THE PERFORMANCE CHARACTERISTICS OF ACCOUNTING FIRMS THAT ARE SENDING THEIR OWNERS HOME WITH AT LEAST $1 MILLION

An Australian Study

With

Global Application

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V 1.04

The Data Set

Before I get started I want you to know that there is an Idea Action Plan sheet on the last page of this report. You might care to use it to make a note of some actions you could take based on some of the thoughts I have shared with you in this document.

A million dollars is a lot of money in any language and I'm not talking about $1m in revenue, I'm talking about a million dollar profit per partner! It may be the sort of income that is being earned by some of the directors or partners in the largest of firms but it is not an income level that's typical of smaller firms. But while it's rare but it is being achieved. And that means it's possible.

The leading Australian accounting firm benchmarking study is undertaken annually by Business Fitness Pty Ltd and is published as *The Good, the Bad and the Ugly of the Australian Accounting Profession* (GBU). Interestingly this study, together with every other one I have had the opportunity to review around the world, reflects a very similar picture. This is typical of a mature industry that exhibits structural stability even though within the industry there is a continual movement of firms from good to great and back again and from good to, dare I say, ugly.

Benchmarking studies of this type are very useful management tools and would be even more so if a lot more firms participated in them. However, the GBU report does have sufficient participation give us statistically valid information and therefore an opportunity to look at your own firm and compare its performance against other firms with respect to typical practice metrics such as hourly yields, write-off %, productivity, team member to partner leverage, expense ratios etc. etc.

It is not my intention in this report to comment specifically on the metrics revealed by this study. For that purpose you can obtain a copy from Business Fitness. While you're there, if you are an Australia firm, you should also take the opportunity to participate in the 2013 survey. What I intend to do here is address the broad question of what are the general characteristics of the small number of firms that out-perform the rest by an order of magnitude.

The results from the 2012 survey are reflected in the graph shown below. The graph indicates that the Net Profit Per Partner (NPPP) varies from a loss (presumably startups) to a high in excess of $1.3m. The majority of firms are yielding a NPPP between $200k and $400k. For the purpose of the commentary that follows I will be concentrating only on those firms that were in the profit zone. In the graphs that follow I have spotlighted the top five firms and have highlighted the one that sits right at the top.

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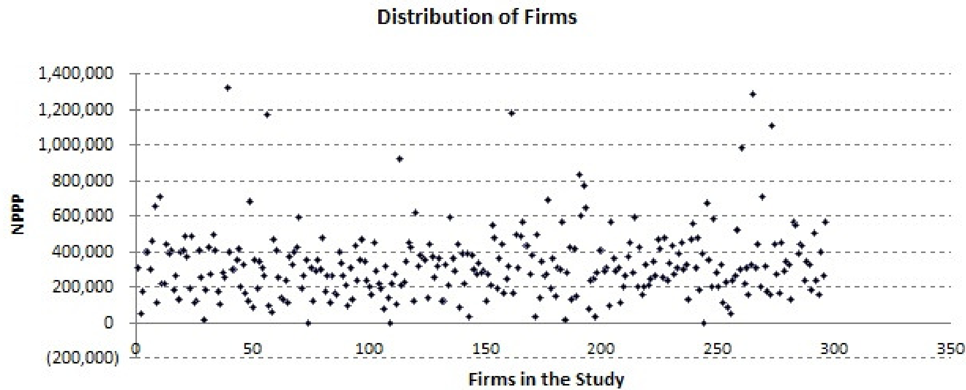
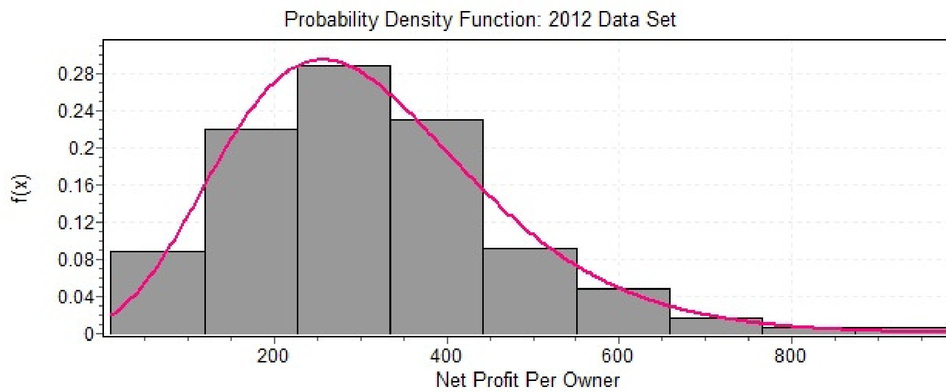


I have analyzed at least 20 sets of inter-firm comparison data for accounting firms on three continents over the years and without exception, when I fit a probability distribution to the data it exhibits the shape reflected in the figure below. This is what's called a positively skewed probability density function because the long tail is on the right hand side. What this tells us is that the median net profit per owner ($300,000) is lower than the average ($324,000.) In other words, more than half the firms in the survey are yielding less than the average of all firms.



This is not a great difference but it is consistently reflected in industry data sets that I have seen and reflects the fact that when looked at as a whole the industry is performing not only below average but below its full potential. To put that more bluntly, if I were to say to someone starting a firm do you plan to create an "average" firm I doubt she would say "that's exactly what I plan to do or maybe a bit worse." And yet, that's precisely what we see with the industry. More than 50% of firms are below average but before we jump too quickly into assuming the industry as a whole is mediocre we need to dig a little deeper.

Of course the study was only done on a small sample of the entire population of firms in the industry so it could be argued that it does not represent the entire industry. However, it could also be argued that the type of firms that participate in studies of this type are among the better ones and if that is the case the evidence of industry-wide mediocrity is even greater.

What I'm particularly interested in is what characterizes those few firms (less than 2%) that totally out-perform the others in this industry, not by a few percentage points but by an order of magnitude. I'm talking about the 5 firms in this survey population of 300 profitable firms that yielded in excess of $1 million to their owners. I'll refer to these firms as the million dollar firms. I should also add there were another 12 firms that yielded $600,000 to the high $900,000's which is still a very good outcome.

It's important to remember these firms are all in the same industry, they serve the same types of clients, they offer the same types of services, they use the same technologies and the same types of people and yet they generate a return that's more than two and a half times the upper quartile firms and 5 times the performance of the bottom quartile firms.

What is their magic pill? Let's take a look at the big picture.

A Caveat

Unfortunately, I do not have access to the names of these firms or any way of being able to determine if they are the same ones who sat in this performance cohort in previous years. This is very important because it is possible that firms may move into and out of performance ranges from one year to the next in which case you could reasonably argue that their superior performance was transitory. Indeed if you were to adopt a totally cynical view you might argue that all 5 of the million dollar plus firms got there by accident rather than by implementing a strategy that has given them a sustainable competitive advantage. I do not believe that to be the case because I have personal knowledge of 2 firms (not in this survey) that are achieving this, or close to this, result and have done for several years. Sustainable superior net profit is the only basis on which competitive advantage can be judged.

