditional accounting services has prompted a shift toward higher value added advisory services. This is where the real growth is in accounting services.

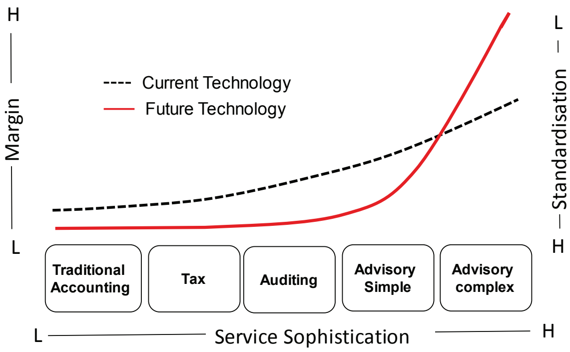
However, while the emergence of cloud based accounting software threatens the long-term viability of those that are reluctant or unable to change the way they operate, it also creates significant revenue opportunities for accounting services providers that are willing to adapt. This is especially true for those that are willing to make additional investments in associated areas, such as machine learning/ artificial intelligence, robotic automation and blockchain data structures. These technologies not only enable accounting service firms with an intimate knowledge of their client's business to add extra value through data mining, "deep-dive" analytics and exception reporting, but it allows them to do so at minimum cost - a key reason why Tier 1 firms invest about US$250m each year on machine learning/artificial intelligence technologies. Not surprising, software companies, such Xero, MYOB, and Quickbooks, are also in this space.

These technologies enable accounting services firms to explain the "so what" to their clients so that they can make informed decisions. Instead of being "order takers" with a product orientation, accounting services providers are increasingly becoming "insight sellers" with a strong customer orientation.

However, while cloud based computing may be relatively commonplace, the adoption of the other technologies listed above is less widespread. Indeed, while significant progress has been made, most of these new technologies are still in their infancy However, as they progress and become more accessible, which is likely to be sooner rather than later, accounting firms will have to adopt them if they want to exploit value add opportunities, minimise costs and remain competitive.

This dynamic will drive further automation in the accounting services industry, meaning that many of the value added services delivered today will become increasingly automated and standardised, attracting lower margins in the future. This will happen at a quickening pace as technology progresses and service lifecycles shorten. As margins come under pressure accounting service firms will forced to reinvent themselves, cannibalising existing services, and rapidly developing new ones where they can.

**Figure 20: Technology impacts on service**




Source: Westpac

Put more simply, technology will drive accounting firms further up the value chain into advisory services. Over time, everything else, from traditional accounting to auditing will become automated and low margin. The accounting services industry as we know it will be no more. Those unable to adapt to this new paradigm will go out of business.

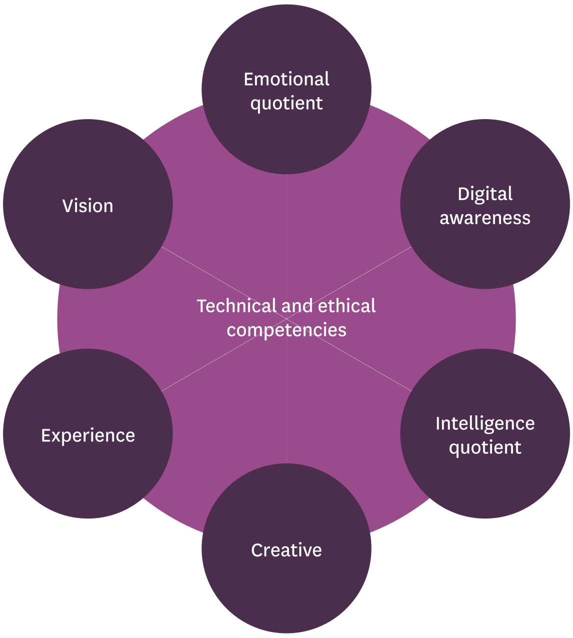
**Skills and competencies**

The technology induced shift towards advisory services has, and will continue to have, significant consequences for the skills and competencies required by accounting service providers.

Although highly educated and knowledgeable in their field, accountants have often been stereotyped as back office "bean counters". Industry sources suggest that most accountants are by nature not particularly entrepreneurial and historically have been more comfortable providing traditional accounting services to meet compliance needs.

However, the shift towards being "insight sellers" is starting to change that.

**Figure 21: Skills and competencies**




Source: Association of Certified Accountants

The next generation of accountants will know how to manage numbers and people, be able to think outside of the box to solve complex financial and non-financial problems, be adaptable to changing circumstances and provide strategic advice and council to their clients.

