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THE ROLE OF THE MANAGING PARTNER

The Definitive Guide to CPA Firm Leadership

MARC ROSENBERG, CPA

with KRISTEN RAMPE, CPA

THE ROLE OF THE MANAGING PARTNER

The Definitive Guide to CPA Firm Leadership

ALSO BY MARC ROSENBERG

CPA Firm Staff: Managing Your #1 Asset
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What Really *Makes CPA Firms Profitable?*
Effective Partner Relations and Communications

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First Edition Published 2020

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Introduction

"Few things are more important to human activity than leadership. It helps countries prosper. It makes businesses successful. Parents help children become successful adults.

The absence of leadership is equally dramatic. Without leadership, organizations move slowly, stagnate and lose their way. We are taught that if decision-making is timely and correct, things will go well. Yet a decision by itself changes NOTHING. More important is implementation, and that's where organizations often fail.

Implementation is about how leaders influence behavior, change the course of events and overcome resistance. Leadership is crucial to implementing decisions successfully."

D. Quinn Mills
Harvard Business School Professor

Success Starts with Management and Leadership

Think of it. Whether it's countries, governments, businesses, education, sports teams, charities or nonprofits, when their histories are written, their successes and triumphs are attributable to strong, effective management and leadership.

- For the United States, it's founding fathers like Washington, Adams, Jefferson, Monroe, Franklin and Madison.

- For governments, it's Lincoln, Teddy Roosevelt, Angela Merkel, FDR, Golda Meir, Winston Churchill and Ruth Bader Ginsberg.

- For cultural change, we turn to Martin Luther King, Gloria Steinem, Gandhi and Mandela.

- In sports, the names of Vince Lombardi, Red Auerbach, Scotty Bowman, Pat Summitt and Tony LaRussa are forever linked with getting overpaid, undereducated athletes to sacrifice self for the sake of winning and their team.

- Titans in business such as Gates, Jobs, Ford, Bezos, Disney, Kroc, Welch and Watson built dynastic organizations that know no boundaries.

And yes, great managing partners of CPA firms, large and small, have led and built fantastic, growing firms by discovering the Holy Grail of accounting firm management: successful cat herding of CPA firm partners, showing them that the firm can achieve greatness by performing as a team rather than as a group of individuals.

My point is not to make MPs feel unworthy if they are not mentioned in the same breath as Jobs, Gandhi and Lincoln. Instead, I want you to see that the biggest factors in achieving organizational success are strong management and leadership. In a CPA firm, the leader is the MP.

Management Is Often Maligned

Regardless of the organization—CPA firms, manufacturing companies, sports teams, governments (especially!), you name it—management is often maligned. It's a shame, but it's hard to prevent people from thinking this way. Management is an easy target.

Humans have a natural dislike for being told what to do. CPA firm partners often feel they have an inalienable right to do whatever they want whenever they please (also known as lack of accountability). Effective leaders get people to follow without making them feel they are being *told* what to do.

Many top management people are indeed ineffective. CPA firms' managing partners have little or no management training or experience, so it's not surprising that their performance is unsuccessful. Besides, many MPs carry a significant client base in addition to their MP duties. How can they excel as MPs if managing the firm is not their #1 focus, both mentally and time-wise? They can't.

People tend to have a healthy skepticism of management decisions. CPA firm partners have a heavy dose of this cynicism because they often think they know more about managing the firm than the MP does.

I'll give you an example in the abstract art world. Most of us have seen some art that, on the face of it, appears strikingly simple. A Jackson Pollock canvas that looks as if someone randomly spilled paid on it. A Mondrian piece that looks like art any fifth-grader could create. I recently saw a pair of coffee cups in an art museum gift shop that nails this sensation to a T. The cup on the left says, "That's not art. I could have done that." The cup on the right says, "Yeah, but you didn't." The moral of this story is that many partners think they can manage the firm better than the MP, but they never step up and try.

