Current Trends and Opportunities Regarding Partner Compensation

By Allan D. Koltin

(The topic covered in this column is based on a presentation given by Allan D. Koltin at The Advisory Board Partner Compensation Symposium in Chicago on September 24, 2009. If you would like to see video coverage of this presentation, go to www.youtube.com and type in "AllanKoltin.")

Q: *What changes have gone on with trends in partner compensation over the past two years?*

A: The pendulum has swung faster over the past two years than in any two years I can recall in the past two decades. We went from lack of talent being the number-one problem in 2007 to laying off over 50,000 accountants nationally in 2009. And that wasn't the only change. We also found that the growth engine came to a screeching halt. Many firms were able to maintain profitability by significantly reducing expenses and reducing payroll, but, as we all know, that is a short fix when running a business. Hopefully, most firms will be within 5% to 10% of 2008 earnings in 2009. That being said, we are seeing the entrance of low-cost providers (lowballers) into the marketplace and, as the old saying goes, it only takes one firm to screw up the equilibrium of any market! I'm glad we feel the recession is coming to an end, or at least leveling off. I am concerned long-term, however, that our profession may be getting back into the "commodity" mindset, and that could hurt profitability (and, hence, partner compensation) for the next couple of years.

Q: *In your presentation you offered a new definition for growth and talked about the role that leaders should be playing. Can you elaborate on that?*

A: Traditionally, most CPA firms grew organically, whether that was through obtaining new clients, cross-selling existing services to existing clients or developing new products, services and niches to bring to the market. The past decade has shown us that mergers and acquisitions are another viable way to grow a firm, and the success of this method can be measured in terms of higher levels of profit per partner — not just for the partners whose firms were acquired, but also for the partners of the acquiring firms. That being said, there are good mergers and not-so-good mergers. I've found there is a direct correlation between successful mergers and well-run firms, which typically determine up front if a merger makes sense for their firm. The third new area of growth, which has taken place especially in the last six years, has been the advent of "free agency." Over the last six years there has probably been more lateral movement of national firm partners, principals and senior managers to local and regional firms than I have witnessed in the last 30 years. Clearly, the demise of Andersen, the creation of Sarbanes-Oxley and the transference of a significant portion of public-company audits to non–Big 4 accounting firms had a lot to do with this. But it's fascinating to see how well these free agents have done in local, regional or middle-market national firms. In many cases, they have reached the top of the food chain within these firms. Not surprisingly, many local and regional firms today boast profits per partner equal to or greater than that of Big 4 accounting firm partners. If you reflect over the past 10 years, it is interesting to note that in 1999 the 100th largest CPA firm in the U.S. had $6.5 million in fees. Today, the country's 100th largest CPA firm is at $30.5 million. For all of these reasons, firms have achieved an incredible amount of growth.

Q: *So what does "highly profitable" mean now in terms of CPA firm average partner compensation?*

A: Again, as recently as 10 years ago, a CPA firm that had average partner income of $200,000 typically scored in the upper quartile when comparing themselves with other similarly-sized firms. Now, we see more and more firms with average partner incomes between $400,000 and $600,000 or higher. It used to be rare to find a partner earning in excess of $1 million. Today, within the Top 200 firms, we are seeing many partners with seven-figure incomes and even noting some who are earning in excess of $2 million or $3 million. While I wouldn't call this the haves vs. the have-nots, I believe there is a direct correlation between level of income and firms that have great leadership, balanced talent, and a lot of "gas in the tank." These firms are essentially on the same page and seem to be hitting the ball out of the park in ways most of us thought weren't possible.

Q: You suggested that partner compensation is a journey and not a destination. Is this to say that we are always looking to make more or something other than that?

A: What I meant in calling it a journey is that partners need to understand that behavior is driven by compensation, and behavior, just like strategic plans, needs to change with the times. The best compensation plans are not only performance based, but are also tied into the firm's overall strategic vision. All too often, firms forget to ask what each partner will need to do to help the firm achieve the goals of the strategic plan. Great performance-based compensation plans begin with a unified firm strategy/vision, tie partner goals to the success of the plan and, equally important, build in a level of governance, accountability and monitoring throughout the year so that there are no surprises at year end.

Q: In the last couple of years what are some of the tougher obstacles you've seen in consulting with firms on partner compensation?

A: The biggest one is when a firm has a formulaic process for determining partner compensation. Whether you call it "you eat what you kill" or something else, there is a breaking point. The easiest example is a firm in which 99% of the compensation is driven by individual partners' books of business, billable hours and new business originations. Safe to say, this firm will struggle with transferring clients to the best person suited to handle that client and probably will not invest a lot of time in the retention and development of future leaders. To get partners to do what's best for the firm and best for the long term, there needs to be a different type of partner compensation structure. I find that the "moment of truth" for firms trying to go to a more subjective determination of compensation is whether they trust the firm's leadership. Where there is trust, the move is somewhat painless; but in firms where there is not a lot of trust in anyone (or any group) as it relates to the allocation of compensation, the partners will want to hold on to a formulaic system.

The other big obstacle in partner compensation is the alignment of individual partner goals. On January 1, some firms simply tell the partners to go out and "do their thing" and circle back on December 31 so they can divide up the profits. Better firms create a contract between firm leadership and individual partners, based on a combination of the individual partner's strengths and those strengths being consistent with the overall strategic goals of the firm. In a perfect system there are also quarterly meetings between the individual partners and department heads (or firm leadership) so that individuals get feedback on how well they're doing, as well as coaching and mentoring along the way.

Q: What fundamental issues, besides lack of goal setting, plague CPA firm partner compensation programs?