The comments that follow are subject the that caveat but I think they give an insight on what you need to do to create a million dollar firm.

When you take a closer look at the data you'll discover the top firms do not have significantly better than average performance metrics. That suggests that they are adopting much the same operational tactics. However, as the graphs below reveal, the top firms are consistently good (but not necessarily great) at everything that counts but there a two things that separates them from the pack. It's like most things in life: great results come from doing the important things consistently a little better than the rest of the pack rather than trying to excel at everything and especially, trying to be all things to all and clients because that simply can't be done.

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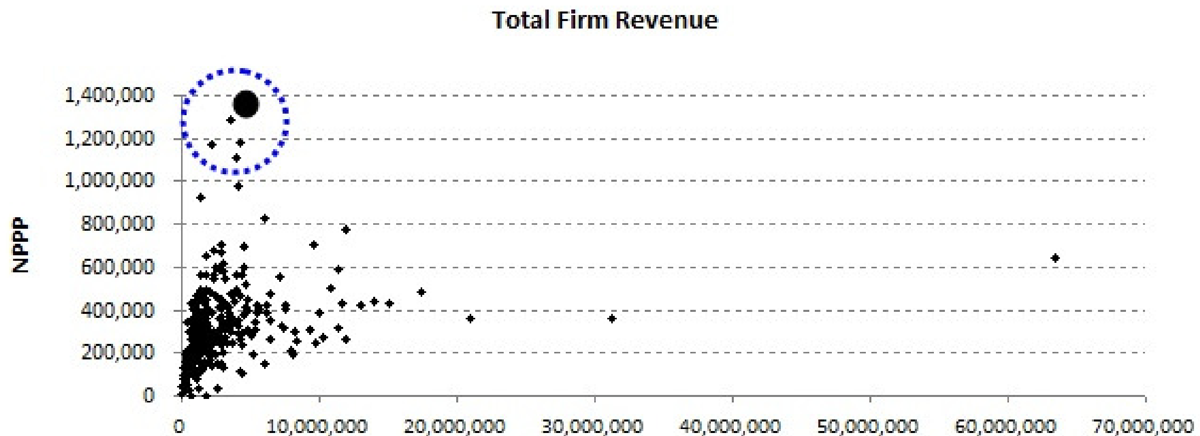
Revenue

Practically every practitioner I talk to tells me s/he would like to have more clients. Revenue growth is commonly seen as the key to growing a firm. That being so it's reasonable to hypothesize that firms with large revenues would be well represented in the top performers. But alas, as shown in the graph below that's not the case. Profit is not simply about revenue as we continually tell our business clients and guess what, that applies to accounting businesses as well. The top performers all have revenues of less than $5 million.



So getting big especially though ill-conceived M&A-fuelled growth is not the answer to improving your bottom line. I'm not saying growth through M&A should not be considered but I will say that in my experience it does not work out very well in most cases unless there is a very good cultural mix and other synergies. That is rare. When you put two ordinary firms together you don't get an extra-ordinary firm you usually get a larger very, very ordinary firm. If I had to choose the best long run strategy for growth it would be organic in character with a smattering of M&A to acquire talent or perhaps talent plus geographic spread and the occasional quality client.

Number of Partners

The first clear separation factor is that the famous five firms are ALL owned by sole practitioners. Multi-partner firms, in this survey anyway, do not send their owners home with a million dollar pay packet. In fact 8 of the top 17 firms that generated more than $600k per partner were sole practitioners.

It's important to consider this in conjunction with the discussion on growth through M&A. That usually results in more partners and more often than not at least one of the parties sees this as an exit strategy rather than a profit improvement strategy. Where that is the case there is

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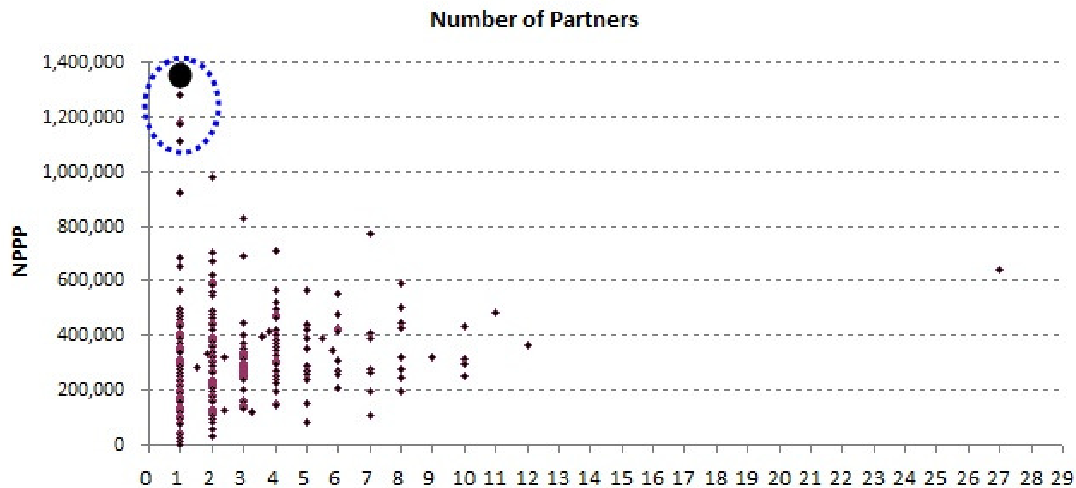
likely to be little energy or attention given to doing any more than protecting the value of their equity value and complying with their earn-out agreement.

That is a somewhat controversial statement to make but it is a fact if one person can grow a business that yields a $1 million or more, then it is clearly possible for another person to do the same by replicating the strategy and tactics. This, of course will not happen overnight but it could be trending in that direction. I'll come back to this later. For now let's take a look at some graphs.



This data also points to the other fact than many firms are over-partnered because they have not given anywhere enough thought to the skill and character set they need to have in a partner. This is not the place to discuss this important issue other than to mention in passing the fact that the most profitable firms are sole practitioners and that sole practitioners are able to secure and retain talent without offering ownership which leads me to the next point.

Leverage

Leverage is the second AND MOST SIGNIFICANT factor separating the best from the rest. All the top performing firms have more team members per partner than the rest (with a couple of minor exceptions). But again, interestingly, the top gun was not the "best" on this metric either. Once again we see evidence that you need to be good but not great.

Also interestingly, one of the top five had leverage of less than 10 people which was at the high end of the rest of the pack but quite a bit below the other top firms. If that firm was able to get its leverage up to the 15-20 mark and maintain its other performance characteristics it would be up with the top gun.

