WHAT *REALLY* MAKES CPA FIRMS PROFITABLE?

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The Essence of CPA Firm Profitability

It has been said that organizations should never have profitability as a goal. Why? Because profitability should be the result of an organization's efforts, not its goal. Profitability is a measure of success in accomplishing core business goals. The Disney Corporation probably says it best in their mission statement, which is short and sweet, but very powerful:

> "Our mission is to make millions happy."

Disney super-pleases parents by creating hundreds of quality movies and lovable characters that children grow up with and adore and by creating theme parks that tap into our fantasies and imagination. They create the Disney magic by operating their entertainment facilities with fastidious devotion to efficiency and cleanliness and fanatical attention to the tiniest details, and by countless other efforts. Disney's customers not only pay for their access to Disney, but do so with a smile on their face, and they keep coming back for more. At Disney the philosophy is clear: Create and maintain a world-class organization that satisfies the customers' needs, and the profits will come as a result.

The same theme is true with CPA firm profitability. To be truly profitable, firms need to successfully achieve business goals *other than profitability*. Then, and only then, will firms be profitable

The Easy Way to Increase Profitability?

Do you want to find easy, quick ways to increase profitability? Do you want to hear about proprietary techniques that previously have never been made public? Do you want to discover revolutionary ways to cut costs? Do you want to find a way to increase productivity without establishing partner accountability?

If your answer to any of the above questions is "yes", this monograph may disappoint you.

If your firm is not profitable today, there are no <u>easy</u> ways to turn things around. There are few quick fixes. Many of the ideas we'll present embrace concepts that you may already be familiar with. Properly applied, they work. Some work better than others, and some techniques are preferable to others, depending upon your firm's current situation. But they *do* work.

The approaches suggested are based upon my experiences working with over 700 firms. The ideas presented here are not merely *my* suggestions; they are the techniques being used by the most profitable and successful firms in this country.

What Does Profitability Mean?

Let's clarify what we mean by "profitable." At a CPA firm, profits are often measured with an imperfect figure called Income per Partner, or IPP. It represents revenues less expenses but excluding any payments to partners. Let's say a firm has 5 partners and the total income for the five is $2 million, which is distributed to the partners for an average income per partner of $400,000. It's important to distinguish between *profits* and *compensation*. To *properly* measure profits, as opposed to "income," a portion of the partners' compensation should be classified as compensation expense. Since there is no simple way to allocate the $2 million between profits and compensation most firms don't bother doing so.

One way to analyze the profitability of a firm is to benchmark against credible national MAP surveys, such as The Rosenberg Survey.

If the IPP of a firm is $400,000 and the national average is $500,000, many might conclude that the firm has below-average profits.

Don't Ask a CPA What Profitability Means

If you asked the president of a Fortune 500 company or the owner of a restaurant to define profitability, they would be able to give a quick, definitive answer. Not so with CPAs. Surely you've heard the story, perhaps apocryphal, of the company that was interviewing for a new CPA firm. Only one question was asked of each candidate: "How much is two plus two?" The firm that won the bid gave the answer, "How much would you like it to be?"

The same can be true of CPA firm profitability. How do we measure it? You would think that the uncontested champions of measuring financial data, CPAs, would have this down to a science. But such is not the case.

The two most common measures are income per partner and partner income as a percent of fees. Income as a percent of fees tends to range from 30–35%, with the most profitable firms earning beyond 40% of fees. But each measure has some significant flaws, all relating to the standards used for making someone a partner. Some firms have very high standards for making people partner, while other firms are quite generous in bestowing the title of partner. Since the computation of these two measures of profitability depends upon the number of partners in a firm, and the standards for who is invited to be a partner vary widely from firm to firm, it can be difficult to compare IPP or income as a percentage of fees from firm to firm.

I've read some articles citing a number of more scientific methods for measuring profitability. Many of these articles suggest that the income statement of the typical CPA firm fails to consider the owners' labor and capital. Therefore, these expenses need to be imputed. For example, the cost of an owner's labor might be imputed by multiplying his/her billing rate by the firm's billing rate multiple. After imputing these costs, a typical firm's net income as a percent of fees might be 10-12% instead of 30-40% under the more traditional methods.

Although this approach seems inherently logical, there are serious flaws in it. Firms with high billing rates–which I have consistently found to be one of the best correlates of financial success in CPA firms (see below)–will show higher imputed salaries for the partners and, thus, lower net income. This makes no sense. Also, firms that require partners to maintain significant levels of capital will have higher interest expense imputed, which results in lower net income. This also distorts the picture.

The best definition of profitability is a blend of the following:

1. *What the firm's budgeted profits are.* Some firms–not many, in my experience–actually do for themselves what they do for their clients: They estimate expenses and revenues, and the difference between the two is the *budgeted* profit. Very simple. If the budget calls for the partners to each earn $300,000, and the firm actually earns $400,000 per partner, then they are "profitable."

