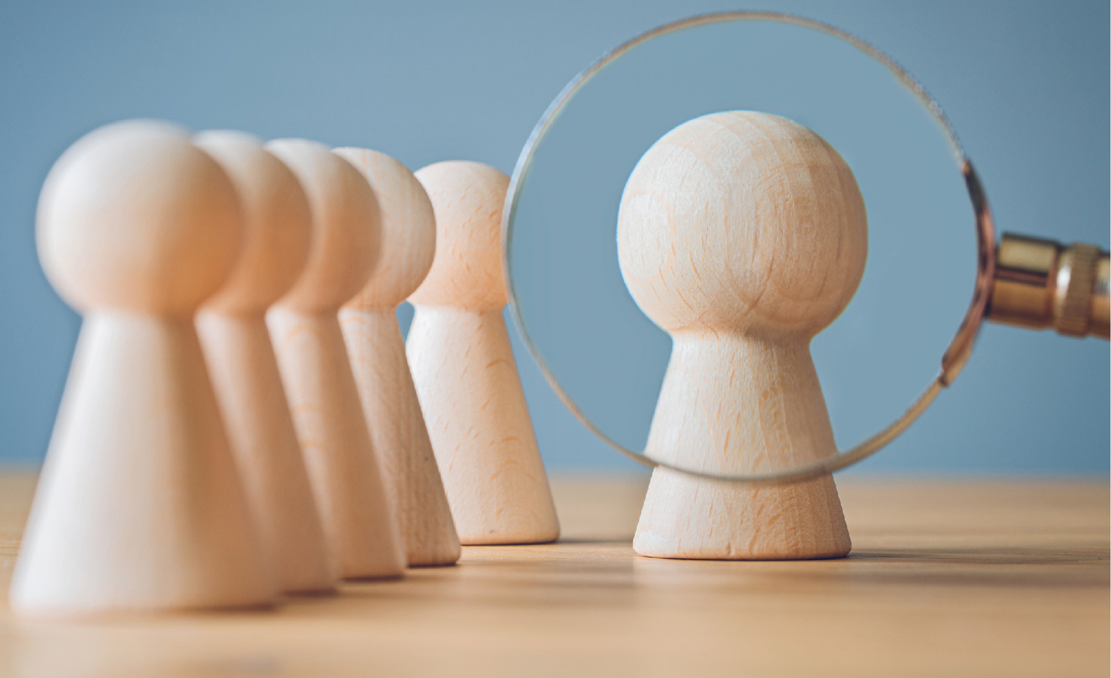
HOW TO OPERATE A COMPENSATION COMMITTEE



MARC ROSENBERG, CPA

HOW TO OPERATE A COMPENSATION COMMITTEE

Marc Rosenberg, CPA

MONOGRAPHS BY MARC ROSENBERG

CPA Firm Management & Governance

CPA Firm Succession Planning: A Perfect Storm

Strategic Planning and Goal Setting For Results

How to Negotiate a CPA Firm Merger

How to Bring in New Partners

What Really *Makes CPA Firms Profitable?*

Guide to Planning the Firm Retreat

Effective Partner Relations and Communications

For more information or to purchase additional titles visit:
www.rosenbergassoc.com + click on
“Monographs by Marc Rosenberg

Connect with Marc:
marc@rosenbergassoc.com
blog.rosenbergassoc.com

HOW TO OPERATE A COMPENSATION COMMITTEE

MARC ROSENBERG, CPA

All rights reserved. These materials may not be reproduced or distributed to any other person without written permission from The Rosenberg Associates LTD. This publication is intended to provide general information in regard to the subject matter covered. Although prepared by a professional, this publication should not be used as a substitute for professional services in specific situations. If expert assistance is required, the services of a professional should be sought.

Copyright ©2013
The Rosenberg Associates Ltd.
1000 Skokie Boulevard, Suite 555
Wilmette, IL 60091

TABLE OF CONTENTS

TABLE OF CONTENTS

1

Introduction

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 is subjected to an allocation process.

