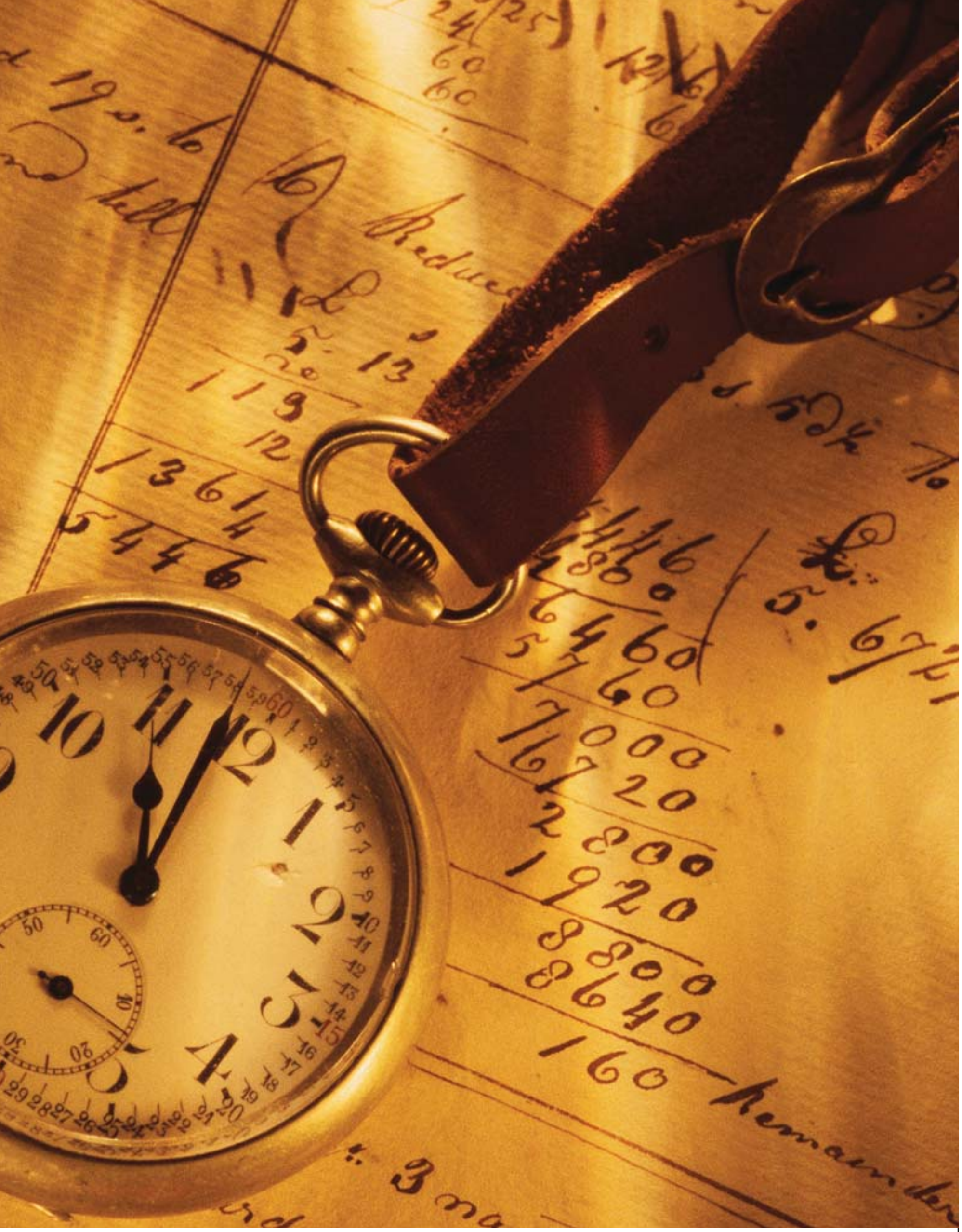

The Firm of the Future

New model shuns time sheets, favors value creation.

by Ronald J. Baker

To a large extent, your company is being managed right now by a small coterie of long-departed theorists and practitioners who invented the rules and conventions of "modern" management back in the early years of the 20th century. Management is out of date. Like the combustion engine, it's a technology that has largely stopped evolving, and that's not good.

