Client Retention and Firm Growth Are Key Issues for Firms

The top issues affecting CPA firms vary by size of the firm. However, growth and client retention are important to all, according to the 2011 PCPS CPA Firm Top Issues survey. This is a departure from the 2009 survey, when client retention ranked number one for firms across the board.

"While client retention and firm growth did not top the list of top issues firms are concerned with across the board, there is no doubt that these are key to all," said CPA Jim Metzler, AICPA vice president for small firm interests. "The AICPA is working with firms to help their clients with better strategic planning and to help firms learn how to best market to future clients, retain current ones and understand the ever-growing complexities of tax laws and audit and accounting standards."

Adding new clients ranks number one for firms employing two to five, 6 to 10 and 11 to 20 professionals. The top concern of sole practitioners is keeping up with changes and complexity of tax laws. Firms with 21+ professionals rank partner accountability/unity as the top concern.

"CPAs can use these lists to benchmark their own experiences against those of other practitioners in firms very much like their own," said Metzler.

Survey Highlights
- Retention of clients was the second largest challenge for sole practitioners, firms with two to five and 6 to 10 professionals. Bringing in new clients ranked second for firms with 21+ professionals and third for sole practitioners. Partner accountability/unity was second for firms with 11 to 20 professionals.
- Developing a succession plan was in the top five for firms with 11 to 20 and 21+ professionals and in the top ten for other sized firms.
- Fee pressure/pricing of services was in the top five for firms with 6 to 10 and 21+ professionals.
- Keeping up with accounting and attest standards was in the top 10 for sole practitioners, firms with two to five, 6 to 10 and 11 to 20 professionals.

Support Change in Private Company Financial Reporting

The AICPA has been leading the call to make private company financial reporting more relevant, more useful and less complex for businesses and their financial statement users. The Financial Accounting Foundation (FAF, FASB’s parent organization) currently is conducting outreach on, among other things, the two major recommendations of the Blue Ribbon Panel on Private Company Financial Reporting: differential standards and a separate board with standard-setting authority. It is critically important for CPAs to write to FAF now to make sure it hears the profession’s support (ahead of a possible proposal). CPAs also should engage other stakeholders—such as private company clients or employers, bankers/lenders, sureties and insurers, and venture capitalists—to voice their support. To help accomplish this, the AICPA has developed an online letter-writing tool to make the task very simple and quick. The letter-writing assistant is available on the AICPA’s Private Company Financial Reporting webpage, www.aicpa.org/privateGAAP. It also was prepared as a widget for placement on Web sites, blogs or social media accounts. In addition, the AICPA has prepared a PowerPoint presentation and a handout that CPAs can use to educate other stakeholders and generate letters from them.
based on the “street value” assigned to various partner roles, which varies depending on if the partner is a client service partner, service line leader, business developer or the managing partner. This step is critical to the perceived fairness of partner compensation, and it is here that we must underscore our philosophy that all partners are not created equal. Some contribute more overall value to the future capacity of the firm than others—and they should be paid more accordingly.

While there is no “perfect” split between base and incentive compensation, too little at risk will not drive desired behaviors, and too much at risk, especially in the first year or two of a new system, may cause too much fear and uncertainty to be of value. In general, a split of 80% base and 20% incentive is typical in many firms. The payment of incentive compensation is subject to the indisputable achievement of specific, measurable, one-size-fits-one goals that are established for each partner each year and documented in writing. The ability to earn incentive compensation should also be tied to meeting specified minimum performance expectations for all partners around total hours, charge hours, revenue contribution, attending partner meetings, being a good citizen, getting billing done, managing WIP and driving collections.

Firms must decide whether incentive compensation will be paid on pass/fail or percentage complete basis. Decisions are also required regarding what to do with incentive compensation monies that are not earned; for example, distributing any “leftover” amounts based on ownership equity or only allowing those who met their incentives to share in that unallocated pool.

Making changes to your partner compensation system must be transitional. Partners need the time and opportunity to adjust to the level of performance required to earn their incentive compensation.