Many firms have negative nellies who love saying, "That will never work" or "We've tried that before and it failed" or the ever-popular "Goal setting is a waste of time." If not dealt with, these negative people infect the minds of others, thereby preventing management from doing its job.

Leaders are often tempted to make self-serving decisions. Unfortunately, throughout all walks of life, we've seen countless examples of this, including the most visible of organizations: government. (My apologies; remember, I'm from Chicago!).

As a result of these challenges, leaders have to build a sense of trust by the governed before they can do their jobs effectively.

The Flawed Operating Model of CPA Firms

This section is bound to raise the hair on your neck. I'm going to expose the traditional model of operating a CPA firm for what it is, deeply flawed. The message of this section is that it's the MP's job to *correct* the flaws.

The points I make primarily relate to multi-partner firms with annual revenue under $20M, which represent more than 99% of all firms. Understand this: Larger firms *became* larger firms because they overcame these flaws.

1. Leaders of firms—the managing partners —are often burdened with a significant client base to manage, limiting their ability and time to focus on what should be their #1 client: the firm.

   Advice: New MPs should delegate a minimum of 50-75% of their clients to others. The better MPs never worry about what will happen if they stop being MP.

2. Too often, partner groups require votes to be taken on minor decisions before they can be enacted.

   Advice: Businesses cannot be effectively run like a democracy. MPs must have broad authority to make daily decisions without having to take votes.

3. The following are examples of the wrong people assuming the mantle of leadership:

   - The founding partner is the MP. Obviously, this is an intuitive choice. But often the people who use their entrepreneurial skills to create a CPA firm are lousy managers. We've seen many firms flatten out after an initial startup surge when the firm becomes too big to ignore management.

   - The rainmaker is made the MP. What made the rainmaker successful? You know the stereotype: Outgoing personality, charm, a drive to make everyone happy. But often, they lack organizational and planning skills and are not good at administering tough love or discipline.

- A retiring MP is automatically succeeded by the next oldest partner. I think you can see the folly in this without my expounding on it.

Advice: Install MPs who are qualified for the job due to their leadership and management skills, period.

4. The firm is run like a group of sole practitioners practicing under one roof, sharing staff and overhead. Each partner has his or her different way of doing things. This focus on the individual is reinforced by (a) antiquated compensation systems that place excessive weight on Finding, Minding and Grinding to the detriment of intangibles such as teamwork and developing great staff and (b) little or no partner accountability.

   Advice: Embrace the word "synergy." A firm can achieve so much more by working as a team than by relying on individuals to carry the day.

5. Michael Gerber's *E-Myth* encourages business owners to work *on* their business, not *in* it. Partners are really executive vice-presidents and should function like executives who delegate and develop people under them. Unfortunately, many CPA firm partners never got this memo. They commit the following sins:

   - Post high amounts of billable hours (over 1,000), many of them for staff-level work, and wear this dubious accomplishment like a badge of honor.

   - Firms often *say* their staff are just as important as their clients, but they rarely walk the talk. Successful executives in any business are driven by the need to develop personnel and help them learn and grow.

   Advice: Arguably, the MP's most important job is to get the partners performing like executives, not glorified doers who are guilty of the above excesses.

6. Strategic planning is nonexistent. Because everyone is so busy with client work and all are rewarded with compensation that most would consider extraordinary (partners earn $300,000 to $600,000 on average), firms have a strong tendency to operate like a factory: Get work in and get it out, endlessly repeated. Focus on today and forget about tomorrow. Fatal flaws of this dynamic include these:

    - The firm evolves into a high-volume/lower-priced firm instead of the higher-priced/lower-volume shop that it should be.

    - There is little succession planning.

    - The firm focuses on compliance work while ignoring the tremendous consulting opportunities with *existing* clients who need these services and will pay premium prices to get them.

    Advice: The MP must be the *one* person in the firm who *never* loses sight of the big picture—what the firm should be tomorrow that it is not doing today.

You might say: "How can our model be so bad if partners earn $400,000, $500,000, $600,000 or more?" Here are my responses:

- Many CPA firms earn handsome profits in spite of themselves. If they were managed more effectively, they might increase their earnings by 25% to 50% or even more. They are leaving money on the table.