—Gary Hamel, *The Future of Management*, 2007

The reigning paradigm of how to manage a CPA firm hasn't changed for more than a half-century:

Revenue = People Power × Efficiency × Hourly Rate

Unfortunately, this model has several limitations. First, it overemphasizes every marginal dollar of revenue—and hence *any* client—as beneficial. But low-value clients consume a disproportionate share of a firm's precious capacity, while keeping it from reserving capacity for its most valuable clients.

Second, most firms attempt to leverage people hours, which is how the traditional pyramid structure was formed. Yet with technological advances and a talent shortage, it becomes increasingly restrictive for firms to think their capacity resides in head counts.

Third, firms attempt to measure efficiency using indicators such as billable hours, utilization and realization rates. These metrics compel firm leaders to believe efficiency is the archetype of running a profitable firm, but what if you are efficient at doing the wrong things? A relentless focus on efficiency comes at the expense of creativity, innovation and effectiveness.

Last, the hourly rate—along with a "you sell time" mentality—has been taught to at least two generations of CPAs, or "Firms of the Past." In reality, clients don't actually buy time, so it is difficult for firms to sell something that clients don't think they are buying. The hourly rate places an artificial ceiling on income potential.

It seems that since the profession invented this model, it should be able to *reinvent* it as well.

An Improved Model

A new paradigm is gradually supplanting the old way of thinking because it offers viable alternatives for leveraging the chief source of wealth in today's knowledge economy—Intellectual Capital (IC):

Profitability = Intellectual Capital × Effectiveness × Price

The new model, or the "Firm of the Future," has several advantages over the old. Rather than focusing on top-line revenue, the firm is forced to think about the profitability of each client, and whether that client fits within the firm's overall purpose and strategy.

Despite common belief, CPAs do not sell hours. A firm's capacity to create wealth for its clients resides in its IC—that is, knowledge that can be converted into profits, rather than simply focusing on leveraging people and hours. A firm's IC has three components:

1. ***Human capital.*** Its people's knowledge, approximately 75% of its wealth-creating capacity, according to the World Bank.
2. ***Structural capital.*** Its systems, proprietary software, tools and resources that enable it to perform its work.
3. ***Social capital.*** Clients, reputation, vendors, referral sources, alumni, alliances and networks.

Firms of the Future focus on *effectiveness* over efficiency. This implies the metrics that have been used to manage a CPA firm are irrelevant to knowledge workers. The time sheet has been supplanted with key predictive indicators.

CPA firms are subject to the same laws of economics and customer psychology as every other business. Businesses have *prices*, not hourly rates. You'd never fly on an airline that charged $4 per minute. Firms of the Future price *all* work upfront.

Meet Four Anomalies

Today, hundreds of firms worldwide—across all professional sectors, from accounting and law to advertising and IT firms—have begun the journey toward becoming Firms of the Future. These firms might be considered *anomalies* because they defy the conventional wisdom regarding the proper way to lead a professional firm.

The Mark Bailey & Co. team, top from left: Stephanie Olijar, CPA; Misty Shore, CPA; Lea Jensen, CPA. Middle from left: Michelle Turri, marketing director; Pam Eugenio, CPA; Christy Horgan, CPA–manager; Erin Mulholland; Julia Kingston, CPA; Jeanne Yamamura, CPA, MIM, Ph.D., director of professional services; Rachel Ringenbach. Bottom from left: Mark Bailey, CPA/ABV, managing partner; Marty Weigel, CPA, assurance partner.