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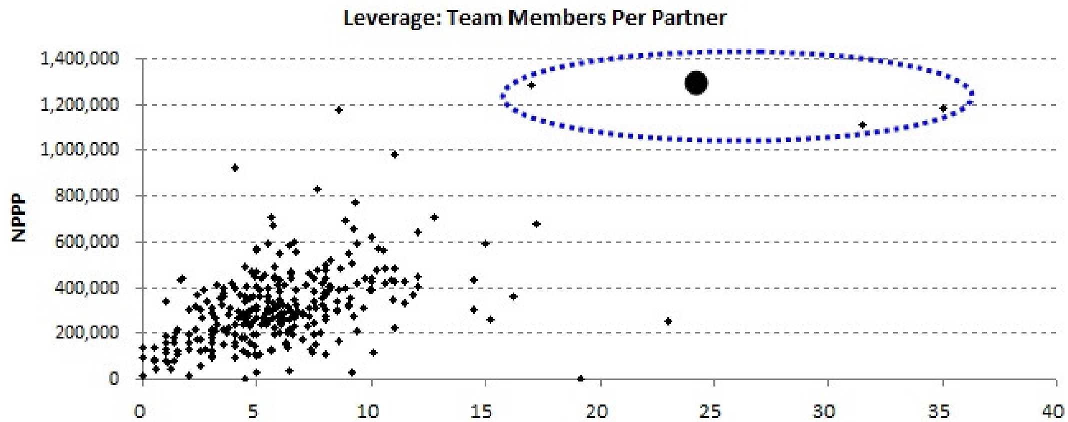
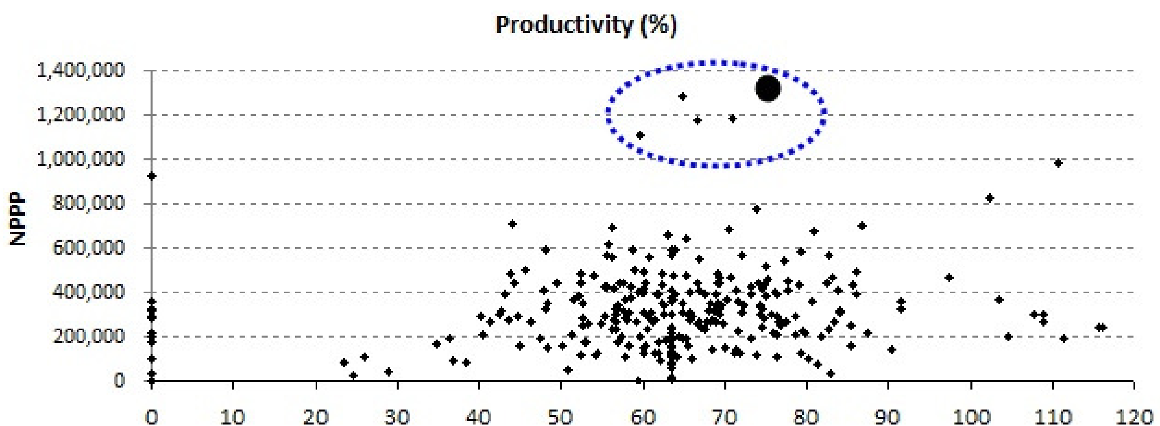


But it's not quite that simple—which is one of the challenges some people have in looking at benchmarking studies when they assume that you can cherry-pick best performance metrics, tell people they can achieve each of these and they'll get an enormous result. That never happens because of the inter-relationships between the drivers of business profitability one of which is the all-important issue of productivity.

Productivity

You'll notice the productivity of the million dollar firms as measured by the ratio of chargeable hours to available hours is in the upper mid-range of 60-80%. They are again good but not great. Notice however that the top gun does have the highest level of productivity amongst its high performing peer group.



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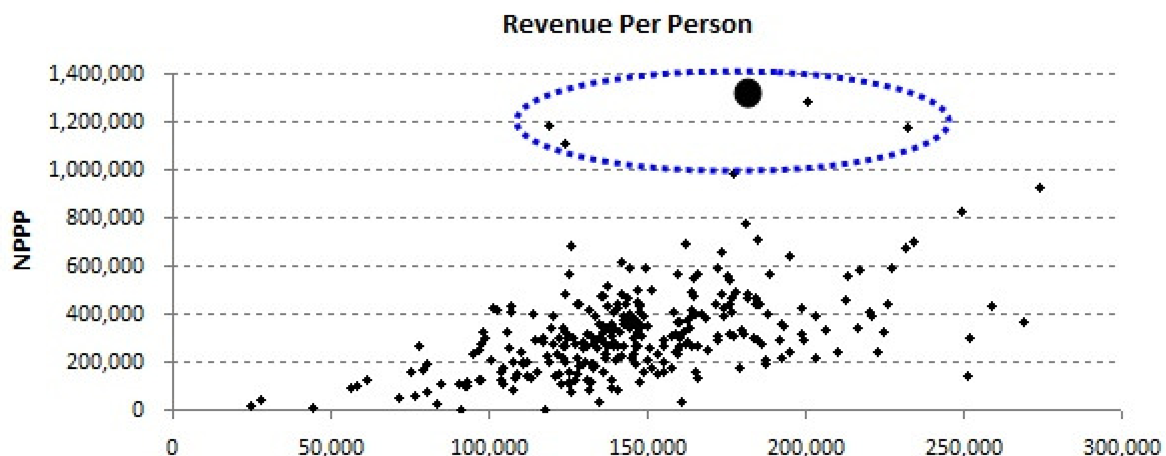
The data points that are located on the vertical axis at the zero productivity level do not have timesheets so they do not have a productivity metric. Interestingly, their net profit per partner performance is below the industry average. That does not mean trashing timesheets will in itself result in lower profitability but it does suggest that eliminating them does not seem to improve profitability. Like every initiative you put in place in any business you need to consider the entire business model dynamic not just one element of it.

You will also note this graph has some data points reflecting a productivity level greater than 100%. The reason for that was these firms charged more hours than the standard number of annual hours used to "normalize" the data. You might describe these firms as the "hard workers" of the group. I'd describe them in a less flattering way if for no other reason than the graph shows their hard work does not pay off with higher profit in most cases. There were two exception firms which had high profit and high productivity. My gut tell me they are "burnout" firms and will more than likely find themselves back with the pack before too long … I may be wrong but I've seen firms drive their partners and team members like lackeys only to find they leave or break-down and the ball game is over.

The really big take-away from the data set is you can create a million dollar firm with productivity in the 60-75% range so it seems you can have a life, fun, a loyal team **and** make lots of money. I consider this to be an incredibly important observation in today's business environment where there is such a strong conversation about work-life balance.

Revenue per person is another way of looking at productivity but as indicated in the graph the top firms perform credibly on this metric but not great.