Partners are highly skilled professionals who work very hard at what they do. The compensation that a partner earns is essentially a "grade" for performance and overall contribution to the firm. One's compensation puts a value on each partner's worth to the firm. So it should come as no surprise that of all the CPA firm management practices , there is nothing more sensitive than the allocation of income among the partners.

It's understandable that there is a fair amount of unhappiness, frustration and yes, conflict among partners over their compensation. The sensitivity lies not in the selection of a system used by a firm to allocate income. Instead, the sensitivity arises because of the competitiveness between the partners over their respective compensation levels. Andrew Grove, the former chairman of Intel, said it best:

> "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."

This quote is particularly applicable to partners in accounting firms. Many partners I've encountered came from relatively humble backgrounds and socio-economic status. They earn many times what their parents earned. When they look at their W-2's each year, a smile comes across their faces because they never dreamed their income would reach this level. (In 2012, the average partner of a local, multi-partner firm earned $350,000 to $450,000).

But that proud smile can quickly turn to a frown. All it takes is finding out that another partner – believed to be far less valuable to the firm than oneself – has received a higher income allocation. It's no wonder that partner compensation is such a sensitive topic.

Why is a firm's income allocation system an <u>art</u> rather than a <u>science</u>?

1. There has never been a system invented that can be considered 100% fair and just to all the partners. Some firms sarcastically state that the acid test of a good system is one in with which all the partners are a little unhappy.

2. There are three main factors to consider in designing a firm's partner compensation system:

   a. <u>Objective</u> factors which are easy to measure. Most are production oriented and include business origination, book of business, billable hours, realization and age of WIP and A/R.

   b. <u>Subjective</u> factors, which consists of intangible aspects of performance such as firm management, teamwork, loyalty, leadership, work ethic, etc.

Order Book

c. <u>Partners' capital investment in the firm</u> is the final major category that influences many firm's income allocations, though its impact is usually much lower than the previous two items.

Balancing the allocation of income between these three factors is not easy and fraught with complexity. That's why the delicate handling of partner compensation is considered an art rather than a science.

<u>The evolution of partner compensation</u>

The art of partner compensation has evolved significantly over time. Many years ago, the vast majority of firms tried to keep the system a science by devising a seemingly infinite number of algebraic formulas to allocate income. Virtually all of the factors used in the formula were production metrics. Very few if any intangible factors were included in the system. A crucial element of these systems was the manner in which each factor in the equation was weighted against each other.

But over time, the philosophy of managing CPA firms changed. Firms discovered that formula systems were inadequate because they largely ignored intangible performance factors. Measuring these intangibles defied incorporation into nice, neat formulas. More diverse and sophisticated systems were needed.

As a result, systems were developed that are effective at addressing <u>both</u> 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.

Order Book

The 7 most common CPA partner compensation systems

System	Pros	Cons
Compensation committee - a small number of partners collaborate to allocate income based on their judgment.	Balances production with intangibles. Easier to link pay with goals.	Lack of partner trust. Failure by CC to communicate with the partners could doom the system.
Formula-an algebraic formula that computes each partner's income. Main parts to the formula are Finding, Minding and Grinding.	CPAs like numbers and formulas. It's objective. Avoids quarrels.	Can cause hording. Bad for teamwork. No credit for intangibles. "I" vs. "We" thinking.
Paper & Pencil – each partner votes to allocate income to all partners, including him/herself. The "ballots" are averaged to arrive at an income allocation.	What could be fairer than a system that collectively assesses the value and contributions of every partner? Avoids arguments.	Hard to know how your partners really perform. Partners may not vote properly. Cliques. Narrows gap from high to low.
Ownership pct – income allocated by ownership percentage.	Common way to pay shareholders of other businesses.	Only through a quirk of fate does owner % match performance.
MP decides- the MP allocates income using his best judgment.	Balances production with intangibles. Easier to link pay with goals.	Partners won't give this power to one person. MP often reduces his own pay.
All paid equally.	Easy. No arguments. Teamwork.	Unfair. Demotivating. Encourages coasting.
All partners decide.	Same as Paperslip.	Chaos!!

