Building a Village" Partner Compensation Plan

During our last column, we discussed ways to make the necessary equity adjustments to compensate successful "Eat What You Kill (EWYK)" superstars for their accomplishments. This is an important step in the road we need to travel to move from EWYK to the "Building a Village (BAV)" model. Today's column will discuss how the equity changes might impact retirement. And once we address retirement, we will have a free hand to address partner compensation.

Now before I launch into this topic, I want to make this clear. I would not recommend making the equity adjustment in our last column and the retirement benefit I am about to discuss in this one without fully understanding this concept. Once you lay all of this out, if the superstar wants to continue to play the superstar game and wants the compensation to be all about his/her individual efforts and book, then terminate them. You cannot make significant change to your organization if you are willing to be held hostage by your superstars. At the end of the day, if you are not committed to the BAV model and willing to hold everyone accountable to your process and policies, then going through this effort doesn't make any sense. For example, you don't need to agree on a retirement buy-out formula under the EWYK model because the partner is not building a client base the firm should be obligated to buy. If a partner wants the right to build and manage their client base any way they want, then the trade-off for that freedom is that no one needs to commit to buy it. When the EWYK partner decides to retire, if someone wants some of the clients, they can make a deal on their own. But there is really no firm here that can be compelled to do anything … just a bunch of individual small practices sharing overhead. However, when a partner agrees to build and manage a client base exactly like the firm directs him/her to do, then it make sense that the other partners would be obligated to buy what they have directed this individual to build. The same is true about equity. There is no reason to adjust the equity of the ownership under the EWYK model since ownership doesn't mean anything. While an EWYK partner may only own 15% of the firm, if they control 50% of the book, then that is the asset they are building to sell. So, only go down this road of adjusting equity and retirement if you are committed to eating the whole enchilada.

Ok, now we are ready to talk retirement. I use a simple analogy for my approach. If you own 20% of a piece of real estate, if you are a passive investor and this is a straightforward deal, what amount are you going to receive when the property is sold? Yes, I know you guys/gals have put together all kinds of strange propositions, but normally, the passive investor would get 20% of the sales price (less debt, etc.). How about an active investor (handles the management) in this same real estate venture owning 20% … what will he/she get? The active investor will get the same amount as the passive investor. However, to be compensated for the daily and monthly management efforts, the active investor would likely receive additional annual compensation from the cash flow of the property. The point is that equity is tied to the value of the asset; compensation is tied to the effort made in generating the cash throw-off.

So, you can see where I am heading. If you own 20% of a firm, then in my opinion, your retirement benefit should be derived *mostly* from the value of your interest in the firm. And the effort you make year-in and year-out should be what drives your annual compensation. The question that immediately follows is, "Ok, so what is the value of your firm to sell to your partners?" Well, that changes with the market. The numbers I typically encounter are somewhere between 65 cents to $1 dollar on the dollar, with the average being about 80-90 cents (of total or adjusted net revenue.) At least that is what I see today. As some of you may remember from previous columns, I have mentioned that I think market for CPA firms' is closer to 75 cents on the dollar. If this is the case, then why would a firm use a number higher than market? Simple! Because it makes sense that a partner will pay a little more for a business he/she helped build and had a say in the firm's evolution. Additionally, this same partner should be in the best position to leverage every resource the firm has to offer.

Sometimes people get confused because of the buy/sell stories they hear in the marketplace. For example, many people would debate that you can get more selling your firm to outsiders than insiders. They will quote that a dollar is a common offer for smaller firms, often more. My response is simple. In the typical outside purchase, if the buyer commits to pay you a dollar for each dollar of revenue, what that means is that they will pay you a dollar for each dollar of revenue they decide to keep, over a multi-year period. When you factor in the business that doesn't transition and the business the new firm runs off, that dollar being paid for the remaining clients will end up representing about 65-75 cent of the original revenue stream. On the other hand, when the firm buys out a retiring partner, the firm typically pays them for all of it (the good, the bad and the ugly). So, at the end of the day, I find inside purchases pay more *total money* than outside purchases.