It is worth noting however, that the two top 5 firms that exhibited relatively low revenue per person were also the ones that had the highest leverage. In other words to generate high profit given low revenue per person you need a lot more people. This is not a mind-shattering observation but it serves to remind us that one path to high performance is via low price + high

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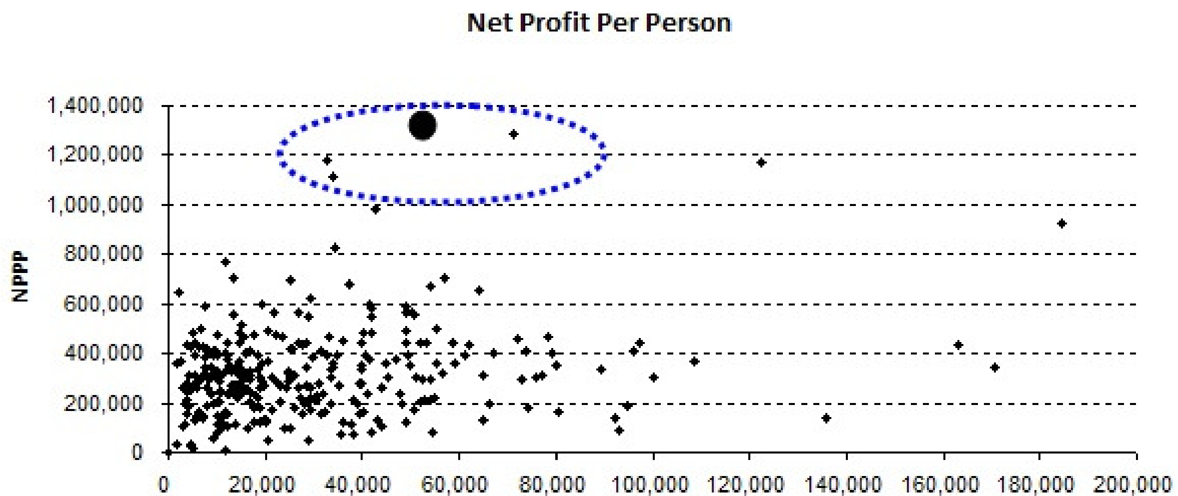
volume and another path is high price + low volume but if you can get relatively high price and relatively high volume you get a double-whammy outcome.

Price, of course is not the only driver of revenue but given that in this data set the productivity level of all the top 5 firms were bunched in the 60-80% range I suspect price was a primary revenue driver which reflects either, or both, a willingness to ”charge what you’re worth” or the high revenue-per-person firms are doing intrinsically higher value work which has client selection implications.

This conclusion is supported by another way of looking at productivity namely net profit per person. As for the other performance metrics the million dollar firms are clustered (with one outlier) in the mid to upper end range for net profit per person.



Hourly Yield

It would be reasonable to hypothesize that a top performing firm would have higher than average charge rates (after write-offs/ons.) The data says, not so. Again, the firm at the top of the pack exhibits a higher than average hourly yield for only two of the famous five cohort and while being at the upper end is certainly not the highest of all firms in the data set. Good but not great prevails again!

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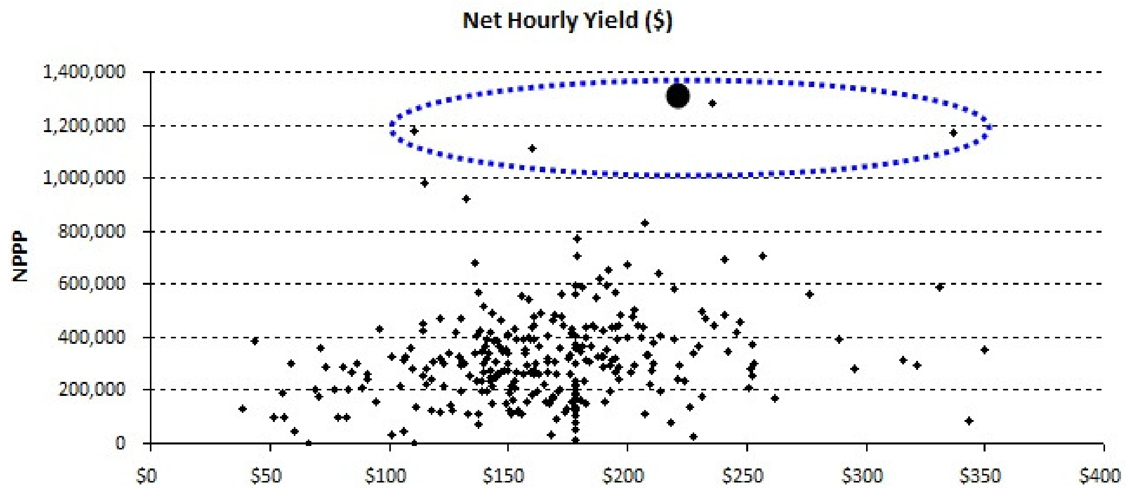
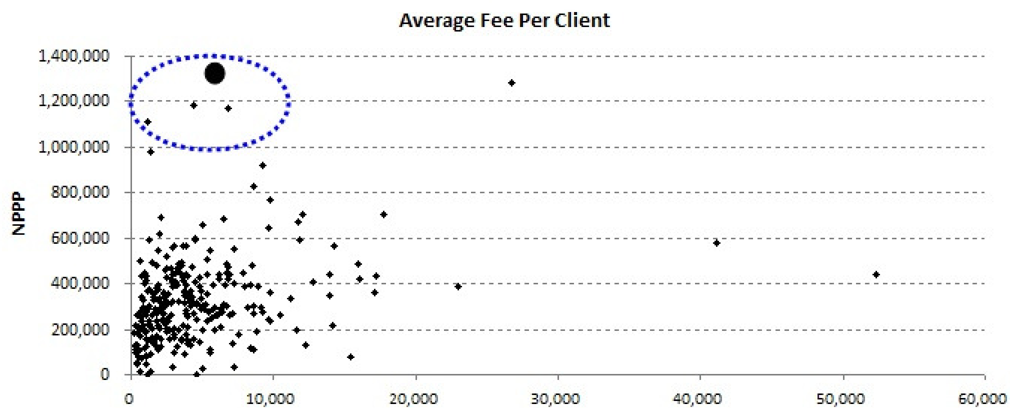


Fee Per Client

It's important to note that the firm that did have the highest yield in the top 5 cohort was also the firm that had the lowest leverage and relatively high, but not the highest, productivity. The data reveals this firm has fewer people who are probably talented and who work with a smaller number of clients but do much more valuable work which is evidenced by it having the second highest fee per client for the top cohort but again, not the highest average fee for the entire population of firms in the survey.

The top cohort firm with the highest fee per client drives home the significance of this even more because it has the lowest number of clients and an average fee per client that's 4 times higher than the next million dollar firm.



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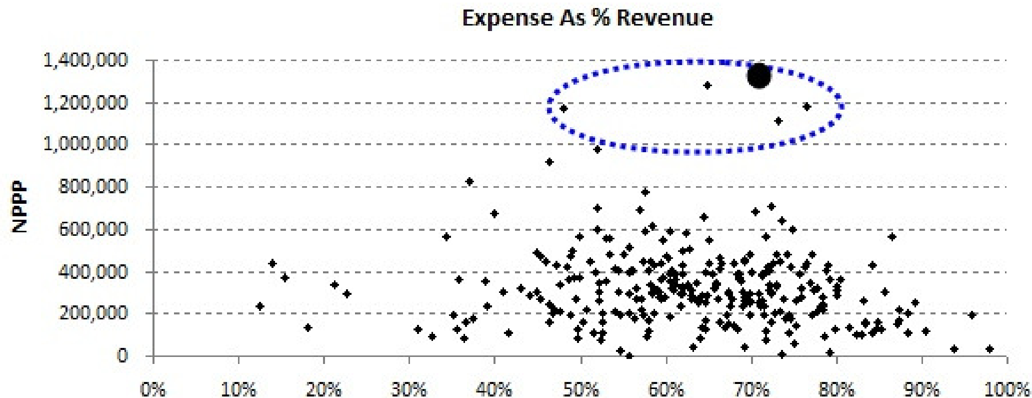
But even more interesting is the fact that there are 52 firms that had a higher average fee per client that was greater than four of the million dollar firms and yet their overall performance was, for the most part, way below the top ones. This again lends support to the hypothesis that superior performance comes from being good but not necessarily great on all of the key performance drivers.

