CPA FIRM PARTNER COMPENSATION: THE ART AND SCIENCE

Marc Rosenberg, CPA

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Introduction

In an ideal world, partners could objectively discuss and debate the firm's partner compensation system without regard for its impact on their individual earnings. But of course, we don't live in an ideal world. It's almost impossible for partners to weigh in on the system without thinking about its impact on their individual earnings.

This is the essence of why partner compensation is such a sensitive and critically important topic to partners.

What do we mean when we say "partner compensation"?

When partners use the term "partner compensation," they may be referring to either or both of the following:

- The system used to determine each partner's income for the year.
- Partners' earnings— the share of the firm's total income allocated to them.

Unless stated otherwise, partner compensation or partner income includes all forms of remuneration such as base salary, draw, bonus, final distribution, interest on capital and other related terms. It does NOT include fringe benefits and perks. But it includes deductions from partners' pay, such as voluntary contributions made to qualified retirement plans and contributions made to a firmwide funded partner buyout plan.

Pies: a great metaphor for partner compensation

A firm can have the most unfair, biased, illogical system known to man, but if the pie (total income to the partners), also known as the profits of the firm) is sizable, the partners will be easier to please because their slice of the pie will most likely be pretty satisfying.

On the other hand, a firm can have the most fair, accurate, logical system ever invented, but if they're dividing up a small pie, many partners will be unhappy with their tiny slice.

The lesson: If partners are unhappy with the compensation system and firm profitability is low, they should focus more on increasing firm profitability than perpetually looking for a better way to allocate income. They will never be satisfied with a small slice of pie.

But this lesson is not easily learned. Most CPA firm partners come from humble backgrounds. Their families may not have been in the poor house, but it's unlikely they were wealthy. When partners think about the annual income they earn ($300,000 to $500,000 or more for many of them), a smile comes across their faces because in their wildest dreams they never thought they would earn this kind of money. But that grin turns instantly into a grimace when they find out that another, less deserving partner earned more.

Andy Grove, the former Chairman of Intel, said it well:

> ***"If people are concerned about their absolute level of compensation, then they can be satisfied. However, if their focus is on relative standing, then they can never be satisfied."***

Get the picture? Partner compensation is much more than a mere number that shows up on a K-1:

- It's a de facto summation of a partner's worth to the firm.
- It's a form of rating or ranking the partners.
- It's a reward for hard work, performing well and achieving goals.
- It's the money needed to enable partners to support their family and maintain a certain style of living.

For these reasons, partner compensation is easily the most sensitive and hotly debated aspect of CPA firm practice management. This topic appears often on conference agendas. It's frequently written about in publications. It's what partners talk about in the hallways and in the privacy of their offices.

Why a firm's partner compensation system is an art rather than a science

The allocation of partner income is much more an art than a science. Anyone who thinks otherwise is either naïve or has never been a partner whose income was subjected to an income allocation process.

Partner compensation is not a science. If allocating partner income were a science, it would be easy to concoct the perfect formula that factors in all relevant performance metrics, both tangible (production) and intangible (leadership, mentoring staff, loyalty, teamwork, etc.), producing results that would be considered fair and acceptable to most or all partners. There would be few arguments among the partners because they would feel the formula says it all and leaves nothing for debate.

But alas, there is no such thing as a perfect partner compensation formula. No system has been invented that (a) is 100% fair in the eyes of all the partners, and (b) is a proper blend of tangible and intangible performance factors. Some firms sarcastically say that the acid test of a good system is one that makes every partner a little unhappy. I don't subscribe to this because it is quite possible to create a system that will satisfy all partners. The goal of this monograph is to show you how this is done.

Partner compensation is an art because it needs to factor in a host of tangible and intangible performance attributes such as:

- Basic production metrics.
- Evaluation of partners in official management and leadership roles such as MP, PICs, Board and Compensation Committee members and practice leaders.
- Major intangible factors such as developing staff, teamwork, loyalty and work ethic. There is no empirical guide to weighting these factors.
- Nuances and subtleties of partner performance.

- Extent to which partners delivered what the firm needed and expected from them.
- Determining the proper breakdown of amounts to comprise income tiers such as interest on capital, base and bonus.
- Balance between a partner's historical performances and performance for the current year.
- How certain partners view their own compensation compared to that of others.