A: The most obvious one is when too much of the pie is allocated up front at the beginning of the year as salary/draw, leaving very little (if any) money available at year end to reward individual partners for the achievement of their goals. In most healthy partner compensation programs, somewhere between 30% and 50% of the total pie is held back and is allocated at year end, based on how well the individual partners achieved their goals, as well as how the firm did overall.

The next issue is whether the firm has an open- or closed-compensation system. Although this is probably more of a problem in firms of $8 million or more, I find that for every 20 firms I talk to that went from open to closed compensation, at least 19 of them will tell me it was one of the best moves they ever made.

Another problem is the whole issue of relative partner income. Quite candidly, it is only human nature that we want to compare what we received against what other partners received. I've seen firms almost break up over where one partner got $2,000 to $5,000 more than another. Firms with closed compensation generally find that individual partners focus more on their own individual compensation than that of their partners. Partners who want to make more can meet with firm leadership to determine what they need to do to get to the next level. I think it would be darn near impossible for someone to argue that closed compensation isn't a better way to manage the compensation process — as long as the partner group can rally around a leader or leadership team they trust to fairly allocate the dollars.

Another issue I see fairly often is the whole area of nonproductive partners. If you think about it, a CPA firm is a relatively simple business. Partners should either lead (impact other people's performance), create (bring in new business), manage (a book of business) or build (recruit, retain and develop talent). This is not to say that billable time, sitting on committees and doing administrative things aren't valuable, but they surely don't have the same value as the other items. For me, firms that are in sync have gone through the painstaking exercise of talking about "highest and best use of time." They know the difference between high- and low-impact initiatives and compensate accordingly.

Q: What do you think the proper ratio should be between the highest- and lowest-paid partners within a CPA firm?

A: This is one of those answers that will probably increase my popularity with some firms and cause me to never be hired by others! If you look at the Top 500 CPA firms (those firms with annual billings of $10 million or more in fees) you will probably see an average ratio of 4:1 between the highest and lowest paid. Having said that, I see firms where the ratio is 2:1 and I also see firms where the ratio is 10:1. The ratio is distorted because some firms differentiate between equity and income partners, while others treat all partners as one group. To paraphrase Thomas Jefferson, who probably said it best, "There is nothing more unequal than the equal treatment of unequal partners." I would suggest that if a firm has eight partners, they have eight unique levels of performance and that if they have 800 partners, they have 800 unique levels of performance. I also believe that the ratio typically is higher in first-generation firms because founding partners usually feel their sweat equity entitles them to a higher rate of return than partners in second- or third-generation firms. I was at a firm a couple of months ago where the ratio was 10:1 (the highest earning partner was $2 million and the lowest was $200,000), and both were extremely happy with what they were earning. The situation was very different at another firm I was at, where the ratio was 2:1 and the lowest earning partner questioned why all partners weren't earning the same amount

One more thing to keep in mind: it's important to remember that things aren't always what they seem. The best example would be an older partner who comes under attack for having little billable time and a small book of business. All too often, we find that this person has been instrumental in creating and transferring three or four books of business to other partners because they have done the right thing for the firm by growing and developing other partners.

Q: ***You talked about some of the old school vs. new school approaches to partner compensation and the importance of focusing on talent. Could you shed some light on that?***

A: When I think of old school compensation, I typically think of a formulaic approach to looking at a partner's book of business, new business origination and individual billable hours. A new school approach would ask the following questions:

- Whom did you personally recruit to the firm last year?
- On the upward evaluation, how many of our people identified you as the main reason they are with the firm?
- How many current and future partners would identify you as their sponsor and key contributor to their success?

If you think about it, a CPA firm is not about accounting, audit and tax. Rather, it's a special formula for being able to recruit, retain and develop stars over a long period of time (doing quality work is a given), much like corporations. More and more firms are realizing the value in approaching partner compensation using the new school model.

Q: ***Do any generational issues (young vs. old partners) affect partner compensation?***

A: This is an excellent question, and one worth addressing. Often, I will see young partners upset about the level of compensation being paid to older (and primarily unproductive) partners. They talk about the "three times payment," whereby they say they had to come up with significant capital for an expensive buy-in, then they watched older partners cruising and earning a lot of compensation, and finally they paid these partners an inflated retirement. We have to accept that things like goodwill and deferred compensation can't be permanent fixtures in any CPA firm. Firms have to be reflective of the times and, more importantly, the continued success of the firm. I've had partners tell me that they don't want to change their deferred compensation program; they had to overpay the generation before them, and they'll be damned if they're not going to see those same benefits. If they don't change their attitude, I tell them, they run the risk of getting no benefits!

In terms of the older partners, we're seeing older partners wanting to work past age 65. I'm finding that we are not so much rethinking mandatory retirement as finding ways for talented partners to take on roles within the firm beyond age 65, providing they de-equitize and don't sit in a leadership or decision-making role. I am seeing many, many talented partners between the ages of 65 and 80 who have a lot to offer, provided they are willing to transition their books and relationships to their younger partners.

Q: ***You had two outstanding quotes to open and close your presentation. Would you share those with our readers?***

A: I opened by saying that, after a grueling nationwide survey, I had found the perfect compensation system: sole practitioner. In that world, if you're not happy with your compensation, go look in the mirror.

The other quote came from Daryl Ritchie, CEO of Meyers Norris Penny. While addressing his partners at an annual retreat, talking about some of the critical investments and strategies that the firm was planning to implement, Ritchie said, "Average partner compensation will increase [due to these initiatives] but, for the average partner, it will probably stay the same." The essence of his comment was that if you want to cruise and not help the firm achieve its strategic initiatives, don't expect the big dollars to come your way when the pie is allocated at year end.

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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@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.*

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