- Just because life (and profits) is good today, there is no guarantee this will continue in the future. As someone who has consulted to a thousand CPA firms over 20 years, I can testify to the many once-great firms that were mired in mediocrity when they hired me. Mistakes, poor judgment and short-sightedness came back to haunt them, dooming their firm with fatal problems.

- Most firms would prefer an exit strategy of staying independent as they bring in new partners, thus preserving their legacy. But for most firms, this option doesn't exist because historically they have failed to focus on planning for succession and developing future leaders. As a result of neglecting these areas, they have little choice but to eventually merge out of existence. 80% of first-generation

CPA firms never make it to the second because their succession planning sucked.

This flawed operating model presents serious obstacles to the MPs' efforts to manage the firm like a real business—before they even start their jobs. The extent to which MPs can correct or avoid these flaws goes a long way to determining the success they will achieve in the future.

The Management Philosophy of a CPA Firm

The diagram on the next page is very powerful. Many firms (and their managing partners) make the mistake of managing the firm from the bottom up on the chart. They appoint a MP, adopt a governance structure (department heads, executive committee, partnership agreement, chief operating officer, etc.) and manage the partners' performance and behavior mostly with the "messages" sent when allocating partner income.

The correct way to manage a firm is, of course, to start at the top and work downward:

The bus. Jim Collins, in his legendary book *Good to Great,* writes, "Before a firm begins strategic planning, it must first get the right people ON the bus and the wrong people OFF the bus." Negativity and skepticism among partners can spread at the speed of light if unchecked. These people must be either dismissed or put in a position in the firm where their harm is neutralized.

The vision. Once the proper team is on board, it crafts the firm's vision. What does it want to look like in 5 to 10 years? What is the firm's mission? Its driving forces?

Firm goals. After the vision is firmed up, next is deciding the specific firm-wide goals needed to achieve the vision.

Partner goals. Firm-wide goals can't be accomplished without people to execute them. The partners and other firm personnel are the ones to accomplish the goals.

The Management Philosophy of a CPA Firm

Right People on the Bus,
Wrong People Off

Craft the Vision

Determine Firm Goals

Determine Partner Goals

Run the Engines

Leadership
Governance Structure
Accountability
Partner Compensation

The engines. Before the "Engines" level of the chart, the firm is like a car that has come off the assembly line but whose ignition has yet to be turned on. The four engines that propel the process and keep it running and finely tuned are these:

- **Leadership.** Every firm needs a champion.
- **Governance structure**. Establishes order and defines duties.
- **Accountability**. Makes people responsible for their role in the firm and establishes consequences for failures.
- **Partner compensation**. Incentivizes and rewards performance and behavior.

This chart illustrates the big picture of managing a CPA firm. It's the managing partner's job to never lose sight of this philosophy.

The Antithesis of the MP: Management by Committee

There is an intuitive notion that comes to partners that goes something like this: "Let's all get together and form a firm that will make us *all* more successful than any of us could be individually. We'll follow the principles of democracy by dividing up the management duties so that no one is overburdened. The partners will make decisions as group, thereby avoiding vesting too much power in one person."

Management by committee is doomed to fail. This chart refutes the excuses partners often give for favoring management by committee.

Why Management by Committee Doesn't Work

Reasons Given for Management by Committee	Why These People are Wrong
1. We don't want one person with too much power. As a democracy, we all want a vote.	A business cannot be run effectively as a democracy. Someone needs to be in charge. Management by committee waters down decisions and lends itself to endless procrastination.
2. None of us has the charisma to be the MP.	Jim Collins said, "Great leaders act with quiet calm & determination, relying on inspired standards, not charisma, to motivate."
3. No one has time to be MP. Splitting up the admin time spreads the burden to all of us.	When partners do admin work, they *lose* money for the firm because instead of partners doing partner-level work, they spend large chunks of time doing the work of a COO or firm administrator, who earns far less than a partner.
4. Our rainmaker would be our best MP, but we'll lose money if we take him or her away from selling.	A rainmaker who has the skills to manage the firm will make everyone else more effective at business development. Besides, MPs should continue wearing their rainmaker hats while they manage the firm.