**Rewarding Partners and the Firm**

Partner compensation is both the “driver” and “end result” of an effective partner accountability model. We encourage you to apply these concepts to transform your partner compensation system so that it rewards partners for both individual and overall firm success.

Jennifer Wilson is co-founder and partner and Jack Lee, CPA, is partner of ConvergenceCoaching, LLC, a national consulting firm that develops leadership, succession, marketing and training and development strategies for CPA and IT firms and the channel organizations that serve them. Jennifer and Jack are both frequent speakers, teachers, facilitators and writers within the profession. Contact them at jen@convergencecoaching.com or jack@convergencecoaching.com. Jennifer Wilson also wrote about “Holding Partners Accountable” in our April issue.

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**PCPS BRIEF**

### The Great Mystery: How Do Billing Rates and Profitability Affect a Firm’s Worth?

*By Joel Sinkin and Terrence Putney, CPA*

When you are buying a CPA firm, historical profit is almost irrelevant. Even less relevant are the partner billing rates.

What? How can that be? When establishing the value of any business isn’t its profitability the most important metric to consider? Aren’t partner billing rates the most important way to know if two firms are a good fit?

**What You Really Need to Know in an Acquisition: Net Profit**

Consider this example. This scenario is extreme and simple to best demonstrate the principle. Assume the
seller owns a $400,000 accounting and tax practice. You could absorb this practice into your current infrastructure with no incremental increases in overhead because you have the excess capacity to take on the workload. Until 2010, the owner of this firm operated from his home. His spouse answered the phone, did some data inputting and basically acted as a high-end clerical/paraprofessional. The owner did the balance of the work. The seller’s profit margin was 85%.

In 2010, the seller decided to move to an office, the spouse was replaced by an office manager and a part-time paraprofessional, and the owner cut back on some of his hours. With the additional overhead, the sellers’ net went down to 40%. Assume you are not required to take on any of the seller’s overhead or hire any of the seller’s personnel. Based on these two scenarios, at what point was the seller’s practice worth more to you? When it had an 85% margin or a 40% margin? Obviously, it isn’t the seller’s margin that matters. It is what the incremental margin will be after you acquire the practice. However, we have seen far too many deals passed over because the potential buyer never could get past the seller’s historical margin. This is especially the case when the historical margin is lower than expected.

After making the necessary normalization adjustments to recast profitability to determine what it really means to the buyer firm, the margin may still be too low to justify the terms. In this case, the deal clearly shouldn’t be done. But the historical margin is only relevant to the extent that it contains costs that will be assumed by the acquiring firm. If the buyer firm must hire more staff (or the seller’s staff), increase rent expense with more space or otherwise incur incremental costs, then profitability is determined based on those costs, not the seller’s historical costs.

Further, the deal’s profitability should be evaluated not only on the recast profit margins, but also the terms of the deal. If the terms call for payments of 16% of collections for six years and the incremental profit margin is likely to be 35%, that is clearly 19% to the good during the payment years and, of course, much greater in the later years. The 35% profit margin isn’t the sole determination of the profitability.

What You Really Need to Know in a Merger: Partner Profitability

When evaluating profitability in mergers (as opposed to acquisitions), more important than profit margins is net income per partner (NIPP). A firm with a $150,000 net income per partner may be vastly different culturally from a firm with $400,000 net income per partner. When evaluating the difference, look into the cause of the difference for a more complete picture. The firm with the lower NIPP either has lower revenue per partner or lower margins.

If partners in the successor firm in a merger manage $1 million of fees each on average and the acquired firm partners manage $300,000 each, you may have difficulty assimilating the two unless both sides believe the lower-performing firm has significant upside potential. It isn’t that unusual for smaller firms to grow dramatically after a merger because they can now offer more services to their clients and develop their practices more effectively. Assuming the merged-in partners are willing and able to manage larger books of business, this is the classic synergy that firms crave in a merger. On the other hand, if the merged-in partners have no interest in growing their responsibilities, unless they will accept a lower level of status in the merged firm there may be poor fit leading to disappointing results.