Expenses

For many people profit improvement means building revenue while reducing expenses so it would be reasonable to hypothesize that the top 5 firms have a lower expense ratio (expenses to net revenue). Again, not so! With one exception, the top firms are at the upper end of the expense ratio metric which reinforces what we all know and that is you can't cut yourself to greatness.



Write-offs

As with the other performance metrics, the top performing firms do not have significantly lower average write-offs than the other firms in the surveyed population. However, it is noteworthy that on this metric they are all in the "less than 10%" range. I have always been of the view that some write-offs are inevitable and as long as your gross charge rate target is at the high end of the range for firms that target your type of client-service mix a write-off % of around 8% is acceptable.

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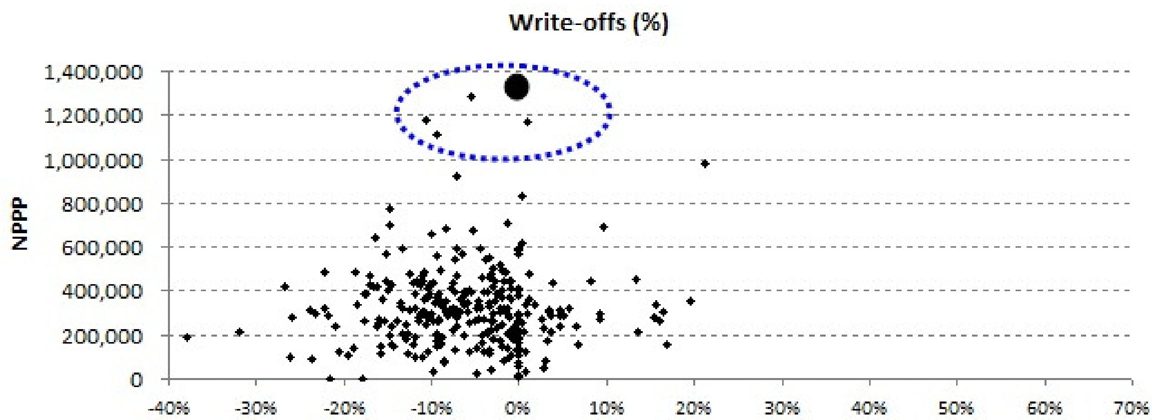

If you have no write-offs your fees are probably too low for what you're doing for your clients on the other hand if your write-offs are too high (and I would suggest greater than 10% is too high) that could be the result of several non-mutually exclusive reasons including: you have an efficiency problem, you are putting the wrong people on the job, you have a workflow management breakdown, you have failed to manage your clients' fee expectation , you have failed to manage scope creep effectively, and you are working with the wrong clients i.e. people in respect of whom you can't add much value given the quality of resources you bring to the table.

Clients' Value Perception

I believe that most firms significantly under-value much of the work they do for their clients. If you do not have clients complaining about your fees they are certainly too low! On the other hand, if you have a lot of clients, especially your "good" ones, complaining about your fees then you need to think about your pricing or, and this is more important, you need to put more time and effort into explaining to your clients what value you actually bring to the table.

This conversation highlights what I consider to be the real problem with the use of time-based pricing. I don't want to get into a discussion of that here but I would like to make the point that some of work firms do for their clients is not worth their standard "hourly" charge rate and clients notice this. It tends to get in the way of the real value you do (or could) provide which is often forgotten about or not even noticed because of the smoke screen created by the low perceived value, but high priced, deliverables.

This problem simply goes away when you price up front following a "value meeting" with your client and put in place a direct debit payment system so that you spread the investment made by the client in your service over a year which, incidentally, improves your cash flow by reducing your receivables lockup.

Clients view compliance requirements as a necessary business and expense. It's something they have to get done but it adds no value whatsoever to their business or their life. Given this, they may like you a lot but they do not like the fact that you are essentially acting as a government agent for the collection of tax and the provision of business information to government agencies. Furthermore, they have no idea of how to value the work you do in this arena because the only result they actually see is a document that goes to the government.

Some people will say "wait there, we minimize our clients' taxes, we return their phone calls promptly, we give them a client portal we do, do, do ….. etc." Bully for you is my response! Unless you're some kind of wizard you won't do any better than any other accountant of equivalent competence and that's the majority, let's face it. That's why the Average Fee Per Client graph shows such a strong bunching of firms because they are all doing the same thing for the same type of clients, and for the majority, at roughly the same fee.

But note also there is less bunching reflected in the Net Hourly Yield graph which suggests some firms are getting their pricing right. In fact the top quartile firms are achieving at least $200 per hour compared to a median value of about $160 per hour which may not seem much but it is in line with the advice I have been giving to firms for the past 30 years that they are probably charging 20-30% per hour less than they should and could be.

There is however, another aspect to the average yield premium and that relates to the "value" of the work actually being done which in turn also comes back to the clients it's being done for. Unfortunately surveys of this type are not able to give us information on the relative quality of clients or the relative quality of services offered. But based on the experience I have had with many firms over the years, better quality clients are more sophisticated buyers of professional services and require higher level work that is inherently more valuable and are therefore willing and able to pay higher fees.

It's important to also take note of the other side of the pricing coin. There are many firms with the same quality of clients as the price leaders BUT they are not capturing their fair share of the value they are creating because they're not willing to charge enough for their work.

There are many reasons for this including: ignorance of the value they have delivered, pricing timidity especially as a result of one or two clients complaining about fees and maybe switching to a lower cost competitor, a tendency to converge towards market "rates" as published in inter-firm comparison studies and inter-personal communication between practitioners, reliance on a time-based pricing system rather than proactively seeking to understand the client's perception of value (see Ronald Baker, Implementing Value Pricing for a more detailed analysis of this issue), a failure to capture technology-driven productivity gains that result in a lower cost to the client because either, or both, lower level people are able to complete the work and/or the work gets done more efficiently.