Line partners should welcome the presence of a managing partner because it (a) ensures that at least someone is making the firm their #1 client, (b) keeps them out of tedious admin tasks that can be performed more effectively by lower-paid people and (c) allows them to focus on the two things that matter most: taking great care of clients and staff.

CPA FIRM PARTNER RETIREMENT/ BUYOUT PLANS

MARC ROSENBERG, CPA

CPA FIRM
PARTNER RETIREMENT/
BUYOUT PLANS

Marc Rosenberg, CPA

MONOGRAPHS BY MARC ROSENBERG

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CPA FIRM
PARTNER RETIREMENT/
BUYOUT PLANS

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Introduction

Show me the money!

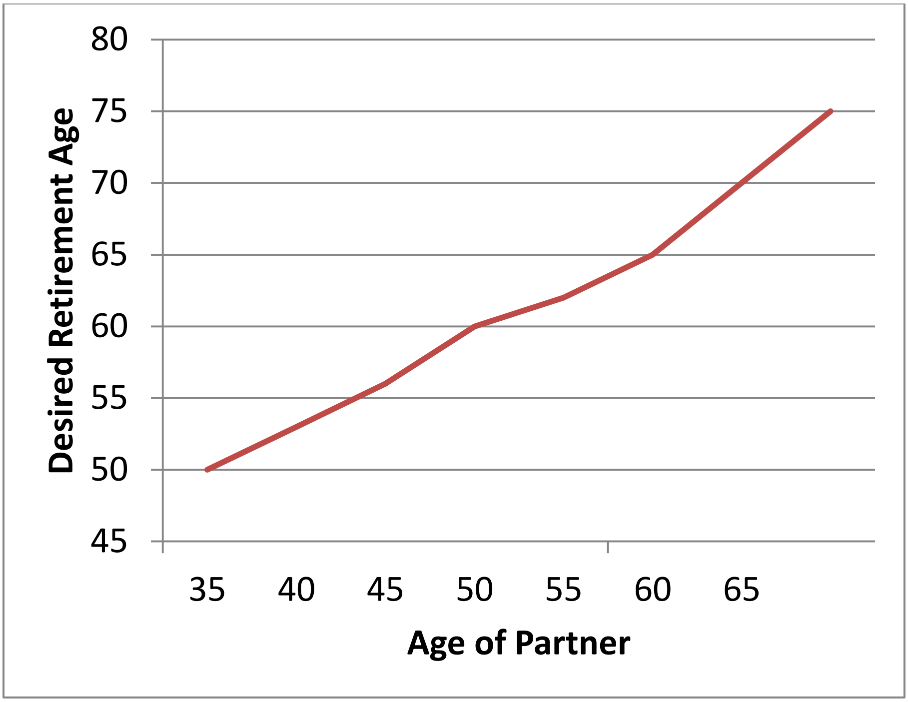
The concept of retirement for CPAs is rather amusing.

Younger partners (say, under 40) insist with unshakable confidence that the oldest they will ever work is 50 or 55. They have other things to do with their lives (own another business, do charity work, pursue hobbies, etc.) besides working at a CPA firm and they want to pursue these interests while still young.

Older partners (say, over 55) see themselves working indefinitely, with 65 being the earliest age that they will even *consider* retiring. This thinking is shaped by various influences, not the least of which are the realities of their financial burdens - college education, caring for elderly parents and the sobering calculation of the nest egg needed to continue the style of living to which they've grown accustomed.

Then too, as partners move north of 50 or 55 they realize how much they love their jobs and can't imagine giving them up. Plus, "65 ain't what it used to be." Medical advances and healthier lifestyles now make it quite possible for people to remain physically vital and mentally sharp well past 65. This concept is illustrated on the next page.

