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Have profit margins, as measured by equity partner profits as a percent of revenue, been declining at firms over the last 10 years or so?

Albert Einstein said "If I had an hour to solve a problem and my life depended on the solution, I would spend the first 55 minutes determining the proper question to ask… for once I know the proper question, I could solve the problem in less than five minutes."

The proper question is: Are CPA firms more or less profitable than they were 10 years ago? The problem with the original question is that its author was unaware that "equity partner profits as a % of revenue" can be a weak and sometimes misleading measure of profitability.

Remarkably, CPAs, the gatekeepers of financial measurement and analysis, do not have a proper measure of firm profitability. Two measures are commonly used: Income per equity partner (IPP) and equity partner income as a percentage of revenue. Both are flawed because they are directly impacted by the number of partners in the firm. The more partners a firm has for its revenue size, the more misleading its profitability ratios will be. Conversely, the fewer the partners, the higher the IPP.

CPA firm partners often use both profitability metrics. But profits as a % of revenue is less reliable than IPP, as the following data from The Rosenberg Survey shows:

$2-10M firms:
- IPP=$345,000
- Profit as % of revenue = 33.1%
- Prostaff to partner ratio = 4.4

Over $20M firms:

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high a firm sets the bar for making partner. At a firm with fewer partners and more staff, employees are doing more of the partner's work, as they should. This increases payroll costs and thus, decreases partner profits as a percent of revenue. But this is more than offset by better partner leveraging, so the firm can operate with fewer partners splitting the compensation pie. As result, IPP, the only profit metric that matters, increases. It's all in the math.

In recent years, though the IPP of larger firms has been increasing, the rate of income growth has been slowing. This has occurred due to:

Partners from mergers. With the frenetic pace of mergers, surviving firms are bringing in partners of the firms they merged in. Since the smaller firm in a merger usually has lower profitability than the larger survivor, this dilutes the larger firm's IPP.

New partner promotions. With the feverish pace of succession planning going on, firms are promoting new partners like crazy. Since firms often keep the near-retirement partners on board for the first few years of the new partners' tenure, this swells the partner ranks and again, pushes IPP down.

Somewhat offsetting the impact of new partner promotions has been a meaningful rise in firms' use of the non-equity partner position. In 2013, 49% of firms over $2M had non-equity partners. The first year we measured non-equity partner headcount, 2008, this figure was 42%. It's reasonable to assume that 10 years ago, 2004, less than 40% of firms had non-equity partners. This means that 10 years ago, the equity partner ranks at many firms have been inflated by partners who, 10 years later, would have been non-equity partners.

Now that you have been properly educated in the nuances of measuring CPA firm profitability, you are ready for the answer to the question: Have CPA firm profits increased or decreased over the past 10 years? Here are the facts based upon the last 10

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So, readers who have read anything or talked to anybody about CPA firm profits appearing to decline over the past 10 years, you can now set them straight. CPA firm profits have *increased* over the past 10 years. As a fellow CPA firm consultant recently told me: "Once again, the facts prevail. Analysis trumps anecdote!"

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Marc Rosenberg is a nationally known consultant, author and speaker on CPA firm management, strategy and partner issues. President of his own Chicago-based consulting firm, The Rosenberg Associates, he is founder of the most authoritative annual survey of mid-sized CPA firm performance statistics in the country, The Rosenberg Survey. He has consulted with hundreds of firms throughout his 20+ year consulting career. He shares his expertise regularly on The Marc Rosenberg Blog.

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