2. *What the partners want to earn.* Everyone has different standards. I know some partners who earn $150,000 a year and don't know what to do with their money. I know other partners who earn over $300,000 a year and seem to live paycheck to paycheck. To some, quality of life is paramount, and they aren't willing to sacrifice their personal lives to make a few more bucks. To others, making more money is the driving force in their lives. They can never make enough.

This definition may not be as satisfying as some of the more traditional measures. And I certainly am not suggesting that firms ignore the traditional measures used in MAP surveys. But a blend of what your budget is with how much you want to earn is probably the best measure of firm profitability.

Now that we've defined profitability, what are the quickest and most reliable ways to get it? This will be the focus of the remainder of this monograph.

An Elementary Economics Lesson

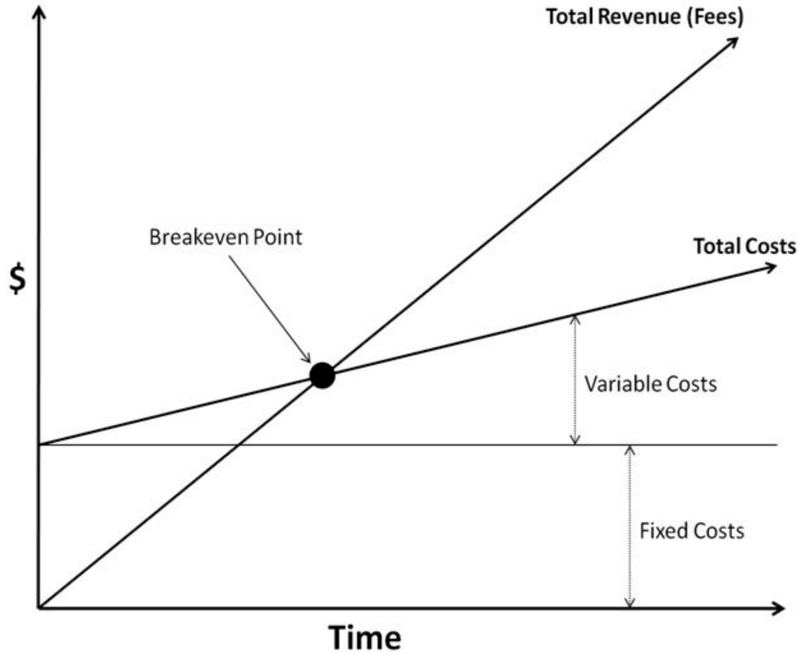
In any business, there are only two ways to increase profits: increase revenues or decrease expenses. CPA firms have few opportunities to decrease costs because most expenses are fixed instead of variable. Besides, CPA firms have never been known to be extravagant spenders. Therefore, it makes sense for firms to focus their attention on the top line. CPA firms are top-line oriented businesses. Increased revenues almost always drop directly to the bottom line.

This is illustrated in the graph on the facing page. Look at the cost section. As you can see, a large portion of the costs are fixed, with just a small portion as variable. This may initially seem inaccurate because intuitively, we would classify the salaries of professional staff as variable. But as a practical matter, staff salaries rarely fluctuate in the short term. The number of staff maintained by a CPA firm almost never changes with small fluctuations in revenue. One exception is when revenues continually increase at healthy rates. Another exception would be during a recession, when staff layoffs are clear evidence that staff salaries are variable.

Staff salaries are in essence a fixed cost, or at least mostly fixed. The only variable costs are <u>portions</u> of expenses such as incremental staff labor, overtime pay, office supplies, and tax processing fees.

As the graph shows, the fastest path to higher profits is by increasing revenues. This can be done in any number of ways–increased rates, higher levels of productivity, new clients, higher realization–the graph isn't particular to any one approach.

Firms simply need to find ways to increase the slope of the revenue line, and higher profits will quickly result.


Total Revenue (Fees)
Breakeven Point
Total Costs
$
Variable Costs
Fixed Costs
Time

Topics Covered in
What *Really* Makes CPA Firms Profitable

- The Essence of Firm Profitability
- CPA Firm Benchmarking
  - The 3 Steps of Benchmarking
  - Five metrics used by elite firms to measure profitability
  - Top 10 Mistakes Firms Make Interpreting MAP Statistics
  - Extracts of Rosenberg MAP Survey Results
- Strong Management and Leadership – The Most Reliable Path to Profitability
  - Proper Management Structure and Positions
- 25 Best Practices that Transform Good Firms to Great Firms
- Partner Accountability- 10 Time-Tested Measures
- 4 Ways to bring down your profits
- Marketing and the Bottom Line
- Other Methods to Improve Profitability
- 40 Great Ways to increase income per partner