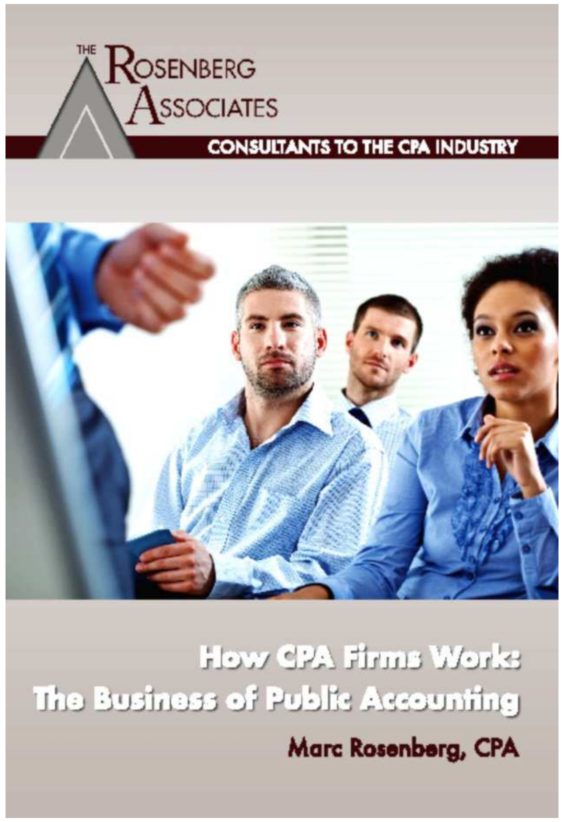

HOWCPA FIRMS WORK: THE BUSINESS OF PUBLIC ACCOUNTING

Marc Rosenberg, CPA

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Marc Rosenberg, CPA

The Rosenberg Associates Ltd.
1000 Skokie Boulevard, Suite 555
Wilmette, IL 60091

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1

Introduction

"Engaging your employees -- involving them in the business -- can drive revenue growth. An educated workforce can also make better decisions, work more efficiently, and seize opportunities faster. Teaching your employees to be smart businesspeople can be a big investment, but it's one that can have a significant return."

Keith Lamb, Inc. Magazine

Personnel in <u>any</u> organization, from widget manufacturers to hospitals to baseball teams to charities, work with more enthusiasm and commitment when they genuinely feel part of the organization. When people understand how they fit in the overall scheme and grasp the essentials of how the organization operates, they produce higher quality work and are more energized. CPA firms are no exception.

Throughout over 20 years of consulting to CPA firms, I have observed hundreds of CPA firm training programs and new employee orientations. But there is one major subject that is consistently missing: staff training in the *business* of running a CPA firm.

Who will benefit from reading this monograph?

Primary group: New staff joining your firm. The primary use of this monograph is to teach staff, especially those going through the firm's new employee orientation process, about the business of public accounting.

Interns. The curriculum at university accounting programs focuses 99% on technical accounting and tax subjects. Students learn virtually nothing about how CPA firms work, how to advance their careers and what makes firms successful. Since internships are now the number one method used by firms to recruit college graduates, this monograph is a great opportunity to expose your future employees, relatively early in their accounting careers, to the CPA firm industry.

Experienced staff. Making sure that your *existing* staff understands the basics of the CPA industry and the firm itself will help reinforce what they have been exposed to throughout their tenure with the firm.

Partners. We are quite sure that partners – yes, partners - who read this monograph will learn a lot about the CPA industry and even about their own firm that they didn't know.

Administrative staff. Countless surveys and interviews of administrative staff have revealed that their biggest gripe is being made to feel like "second-class citizens." This usually isn't intentional. It's just that CPA firms are very busy places and are very client-centric. As a result, client service personnel often don't take the time to explain to admin staff why their work is so important and how it fits in to the overall scheme of things. Their occasional rudeness to admin staff may further the problem.

This monograph will provide your admin team with a new perspective on the business of CPA firms - i.e., how their functions contribute to the firm's success and profitability.

What you will learn from reading this monograph

1. Current trends in the CPA profession.
2. Demographics of the industry.
3. What CPA firms do.
4. How CPA firms measure their performance.
5. How CPA firms are managed and organized.
6. How CPA firms get clients and keep them.
7. The tremendously impressive list of innovations that have taken place in CPA firms over the past 20 years.
8. What attracts staff to firms and what it takes to retain them.
9. What it takes to be a successful staff person at a CPA firm.
10. How staff advance at a CPA firm.
11. Reputation of CPAs compared to other professions.
12. CPA firm economics: what makes firms profitable…and what holds back the bottom line.
13. The 25 Best Practices of well-managed firms.
14. Computer software commonly used by CPA firms.

5

CPA Firm Economics 101

The economic structure of a CPA firm

One of the main purposes of this monograph is to provide CPA firm personnel with an understanding of how their firm makes money and what holds back profitability. With this knowledge, team members will make better decisions about how they spend their time and perform their work.