Balancing the allocation of income between objective, traditional production metrics with subjective performance factors, though certainly not rocket science, is not easy and is fraught with complexity. It's an art.

Partner compensation has evolved significantly over time

Years ago, most firms tried to keep the system scientific by devising endless algebraic formulas to allocate income. Virtually all of the factors in the formula were production metrics. Intangible factors were largely ignored.

But the philosophy of managing CPA firms has changed over time. Firms now see that there is much more to managing a successful practice than bringing in clients and working billable hours. They learned that management of the firm, developing good staff, teamwork and many other intangible factors are also critical.

As a result of these changes, formula systems became increasingly inadequate because they largely ignored intangible performance factors which were difficult to incorporate into nice, neat formulas. More diverse and sophisticated systems were needed.

Today, compensation systems have been developed that effectively address production as well as intangible and interpersonal factors. The two most common systems for this are the *Compensation Committee* and the *Managing Partner Decides* systems, both explained in Chapter 5.

How partner compensation fits into the overall scheme of managing a CPA firm

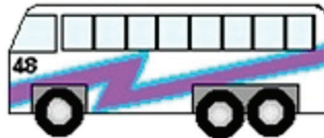
Partner compensation is obviously very important to partners. Some misguided firms feel that partner compensation is the most effective way to run a firm. Their reasoning is that running a CPA firm is simple:

> ***Go out and bring in business and get the work done in a profitable manner that keeps clients satisfied. If you reward partners for this, everything else sort of takes care of itself.***

The reality is that partner compensation is only one facet of what it takes to manage a successful CPA firm. This is best illustrated by one of my favorite charts of all time, on the next page.

FLOWCHART
HOW PARTNER COMPENSATION FITS INTO THE OVERALL SCHEME OF MANAGING A CPA FIRM

Management Philosophy of CPA Firms



VISION

FIRM GOALS

PARTNER GOALS

ENGINES:

Leadership
Governance Structure
Accountability
Partner Comp

Here's how to interpret the flowchart on the previous page.

The bus. Jim Collins, in his book *Good to Great*, wrote that "before a firm begins strategic planning, it must get the right people ON the bus and the wrong people OFF the bus." If there are negative-thinking partners on board, they will sabotage the creation of a unified strategy and vision, so they must be either dismissed or put in a position where their harm is neutralized.

The vision. Everything starts with a vision. What does the firm want to look like in 5 or 10 years, as opposed to how it looks today?

Firm goals. The next step is to decide the firm-wide goals needed to achieve the vision.

Partner goals. This is the first stage where the firm's vision is converted into action; specific people or teams are assigned to achieve the firmwide goals, with deadlines assigned.

The engines. Prior to the "Engines" level of the flowchart, the steps preceding it are like a car that has come off the assembly line but the ignition has yet to be turned on. The four engines that propel the process and keep it running:

- **Leadership.** Every plan needs a champion.
- **Management structure** that supports the vision.
- **Accountability** for partners with roles in the plan.
- **Partner compensation** that incentivizes partners to fulfill their roles in the plan.

Partner compensation is not a method for managing a firm; it's just one of many factors that need to be considered.

Many firms make the mistake of devising a partner compensation system before creating a firm vision. How can a firm put together a compensation system if it doesn't know what it needs the partners to achieve and what to reward them for?

I once facilitated a partner retreat of a very successful firm. At the end of a spirited discussion about changing the firm's current compensation system, one of the 12 partners said:

> ***"A partner compensation system is just a way to allocate income among the partners. It's NOT meant to be the primary way to run the firm."***

Here's what he was saying. For firms to be successful and profitable, they need their partners to post strong production metrics such as business origination, book of business managed and billable hours. Many firms feel that the best and the only way to get partners to achieve high production metrics is by tantalizing them with the potential of a big paycheck. They feel that this is the only form of management that the firm needs. ***This is misguided for two reasons:***

1. Partners who underperform at the basic production metrics will not improve simply by having money waved in front of them. They need training, mentoring, guidance and coaching from the management team. They also need to be put in roles that match their skills. I don't care if you waive a billion dollars in front of partners who have never been good business getters. They won't suddenly turn around and become rainmakers.

2. Are firms successful because their partners post strong production metrics? Definitely. But there are many other critically important factors that make for a successful firm. These include strong firm management and leadership, sustaining a strong growth culture, developing great staff and teamwork.