TARGETED RETIREMENT CHANGES AS CPAs AGE



So, owners of CPA firms are faced with two of the biggest challenges of their professional lives as they approach traditional retirement age:

1. They don't want to retire and they don't want anyone to make them retire. We'll address this a bit throughout this monograph, but #2 below is the primary focus.

2. When they *do* retire, they want to "cash in" their share of the firm's value. But how is the firm's value determined? And how is their share of that value calculated? In many cases the partner's share can range from $750,000 to$2M.

   How CPA firm owners meet this challenge is the primary focus of this book.

Why CPA firms have partner retirement/buyout plans

Owning most businesses provides owners with two paydays:

1. Annually, in the form of compensation.

2. Upon retirement, when the owner's interest in the firm is redeemed, either in the form of a buyout by remaining owners or an outright sale.

Partners in CPA firms are no exception. CPA firms have a substantial value that builds up over time. There is a strong market for the purchase or merger of CPA firms, making firms' values fairly liquid.

So, given the substantial "street value" of a CPA firm, when partners retire, they want to cash in their share of the firm's value. And they want to do this in a way that enables the firm to continue as a successful, viable entity. This is accomplished by creating a partner retirement/buyout plan.

A partner retirement plan results in a win-win situation for all stakeholders:

- The retiring partner receives his/her share in the value of the firm.

- The remaining partners are able to pay off the retiring partner without having to liquidate the firm.

- One of the firm's most valuable assets – its clients and the accompanying revenue stream – is retained.

The other valuable asset - the firm's people - is retained because the firm is able to survive the retirement of key owners while providing its personnel with continuity and stability, not to mention the opportunity to eventually replace the retired partners.

What CPA firms are worth

To illustrate a CPA firm's value, let's use an example of a "vanilla" or average firm:

- Annual revenues: $6M.
- 6 partners with ages spread evenly between 45 and 62.
- Average partner income: $350,000.
- Ratio of professional staff to partner is 3.5.
- Firm is located in a city with a population in excess of 1M.
- Clients are all in common industries such as manufacturing, real estate, health care, etc. No niches or specialties.
- Services are all traditional annuity types such as accounting and tax.
- The firm's accrual basis capital, primarily WIP & A/R, is $1.2M.

This firm has a value of $7.2M, computed as follows:

$6.0M	Goodwill value (also referred to as intangible value)
$1.2M	Capital (the tangible value)
$7.2M	Total

For purposes of this simple example, we have assumed that the goodwill is valued at one times fees, a common rule of thumb. Later in this monograph, we will discuss goodwill valuation in more depth and address how the one-time-fees convention, though still common, varies widely and is in no way universally accepted or guaranteed.

As the above calculation shows, the biggest component of a firm's value is its goodwill or intangible value. This is because a CPA firm practice is a very low capital-intensive business. Other than a small investment in office furniture and computers, little additional investment is needed to start and operate a firm. Most firms' largest tangible assets are their WIP and A/R.

Substantial goodwill value is directly linked to the annuity nature of most CPA firm revenues. Revenues from audit, accounting and tax services are routinely provided to the same clients for many years. This revenue stream is quite valuable because:

- It virtually guarantees a significant, steady cash flow for years to come, even if the firm doesn't add new clients.

- It significantly reduces (but doesn't eliminate) the need for CPA firms to bring in new business, a skill at which a majority of CPAs do not excel.

<u>The demand to acquire smaller firms is limitless</u>

An ample supply of willing buyers is a critical factor that strengthens and confirms the value of *any* asset, let alone a CPA firm. Virtually every firm, from sole practitioners to the Top 100, is eager to acquire a smaller firm. Why is this?

1. **Acquiring a CPA firm is inexpensive.** It's far less expensive to buy new clients, via merger or acquisition, than to develop them organically, from scratch. Also, since virtually all firm acquisitions are paid from earnings of the acquired firm, there is usually little upfront money that the buyer needs to invest.

