On Your Mind

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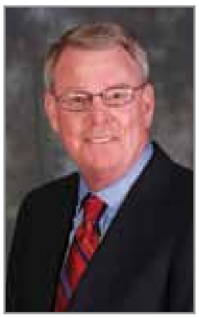
What Marketers Need to Know About How Accounting Firms Make Money



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CPA firms deliver highly technical and complex professional services, all the while operating under a complex regulatory environment. But CPA firms are also businesses and the business model itself is quite simple. The leadership of most firms use a few simple measures, such as realization and net income per partner, to describe the state of the business. This article will begin to explore the nuances underlying the most common performance metrics used by CPA firms as a way to help marketers increase their contributions to both the growth and profitability of the business.

Common Performance Metrics

The basic financial statements of a CPA firm are no different from the basic financial statements of the clients the CPA firms audit. The firm's balance sheet and income statement are the primary financial statements of interest to owners (partners).

The most critical items on a CPA firm's balance sheet are the client accounts receivable and unbilled work in process. The absolute amounts are not as important as the aging. A healthy CPA firm converts services rendered to invoiced work, to an outstanding client receivable and finally to cash in the bank in a cycle of less than 90 days. So if the firm's combined accounts receivable and unbilled work in process exceeds the trailing three months of revenue, it indicates potential unhealthy business practices that should be addressed.

The income statement is of most interest to partners, because income drives partner compensation. The basic income statement is quite straightforward. The metrics underlying the income statement, which are used to measure individual and group performance, is where the things get tricky. The use of metrics in determining individual partner compensation will drive partner behavior, and over-reliance on any one of those metrics can produce unintended consequences for the firm.

The basic formula that drives value for a commercial business is return on equity. The equivalent measurement in a CPA firm is net income per partner. That return on equity formula in a CPA firm is as follows:

Net Income per Partner = [Revenue/ # of people] x [net income/revenue] x [# of people/# of partners]

Revenue Per Person: Revenue is the amount actually billed to clients. It is the result of the client service hours charged by all employees, times the firm's established standard rate for each person, reduced by amounts the firm is unable to bill, either because an engagement is quoted at a fixed fee or a client is granted a discount from the standard rates. At first glance, if revenue per person is lower than expected, we might jump to a conclusion that the firm is over-staffed.

But revenue per person is a function of charge hours, standard bill rates, and realization. Realization is the percentage of the firm's standard rates that is actually billed to clients. Firms often use realization as a measure of many attributes, including:

- ✔ Quality of a client relationship,
- ✔ Partner and staff performance, and
- ✔ Relative profitability of an individual employee, a group of employees, an entire service line, an individual partner's assigned client base and/or or the entire firm.

However, standard rates are not universal and consistent. They are set by the firm and vary widely from firm to firm. Typically, we derive the rates with a formula, using a multiplier on the individual employee's compensation, divided by an expected level of charge hours. Some firms set rates based on local market knowledge and benchmarking information available throughout the profession.

From personal experience, low realization can result from one or more of the following:

- ✔ Unrealistic standard rates,
- ✔ Inadequate scoping and pricing of engagements,

- ✔ Ineffective engagement planning, supervision and execution,
- ✔ Failure to capture time for out of scope work and billing it to clients,
- ✔ Staffing of engagements with the wrong level of personnel,
- ✔ Billing processes that allow unnecessary discounting of fees,
- ✔ Poor individual employee performance,
- ✔ Partners too willing to grant discounts to retain clients, and
- ✔ Staff "stuffing" non-billable or idle time into engagements to hide their lack of productivity.

High realization may be an indication that the firm has set standard billing rates too low, or employees are not accurately and completely charging all their time spent on behalf of clients.

Since the realization metric itself can be impacted by so many diverse factors, management needs to dive deeper into the details to determine if corrective action is required.

Another widely quoted metric, based on charge hours, is collected rate per hour. This metric is derived by simply dividing the revenue collected for a time period (typically one year) by the total number of charge hours reported. The collected rate per hour, client by client, can be used to measure the relative quality of one client compared to another, or the quality of one partner's assigned clients compared to another. The collected rate per hour metric is impacted by many of the same issues that cause either low or high realization. A high collected rate per hour may also signal that more experienced personnel are hoarding work and not pushing it down to the appropriate level.

> "A change in leverage does nothing to improve the underlying quality of the CPA business."

Both of these metrics are useful tools in managing a CPA business. But firms should use them as a diagnostic tool, not purely at face value. I used these metrics as a factor in personnel evaluation and individual partner compensation, but I do not recommend using them as a primary determinant. This practice creates too much temptation to short cut the firm's quality standards and can foster under-reporting of true chargeable hours. As indicated above, these metrics should be the starting point for diagnosing the underlying causes of less-than-expected results.

Net Income to Revenue: Also referred to as net margin, this is the amount of each dollar of revenue that falls to the bottom line, after paying client server salaries, administrative staff and firm overhead.

When firms fail to meet profit expectations, it is only natural to focus on squeezing overhead. This can be ill-advised and cutting overhead excessively can damage the long term health of the firm. Managing overhead costs is a good management practice, but there is far more profit improvement to be gained by diagnosing and curing the causes of poor realization and collected rate per hour.

Our firm found it helpful to segregate the client service personnel cost from all other expenses, including the compensation of marketing, finance and other internal departments. This allows a firm to calculate gross margin, which is firm revenue minus client service personnel cost, and then take a separate look at all other expenses (firm overhead) in arriving at net income. This helps focus management on improving gross margin first, where the real opportunity for profit improvement exists.

Staff to Partner Ratio: Another factor that impacts the ratio of net income to revenue is the leverage ratio. But simply changing it does nothing to improve the quality of the firm. Let me explain why.

When calculating net income per partner, partner compensation is the answer, not part of the equation. While the revenue individual partners generate is included in net income, their compensation is not. So, if there are two identical firms, with the same number of total personnel, total revenue, and total costs, but in one firm there are five partners and in the other firm there are 10, then the difference in the "staff to partner" leverage ratio results in the five-partner firm having twice the net income per partner as the 10-partner firm. Is the firm with the higher leverage ratio any better than the one with the lower ratio?

As illustrated above, firms seeking to raise net income per partner can do so by simply reducing the number of partners. However, management should first look to the revenue side of the equation and fix the issues impacting realization and collected rate per hour, as a change in leverage does nothing to improve the underlying quality of the CPA business.

Use Metrics to Challenge the Status Quo

As a marketing professional in your firm, it is important that you understand the metrics that firms casually use to explain away unexpected results or justify business as usual. There is no magic in metrics, once you understand them and what causes them to deviate from expectations. I am convinced that a true marketing professional, armed with an understanding of the metrics, can challenge the status quo and help move their firm to the next level.

About the Author

Tom Siders, CPA, CGMA is a partner with L. Harris Partners, LLC, a firm dedicated to helping CPA firms build value. To learn more, visit www.LHarrisPartners.com.