Order Book

Partner compensation systems: Usage by size of firm*

	2 Ptrs	3-4 Ptrs	5-7 Ptrs	8-12 Ptrs	13+ Ptrs	All Firms
Comp Comm	0%	19%	23%	54%	70%	32%
Formula	23%	36%	36%	29%	11%	30%
Paper & Pencil	3%	4%	5%	2%	2%	3%
Owner Percent	10%	4%	6%	2%	8%	5%
MP Decides	12%	11%	12%	6%	9%	10%
Pay Equal	32%	6%	4%	4%	0%	7%
All Decide	20%	20%	14%	3%	0%	13%
Open Closed	98% 2%	82% 18%	81% 19%	65% 35%	49% 51%	77% 23%

Here is a summary of the movement by firms over the past 6 years, TO the compensation committee and AWAY from formulas*:

	5-7 Partners		8-12 Partners		13+ Partners	
	2011	**2005**	**2011**	**2005**	**2011**	**2005**
Comp Comm	23%	19%	54%	39%	70%	58%
Formula	36%	47%	29%	39%	11%	38%
All Other	41%	34%	17%	22%	19%	4%

* From a very recent Rosenberg MAP Survey.

Order Book

As partner compensation systems grew in complexity over time, three subjective systems for allocating income become more common:

1. The managing partner allocates the income based on his/her judgment of what is fair.

2. All the partners decide together how to allocate income. One system devised to do this is the “Paper and Pencil” system. This is a system in which each partner votes to allocate income to all partners, including him/herself, and the “ballots” are averaged to arrive at an income allocation. The thinking is: what could be fairer than a system that collectively assesses the value and contributions of every partner?

3. A compensation committee consists of a small number of partners that allocate the income based on their collective judgment. They function as judges, impaneled for the sole purpose of allocating income.

Today, far and away, the compensation committee has emerged as the system of choice among multi-partner firms, especially those with 8 or more partners.

This monograph focuses on the compensation committee system to allocate partner income.

Order Book

The dreaded “smoke-filled back room”

To some partners, the term “compensation committee” (CC) conjures up all sorts of negative images, fueling a fair amount of anxiety over adoption of this system, despite partners’ acknowledgement of the system’s merits on an intellectual level.

The term “smoke-filled back room” has long been used as a term to describe a cabal of powerful, well-connected, cigar-smoking men who meet privately, and usually secretly, to nominate a political candidate without regard for the will of the public. As a life-long Chicagoan, this author has certainly observed this term’s usage in the way political decisions are made in the Windy City. New York, Boston and other cities have equal reputations for smoke-filled back rooms.

There is a natural tendency for CCs to be seen by the partners as “smoke-filled back rooms.” Part of the problem is perception but unfortunately, part is due to the reality that many CCs fail to communicate to their partners how they work. And as we will see throughout this monograph, communication between the CC and the individual partners is critical to the success of the CC and its acceptance by the partners.

A related fear of a CC is the dreaded word “subjective.” The overarching definition of a CC is that it is a subjective system rather than an objective system. Unfortunately, many partners define “subjective” as biased, unfair, one-sided and self-serving. But in the context of a CC allocating partner income, “subjective” should be considered a strength of the system rather than something “bad.” If a CC functions correctly, “subjective” means that the committee members have given careful, studied, objective and unbiased consideration to all facts and information relevant to assessing each partner’s performance.

Order Book

Practical, easy-to-read, actionable solutions to launch your firm into the next level of success.

Generous bulk discounts available.
Contact us with any questions at service@rosenbergassoc.com.

CLICK HERE TO ORDER NOW