“Building a Village” Partner Compensation Plan

My last three columns have focused on some fundamental compensation issues found in “Eat what you Kill” (EWYK – often called a Silo Model were there are multiple firms operating within one firm) and “Building a Village” (BAV - often called a One Firm Concept) partner compensation models. I have already discussed common elements in an EWYK model, so there is not much more to discuss. However, if you want to build a compensation formula that supports a BAV model, then that is where we are picking up today’s topic.

We left off after I introduced how ownership and retirement, typically, have to be dealt with first before partner compensation can addressed. If you need a refresher on that discussion, you can link from our newsletter to my past columns on this subject and you will quickly be up-to-date. If you are in a firm with equal ownership or if your ownership is dramatically inconsistent with earnings, we usually have to address this before we can tackle retirement. And we have to deal with retirement before we can address annual partner compensation plans. Why? Because most firms use book of business as a key driver for compensation, and then use compensation as the key driver for determining retirement benefit (i.e., multiple of salary). Given this connectivity, the larger booked partners are rarely willing to support the changes necessary to create a BAV model without protections written into the partner agreement against radical compensation and retirement benefit shifts once they start distributing part of their book (power-base) to other members of the firm.

Just so you know, generally, I personally agree with them (unless partner compensation is predominately entitlement based). Unfortunately, most partner meetings on compensation start with the partners that make less money wanting to restructure to compensation plan so that they take money away from the highly compensated partners. My belief is that you need to set up a compensation system that is built to generate more total partner compensation. This gives the highly compensated partners the ability to earn even more, or at least make what they have been making, while others close the gap. In my opinion, partner compensation should be distributed according to how well each partner meets his/her goals, objectives and has supported the firm’s strategic plan. However, for the record, this last statement describes very few partner compensation plans in our profession.

The only way I know how to get from where most firms are to what I just described in the last paragraph above is for the partners to be willing to make some adjustments to ownership equity, compensation guaranteed salaries, and to the retirement formula to allow all of the new pieces to come together.

Since it is common that a partner’s book tends to drive both annual compensation and therefore the retirement benefit calculation, in order for both of these tools to better support a BAV environment, we need separate them and tie them to other factors. As I said above, I like to tie compensation to strategy. As for retirement (for firms with less than 25 partners), while there is no perfect answer, I prefer tying retirement – at least a major part of it -- to equity ownership. So, often, the starting place for me is to dig into equity ownership and see how that is influencing, if at all, either retirement or compensation.

If the equity ownership of each partner is proportionate to each partner's book size and relative compensation, then this first step is a non-issue. While we might have to make some minor adjustments to equity, there is rarely a big political battle to fight. So, we can move on to dealing with the next issue – retirement. However, what is common, especially when you have more than 2 partners, is that equity ownership has very little relationship to compensation or book size. Therefore, the partners have utilized and made important other mechanisms to create power and influence within the firm to compensate for the imbalance in equity ownership. This will come in many forms, but the most common are:

1. An EWYK compensation system (built on book of business formula that requires an act of Congress to change),
2. An executive committee in a 10-12 partner or less firm designed to concentrate the decision making power in a select few, and/or
3. A firm made up of individual firms within one firm so that very little accountability can be enforced within the firm.

These are structures that our entrepreneurial CPAs will use to "make right" what they overlooked when growing the firm and adding new partners. So, my belief is to deal with the real issue, fix the real problem, and reflect the power the way it actually is so we can move on. Since most firms operate under an EWYK model, and since book size is key to both retirement and annual compensation, and since the partners have been performing under this framework as the firm has evolved, then it is only fair to start the "equity adjustment dialogue" around present compensation and performance. Here is an example:

Consider three partners:

| | Book of Business | Compensation | Ownership | Retirement |
|---|---|---|---|---|
| Stan Winters | $1,200,000 | $320,000 | 33.33% | in 5 yrs |
| Dom Cingoranelli | 900,000 | 250,000 | 33.33% | in 9 yrs |
| Michelle Cameron | 500,000 | 200,000 | 33.33% | in 15 yrs |

As you can see, in this example, each partner has the same equity ownership. Why? Because at the time the firm added each new partner, 1) equity seemed like a non-issue, 2) the firm had a "we are all in this together" perspective, and 3) nothing was really tied it. So, equity just got overlooked. And when you consider how these firms are run and decisions are made (influence and control come from book size), equity really doesn't matter much anyway. However, as firm's get larger with more partners, control and influence becomes more convoluted as ownership interest (voting) starts to clash with sizes of partner books. The problem is … there are two very different decision making systems in place and with each additional dollar of growth, there is a power struggle that will likely cause the firm to split up in order for it to be resolved. So, in my opinion, the best approach is to adjust equity to reflect the current power, control and influence so that we position the organization to move forward as one firm.