2. **Bringing in business is very difficult for CPAs.** Acquiring smaller firms is a much-preferred growth strategy for many CPAs than engaging in practice development activities.

3. **Bigger is better**. Statistics consistently show that the greater a firm's revenue, the higher their profitability. This isn't guaranteed, but it's a safe bet.

4. **The return on investment for acquiring a CPA firm is huge.** Purchasing a CPA firm for a mere one times fees often results in a return on investment (ROI) of 50-80%, a result that would cause most people to describe the acquisition as a *steal.* If a firm were to pay as much as <u>two</u> times fees (an unheard of price), it would <u>still</u> be a good deal for the buyer. Later in this monograph, we will expound on the ROI calculation for purchasing a firm.

5. **Mergers are a great way to acquire talent**. The CPA firm industry is in the throes of a near-permanent labor shortage.

Some firms merge in smaller firms as much if not more for the *talent* acquired than the additional revenue stream.

6. **Attract younger employees**. Along the same lines as #5 above, merging in a smaller firm can be a great way for an "older" firm to bring in more youthful labor.

7. **A way to jumpstart specialization**. In addition to acquiring a revenue stream and talent, many mergers are done to acquire the seller's specialty, whether it's a new one or one that expands or compliments an existing specialty.

Evidence that the value of a CPA firm exists

Even casual observers of the CPA firm industry have seen the frenetic pace at which mergers and sales of firms are taking place. This has been going on since the onset of the 21st century and shows no signs of abating. The merger activity has been triggered by the relentless aging of Baby Boomer CPA firm owners. Lacking capable successors, they're increasingly turning to mergers and sales as the only way to "cash in" the value of their firms.

The presence of a large number of sellers coupled with a seemingly infinite number of buyers represents conclusive proof of the substantial value of CPA firms and the active market for CPA firm mergers and sales. The sales prices of the vast majority of these firms range from:

- 80-100% of fees for multi-partner firms.
- 90-130% of fees for sole practitioners.

Fifty-percent of all CPA firms are making buyout payments to retired partners, according to the results of The Rosenberg MAP Survey. This is an obvious acknowledgement by partners of the value of their firm. Note:

- Roughly half of the 50% of firms that are <u>not</u> making buyout payments are in this situation for a simple reason: they are first generation firms that have yet to retire their first partner.

- The remaining firms are <u>not</u> making buyout payments because they don't have a retirement plan in place. This is because the partners either haven't been able to agree on how the plan should work or they feel that putting the plan together would be wasted effort because their exit strategy is to sell or merge up.

<u>It's all about the clients, not the gold watch</u>

We've seen people in real life or the movies who worked for their company for 30-40 years, retired and received a gold watch from management as a thank you for their many years of loyal, hard work.

CPA firms are totally different. Virtually no part of a partner's retirement benefits has anything to do with their loyal years of service to the firm. Instead, the retirement payments are directly linked to the value of the firm's clients and the firm's ability to retain the clients after a partner retires. There is not one firm on the face of this earth that would pay hundreds of thousands of dollars to retired partners if they knew for a fact that the retiree's clients would leave.

With this strong link between retirement benefits and client retention, it's easy to understand the critical importance of client transition practices. We will address client transition issues later in this monograph.

A partner retirement plan is not a savings plan

Partners have a natural tendency to view the firm's partner retirement plan as a personal savings plan, but that's not how these plans work. A savings plan is a pile of money that increases in value over time that can be 100% withdrawn for any reason at any time by the owner. Withdrawal of the savings is not tied in any way to actions required of the owner before the withdrawal is allowed.

CPA firm retirement plans are quite different. Designed to encourage partners to stay with the firm for the long haul, these plans strictly limit a departed partner's ability to withdraw benefits in the early years of tenure with the firm. There are two reasons for this:

1. Retirements within the first 10 -15 years or so of a partner's tenure with the firm could result in windfall benefits to the individual.

2. Partners are very hard to replace. Firms really need their partners and often the departure of even one partner negatively impacts the firm for years to come.

