EQUITY -- ALLOCATION AND REALLOCATION PART 3

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A REALLOCATION PROCESS

In my last column, we reviewed how changes in ownership, without proper planning, can easily alter the decision-making dynamics in a firm forever. With this column, we want to introduce how we typically approach the equity reallocation process.

The process we use considers several factors in determining equity allocations:

- Compensation history
- Partners' ratings of one another's skills and leadership ability
- Partners' suggested allocations of equity ownership percentages
- Other factors

COMPENSATION HISTORY

We use compensation history as one of the factors in this process because the amount of compensation earned typically reflects more or less how well someone has performed under the previous operating model and expectations. However, as with everything we will discuss, while you need to review the numbers, you also have to consider the factors that influenced the final pay per owner. For example, consider the portion of pay that is attributable to existing equity ownership. Compensation for the purpose of this analysis may need to be calculated without this component of pay since it is not performance-based. Additionally, since ownership percentage is under review here, we're looking at compensation more as a demonstration of how well the partner lived up the outlined performance metrics at the firm than as an entitlement based on ownership percentages.

PARTNERS' RATINGS OF ONE ANOTHER

Another factor, and we believe it is a big one, is how a partner is viewed by the other partners. When you are deciding who should have more say (or less say which is just as important), it seems critical to us that you need to consider issues such as whose judgment partners trust, who is pulling the wagon, who consistently acts in the firm's best interest, who is viewed as a current or future leader, etc. With this in mind, here are some of the areas we typically investigate and obtain feedback on in this phase of our process:

Technical ability

How strong is this partner technically in his/her area of specialty? If they are the CEO or Managing Partner, how strong are they in their management and leadership skills? For department, unit or division leaders, you're going to want to know about both their technical skills and their management skills.

Client service

Does this partner have loyal clients who stay and act as referral sources for yet more clients? What's this partner's client turnover like? Good client service should result in low client turnover with the firm realizing reasonable revenues from the work performed. It shouldn't take discounts to keep turnover low.

Trusted business advisor
Does this partner proactively seek to understand clients' business needs and concerns—not just financial and tax? Can he/she list the top few nonfinancial, nontax, strategic concerns of each of his/her top "A" clients?

Delegation
How well does this partner move lower level tasks off his/her plate to allow him/her to work at the highest level? Delegation involves more than "dumping." It requires appropriate setting of expectations, providing sufficient direction and support, and monitoring progress.

Project management
How well does this partner anticipate projects, schedule, plan and oversee them through his/her managers? What kind of a job does he/she do in getting work out the door within time frames expected by clients?

People Development
Does this person take an active interest in the development of others through the way he/she delegates work and assigns jobs, or is people development an afterthought that only gets attention when things are slow?

Business savvy
How much business acumen does this person exhibit? Do they consistently sell work at pricing levels that comfortably allows the firm to complete the work within standard rates? Are they timely in the way they bill and collect the bills? Do they minimize write-downs and charge offs?

Marketing focus
Does this person look for and find opportunities for others in the firm? Is he/she constantly working to build and leverage a network of influential referral sources, and continually on the lookout for cross-selling within the firm as well? Do they initiate, participate and support practice development activities?

Ability to lead in the future
How much personal influence does this person wield—can they attract a following and positively influence others? Do they have the integrity required to lead? Will they be capable at some point of leading the other partners at this firm?

Partners' Suggested Allocations of Equity

It's wise to identify how the existing partners see the equity ownership being allocated, even if this factor is not a key consideration for the final allocation of ownership. After all, it is their firm, and they each have a personal financial stake in the outcome of this process. We often find that there is a misalignment between how the partners think ownership should be shared and how they've rated one another. Comparing and contrasting these two sets of suggestions will provide you with some food for thought and potentially lively discussion.

OTHER FACTORS
Other considerations, that may or may not be included in this analysis, depending on the firm makeup, culture, and mode of operation, might be: managed revenue per partner (a/k/a "book of business"), realization, and profitability just to name a few. If, for example, a firm has successfully made it from the "Success Mode" to the "Continuation Mode,"[1] of operation or is well on its way to completing that transition, then looking at managed revenue per partner in this process is probably not a real good idea. This particular metric would not be that relevant to the firm because at this level of firm evolution, in this mode of operation, the firm is already functioning, more or less, as one firm. To focus much at all on book of business in this process could add pressure that would drag the firm back to an Eat What You Kill business model.

We also like to use various tools to confirm our thoughts, ranging from our 360° Succession Institute Managerial Leadership Assessment (SIMLA), to a variety of DiSC tools to better understand the key players in the firm. Our proprietary SIMLA is based on primary and secondary research into best practices employed by leaders, and it is customized for CPAs in public practice. It helps quantify a partner's strengths as well as improvement needs, and provides a prioritizing process to narrow down the focus on those areas of improvement that are most important for the partner and the firm. The DiSC suite of tools allows partners to increase their self-awareness and their understanding of others as to differences or similarities in each person's motivational needs. The feedback from these instruments helps predict how someone will behave in certain circumstances. By being able to accurately predict these behaviors, a partner will be able to address ways of modifying his/her behavior for more effective interaction with peers, direct reports and clients. This is not about being "warm and fuzzy." It ***is*** about ramping up our interpersonal awareness and skills to be better leaders. People who can lead, develop, train and supervise ***others*** are worth much more than those who can just make ***themselves*** faster, better and stronger.

PULLING IT ALL TOGETHER
In the end, we summarize ratings, using complex spreadsheets, content analysis and other methods. We then talk through everything to see what relative weight should be accorded any of the factors based on the unique circumstances of that organization. Most of the time, relatively more weight is given to the "Partners' Ratings of One Another" because going forward, if the firm is to flourish, you have to build it on a strong foundation of people whom others are willing to follow. The leaders who people want to follow generally are willing to not only talk about the core values of the organization, but to live up to them and lead by example on a daily basis.

Equity ownership allocation is a critical success factor if you expect your firm to continue after you leave. For many firms, reallocation of equity ownership is or will be an important part of succession planning. While it can cause some anxiety for your owners' group as you go through the process, it's better to confront the issues now, to help ensure that your firm is in good hands after your leave. It's not necessarily easy, but it must be addressed for long-term success.

Footnote
[1] See Columns "Moving from the Success to Continuation Modes of Operation Part 1 & 2" for discussion of Modes of Operation