METRICS: THEIR VALUE IS IN CREATING MORE QUESTIONS

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When it comes to metrics, we don't spend a lot of time with them. Don't get me wrong, we look at them, but they are simply a view of the firm at a point in time, not a solution. Metrics just help you ask more questions, but they rarely give you definitive answers.

When we work with firms, we start our focus on the strategic plan, and then make sure that it is trickling down to the managing partner, then trickling from there to the entire partner group, and continuing on downhill until everyone is being aligned and held accountable for whatever the firm has decided is important at this point in the firm's evolution.

Metrics can show both possible strengths and weaknesses with the exact same statistic, so we think of them more as a tool than a benchmark. For example, over the last three years, we have been harping on most of our client firms to ignore realization. Realization is fine when we use it in a consistent environment with some excess capacity to try to improve performance (both performance from the perspective of the partner better selling the job as well as the manager or supervisor running it). But many of our firms are in a high people acquisition mode, and therefore, our position is to stop focusing on realization or the result you will achieve is more and more people sitting idle that need work and need training, with the other more senior people working longer and harder for little extra reward. While management should constantly monitor realization, the minute that metric rolls down into a firm-wide focus area, training will stop, delegation will diminish, and the firm will start being more efficient today while sacrificing effectiveness for the firm's long term future (effectiveness being defined here as being able to grow, closing competency gaps at each level within the firm, creating a reasonable work/life balance expectation for its people, slowing the reverse delegation that occurs so often when senior level people delegate work only to receive it back due to capacity and skill limitations, etc.). To create a positive and healthy environment when a firm is adding people, a firm needs to make sure that the new people are being trained, ensure that their work is being monitored frequently, and that they have plenty of opportunities to shadow more experienced people doing the work for OJT (on the job training). In times of heavy people acquisition, realization being high could be an indication that the firm is throwing away money by under-utilizing its newer people and overworking their senior ones. However, when firms have capacity among well trained people at all levels, high realization could be an indication of good workflow as well as proper workload delegation throughout the projects. Or high realization could mean that the partner sold a project at a reasonable price. The reverse is also true. Low realization could be a good sign that work is being delegated down with proper oversight and training which requires more time being spent on projects so that the firm's capacity and skill levels improve. Low realization could, and often is, an indication that the partner gave away the job to get it. Or it could be an indication that a project is a "one-off" project and because no one does that specific work often enough, it is hard to be efficient when doing it, no matter how experienced the staff is. The point is … realization is a management tool. And as it fluctuates, it helps management know what areas to research so the problem can be identified and then addressed. However, with most firms, realization is used as an important part of the compensation component for partners, sometimes all the way down through staff, which unfortunately takes a firm operating in an Eat What You Kill (EWYK) mode of operations (everyone developing themselves instead of developing others) and makes sure that the firm is cementing itself forever in that same mode of operations.

Another example of a metric we look at is "leverage." Many firms use a broad calculation of this, which is different than the way we use it. For example, the most common definition of leverage is determining a firm's revenue per partner ratio. So, a firm with $5 million in annual net revenues and four partners would calculate a leverage of $1.25 million net revenues per partner. This is a fine use of the metric, but there is far more to it, and a high number doesn't necessarily mean good things.

First, let me tell you how we use it. We calculate leverage as the book a partner manages (not the book a partner owns, which is EWYK), divided by all partner billings on that book. So, using the example above, a partner having a $1.25 million leverage could be good or bad. Certainly, in a general sense, $1.25 million per partner would be considered a good number for the vast majority of firms. As an example, many firms through the top 50 and beyond will have an expectation of $1 million in revenues per partner as the minimum threshold. So, $1.25 million is even better than that. However, that number alone doesn't say much about the profitability and the management of that work. Using our formula, we drill down deeper per partner to understand more. For example, we commonly find two partners with about the same book size, with one leveraging the work in a much more profitable and healthy way the other. Consider a partner with a $1.25 million dollar book, who bills $400,000 personally on his/her book and utilizes two other partners to help get the jobs done (with one partner billing $200,000 and another billing $150,000). In this situation, all partner billings amount to $1 million of the $1.25 million dollar book, creating a leverage ratio of only 1.67 to 1. Now consider another partner with a $1.25 million dollar managed book, who bills the same $400,000, but all of the other work on his or her book is done by managers and staff creating a 3.125 to 1 leverage ratio. Our point is that there is VERY LIMITED leverage when partners call upon other partners to manage their work. We find many senior partners in firms carrying a $2 million to $4 million dollar book of business having an unhealthy, low leverage ratio because they simply have all of the younger partners, who most likely were made partner because of the amount of work they did for the senior partner, doing the work. Big books don't mean good leverage, or the right leverage. But as with the realization metric, we try to take any metric and use it to help us dig a little deeper, like general partner leverage as one calculation followed by our deeper look into individual partner leverage ratios using our formula to try to determine whether the firm, and or individual partners, are operating in a healthy or unhealthy manner.

