METRICS: THEIR VALUE IS IN CREATING MORE QUESTIONS – PART 2

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We discussed several metrics in the first column: Realization, Leverage, Net Income per Partner, and Business Generated. We will pick up this article with more metrics for your consideration. The theme is still the same – metrics are valuable, but as management information. When you view metrics as answers, you often miss the mark because there are many causes for good or bad numbers, and assuming the results are purely related to the employee's work habits or ability is often a mistake.

I want to pick up with the metric we call **Capacity Budgeting™**, which includes projected revenues, staff turnover ratio and a requirement to inventory your current people's competencies to determine weak or marginal performers. This metric is one of the first we calculate with new clients because it demonstrates so clearly the inadequacy of most firm's current hiring practices. As well, it is a critical metric and a sanity check to assess a firm's commitment to its desired growth strategy, as well as to understand the magnitude of capacity acquisition required to achieve a firm's projected growth. Some of you may be thinking, "This doesn't apply to me—I've got a small firm, and this is only relevant for big firms." The fact is that, unless you truly work as a one-person shop, this does, indeed, apply to you. In fact, it's more critical for smaller firms than for larger firms. To illustrate this concept, consider a firm with 20 employees. If one employee leaves, that's five percent turnover for that year, and although it may be a little uncomfortable, spreading the person's work around to the remaining 19 people should not be too difficult. Next, take a firm with five employees. If just one of them leaves, that creates a gaping hole in capacity due to 20 percent turnover, with less people to whom you can spread the excess work left by the departing staff person.

Now, let's compound the problem for both the larger firm and the small firm mentioned previously. If the partners are looking to train their people and push more work down while growing the practice, they need more capacity than they probably have right now. So, given the shortage of CPAs or young accountants in the marketplace and the likelihood that in today's market, firms are going to have to recruit straight out of school to find talent, spending some time to map out a firm's capacity needs over the next few years is not only essential, but critical (because most firms get this wrong inasmuch as they do not hire nearly enough people to handle the growth and increasing personnel demands required by their firm).

For example, let's say we are working with a firm that has $2 million in net revenues, 16 FTEs (an average of $125,000 per FTE), and two partners (an average owner book of $1 million), and it has been growing at a minimum of eight percent annually for the last three years. If you assume, for planning purposes, that their growth will continue at eight percent, then the firm would be looking at net revenues of almost $2,520,000 over a three-year period. If average revenue per FTE holds (and during periods of growth, it rarely will go down), this firm will need to have 20 employees by the end of the second year to do the work, or an increase of four employees (two per year). And that alone is more hiring than most firms this size will do, but the story gets worse. So, let's consider some additional information. First, what if this firm has been experiencing a loss of two people per year (either due to termination or staff quitting, staff moving with their spouses, etc.) Also, let's assume that the firm believes two of their current people are very marginal (but they can't let them go due to the current overload of work). And finally, from a current capacity perspective, the firm feels that it's short one person already at its current volume. Now, an entirely different hiring picture begins to come into focus.

Based on this information, in order to be staffed to produce a little over $2.5 million in revenue, the firm suddenly needs to hire four new employees to accommodate the 8% growth, six new employees to reflect the two per year they have been losing, two staff to compensate for the marginal employees that need to be replaced, and one more person because the firm is currently short-staffed. That means the firm needs to hire a total of 13 people by the end of the second year, or six this year and seven the second year. Although a reasonable amount of the $520,000 in growth will come from increased fees (so we could factor that into our equation), we also did not factor in an offsetting capacity shortfall that is likely to occur due to higher-than-normal turnover commonly experienced when hiring talent fresh out of school. Consequently, this example is pretty conservative.

So, here is a 16-person firm, growing at a conservative rate that needs to be hiring a minimum of six people per year for each of the next two years in order to just meet the predictable firm demands of growth, turnover and replacing currently identified marginal staff. But we find these same firms, prior to our involvement with them:

- Hiring at most two people per year creating more pressure on their good people (due to overtime demands),
- Having no work life balance – especially for the partners (because in the end the partners have to get whatever work out that staff can't get done), and
- Maintaining an environment where marginal people are able to hold the firm hostage, demanding more pay than they deserve because the firm is so short of capacity.

Remember this: people are our inventory. When you run out of time to get in front of your clients and find out what is keeping them awake at night, your revenues will flatten. Yes, when you hire more people than you can keep busy, you run the risk of having excess inventory and not enough offsetting new business, but we believe – and have seen over and over -- that this overcapacity is a short-term situation. In the worst case, you can cull through your employee list and let go of your worse employee(s) or be in a position to renegotiate with those who have been holding you hostage because they knew you couldn't live without them. In almost every case—and we see a lot of them—when firms hire good people, the work comes in because the partners are motivated to use their freed-up time to take better care of their top clients, which instantly converts into more opportunity. On the opposite side of this spectrum, we have also seen what happens when firms try to live with a labor shortage for too long:

- Growth flattens, except for price increases because there is no more labor to sell and partners actually discourage new work because they are overwhelmed to begin with.
- Clients get frustrated with late work and leave.
- Because of the stress of keeping up with in-house project demand, good people quit, thereby reducing inventory. The firm's best workers go find another job because they get tired of management (the partners) continually promising to fix the overtime problem when in fact it only seems to get worse every year.
- The firm struggles to find people to replace those who left, only to find that the capacity of the new people is less than the capacity of the people they replaced because the people who left already knew how to do the work and were familiar with the firm's processes and procedures.

Ask any retailer: Learning to manage inventory is the key to success and profitability. We, as CPA firms, need to do a better job managing our inventory (building the right level of time capacity and developing the competencies available with that time).

In my next column, we will work through a tool we use to determine a reasonable employee ROI by addressing what a fair amount of billings a firm should expect from an employee at a specific staffing level given their current pay (salary plus overtime). Just like every tool, using it should help you ask better questions, but it doesn't answer them as there are many variables in play that determine a final statistic or metric. Until then, work through your *Capacity Budget*™ and see how close you are to a realistic hiring level for your current growth, turnover and employee competency.