The accountant, for so long simply a numbers person, is now becoming a people person, with a broader range of softer relationship skills to complement already well developed technical and ethical competencies and problem solving abilities. Being entrepreneurial, having a strong business acumen and being able to think strategically are additional sought after competencies. Specialist knowledge areas such as negotiating deals, mergers and acquisitions, shareholder disputes, due diligence, raising finance through debt or equity are areas where accountants can really add value due to their exposure to a broad range of businesses and transactions.

As a result of this shift, accounting firms are changing their hiring practices. While accounting graduates still make up the largest share of new employees, an increasing number of these come other disciplines. A 2017 US report by the Association of International Certified Professional Accountants reported that since 2014, 20% of new hires by accounting firms in the US were non-accounting graduates. KPMG has publicly indicated that a similar trend is evident in New Zealand, with about a third of its annual intake being people with backgrounds in economics, political science, and computer science or data analysis.

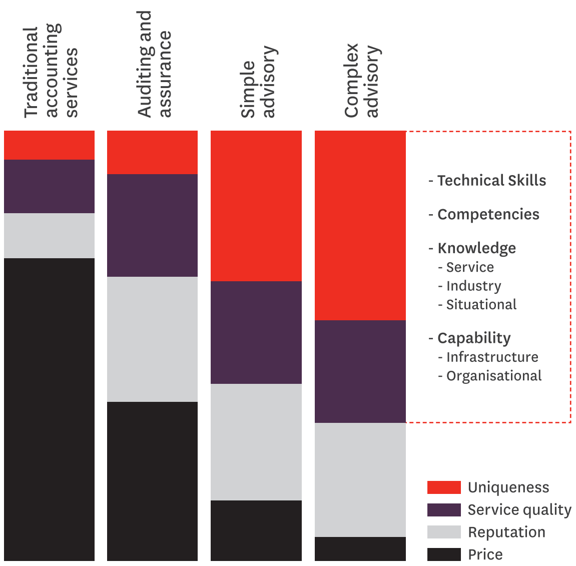
An industry source has suggested that the shift towards advisory services requires extensive subject matter knowledge, which only comes with age and experience. Subject matter expertise is often the attribute that is in short supply for those looking to move into advisory services.

# Industry rivalry

Competition in the accounting services industry largely occurs within market segments defined by a) customer size; b) complexity of the services provided to address their needs; and c) the capabilities of accounting service firms.

At a summary level, how accounting services firms compete depends on the nature of the services that their customers demand. Simply put, the less complex the service, the more commoditised it is likely to be, the greater the likelihood that accounting service firms will compete on price. This is certainly true of traditional accounting services, which have increasingly become automated, thus reducing the scope for differentiation on the basis of service quality or a well established reputation.

**Figure 22: Competition by service attribute and type**




Source: Westpac

Industry sources have indicated that it is not unusual for accounting services firms in New Zealand competing in the traditional accounting services space to outsource most of the "grunt" work involved to low cost service providers operating in South and South East Asia. This enables them to compete better on price.

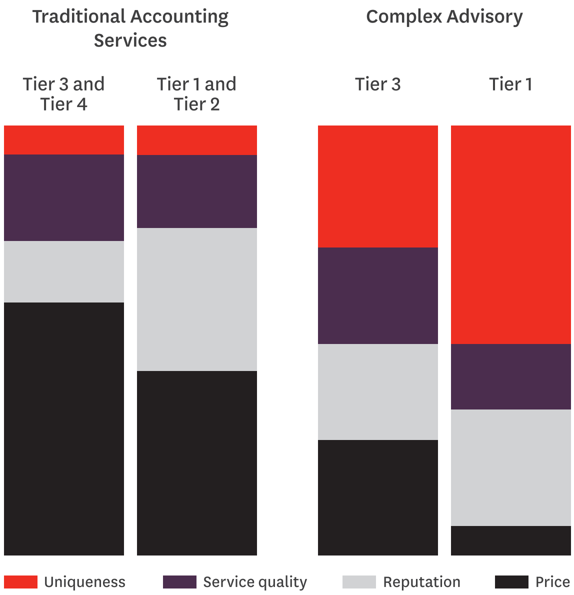
The opposite also applies. The more complex the service, the more tailored it is likely to be to the customer's requirements and so the ability to differentiate is much higher. Firms that deliver complex advisory services, for example, compete on their ability to deliver solutions that are unique and able to add value to their customers business rather than just price. This requires an ability to demonstrate that the way they do business is different and superior to their competitors, either because they have some unique technology (patents, trade secrets), or a sustainable competitive advantage (global reach, subject matter and industry expertise, internal processes, etc.).