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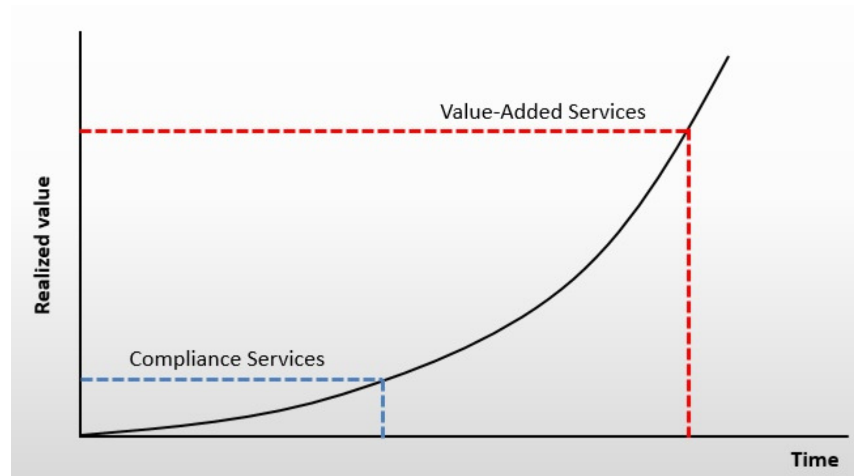
And that brings us to the critically important point which is: by far the best way to create a higher perception of value is to actually create more value. This is not a game of smoke and mirrors. Consider the figure shown below.



If you want to capture more value for yourself you have to become more valuable to others. The figure above reflects the idea that the time it takes to complete a client's compliance requirements will yield a relatively low level of value as perceived by clients. On the other hand, time invested in actually creating value for a client yields an order of magnitude increase in the client's perception of value and therefore an opportunity to capture an order of magnitude increase in your share of that value.

Put simply, this means the opportunity for you to increase the yield you get from the time you invest in working with clients is going to be greater after the compliance work is done than during it and that's a very good reason for using a different pricing methodology for value added work.

To take advantage of this you only need to do two things. First, you need to acquire the skills required to offer the value added services and secondly, you need to concentrate your marketing and sales process on clients who have the potential to benefit from these services. Both of these are within your control.

One of our long standing member firms in the UK, O'Byrne & Kennedy (www.obk.co.uk), picked up on this idea from a Boot Camp they attended in London many years ago. The late Paul O'Byrne told me "we came to the realization there was a lot more value we could create if our minimum fee was £10,000 than if it was £1,000 so instead of servicing 500 clients at an average of £1,000 [which is what they were doing] we set about working towards 50 clients at £10,000 and that strategy has worked brilliantly."

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The reason it's a killer strategy is you deal with less clients, for whom you do much more rewarding work, with less stress, more profit, you attract and retain better team members but often less of them so your "people management" problems are less (less stress again!) and your infrastructure requirements are lower and represent a smaller proportion of revenue and hence higher margin, more professional satisfaction for you and your team, more challenging work that stretches and improves your ability and the value of the intellectual capital attached to your firm, much better quality referrals, and much more loyal team members and more loyal clients because their switching costs are so much higher. Wow, that was a mouthful!

Oh …. and one more thing, you are able to differentiate your firm from the rest of the pack if for no other reason than your minimum fee is, for example, $20,000 but way more importantly, your focus is on creating positive value e.g. increasing business profitability and value which offers a better life and lifestyle for the business owners.

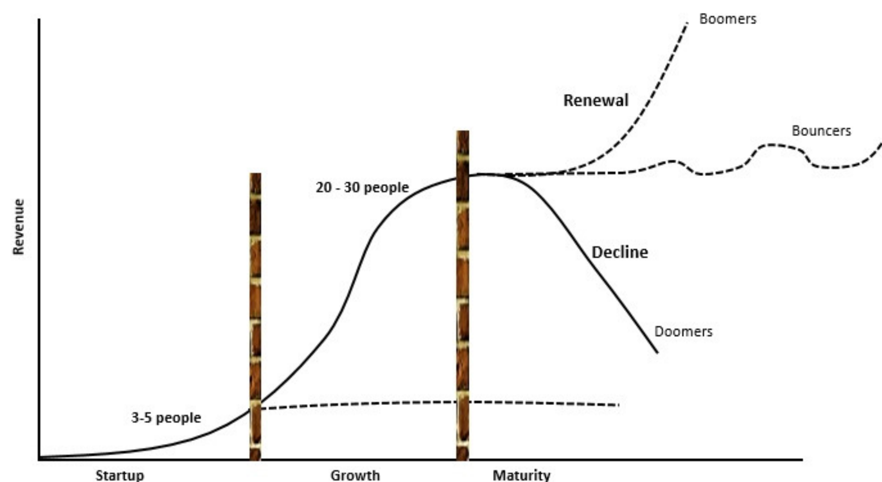
The key to this strategy is its focus on **actually creating value**. Once you make that your focus several tactical initiatives need to be put in place the most important of which is client selection. For this strategy to work you can only work with clients in respect of whom you are able to create value, clients who recognize the role you play in doing that and who are willing to share a fair proportion of that value with you. Armed with that high level client selection criterion you then need to break that down into a set of identifiable characteristics of those prospective clients and use that in your marketing and sales strategy. This process is embodied in Principa's *Practice Development Challenge* and it's what has enabled hundreds of firms we have worked with dramatically increase their profitability.

To create a million dollar firm using this model you need to implement one more step which I will address later. What I need to talk about first is why most firms hit a growth barrier at one of two points and how to get through those.

Growth Stalls At The Two Brick Walls

The accounting services sector is a highly fragmented industry. This is the inevitable form of industry structure that evolves when several economic characteristics are in place including: entry barriers are relatively low, exit barriers are relatively high, the principal value created by the industry comes from the heads of well-qualified people who can't be "owned" like machines, the work that is done by the industry is performed by the people who own the business entities so there is a tendency for them to see the value they bring to the table as being the work they do rather than the business they run, and there are few economies of scale (but considerable economies of scope). I have written about this in some detail elsewhere but there is another reason why it's a highly fragmented industry that is relevant to the present context.

Most firms are small (or rarely become very large) because their owners have difficulty breaking through two important brick walls which become effective growth stall points. Consider the following figure that represents a typical industry life cycle.



The first brick wall gets hit when the startup firm gets to the point where the owner is extremely busy doing the work that the firm does. The owner is starting to generate a reasonable income but because s/he’s so busy s/he can’t give attention to either the marketing or the service responsiveness that characterized the firm when it was started. Clients notice this and are less inclined to refer so revenue growth slows and ultimately plateaus. The owner has a couple of employees, has probably taken on some debt and has become used to the income the practice yields. S/he doesn’t want to “give away” too much income so s/he has hired pretty poor team members who just makes the owner’s job harder not easier.

The owner soon feels trapped and has lost the energy and excitement that s/he felt in the early days. Often the owner becomes cynical about clients and team members and blames circumstances for the situation the firm is in rather than taking responsibility for looking beyond the circumstances and making investment choices (e.g. hiring talent and firing clients that do not have a growth profile) that will take the firm to the next level.

The underlying reason for this stagnation is the lack of a really challenging goal and a willingness to step outside your comfort zone. It’s common for someone who makes decision to start a firm to aspire to create a business that will replace his/her current income or yield an income that is in line with other independent operators while at the same time enjoy the benefits of “being your own boss.” I’ll call this a “me too” goal.

