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# Mind the Profit Gap

## Partners are often the problem when it comes to building a strong partner comp system

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Accounting firm partners can no longer ignore a looming threat to their income, and not just because they look it in the eye at every partner meeting. The biggest obstacle to fair partner compensation is other partners -- specifically those thriving under a traditional equity-based compensation model, which could very well include themselves.

Underperforming partners can literally afford to be complacent when compensation is doled out based on individual stake, while high performers aren't incentivized, and are often completely discouraged from achieving their potential. "Whether their performance is poor, average or superior, it's not going to make a difference," said August Aquila, chief executive officer of Minnesota-based Aquila Global Advisors, who specializes in compensation and partnership issues. "It's not healthy in today's environment."

More firms are being forced to diagnose the vacuum between steadily rising compensation and the fluctuating firm profits those fixed numbers engender.

"It comes down to that old adage of when partners are left to their own devices, they pretty much do whatever they want," explained Allan Koltin, CEO of Chicago-based professional and financial services firm consultancy Koltin Consulting Group. "It is one of the major profit improvement gaps that exist in CPA firms today. The pattern comes back to shared goals - we tell them what their goals should be. But there's invariably a big gap between what [partners] want to do, and what they should be doing. A $100,000 profit gap, and with eight partners, that's an $800,000 profit gap."

### SELF-RECOGNITION

The logical move, then, is to switch over to a more performance-based model, a light bulb moment that Koltin witnesses when he advises partners to participate in an exercise during retreats. He asks each partner to leave the room and write down their goals for the upcoming year, while the others discuss that partner's strengths and what he or she should and should not be doing.

"Accountants are much like the state of Missouri, the 'Show-Me State,'" Koltin said. "With that exercise of one out of the room at a time to talk about you, it was so easy for them to see the profit that other partners are leaving on the table. When they see it from that perspective, instead of a focus on them where they will get defensive, they come to a realization, or I hope it happens, of, 'Look how much money we're leaving, a part of the profit gap.'"

Those tabled profits can't be immediately reaped post-revelation, of course, as many firms move into a system of anywhere from 25 to 50 percent of partner compensation tied to performance, with Aquila recommending a gradual reduction of base pay at about 5 percent annually to ease into this hybrid model.

## ONE FOR ALL

"There's no silver bullet in partner compensation," Koltin shared. "As with any major change to a system, it takes somewhere from two to three years to have full effectiveness ... and culturally, how do you move the firm forward and what is the starting point? You have to make a decision - do you want to be a country club or a country?"

In a country club model, Koltin elaborated, the managing partner comes to the partner group with new best practices to implement, and eventually most partners will raise their hands and give excuses why those guidelines should not apply to them.

On the flip side, in "the highest performing firms of all sizes, there is a high level of accountability, a country approach as opposed to a country club, where the leadership sets the tone, guidelines and policies," Koltin continued. "Certain partners are not going to love the recommended changes. But overall, changes make the firm more successful."

This "one firm" approach does not mean sacrificing individual profit, as many partners imagine, Aquila said, but instead a true Musketeers-style source of positive progress for all. "The trend now is saying Partner A or B has some special skills, and what you want to do to improve those skills that bring value to the firm, rather than correcting weaknesses," he elaborated. "Focusing on strengths, not weaknesses ... . Partners at one time used to think if Partner A makes more money, it's going to come out of my pocket, but that's not the case. If you have compensation based on performance, I'm not competing against you, but the goal I've set for myself. It's conceptually not a zero-sum game. I can make more, you can make more, we both can win."

## MODEL OF ACCOUNTABILITY

Breaking away from this old autonomy is crucial, according to Koltin, as it can be the enemy of accountability. "You have to decide for yourself if you want to be a high-performing firm making a lot of money, and give up some autonomy, add some accountability, or remain unhappy ... . Autonomy means low profits, and at many of these firms the level of trust in leadership, if indexed, is at a low level. Clearly, the firms where partners trust and respect leadership and are willing to be managed and held accountable by leadership -- those firms blow away all other firms. They have an enormous competitive advantage."

Accountability is the foundation of what Koltin has determined to be a perfect partner compensation system, in four levels.

The first cut of compensation, he explained, should be a return on that partner's accrual-based capital, of a couple points over prime on their investment into the firm. Then, 70 percent of total compensation should be the market-based draw/salary. The remaining 30 percent, he continued, should come from a bonus pool and be allocated by the managing partner or compensation committee "to those partners who have at least met or, better than that, exceeded the individual goals for the year." Then, any excess profits should be allocated based on ownership percentages, though Koltin acknowledged that most firms don't have much money left over at this final level. This system, according to Koltin, solves the problem of unmotivated partners who scrape by in many of the firms that guarantee 90 to 95 percent of compensation in draw/salary.

"Some firms have this structure and where it fails is a practice that I refer to as a school of good harmony," Koltin explained. "When it comes time to allocate compensation, they don't want partners to be upset, so they spread it between the highest and lowest performing partners ... which sends a message to high performers that it's not worth it ... no matter what they do, they can't make a lot of money."

## LIFETIME PERFORMANCE

Moving to an accountability-heavy system requires strong governance, which Koltin recommends involve department heads or someone in a position of authority sitting down with each partner to tie their strengths to goals, and then coaching and holding them accountable through periodic meetings.

In addition to clearly aligning performance and compensation in a way that even skeptical partners can accept, these meetings serve to eliminate surprises when end-of-the-year bonuses are distributed.

To be successful, they must also clearly define the meaning of performance, which Aquila said has moved from the traditional idea of pure new business and billable hours. "What I've seen working with clients, and what performance bonuses should recognize, to me, are two things," he advised. "Good behavior: being a good citizen and not being a prima donna, lone wolf or S.O.B. One of the things you should reward a person for is trying to create a firm with a 'one firm' culture. The other thing you should reward is productivity in a different sense, of results people want to achieve - production, new business development, value enhancement to the entity. You're looking at a good performance system to recognize and reward behavior and development of competencies in the firm, or developing a new area."

This model, Aquila added, is not about creating clones in service of the "one firm," but rewarding partners in ways that will differ by partner, and by firm. The very nature of this firm and individual variance means no system will be perfect, but the mere recognition of that complexity brings firms closer to their profit potential.

"I've said sarcastically, since everyone wants to hear the perfect partner compensation system, that based on all this research ... it's the sole practitioner," Koltin quipped. "When you're a sole practitioner, you look in the mirror and it's just you. The day you start a multi-partner firm is the day potential conflict exists."

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