All businesses have economic structures unique to their industries:

- Grocery stores are high volume, low profit margin.
- Real estate ventures use accelerated depreciation and other tax "angles" to generate cash flow.
- Professional sports teams focus on increasing the value of the franchise so it can eventually be sold for a gigantic profit.

The typical CPA firm is a **low volume, high priced business**, with a relatively high profit margin (generally 30-45% of revenue). This results from two factors:

- The supply of CPAs and CPA firms is relatively low compared to many professions. There is competition, but established firms don't worry too much about competing firms.

There are several formidable barriers to entry: the work is technically demanding and growing in complexity. While not rocket science, accounting requires a high level of intelligence and aptitude that many people don't possess. It's also very hard to attract clients, especially if you start from scratch without an established client base.

- The supply of labor is extremely low. Accounting is not considered "exciting" or popular by many young people. As a result, one of the principal operating tactics of CPA firms is allocating their scarce labor resources to those clients and projects that generate the most revenues.

The vast majority of a CPA firm's revenues is considered "annuity" business. Clients of CPA firms typically remain with their firms for 5-10 years or more, thereby providing a relatively "safe" revenue stream that continues every year, primarily compliance projects such as audits, reviews, compilations, bookkeeping and tax returns.

Most expenses are fixed vs. variable: Even though staff labor is theoretically a variable cost, with the exception of major recessions, the headcount at firms stays relatively constant despite fluctuations in revenue. Most firms can absorb a certain number of new clients without increasing their personnel headcount.

Also, due to the extreme shortage of labor, most CPA firms are continuously in a hiring mode: if a firm is fortunate enough to come across someone who has a good resume and is available, the person will generally be hired immediately, even though the firm's revenue volume might not appear to justify increasing headcount.

Low overhead expenses. CPA firms have low overheads compared to law firms and other businesses. Despite earning substantial profits, the vast majority of CPA firms are not big spenders. Many have very nice offices but would never be considered lavish. A very small percentage of a CPA firm's expenses are discretionary.

CPA firms are "top line" driven. In the pursuit of increased profitability, many businesses are presented with two alternatives: Increase revenues or decrease expenses. But CPA firms rarely focus on controlling expenses because there is little excess to trim. Instead, virtually all of the focus is on generating increased revenues. This is done by:

- Bringing in new business and clients.
- Increasing billing rates.
- Increasing realization - billing a higher percentage of time spent on client work.
- Increasing productivity – getting personnel to bill more hours and work more efficiently.

As a result of the above, CPA firms are considered "top line driven" businesses: Increases in revenue drop directly to the bottom line (profits) because these revenue increases rarely cause the firm's expenses to rise very much.

Leverage is king. The vast majority of the work performed by a CPA firm can be done by staff instead of partners. Therefore, one of the top operating strategies of firms is to maximize the amount of client work that each partner can create for non-partners to perform, under their supervision. Achieving this high leverage frees up partners' time to devote to practice development, nurturing relationships with clients and referral sources and helping staff learn and grow.

Bigger is better. Any analysis of CPA firm profitability will consistently and conclusively show that the higher a firm's revenues, the higher their profits will be. This is because the bigger the firm, the more affordably it can engage in sophisticated marketing programs, develop specialties and niches, aggressively pursue mergers, create better training programs and hire high level professionals in the administrative, marketing, HR and IT areas. All of these tactics attract larger clients (who pay higher fees), more talented staff and smaller firms looking to merge in.

Key definitions

Charge hours or billable hours. A CPA firm's widgets are their hours (apologies to Ron Baker). The vast majority of a firm's revenue is billed directly or indirectly by the hour, so CPA firms pay a lot of attention to the billable hours worked by their personnel.

Non-charge or non-billable hours. All time that is not worked on client projects. This includes training, firm meetings, practice development, vacation, holiday and sick time.

Work-in-Process (WIP). A "receptacle" in the time and billing system where all time and out-of-pocket expenses are accumulated by client. When clients are billed part or all of the accumulated WIP, these billings are deducted from WIP balances, leaving a net unbilled amount for each client. These amounts are either carried forward to subsequent months to be billed at a later date or written off.

Write-offs. CPA firms (law firms, too) are rarely able to bill for 100% of their actual time spent on client work. The value of client work that is not billed to clients is called "write-offs." The vast majority of firms write off 10-20% of their client time.

Numerous other key terms are included in the complete version

What CPA firm income statements look like

The typical CPA firm income statement looks something like this:

	Amount	Percent of Net Fees
Gross fees	$5,000,000	
Write-offs	500,000	
Net fees or billings	4,500,000	100.0%
Expenses: Staff salaries and benefits Overhead expenses* Total expenses	 2,000,000 1,000,000 3,000,000	 44.4% 22.2% 66.6%
Total income to the partners	$1,500,000	33.4%

* Rent, office supplies, marketing, insurance, training, IT costs, etc.