Limited access to resources has driven merger and acquisition activity, with larger firms acquiring smaller ones that specialise in specific areas to gain specific competencies and skills. Firms are also likely to seek assistance through their international connections or by entering into joint ventures and alliances to access the resources they require.

It's not just the nature of the services that determines how accounting services firms compete with each other. Market segments also matter. Firms that provide a particular service in one market segment will compete on a slightly different basis to a firm offering a similar service in another market segment.

When Tier 1 and Tier 2 firms provide traditional accounting services to large corporates, they do not compete on the same basis that Tier 3 and Tier 4 firms do when providing the same type of service to small firms. Indeed Tier 1 and Tier 2 firms will still compete on price, but are more likely to try and gain a competitive edge by leveraging off their reputation (and branding) and standing as the world's largest accounting firms. Tier 3 and Tier 4 firm do not have that luxury and are more likely to compete on price and the quality of service that they are able to provide. These firms also tend to rely heavily on relationships that they have developed over an extended period of time.

**Figure 23: Competition by service attribute and market segment**




Source: Westpac

The same is true for Tier 1 firms that compete in the complex advisory space. They will compete largely on their ability to deliver tailored solutions that add value to their clients business, differentiating themselves through the expertise that they are able to offer across a wide range of advisory services. By contrast, Tier 3 firms who operate in a different market segment will compete both on price and their ability to deliver tailored solutions that add value, limiting themselves to selective services where they have the skills, competencies and specialist knowledge.

## Most firms in New Zealand attempt to differentiate themselves by emphasising the range and quality of services they offer. Industry sources suggest that it's not unusual for firms to exaggerate their delivery capabilities.

Irrespective of differences in size and orientation, the profitability of accounting firms depends on the right mix of services and effective marketing. Larger firms have advantages in providing wider range of services to large corporate clients and having the resources to serve customers in many locations across the world. Smaller firms can compete effectively by specialising in selected areas, providing superior levels of service and/or leveraging off other members of the organisations that they belong to.

## Industry rivalry is high in most market segments. However it is low among small Tier 4 firms and "across the kitchen table" services providers that deliver services to very small firms/individual with whom they have developed long- standing relationships.

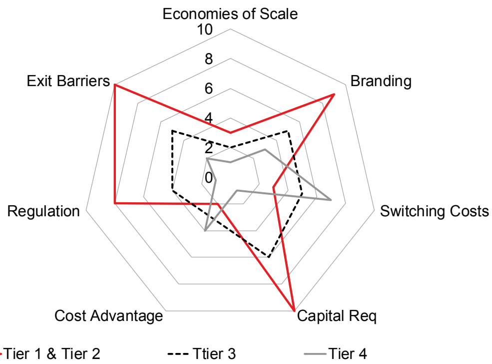
# Potential entrants

Barriers to entry in this industry differ by market segment. In simple terms, barriers to entry into the large and mid-tier corporate market segments where Tier 1 and larger Tier 2 firms compete are significantly higher than those in the SME and individuals market segment where a large number of Tier 3 and Tier 4 firms compete.

The ease with which firms are able to enter and exit the accounting services industry depends on a number of factors.

The first of these is whether firms are able to generate cost advantages through economies of scale; i.e. the ability to reduce unit costs by maximising production volumes over costs. However in the accounting services industry, variable costs tend to be high due to the labour intensive nature of production, meaning that there is limited scope to generate economies of scale. Some economies of scale can still be generated through bulk purchasing, standardisation of processes and specialisation (including outsourcing), although these are not particularly high barriers to entry for new entrants. This is especially so in market segments where Tier 3 and Tier 4 firms compete, but less so for Tier 1 and Tier 2 firms.

**Figure 24: Assessment of barriers to entry**




10- high barrier to entry; 0 - no barrier to entry

Source: Westpac

Brand loyalty is a key feature of this industry. If existing firms have high brand loyalty, new entrants might need to invest heavily in their own branding, which is a barrier. This is particularly true of Tier 1 firms that have established global brands, and to a lesser extent Tier 2 firms. Tier 3 firms that are members of global organisations, are also able to leverage off these affiliations. It's also true that branding plays a different role depending on the type of service being provided and the size and sophistication of customers that purchase them. Large firms listed on the New Zealand Stock Exchange, for example, will typically seek auditing services from Tier 1 firms because of the prestige of being associated with these firms.