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Mark Bailey is founder and managing partner of **Mark Bailey & Co. Ltd.**, a Reno, Nev.-based SEC audit boutique firm. In 2008, the firm is projected to produce $2.8 million in revenue and employs 14 full-time equivalent, or FTE, team members. The firm prices every piece of work upfront, offering its clients certainty in price. It does not use time sheets. To capture, share, and leverage its IC, the firm hired a chief knowledge officer. It abolished annual performance reviews and has a waiting list of talent eager to join its ranks. Here, Bailey describes his journey to becoming a Firm of the Future:

> Beginning with the realization, three years ago, that CPA firms do not sell time, but rather value based on intellectual capital from knowledge workers, our firm has undertaken the

EXECUTIVE SUMMARY

- **The traditional business model of focusing on top-line revenue has several limitations** when it comes to running a CPA firm because it overemphasizes the benefit of every marginal dollar of revenue and every client and places an artificial ceiling on income potential.
- **Measuring efficiency based on indicators such as billable hours, utilization and realization rates** comes at the expense of creativity, innovation and effectiveness.
- **The new paradigm for firm management is based on intellectual capital (IC),** or knowledge that can be converted into profits. A firm's IC is comprised of human, structural and social capital.
- **By focusing on effectiveness over efficiency,** firms are forced to consider each client's profitability and how that client fits within the firm's overall purpose and strategy.
- **Firms that understand the difference between knowledge workers and service/manual workers** will have an enormous window of opportunity to attract, develop, inspire and profit from their human capital investors.

Ronald J. Baker *is the founder of VeraSage Institute. His e-mail address is ron@verasage.com.*

The Snyder & Co. team, top from left: Ronnie Blankenship, CPA; Tracy Andrix; Shelley Karnes, CPA; Linda Albright, CPA, CFP; Stephanie Brown; Marcia Friesner; Jane Morrison; Tammy Boring; Peggy Blauser; Erin McCauley; Cathy Gierhart. Bottom from left: Victor Christopher, CPA, CVA; Linda Sheridan, CPA, CVA; John Snyder, CPA. Not pictured: Kerry Sheets, CPA; Sue Sohonage.

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challenge of implementing an operational and pricing model based on value rather than the traditional model based on time spent times hourly rates.

The initial challenge was to abandon time sheets as a benchmark for pricing services, relying instead on a fixed-price agreement and annual client service plan for each client, established by the firm's pricing committee. This agreement incorporates a comprehensive suite of tailored services, which recognizes the individuality of each client and is priced accordingly. Not only are the services to be provided specifically discussed, the responsibilities of the client are as well. Modifications and scope changes are negotiated and documented in a change order appended to the fixed-price agreement as the engagement progresses. While initially unsettling, the axiom of profit as a reward for risk is true. In three years, the firm has experienced a 350% growth in revenue and a 500% growth in profitability, while the professional team (FTEs) has grown from five to 14.

More importantly, the quality of the service provided and the overall client satisfaction have seen marked improvement. Employee retention has been outstanding and the recruiting efforts of the firm extremely successful in attracting high-quality talent from top-tier firms as a direct result of not being tied to the time sheet. This has furthered the opportunity to implement a positive work/life balance for everyone by almost eliminating overtime while offering a superior compensation package.

Micromanagement of knowledge workers is the culture of most firms. Tracking time in six-minute increments, measuring productivity, measuring efficiency, and measuring relative worth all are driven by time sheets. The management attitude that anything that is not billable is not worthwhile has destroyed the intellectual pursuit of knowledge and self-improvement that is critical to the long-term success of every professional knowledge firm.

