Thought Leadership and Best Practices: Partner Compensation

By Allan D. Koltin

The topic covered in this column is based on presentations given by Allan D. Koltin at The Advisory Board Partner Compensation Symposiums in New York September 20–21, 2010, and Las Vegas September 27–28, 2010. For additional information on the conference, go to www.partnercompensation.com.

Q: ***You had approximately 150 of the Top 500 CPA firms at your recently completed Partner Compensation Symposiums. How do firms seem to be doing?***

A: Surprisingly, firms seem to be doing rather well when we consider that most of them are navigating what we refer to as the "new normal. "Outside of merger growth, the majority of firms are budgeting anywhere from 0% to 5% organic growth and will remain cautious throughout 2010 and probably into 2011. Having said that, a majority of the firms are projecting a slight increase in average partner compensation for 2010 vs. 2009 and appear to have done a great job of cutting costs and expenses, as well as reducing headcounts.

The interesting part, as it relates to headcounts, is that, unlike the first cuts on payroll one to two years ago (which were mainly at the lower staff levels), the current cuts are much more strategic and higher-level, primarily at the senior manager, principal and partner levels.

Q: ***Was there one big takeaway from the conference, as it relates to partner compensation?***

A: There were actually three big takeaways. The biggest takeaway for the participants was that there is a direct correlation between firms' happiness with their current partner compensation programs and their degree of trust in firm leadership (and/or in those who are part of the compensation committee). Candidly, it almost makes the actual system secondary because, at the end of the day, as long as partners know they will be treated fairly and rewarded accordingly for their performance, they seem to be OK with whatever system is in place. Second, it was apparent that more firms than ever before are connecting their partner compensation plans to their overall strategic plan and holding partners accountable for "doing their part" as it relates to the strategic plan. Lastly, it was interesting to see how firms' partner compensation plans evolved and changed as the size of the firm increased. Safe to say, the majority of firms bought into the concept that the only constant in partner compensation is that of change.

Q: ***What metric do a majority of the firms use to measure performance, as it relates to partner compensation?***

A: There is no clear answer to your question. Some firms report average partner compensation including all partners (income and equity), while other firms report average partner compensation based only on equity partners.

We need to be careful not to look at average partner compensation for any one year, but to look at the trend over a three to five year period.

Also, I shared with the conference participants my definition of average partner compensation, which is, "What are you earning at the firm vs. what you think you are worth?" All too often, partners get hung up on relative income (especially when the firm has an open partner compensation system, in which everyone knows what everyone else makes). Instead, they should be focusing on what their worth is "on the street" and how well they are doing in terms of earning what they are potentially worth. The average statistics of others isn't nearly as important.

Q: ***What part, if any, does culture play in the success of high achieving firms when it comes to partner compensation?***

A: In our study of the Top 200 firms, we dissected the highest one-third of firms when it comes to compensation and found, for the most part, that they performed in a highly "accountable" environment. Not surprisingly, when we looked at the bottom one-third of firms that reported partner compensation, we found that their cultures were, for the most part, highly autonomous and partners essentially "did their own thing." I could clearly see a delineation between the highly accountable firms that put great value on individual partner goal-setting and tied it to performance and those that were in highly autonomous environments and basically did a "look back" at the end of the year to see how well they did.

Q: In your survey, you asked firms what percentage of their partner compensation dollars were guaranteed (salary) vs. at risk (bonus). What takeaways, if any, did you observe?

A: We found that, in the highest performing firms, somewhere between 30% and 50% of their total compensation was discretionary and was usually part of a year end bonus pool that rewarded partners based on their actual performance. We found that some firms were trapped, in the sense that they were already paying high draws to their partners and/or had a significant part of the compensation tied up in ownership and, thus, had very few discretionary dollars available to truly reward exceptional partner performance. My guess is that you will see more firms pecking away at the draws or percentage of profits they reward for ownership as they continue to move more to a performance-based system.

Q: A controversial question always is whether the partner compensation system is open or closed. How did a majority of the firms respond?

A: The vast majority of firms in our survey reported that they have a closed or quasi-closed system of partner compensation. In a closed system, partners still know the average partner compensation and might even know the highest and lowest. In a quasi-closed system, they have all of that information, as well as possibly a greater breakdown such as an average within four different quadrants of partner compensation levels. Also, in a quasi-closed system, for the one or two partners that had a need to know what everyone else made, the managing partner might make an accommodation and meet with them privately to "verbally" share selected information. Interestingly, when we asked the firms that offered this option if the partners took advantage of it, they said one or two partners may have asked once to see the information, but never requested it again.

Q: What was the most surprising takeaway in your survey of firms when it came to the issue of partners' capital?

A: If I were to plot on a graph the answers to how partners capitalize their firms, it would look like an erratic heartbeat! The issue involves the philosophy of how the firm is financed. Clearly, there is a group of firms that saw what happened to Arthur Andersen and doesn't want to have any of their capital in the firm. These firms rely heavily on bank debt to fund their growth and operations. There is another group of firms with a completely opposite philosophy. This group relies heavily on partners' invested capital to fund the growth and operations, pegging that percentage somewhere between 60% and 95% of a partner's compensation. A third group pegged capital as a percentage of the firm's total revenue and, in those instances, it was somewhere around 30%. The majority of the firms did report paying a meaningful interest factor on the accrual-based capital that the partners invested.