If the costs faced by customers of switching between different service providers is high, new entrants might find it more difficult to compete. Switching costs in this industry are relatively low, but this depends on the services purchased. The costs of switching between firms that deliver complex advisory services are likely to be much lower than those providing auditing services. The ability to switch between suppliers of traditional accounting services is relatively easy because of cloud based accounting software. However, for some clients, the costs of moving from one traditional accounting service provider to another could be high, especially where relationships have been developed over many years. This is particularly true for smaller clients.

The capital requirements of setting up shop are not insignificant. But this depends on which market segment a new entrant is targeting. For the large and mid-tier corporate market segment, where Tier 1 and Tier 2 firms operate, the capital requirements are so large that they effectively prohibit entry by new firms, although it could be argued that some global management consultancy firms that provide similar advisory services could have the resources to overcome this barrier. The same applies to human capital, where Tier 1 firms have access to the "best and the brightest" across a range of different subject areas and competencies. Indeed, Tier 2 firms are unable to join Tier 1 firms mainly because of these constraints and their inability to scale up through mergers and acquisition activity. By contrast, in the SME and individuals market segment where Tier 3 and Tier 4 firms compete, the capital requirements are very low, mainly because of the impact that technology has had on automating much of traditional accounting work.

Some smaller Tier 3 and Tier 4 accounting services firms are able to generate cost advantages that are independent of scale because they "cherry pick" the services they deliver, specialising in specific areas and/or by providing superior levels of service. Larger Tier 3 firms also generate cost advantages by outsourcing non-core traditional accounting work to firms that specialise in this area, allowing them to focus on other areas more closely aligned to their core focus.

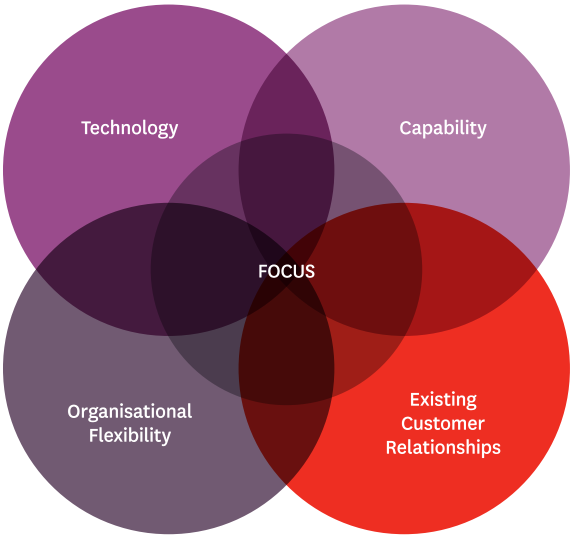
Regulatory controls in this industry are not particularly high, except perhaps for firms that are involved in auditing and assurance activities. Firms providing these services are closely monitored, are subject to practice reviews and the possibility of heavy sanction. The requirements to become CAs and CPAs are also significant.

If it is too difficult or costly to exit an industry, then new entrants might be discouraged from entering. For smaller players in the accounting services industry there are few barriers to exit. However, there are higher barriers to exit for Tier 1, Tier 2 and larger Tier 3 firms who have invested significantly in physical and human capital.

# Critical success factors

Irrespective of what market segment firms operate in or what size they are, there are a number of generic factors which collectively determine success in this industry.

**Figure 25: Critical success factors**




Source: Westpac

The first is the ability to leverage off new technologies, including machine learning/artificial Intelligence, blockchain data structure and process robotic automation to deliver new solutions to customers at lowest cost. Technological progress will drive the development of new services, which will be delivered at an ever quickening pace, and within shorter cycle times.

The second relates to the capabilities of accounting services firms. As firms move more towards providing solutions tailored to their customer needs, they will need to improve their situational expertise (industry, regional, regulatory and service knowledge) and this will require an expanding set of competencies and skills not traditionally related to the field of accounting.

The third relates the ability to develop and maintain customer relationships. The focus will increasingly be on being a trusted partner (rather than an advisor) who understands all material aspects of their client's business, strategically, tactically and operationally. The ability to communicate effectively at each level will be critically important.

The successful accounting firm of the future will also need to be able to adapt to changing market conditions. In the long-term, the accounting services industry as we know it will no longer exist, but will instead sit within a broader advisory/professional services sector. Accounting firms of the future need to be entrepreneurial, actively looking for new ways to improve revenues and be willing to shed those services that limit revenue growth rather than cling onto them for dear life. Firms should also be looking to focus on core activities, outsourcing where necessary and implementing the necessary quality regime to ensure that outsourced work is to a suitable standard.

The final critical success factor is having a clear vision of what market segment and what service offering will maximise profitability. For smaller Tier 3 and Tier 4 accounting services firms, specialisation can be a successful business strategy.

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