For example, we ran across a firm where a partner had a large book, with the partner billing in excess of 3,000 hours against it. So, at first glance, the leverage looked good, but with a closer look, the leverage ratio was an indication of an unsustainable culture where excessive work was considered the norm. Would it surprise anyone that this kind of excess hour expectation made it difficult for this firm to hold onto young talent? Would is surprise anyone that the culture was very tense and often confrontational due to key people constantly under stress, overworked with tempers flaring at times? Would is surprise anyone that the partners were maintaining an unhealthy, unsustainable life style? Metrics are not good or bad, they are just data that should lead us to what they are really revealing to us. When we look at the leverage ratio, we are trying to assess how much of the billable work on a managed book of business is being done by the people below partner level. It is helpful in creating context for partners to learn to delegate more and change the firm culture towards greater training.

Another metric we use is NIPP (net income per partner). We typically use this to set a goal for the managing partner to achieve. In our opinion, this is a key metric for evaluation of the managing partner. We understand that this is not the only metric, and often not the most important, but it should still be on the short list of goals the managing partner is expected to achieve for the creation of a sustainable firm. However, use of this metric, as with others, can result in good or bad consequences. For example, if the reason NIPP is high is because all of the partners are billing 1,500 charge hours and working 2,800 hours, then it's probably not sustainable or something for the firm to brag about. Any firm can look good statistically if they are expecting everyone to work unreasonable hours. The problem caused by this is, once again, is short-term efficiency (more profits today due to excessive work) with unsustainable effectiveness (key people will burn out, creating the need for partners to work even more hours in the future to maintain their income). Or a high NIPP could have been generated because the MP slashed all expenses and investments, thereby sacrificing the future of the firm to make excessive nonreplicable profits in the future. Or on the good side, high NIPP could be a sign of excellent management.

Another metric we look at is new business generated. However, like so many metrics, we drill down on this one differently than most others do. It should go without saying that new business gains need to be considered in light of lost business. For example, what good is it for someone to bring in $500,000 in new business in a year (a good number in any firm) and lose $600,000 due to lack of proper levels of service? Another variation on this metric is determining what constitutes new business. In most firms, it is simply new clients brought into the firm and their project revenues for that year. To us, this is a small part of the new business number and quite frankly the least profitable. We look at two other factors that also make up new business. The first factor is new projects from existing clients. The second comes from one of two changes – a substantial price increase or a change order to existing work. What constitutes a substantial price increase varies from firm to firm, and from service area to service area. For example, a substantial price increase for the tax department of a $10 million dollar firm might be a minimum of a $750 price increase for the same return (in other words the same work, with no additional scope) or a minimum of $2,500 price increase for the same audit.

Change orders, while they can be applicable to any work, often occur with audits. A common cause for a change order is that the work performed by the client is substandard and has to be addressed before the firm auditors can continue. However, to make the change order process work, it has to become part of the culture as change orders have to be initiated in the field prior to the work being completed. Clients rarely pay for change orders after the fact because they are left with the perfect excuse, "If you would have told us, I would have had my people get you whatever you needed or would have cleaned it up to your expectations." The simple fact is that our clients are typically running with about the same level of capacity problems as CPA firms are so most of the time, when faced with the dilemma of getting their people to provide the necessary work in a timely fashion, or authorize a change order, it is usually the latter that is approved. Cost of living increases don't count as price increases for this metric.

Interestingly enough, of the three ways to drive new business, price increases or change orders are typically the most profitable for the firm, adding new projects for existing clients are the second most profitable, and bringing on new clients the least profitable of the three. Why? Because firms often compete to bring in new clients, but new work with existing clients is usually less competitive to obtain and therefore better margins are probable; and price increases for the same work simply drop to the bottom line since the work was being performed anyway.

Using this metric by itself and under the most common definition of new business generated, virtually any number sounds totally positive and someone without new business sounds like they are falling short. But often, when you layer in "lost business" along with new projects for existing clients as well as price increases, don't be surprised if the tables turn a little as to who is driving your growth and your profitability when you look at the whole picture.

In our next column, we will pick up with more metrics as well as a tool we use to determine an acceptable profit return on various levels of staff through manager.