Profit margins in a merger can be misleading if you don’t investigate what is driving them. Assume one firm has a 50% profit margin (before partner compensation) and the other a 30% profit margin. Which is better? If the firm with the higher margin has low staff leverage, that means the partners do most of the work. That may make it a poor fit for a firm with eight staff for every partner. There is a huge cultural difference between those two firms. On the other hand, if the lower margin firm suffers from low productivity and poor cost management, it may be a poor cultural fit with a firm that expects high partner and staff productivity and tight cost management.

Billing Rates: Do They Really Matter?

We recently consulted on a deal in which a large local firm was considering merging with a smaller practice. The smaller firm had three partners and no real bench strength of seniors, managers or junior partners. These partners did almost all the chargeable work personally. Two were seeking succession in the next two years. The partner billing rates were $200 to $225 per hour. The large local firm, our client, called us with a concern because their partners billed between $300 and $400 per hour and felt they would have to walk away from the deal. They thought there

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was likely no way the acquired firm’s clients would accept their higher billing rate.

We asked our client, “If you were to merge in this firm, who would be taking over the retiring partners’ chargeable hours?” They told us they would pass most of that work down to experienced seniors and managers in their firm. After comparing our client’s billing rates for that level of professional to the rates of the acquired firms’ partners, it was obvious there was actually tremendous upside opportunity. Their $150- to $200-per-hour professionals could theoretically bill out at higher rates! Then we asked the definitive question, “If they are billing a corporate return at $7,000, how would you bill the same return in your firm?” After further investigation they determined they were in the same ballpark on what they charged their clients. In this case, the partner billing rate difference was irrelevant.

The opposite can also be true. In a deal we consulted on recently, the target firm had an efficient practice. Billing rates matched up well between both firms. However, in due diligence it was determined that at the target firm, audits were being handled by one partner from beginning to end. The successor firm’s quality control document required a much more robust secondary review of all audits, among other differences. The target firm was informed that additional hours would be required in every audit, resulting in higher fees. The deal died since the target firm was unwilling to accept the risk of those higher fees.

We have seen many potential mergers passed on by acquirers due solely to a perceived difference in partner billing rates. Consider these factors when comparing billing rates:

- For the most part, clients don’t care what your billing rates are. They care what they will pay for the service they receive. Evaluate the fees for comparable services to determine fit.
- The true measure of profitability in billing rates is not the rate itself but the markup on cost. A firm that bills an $80,000 per year professional at $100 per hour is not capturing enough value to justify the cost and is likely not profitable. A firm that is billing that same professional at $175 per hour or higher is in the normal range; it matters little what their titles are.
- Technology can make billing rates in an acquired firm irrelevant. If your firm’s technology can streamline the processes necessary to produce deliverables and increase margins, the acquired firm’s billing rates may be irrelevant.

Smaller firm partners have to wear lots of hats in order to manage their firm and its clients. Sometimes what they are doing is worth $300 per hour and sometimes it isn’t worth $100. They often don’t have the luxury of sufficient appropriate staff to make assignments. As a result, they tend to hold down their partner rates. If merging into your firm makes it possible to better assign their lower level work, they might be able to bill their partners at a much higher rate without increasing fees to their clients proportionately. Once again, the synergy craved in most mergers.

**Deal Terms: How to Factor in Profitability**

Profit margins should be considered when structuring buyout terms, whether in a straight sale or a merger. If, after considering the complete opportunity, a potential deal is attractive, the profit margin (adjusted for the successor firm’s operating environment per the above discussion) might be a consideration in setting the buyout terms. For instance, if after replacing the retired partner’s hours and assuming all the other costs, the incremental margin is only 25%, the successor firm might adjust the terms to 15% for seven years instead of 20% for five years in order to generate enough positive cash flow. Buyers tend not to want to do deals that don’t generate a decent profit and the prospect of waiting seven or eight years for positive cash flow in a deal is not often compelling. On the other hand, it is also difficult for a seller to accept a lower multiple than what they believe the market will normally pay.