Snyder & Co. of Lancaster, Ohio, with $1.3 million in 2008 revenue and 13.5 FTE employees, trashed its time sheets as of Jan. 1, 2008, part of a three-and-a-half year transformative journey. Partner Victor E. Christopher explains the firm's shift to becoming a Firm of the Future:

> Our journey began in 2003. We created a development committee to begin formulating the "nuts and bolts" of how we would begin making the conversion. The committee consisted of individuals from throughout the firm, eventually including administrative personnel, as the change to value pricing certainly impacted many of our internal administrative processes. We established our initial pricing committee, which we envisioned as the group having overall authority to approve prices. We also wanted the pricing committee to be fluid, wherein we would periodically rotate team members through the committee. The idea was that in doing so it would make us better at pricing across the organization.

PHOTO BY ENVIOUS PHOTOGRAPHY

The Harrex Group team, from left: Ceara Irwin; Rhonda Reid; Jessica Stephen; Leigh Tweedle; Nicki Morsink, CEO; Nikki Kemp; Justine Kelly; Tony Cole; Raewyn Whyte; Emma Hammond; Marian Styles; Andrea Robins; Jill King; Brendon Harrex, director; Heather Mouat; Kylie Davidson; Helen Burgess; Maree Abernethy; Rose Johnston; Sonia Liddell.

Our fixed-price agreements (FPAs) are designed to detail the services to be provided, the price and the payment terms. Each FPA includes "unlimited access" to us, where if a client has a question, they pick up the phone and call or send an e-mail without worrying about a clock running.

As a way to minimize our risks during the transition, we decided to implement value pricing by way of a phased-in approach. In late 2004, we began upfront pricing for new clients. For the new clients who were coming to us with an existing CPA relationship, our upfront pricing philosophy with unlimited access was an easy sale. Many of those businesses complained about receiving a bill for a 10-minute phone call. The idea of getting an upfront price and knowing that we would be there for any questions they would have during the course of the year was a jaw-dropping experience for some of them.

Our goal was to have every client on a fixed-price agreement by 2007, which we ultimately achieved. After completing our first busy season without time sheets, it has never been clearer to us that pricing needs to be based on value and not hours. It is my belief that the negative aspects of time tracking have played a major role in driving highly qualified individuals out of our profession, not to mention discouraging young, intelligent individuals from entering the profession. If price and staff worthiness are based on hourly billing, it is inevitable that the trend will continue. At Snyder & Co., we are committed to making a difference in the lives of our professionals, our clients, our community and our profession.

Harrex Group is in Invercargill and Gore, New Zealand. The firm was founded in October 2007 by Brendon Harrex—the world's first chief value officer at his prior firm. He launched his firm, embracing the new business model in its entirety. In its first fiscal year, ending March 31, 2009, Harrex Group is projected to gross $2.2 million with 21 FTEs. It also has a waiting list of eager talent. Harrex and CEO Nicki Morsink convey the firm's philosophy:

> Creating a culture of collaboration and becoming more effective means caring for your employees enough to know their strengths and release them to work in those areas. There is overwhelming research that indicates people are more passionate, motivated, and enjoy higher job satisfaction when they work in their areas of strength.
>
> Getting your organizational structure right is critical in order to get the right work to the right people and, therefore, best serve your clients. However, you still have to run the business. A focus on time and cost only creates the illusion of managing a professional knowledge firm. It accounts for the hard costs of input and output but does not measure what we consider to be the lifeblood of any business—value creation.
>
> The Harrex Group's key predictive indicators (KPIs), which essentially replace the time sheet, are:

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The Kennedy and Coe LLC team, top from left: Bob Schuster, CPA; Shannon Buchanan, CPA; Chuck Marshall, manager; Kevin Mills, CPA; Jesse Hough, CPA. Bottom from left: Jeff Wald, CPA; Brian Wurst, CPA; Dixie Larson, principal; Donna Funk, CPA; CEO Kurt Siemers, CPA.