Given our discussion above, let's take a look at a benefit calculation policy which has been adapted from numerous firms:

> *It is agreed by the shareholders that the retirement benefit for a retiring partner/shareholder will be calculated as follows:*
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> - *Per agreement on January 1st, 2008, "Fair Value Adjustment" is 85 cents on the dollar for each dollar of the firm's Adjusted Net Revenue. It is the intent of the partner/shareholders to review and possibly adjust the value, as condition warrants. The fair value adjustment in place at the time that the retiring partner provides three years notice will be the fair value adjustment used to compute the retirement benefit of the retiring partner, even if the fair value adjustment is subsequently changed (up or down) prior to the actual retirement date.*
> - *Net Revenue is based on an average of the last two full calendar years (accrual basis) net revenue amounts immediately prior to retirement.*
> - *Adjusted Net Revenue is Net Revenue less the sum of the outstanding retirement payments to all retired partners at the time of retirement.*

For clarification, the following example was created to show this calculation assuming the firm's average Net Revenues for the last two years were $4,500,000:

Net Revenues	*$ 4,500,000*
Less Outstanding Retired Partners Retirement Benefits Balance	*$ 600,000*
Adjusted Net Revenue (ANR)	*$ 3,900,000*
The "Fair Value Adjustment" for the firm as a factor of ANR	*85 cents/dollar*
Value of the Partnership	*$ 3,315,000*
Calculation for Retiring Partner/Shareholder with 25% Ownership	*$ 828,750*

I want to point out several things. First, this is just an example and they often get more complicated. Second, all existing retirement debt obligations come off the top. Why do they come off at 100%? It is your choice, but since these numbers are at gross face value rather than present value, we are just taking a simple approach. You can make this as simple or as complicated as you want. The only other debt we typically remove is obligations still owed for prior business purchases (relative to this income stream).

At this point, some firms add the retiring partner's equity portion of the book value of the firm to this number, others might add capital too, and yet others might do any combination or do nothing more than what is above. You name it and someone is doing it.

So, what is wrong with this model? Generally, I like it. However, this model is all about ownership entitlement. I believe there should be some factor for the effort people make year-in and year-out since this is a professional services firm we are talking about. Don't misunderstand me … I think equity should be the main driver. But if I have two partners, both owning 50%, one works around the clock to make the business better, faster and stronger, and the other is a good partner but is more focused on work/life balance, requiring annual compensation to balance that entire differential may be asking too much. I will give you some examples to consider that might help you create balance once we have finished partner compensation.

While it is clear that I don't have an objection to annual compensation creating a slight adjustment factor to equity when determining the retirement benefit, I definitely have a problem with annual compensation being the main driver of the retirement calculation. If you are one of the top 100 firms, then certainly using salary makes sense. The reason is simple. For the vast majority of partners, they have little say as to how their compensation is calculated. Only a very few get to seriously take advantage of this system. So, for almost everyone, earning their salary is more of an arm's length process based on accountability.

However, when there are less than 15 partners, which represents almost all the firms in our profession, then those partners have too much say as to the make-up of the compensation variables for this to be a healthy system. When you use the salary model to calculate retirement benefits, you end up with partners in their senior years double dipping – trying to maximize their salaries because it simultaneously maximizes their retirement. When partners are in their senior years, the value of their share of the practice should be going up as the firm's value goes up.

But, their compensation should be based on their current performance. Generally, senior partners start slowing down, not speeding up.

When retirement is based on equity, then senior partners have the luxury to slow down, earn less annually, but know that their nest egg value in the firm becomes healthier with every step they take to make the firm stronger. For example, transitioning of clients to other partners makes the firm stronger. When salary is the main driver, senior partner tend to hoard clients until the last possible second to leverage their annual compensation (which boosts their retirement calculation). Unfortunately, when salary and retirement are tied together so tightly, you tend to find an entitlement system that everyone knows about, that everyone sees the injustice in, but no one objects. It allows senior partners to coast during their last 4 or 5 years, earn a top salary for an ordinary effort because of their seniority, all the while increasing the value of their retirement payout. No one objects mostly because they are calmly waiting for their turn to rape and pillage the company on their way out the door. However, there is one premise you can count on in business. You cannot continually sell a company for more than its worth or it will eventually crack from trying to carry its own weight.

I will pick up here in my next column to take our first crack at partner compensation, given that we have addressed equity and retirement.