Q: In your survey of the Top 200 firms, what portion of their overall compensation is strictly formula based?

A: In our survey, we found that over 80% of the firms no longer peg compensation to an exact formula. Having said that, this was one of those issues in which the firm size greatly impacted the answer. In firms of $10 million in fees and under, it was almost a 50/50 proposition whether compensation was formula based or subjective. In firms of $10 million to $20 million, we could see the pendulum moving from a formula-based to more of a subjective approach. The vast majority of firms of $20 million or more had eliminated any type of formula and had moved to a program driven primarily by individual partner goals. I think it is safe to say that as firms get larger they find there are many things partners need to do as leaders and many of these items simply aren't as easy to measure as billable hours or book of business. This is where the subjective determination of compensation steps in.

Having said that, we had a $25 million firm and a $65 million firm at the conference that both still dealt with partner compensation on a strict formula basis, and they were two of our highest earning firms. One of the firms charges the partner back directly for any WIP or AR that goes over 60 days and/or ultimately gets written off. Talk about a high level of accountability and not having any cash flow issues along the way!

Q: Did you discuss the area of deferred compensation benefits/goodwill for retiring partners and, if so, was there a common way of valuing it?

A: The vast majority of firms (over 95%) reward partners with some type of deferred compensation program. Of those, most have a program that essentially is a multiple (two to three times) of some average of their prior best years of earnings. It is typically paid out over 10 years as ordinary income and, for the most part, with no interest. Some firms, however, continue to use the old "AAV" model, in which the firm is valued annually and a partner's deferred compensation is based on their ownership percentage multiplied by the value of the firm. While this group is a minority, there still are firms that use this valuation-based deferred compensation method. A very small percentage of firms (less than 5%) does not believe in any type of deferred compensation benefits for their partners and doesn't pay anything other than a return of capital to retiring partners. In my opinion, this group is being overly cautious (about bankrupting the firm) and should pay retiring partners some value for the business they helped

create. Lastly, the majority of the firms had vesting schedules, as well as cap limits (either as a function of net fees or firm profits) and a handful of firms reported that they were able to provide retiring partners with capital gains treatment on their deferred compensation benefits.

Q: What primary differences did your survey point out in how income partners were treated vs. equity partners?

A: Tough question. Maybe a good way to answer it is to discuss what an income partner gets as part of the package. For the most part, they have a guaranteed salary and the possibility of a small bonus. With occasional exceptions, their compensation would be less than that of an equity partner. Most income partners typically had smaller books of business and were either developing their books or served more as a support partner to some of the equity partners. Also, the majority did not make a capital contribution or receive any type of retirement benefits. Nevertheless, the survey showed a definite uptick in terms of the number of firms that now have both income and equity partners.

With more women advancing to the partner ranks, both genders looking for a better life/work balance, firms continuing to bring in more lateral partners, and increasing mergers, we will continue to see an increase in income partners within CPA firms over the next decade.

Q: How were underperformers penalized when it came to partner compensation?

A: The first level of adjustment seemed to be a compensation decrease of 10%, 20% or 30%. The second level of adjustment might be moving an equity partner to an income partner. The final path of adjustment was to counsel the partner out of the firm. Interestingly, about half the firms reported having an actual percentage cap on how much a partner's compensation could drop in any given year, whereas the other half of firms reported that there was no limit on what a partner's compensation could be reduced to.

Q: How important did firms say that individual goal-setting was, and who actually sets the goals (leadership or the individual partner)?

A: All firms responded that individual partner goal-setting was critical to the compensation process, but firms continue to struggle with getting their partners to develop truly meaningful goals and then also with tying the accomplishment of those goals to compensation. It does seem that more firms have found a way to incorporate individual goal-setting into their compensation process and are looking at it more than ever in terms of determining a partner's compensation. I found it interesting that, when we asked the firm who really sets the goals, the common answer seemed to be that they were typically set by the individual partner but not before quite a bit of prodding and negotiating on the part of the department head or managing partner had occurred!

Q: What did firms say was the biggest change or issue to their partner compensation program over the past one to two years?

A: Unfortunately, this was an easy one. For many firms the pie leveled off or contracted a bit and we found firms truly attempting to protect their "superstars," whether they were managers, principals or partners. What this typically meant was some significant reductions in compensation for average to below-average performers and, in some cases, counseling some of these individuals out of the firm. The only other item of interest was the issue of the range between the highest and lowest paid partner. Some firms have a ratio of 10:1 while others have a 2:1 ratio. Clearly, the issue of partner comp is still open to debate.

Allan D. Koltin, CPA, *is CEO of PDI Global, Inc., a Chicago-based management and marketing consulting firm for professional services firms, and a member of The Advisory Board, a coalition of leading accounting firm consultants. Contact: akoltin@pdiglobal.com*

Editor's note: *If you have any questions about this article or any other issues facing your firm, please feel free to contact Allan D. Koltin, CPA, CEO of PDI Global, Inc. and a founding member of The Advisory Board, at AKoltin@pdiglobal.com or 312-245-1930, or Marsha Leest at Marsha.Leest@WoltersKluwer.com. We welcome your input and ideas and we hope you will continue to look to* CPA Practice Management Forum *for guidance and best practices.*

TURNING POTENTIAL INTO PROFIT

800 227 0498 www.pdiglobal.com