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

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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

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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 on 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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In Brief: Tips on Making the Best Deal

Here are some simple tips to keep in mind when contemplating a deal:

- When valuing an accounting firm in an acquisition, successor firms should determine the profit margins of the practice once it is in their hands, not based on historical margins.
- In mergers, consider relative NIPP between the firms for clues to cultural differences and then dig into what is driving them to spot potential problems or untapped opportunities.
- Relative billing rates are not nearly as important as what clients will pay for comparable services and, in fact, can be very misleading.
- There are usually many different ways to deal with a range of profit margins. Using a flexible approach to deal terms can keep the deal profitable for the successor without requiring the seller to diminish value dramatically.

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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.

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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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