Now, take a look at this table.

| | Based on Current Ownership | Approx Ownership based on Compensation | Approx Ownership based on Book Size |
|---|---|---|---|
| Stan Winters | 33.33% | 40% | 45% |
| Dom Cingoranelli | 33.33% | 33% | 35% |
| Michelle Cameron | 33.33% | 27% | 20% |

In this example, if compensation more approximated equity ownership, take home for the partners would be about equal approximating $250-$260 per partner. While Dom's compensation is in that ballpark, Stan's and Michelle's are not. So, clearly, equal ownership does not represent how the firm is being run. For Stan's compensation to reflect to his equity ownership, he would need to own about 40% of the firm, Dom around 33% and Michelle about 27%. Looking at this firm from the book-size perspective, Stan should own about 45%, Dom around 35% and Michelle 20%.

Please don't misinterpret what I am trying to discuss here. I am sharing this example, which can be found in numerous firms across the country, to show you how I go about making adjustments to equity so that the firm can begin to re-address retirement, which will then open the door to finally dealing with partner compensation. Without taking this approach, there is little chance that Stan, who controls 45% of the firm's clients will support any real changes to the way this firm operates. So, you have to put a stake in the ground (in this case, my first stake is suggested equity adjustments), then address how that will work with and impact retirement benefits (planting the next stake) and then address compensation. No one will completely sign-on to any of this until they see it all laid out … but you have to put a stake in the ground to work from or all three issues will constantly be moving parts with no way to build a system that supports a BAV solution.

Given the discussion above, if I were working with this firm, and had no other information, I might suggest an equity ownership shift to look something like this:

| | Current Ownership | Suggested Ownership |
|---|---|---|
| Stan Winters | 33.33% | 42.5% |
| Dom Cingoranelli | 33.33% | 34.0% |
| Michelle Cameron | 33.33% | 23.5% |

Understand the key is "no other information." Many factors influence proposed equity ownership adjustments. Examples of factors that would impact this adjustment would include 1) if income fluctuates dramatically between partners each year, 2) books of business are undergoing significant shifts, 3) partners work ethics and efforts are all over the board, 4) a partner's book is so unique that no one else can do the work once he/she retires, 5) how much of the detail work the partner does, versus managers and staff, in order to manage the book, 6) the profitability of the book, 7) the regeneration or recurring nature of the work, etc. Even though there is plenty of data to crunch to help you come up with proposed equity adjustments, getting everyone to agree or compromise (or those who can't find a way to compromise to leave) is very much of a political process.

Equity changes are a big deal. Once approved (at least in spirit until everything can be laid out), they signify the beginning of a new era. Not only do they end up having an impact on the retirement calculation, but the bigger issue is that you connected the existing power structure within the firm to the legal voting rights which control firm strategy, policy and process.

While some of you may feel like changing equity is too radical, I would suggest that in the case above, Stan managing a book of business almost as big as the other two partners combined is already carrying the equivalent of a 45% vote on decisions now … maybe actually more than 50%. In every partner meeting I have ever attended, which have been quite a few, there is a constantly looming threat overhanging the partner meetings by the big booked partners with the unspoken (and unfortunately often spoken) message of "vote however you want and then I will decide whether I will stay or take my clients and leave." In the BAV model, this kind of threat is dealt with severely because it is very damaging to the firm's future success and evolution.

When you switch from the EWYK to the BAV model, you try to give the big booked partners the vote they deserve for the business they developed while under the EWYK model. Now their contributions have been acknowledged and formalized and it is time to put this behind you. Under the BAV model, you want the clients of the partners to become the firm's clients. You want to balance the books of business (to whatever makes sense) so that each partner can carry his/her fair share of the load. You want to stop partners from hoarding clients (hoarding occurs when partners keep clients in their book, even though they poorly service them, in order to earn entitlement compensation). You want to stop junior partners from spending all of their time acting like managers on the senior partner's books of business. You want the partners to commit that the firm has to be protected more than any individual partner. You want the partners to know that the more successful the firm, the greater their retirement benefit because they are growing the value of the asset. You want the partners to understand that they work for the firm and if anyone wants to leave before they are eligible to retire, they will leave almost empty-handed. In other words, you get your value out of the business by serving your time and delivering quality services, not because you were allowed to incubate your own enterprise within the walls of the firm.

Once the partners' sign-off, if necessary, on any proposed equity adjustments (conditioned on seeing the other two variables formalized as well), it is time to address the retirement benefit calculation, which is where I will pick up in the next column.