When this becomes the goal seed that is fed into your mind your senses go to work to help you get there. Soon enough you do – typically that will happen within 3 to 5 years. But unless you

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replace that goal with another grander aspiration, your senses direct your actions to activities other than growing the firm. You may "want" to grow it but wanting or hoping to achieve something is not a strategy, it is a state of mind. Taking determined action to achieve the desired outcome is the key. Once your "me too" goal has been achieved it becomes a limiting belief that you have reached your objective which now becomes a barrier rather than a goal.

This brick wall is not limited to sole proprietors. It is often hit by small multi-owner firms as well. They all behave as I have outlined above and the end result is a firm where revenues hit a no-growth or very slow growth pattern and stay like that for a long time.

But some people do break through the first brick wall. This may happen with what might seem to be a bit of luck but it is always the result of choices made by the owner(s). I mention "luck" not because I think it is the cause of success but because every successful entrepreneur admits to having some luck. A much better way of defining "luck" is to describe it as the situation that arises when preparation meets opportunity.

However, the often misunderstood element of the "luck" phenomenon is that when you have a clear goal in the top of your mind that is significantly beyond where you are now your sub-conscious (a part of your brain neuroscientists call your Reticular Activating System) directs you to people, ideas and opportunities that will enable you to reach your goal. The key here is having a goal that is significantly beyond where you are now AND being willing to take action, even though it may be shrouded in uncertainty, that will move you in the direction of that goal.

In keeping with the idea I have expressed above, one element of luck that does play a major role in breaking through the first brick wall is bringing on board a person who shares the founder's vision of being able to create a great firm and has the energy and desire to make that happen. This energy is contagious and if it is accompanied by an appropriate skill balance synergy is likely.

For example if one of the owners is a great rain maker and the other is a great technician the firm is off to a good start—provided of course they each recognize and their respective contributions to the growth of the firm. I mention this because so often the people who "do the work" frequently feel they are more valuable than people who "get the work" and vice versa. This does not make for a great productive partnership based on true synergy. When all partners make exactly the same contribution all you end up with is a coalition of sole-practitioners which affords virtually no competitive advantage.

If the owners understand that in order to grow the firm, investments have to be made in people, technologies, marketing etc. and are willing to trade-off some current income to make the right investment choices profitable growth is almost assured. The energy that comes from people like this inspires the team and clients and before you know it the firm has several partners and many clients.

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It then hits the second brick wall. The time from startup to the second wall may be 5 years or 25 years but it's inevitable for most firms. Here's why. The people who started and drove the firm in the first place take it on a fantastic growth path. They are classic entrepreneurs, they're probably good leaders and people managers, they have a great vision that excites people and the energy to make it happen.

They usually promote from within and the people who end up in leadership positions with the founders have done all the things needed to impress them which, more often than not, is the technical work the firm does rather than the things that grew the firm in the first place. In other words, what got them there (to partner) will not take them there (building the firm at the same pace.)

When this happens you have two groups of leaders at the top. The first group are the original founders who are enjoying the abundant cash the firm is now spinning off as its growth rate has slowed and there is less need to re-invest profit to fund working capital. Their energy levels are not as great as they were and/or they may have other outside interests including investments and they see the firm as a cash cow rather than a growth star in their mind. It's also highly likely that these people will not want to take the risk of pursuing an aggressive growth renewal strategy and/or may not want to make an investment that may not yield a return until after they leave. Finally, these people will often form the view that if the "young guys" want to take the firm to then next level then they need to exhibit the same entrepreneurial skill "we employed to get the firm where it is today." The problem with this view is that they probably hired these "young guys" because of their technical skill not because of their business building skills.

The second group of leaders are the "technical" partners who are undoubtedly good and talented people but they're likely not skilled in the art of growing the practice. Because they played such an important role in getting the work done during the growth phase of the firm they were not mentored or coached by the entrepreneurial founders in the art of building the firm. Moreover, they were also "rewarded" with money and responsibility for exhibiting the habit of doing the work accountants do rather than growing the business which is not just about bringing additional work but includes exhibiting people development and management skills.

At this point, you've got some owners who know how but don't want to grow the firm and you have some technical owners who want to grow the firm by don't know how and who probably don't have the support or the management power to do it. I should add that the firm's partner compensation model is also likely to encourage a focus on "billable time" which discourages people from taking an income risk associate with investing in people development (mentoring, coach, delegation), personal development and client acquisition.

The result is stagnation – let's call that the bouncer firm because it tends to bounce along with some good years followed by some not-so-good years where the overall trend may be up but not markedly so.

Sometimes, though too rarely, someone takes a strong directional leadership role and points the firm on another growth trajectory (I like to call this a boomer firm.) Part of this growth may come from M&A activity but a good part of it will come from organic growth which is a clear indicator (in my opinion) that it has the right people, the right clients, the right systems and the right service offerings in place and that the firm is effective at marketing and sales. Firms that achieve size through organic growth generally have a sustainable competitive advantage that other firms find hard to replicate.

The easiest way to grow a firm is through mergers and acquisitions but when that happens, more often than not, a few of the owners and/or some of the managers of the M&A firms split off and start their own firms and the cycle life starts over again. There are few economies of scale in the accounting services industry and there are diseconomies of scale. This is not to say there's no place for M&A in your growth strategy but if you do go down that route it's important to have great skill in finding suitable candidates to acquire/merge, be extremely good at doing your due diligence and be skillful and managing the cultural fit when the organizations come together.

Sometimes the firm fractures and goes into steep decline. This is what I call a Doomer firm. It may occur because a partnership split or the retirement of a key person who did not give any attention to a leadership development program. Another reason for a firm going into decline is the owners simply losing interest in growing the firm (for reasons outline above) with the result that a couple of key team members leave with some good clients because they can't see any opportunities for them in the firm. This causes a general malaise to settle over the entire firm and the loss of vitality reveals itself in further decline.

Summary, Conclusions & Lessons

I started this White Paper with a statement to the effect that it's certainly possible to create a firm that generates a million dollars for its owner(s). From the survey data available a small number of firms (less than 2%) are achieving that so we can say unequivocally that it's possible.

How that can be achieved and how sustainable are probably more important questions than can it be done. The data indicates that leverage (that is, the number of people per owner) is a key profit driver. In fact it is 10 times more impactful than the next major driver of profitability being the average hourly net yield. In the following table I have compared the median of the total survey participants with the median of the million dollar plus firms on the five key drivers of profitability.

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Driver	Survey Median	Top 5 Median	Difference
Leverage	5.75	24.0	317%
Yield	$166	$221	33%
Productivity	63.4%	67.5%	5%
Expense % of Revenue	64%	68%	5%
Hours charged	1,345	1,284	-4%
Net profit / Owner	**$301,047**	**$1,180,039**	**292%**

If the data are to be believed it would seem that our operational focus should not be on trying to get more productivity out of our people, or attempting to keep costs down, or expecting people to put in longer hours.

In fact it would seem that the "solution" is simply to hire more people (or do some de-partnering), charge what your unquestionably worth and continue to do what you've always done operationally. But I don't think it's that simple.