- Ability to think strategically on behalf of clients
- Client Communication
- Delegation
- Turnaround Time
- Client Feedback
- Effective Listening and Communication Skills
- Knowledge Elicitation/Coaching
- Risk Taking, Innovation and Creativity
- Continuous Learning
- Passion, Attitude and Commitment
- Team Player

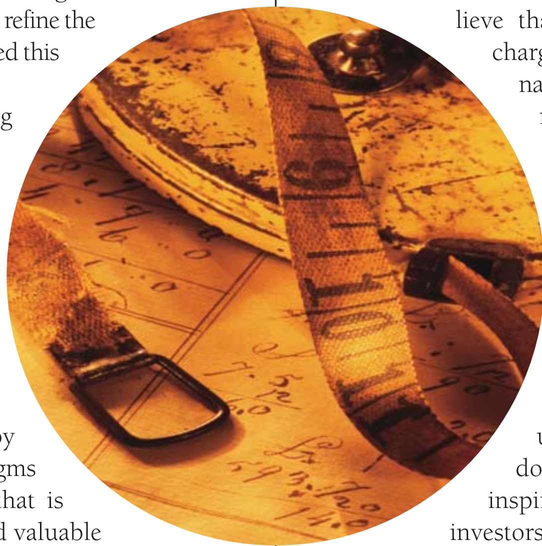
We acknowledge that many of these KPIs are, indeed, subjective, but we are managing people, and people are subjective! It is our belief that the ultimate flaw in the time and cost model is ignoring this fact. In a knowledge firm, a *judgment* is more important than a *measurement* in evaluating professionals. We would rather be approximately right than precisely wrong.

In conclusion, being a Firm of the Future, providing top-quality service for your clients, and building great careers for your team are certainly not easy goals. You have to be focused, dedicated, willing to face great change, innovate, and constantly challenge the status quo of complacency and comfort. The results, however, are nothing short of stunning.

Kennedy and Coe LLC is the first Top 100 firm (No. 86 as of 2007) in the United States to embark on the voyage to becoming a Firm of the Future. CEO Kurt Siemers makes clear why he believes this transition is essential:

> Kennedy and Coe LLC is in the midst of a significant transition in how we think about our firm, our people, our clients and the professional services we provide. At the core of this transition is a different, and we believe better, way of approaching value—how we create it for our clients and how we are compensated for its creation in a manner that leaves everyone better off.
>
> Through the years, we have delivered many valuable services to our clients. Often, however, the payment we received had very little relationship to the value we provided the client, primarily because we were limited to an hourly rate for billing clients. Even "premium" hourly rates and "value adjustments" often did not approach the value the client received.
>
> Our current transition is a deliberate attempt to supersede the "hourly rate" paradigm with one that measures value in the way our clients individually value our services. Historically, the approach has been that people need to work more and/or become more efficient in order for a firm to be more profitable. Since efficiency is a zero-sum game over time, we have been left with working more hours to earn more. This mode of thinking found itself on a collision course with our firm's commitment to the well-being of our people.
>
> In 2007, we went through a process that resulted in the decision to transition completely away from billing clients based on the hours involved in a service to what we call Value Creation—a process to determine the services our clients need and want and how they might measure the worth of those services. That sense of worth may be "real" in financial terms, or perhaps only "perceived," but determining the reality of their sense of value is imperative to the process. Only then do we establish pricing based on client value. The scope and parameters of service are written into a Value Creation Agreement, which is signed by the client and someone in the firm *before* services begin.
>
> The following represents a summary of some of the major steps we have taken:
>
> 1. Provided education and created an understanding with our staff of the old and new paradigms and why we are making the change.
> 2. Formed a Value Creation Panel with a chief valuation officer to lead the transition and create processes to guide a successful transition.

3. Set a minimum fee level for each client and agreed to terminate about 40% of our clients (about 10% of our fees) in the first year that do not fit our "Best Client" profile and set up specific plans on how to accomplish this.
4. Started using the Value Creation Agreement process with selected clients to refine the process and have now expanded this process to all client groups.
5. Set a transition goal of having all clients converted to Value Creation Agreements by summer of 2009.
6. Set a goal of eliminating time sheets by June 30, 2009, severing the final link in the traditional "time and billing" model.