In addition to all the other deal terms (down payment, period for payments, client retention adjustments and overall multiple), the tax treatment is also an important consideration in determining the deals’ profitability. Acquisition payments that have to be recovered over 15 years as amortization result in lower profitability than those deductible as paid. A logical result of less favorable tax treatment for the successor/buyer might be a longer payout period or a lower multiple in order to keep the deal profitable.

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**Focus on Human Capital Concerns**

The AICPA Human Capital Forums offer human resources professionals updates on hot topics in the profession, connects them to the AICPA and its resources and features well-known speakers offering advice on critical issues. They also allow participants to network with their peers and share best practices. Among the topics to be covered at the next Forum, which will take place on October 6 and 7 in New Orleans, is maximizing the impact of human capital efforts. Speaker Rita Keller of Keller Advisors, will tackle critical concerns in light of the retirement of many long-time firm leaders. She will cover question such as:

- Is your firm’s future a mystery?
- How do you define your leadership gap?
- What are the special challenges in CPA firm succession?
- The foundation of succession planning means hiring exceptional, motivated people. Do you have them?
- Are you identifying and fulfilling your team’s developmental needs?
- Are you focusing your resources on key employee retention?

In another presentation at the Forum, Jennifer Wilson of ConvergenceCoaching will address:

- How HR advisers can elevate their roles and add more value to the firm’s leadership team.
- How the HR adviser can facilitate open and honest dialogue and drive real improvement.
- How to ensure accountability for HR goals.
- How to minimize conflict.

Click here to learn more about registration.
Dig Deep for More Insights
A seemingly bad deal may turn out to be a great fit in the end, while a deal that appears to be perfect may fall apart down the road. Finding the best deal clearly requires digging below the surface to get a better sense of what the numbers really mean in each unique situation.

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Retaining and Developing Women Leaders: A Business Issue

What motivates firms to reassess their efforts to retain and nurture women’s leaders? “We really didn’t come to a sharp realization that we had a problem,” says CPA Todd Mitchell of Elliott Davis, in Greenville, South Carolina. “But we did notice that we had a great group of people through the manager level, then a lot of managers started to disappear, and they were all females. We had both women and men moving up, then all of a sudden the number of women dropped off, with very few at the shareholder level.”

What was behind this problem? “We found the issue was not only turnover but also stagnation,” Mitchell says. “Our team members were talented, but they were not moving ahead.”

In the midst of this process, the firm was also considering succession issues. “We asked ourselves who would succeed our stars and superstars,” he reports. “We realized that even if every male in the pipeline moved up, we wouldn’t be able to fill the positions we were projecting in our strategic plan, given our expected growth. That’s when we knew we had to be more successful at moving women into top leadership, including ownership positions.”

The problem also had an impact on the firm’s M&A prospects. “Women at potential merger partners asked where our female leaders were,” he says. “They questioned how they would be treated at our firm.”

Such questions hindered the firm’s ability to grow through mergers.

According to consultant Mary Bennett, stagnation and turnover among women, a lack of female leaders and succession concerns are common problems at many firms. Given the impending retirement of the baby boom generation, firms are assessing how many new leaders they will need. “They are realizing they cannot get there with half the population. Firms will fall short if they don’t take advantage of all the talent available to them.”

As firms wrestle with this challenge, Bennett cautions against succumbing to the “pipeline myth.”

“Many people say that once women have been in the pipeline long enough, we’ll see progress,” she notes. “Women have been in the pipeline for over 30 years, but their progress is still not proportionate. There are some estimates that at the current rate of progression, we will not see leadership parity for 300 years. But we need all of our top talent now if firms want to continue to grow and develop. Given the progress we’ve seen, the do-nothing approach will take much too long.”

Mitchell and Bennett will be the featured speakers at the AICPA Retaining and Developing Women Leaders: Organizational Strategy Workshop, which will be held in Chicago on October 17 and 18. Strategy sessions

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