In order to keep talent (and friendships) the traditional business model has been to offer people a partnership at some point in their career. That being so, if our $1.2 mill firm sold some equity to Mary Newpart the net profit immediately drops to $600k even though the selling partner may retain a large piece of the equity and may still be taking home a large piece of the total firm profit.

This suggests that net profit per person may be a better metric and when you look at the graph for that metric you'll notice many firms are achieving a better result than the top 5 with only one of them being in the "new" top five and the next one coming in at position number 24. But what's interesting is the firm that wins on this metric is still a sole practitioner and is making more than $900k, with lower leverage and much higher yield per person – that firm is doing considerably higher value work with a small number of clients. It's also interesting to note that you have to get to the 95th firm before you find more than two partners in the top range of NP per person and of those 95 firms only 24 have two partners.

Although the data shows some sole practitioners are making big money it would be wrong to conclude that multi-owner firms are not as profitable. In fact the data does indicate that size does matter (a bit). This is summarized in the following table that shows the median and average values of net profit per owner for different firm sizes.

Number of Owners	Median	Average
1	266,000	314,000
2	299,000	253,000
3	281,000	302,000
4	347,000	349,000
5	288,000	320,000
>5	346,000	353,000

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Although sole practitioners are the ones who seem to be getting the highest net profit per owner they are also the firms that exhibit a positively skewed probability distribution as evidenced by more than 50% of firms earning less than the average for that cohort; however, it gets very close to a normal distribution when the average is calculated without the top five sole practitioner firms. This undoubtedly reflects that fact that are relatively young firms in this group and their net profit is likely to be small compared to established firms. For the most part it would seem that bringing on board more partners does manifest in higher net profit but whether or not that is worth the effort of dealing with more people and having to continually look for new clients.

One thing a study of this sort does not reveal is how stable firm performance is over time. For example we do not know if the top performers retain that position. Business life cycle theory suggests that it's highly unlikely that there will be stability of the profit distribution over time and based on my experience with a lot of firms over the years I believe that to be the case.

However, what we do see from this study and all data sets I have worked on is that solid, sustainable superior success is possible by pursuing a fairly simple strategy that has the following elements:

1. Slightly above average performance is required in relation to the productivity of fee earners, typically in the 60 – 75% range, depending on the net hourly yield realization. That is, if you are doing lower level work that does not command higher level fees you need to be at the upper end of productivity.
2. Write-offs should not be zero nor should they be above 10% but that is subject to the level of the average hourly yield. With low value, high volume work there should be very little write-off. In fact you should not even be running a timesheet on this type of work. Many of the very high revenue firms have "scary" write-offs due in the main to poor workflow management and poor pricing decisions.
3. Expenses for the top performing firms appear to be within the "normal" range of 60 to 70% of revenue. This reflects the fact that they are servicing similar clients and, as the average yield figures attest, are charging much the same prices. Firms that step away from time-based pricing and are more careful with their client selection process are achieving much higher yields than are reflected by this data set and as a result their expense ratio is lower than 60% and net profit margin quite a bit higher. The industry's traditional pricing policy of setting charge rate as a multiple of salaries is the treason for the stability of net profit margins falling in the 30-40% range.
4. To be a top performer your net hourly yield should be above average but it does not have to be off the page. Having said that if you focus your energy and attention on seeking out clients who have the greatest potential for your to add value and set your prices accordingly you will achieve extraordinary results.
5. The major driver of exceptional results as shown in this data set is leverage. Put simply, if you are a sole practitioner and you have at least 15 people working for you it's highly

> likely you are going to be making a lot of money (whether you are having a “lot of life” is another question that at the end of the day may be more important.) Of course you must also have control over the other things that we might call core performance drivers – productivity, net yield (i.e. pricing and write-offs), and expenses. If you are a multi-owner firm you need to be looking at a leverage ratio of around 8-9:1 to start making the big bucks. But way too many firms can’t break through the first brick wall that I spoke about and as a result they languish with 0 to 5 team members of whom at least 1 is in an administration role. It’s hard to make significant income with this business model unless you are targeting a very narrow niche and you can generate an exceptionally high hourly yield.

This review confirms a view I’ve held for a long time and that is the key to building a very successful practice is exactly the same as building any other type of business. It is to have a clear vision for where you want your firm to get to and then organize and execute relentlessly around that vision. To build a professional service firm with a high level of leverage requires exceptional management and leadership skills because professional knowledge workers are so fickle and can leave at any time. There will always be some firms that achieve the top 5 results that we see here but I do not believe it’s a sustainable model.

The one thing that leads to exceptional firm performance is creating value for customers. Whether that creates wealth for the firm in turn depends on two things: how much value is created for each customer and how many customers you can attract. The firms that have achieved high levels of leverage don’t necessarily have the most clients but those with less clients do have higher average fees per clients and vice versa.

As Peter Drucker said many years ago:

> “Because the purpose of business is to create a customer, the business enterprise has two–and only two–basic functions: marketing and innovation. Marketing and innovation produce results; all the rest are costs. Marketing is the distinguishing, unique function of the business.”

To build a great firm you can take many paths but the important thing is to decide which path suits you. Don’t jump from one path to the next simply because you see a nice shiny new toy on it. Most firms try to be all things to all people and when you combine that with the two brick walls you end up with a small firm going nowhere.

There are, however, firms that truly understand Drucker’s advice and focus on ways they can innovate with service design and delivery and do so in a way that gives them a strong marketing message to attract the type of customers they want (recall the example of OBK I spoke of) in numbers that produce serious returns AND attract and retain team members with the requisite attitude and aptitude to deliver the promised value.

What this is about is not looking to implement the latest technologies, best practices and managements fads. It's about creating a business model that meets a real need and then executing with precision. To do that requires leadership at a high level. The essence of leadership is the process of creating and articulating a desirable vision that your team embraces and then investing in the development of those people to make it happen. But since you can't give what you don't have it all starts with developing yourself which is why I feel strongly that personal development comes before practice development.

Accountants in public practice can do what the practice does and therein lies the heart of the problem. Jim Collins calls this the curse of competence. Michael Gerber calls it working IN your business rather than ON it. If you want to create a very profitable firm you can—the fact that we see the evidence for this is in this data set. But you will never do that unless you assume the role of leader and the quicker you make that a full time role the quicker you'll see the results that are possible.

Can I Help You?

I am always interested in learning more about our profession through feedback from practitioners. I would therefore love to hear from you about your thoughts on what I've written here. What do you agree with? What do you disagree with? Please let me know your thoughts by sending me an email and in it please reference the version number of this report (yes I do change or elaborate on my thoughts from time to time!) and let me know if you would like me to contact you to have a chat about the report or my thoughts on practice development.

Thanks for taking the time to read this document.

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Idea Action Plan

Results come from DOING not TALKING. Start a task list of actions you could begin implementing immediately to take your firm to the next level. I have taken the liberty of starting it for you.

#	Action Initiative	Delegate to	Complete By
	Email Ric to discuss our firm’s direction & potential		

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