One of our firm's core values is to practice creative destruction by destroying some traditional paradigms and creating a business model that is focused on providing relevant and valuable services to our business clients and attracting devoted staff with the passion to provide those services. We acknowledge that the road ahead has many unknown curves, but we firmly believe in the decision and feel confident in our ability to respond to the challenges and keep moving forward. Thus far, it has been an exciting and challenging journey!

A Paradigm Worthy of a Proud Profession

Embracing the new model requires leadership and vision: an attitude of experimentation; less measurement and fear, and more trust; and the self-respect and dignity to believe that you are worth every penny you charge. By focusing the firm on the external value it creates for the client and committing to work only with clients with integrity, whom you enjoy and respect, you are building the type of firm people are proud to be a part of and contribute to—the sort of organization you'd want your son or daughter to work for.

The first wave of firms that understand the difference between knowledge workers and service/manual workers will have an enormous window of opportunity to attract, develop, inspire and profit from their human capital investors. The firms that don't will continue to struggle in the competition for talent. It is the difference between remaining a Firm of the Past or emerging as a Firm of the Future. The choice is yours. ❖

Additional insights from employees and clients of the firms profiled are available with the online version of this article at **www.journalofaccountancy.com**.

AICPA RESOURCES

Private Companies Practice Section

The Private Companies Practice Section (PCPS) Firm Practice Center has related archived Web forums, articles and publications. Visit the Fee Pressure/Pricing page of the PCPS Firm Practice Center at **http://pcps.aicpa.org/Resources/Fee+Pressure+Pricing**.

OTHER RESOURCES

Books

- *The Future of Management*, by Gary Hamel with Bill Breen, Harvard Business School Press, 2007
- *The Myth of Market Share: Why Market Share Is the Fool's Gold of Business*, by Richard Miniter, Crown Business, 2002
- *Peter Drucker: Shaping the Managerial Mind*, by John E. Flaherty, Jossey-Bass, 1999
- *Profit Beyond Measure: Extraordinary Results through Attention to Work and People*, by H. Thomas Johnson and Anders Bröms, Free Press, 2000
- *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making*, Second Edition, by Thomas T. Nagle and Reed K. Holden, Prentice-Hall, 1994
- *Where Is the Wealth of Nations?: Measuring Capital for the 21st Century*, The World Bank, Washington, D.C., 2006, at **http://siteresources.worldbank.org/INTEEI/214578-1110886258964/20748034/All.pdf**
- *Abolishing Performance Appraisals: Why They Backfire and What to Do Instead*, by Tom Coens and Mary Jenkins, Berrett-Koehler Publishers Inc., 2000
- *The Firm of the Future: A Guide for Accountants, Lawyers, and Other Professional Services*, by Ronald J. Baker and Paul Dunn, John Wiley & Sons Inc., 2003
- *Pricing on Purpose: Creating and Capturing Value*, by Ronald J. Baker, John Wiley & Sons Inc., 2006
- *Measure What Matters to Customers: Using Key Predictive Indicators*, by Ronald J. Baker, John Wiley & Sons Inc., 2006
- *Mind Over Matter: Why Intellectual Capital Is the Chief Source of Wealth*, by Ronald J. Baker, John Wiley & Sons Inc., 2007

Web site

Visit **www.verasage.com** to download free PDF copies of the following:

- *Burying the Billable Hour*, by Ronald J. Baker, The Association of Chartered Certified Accountants, 2001
- *Trashing the Timesheet*, by Ronald J. Baker, The Association of Chartered Certified Accountants, 2003
- *You are your Customer List*, by Ronald J. Baker, The Association of Chartered Certified Accountants, 2004

Blog

Visit the "Trailblazers" section at **www.verasage.com** for more case studies of firms that have made the transition to a Firm of the Future. A host of free resources can be found throughout the site.