To ensure that a partner buyout plan does not function like a savings plan, CPA firms typically adopt four plan features which we'll elaborate on later in this monograph.

1. Vesting based on years as a partner.
2. Vesting based on one's age at the time of withdrawal.
3. Notice of intent to retire or withdraw.
4. Transition of clients to other firm members as a condition for receiving goodwill-based benefits.

Who participates: Just equity partners or others?

Virtually all firms limit participation in the partner retirement plan to equity partners only. Other personnel such as non-equity partners and managers are usually excluded. This practice doesn't make it "right" or fair to personnel other than equity partners; it's simply a statement of a practice firms commonly follow.

This practice is understandable. How many non-owners of other businesses participate in the proceeds of the sales value of the business when they leave the company? Not many.

Another reason for limiting participation to equity partners is that equity partners drive the firm's growth and profitability. They create the firm's value. They have capital invested in the firm that is at risk. Firms reason that only owners with these attributes deserve to be compensated for creating and increasing the firm's value.

A small but growing number of firms include non-equity partners and senior managers in the buyout plan. In these cases, their participation in the value of the firm is usually at a much lower rate than that of equity partners. If and when they become equity partners they participate the same as other equity partners. Firms reason that these individuals are future equity partners in the firm and as such, begin driving up the value of the firm in the years prior to becoming equity partners. Therefore, they should be rewarded for these efforts.

<u>Amazing but true: 20-30% of multi-partner firms have no retirement plan</u>

Despite the clear, substantial value of a CPA firm, roughly 15% of multi-partner CPA firms do not have a formal, written partner retirement plan. Most of these are firms with four or fewer partners. Why is this?

- The partners don't want to be obligated for substantial liabilities that may not be affordable years into the future, to fellow partners who they feel may not deserve a huge payout.

- The partners can't agree on terms of the buyout agreement.

- The partners believe the firm will eventually merge out of existence, so they feel it would be a waste of time and money to create a buyout plan.

- One or more of the younger partners are afraid they will be the last partner to "turn out the lights" and they refuse to sign a buyout agreement.

- The partners run their firm like a group of sole practitioners operating under one banner. Retaining clients is so heavily linked to the tight relationship between the clients and the controlling partners that the partners are convinced that clients will leave when a controlling partner retires. Or, the clients of the retiring partners will be so old that they will cease to remain in business once the partner retires.

If the partners of firms without a retirement plan in place are asked why this is the case, their response will usually be something along the lines of "we just haven't gotten around to it." It is my experience that this is a copout – something easier and less anxiety-provoking than the true reasons for not having an agreement, listed above. Perhaps without realizing it, they choose the path of least resistance – procrastination - a natural behavior when one is faced with an extremely sensitive, gut-wrenching, difficult problem with no easy solution.

Definitions

For purposes of this monograph, a few terms need to be defined:

Retirement and retired partner. These terms relate to an equity partner who leaves the firm and ceases to be a partner. The departure could be due to retirement, withdrawal, expulsion, death or disability. In subsequent chapters, we will expound in detail about important differences in these various types of partner departures. But for the most part, "retirement" is any situation where a partner leaves the firm.

Retirement benefits and payments. As stated earlier, there are two types of payments typically paid to a retiring partner, capital and goodwill.

- Both of these types of payments are often referred to as "buyout" or "retirement" payments.

- Goodwill-based payments or benefits are synonymous with deferred compensation or intangible benefits.

Mergers. When we use the term "merger" in this monograph, we use it in its broadest sense. So, "mergers" refers to any combination of two CPA firms, including true mergers, sales and purchases of firms.

Partnerships vs. Corporations. For purposes of this monograph, we have assumed that all firms are partnerships, if not in form, then substance. This means that those of you who operate as true corporations (and hence, don't have "partner capital accounts") will need to think of their firms as partnerships, not corporations.

CPA FIRM

PARTNER COMPENSATION

The Art & Science

MARC ROSENBERG, CPA

CPA FIRM PARTNER COMPENSATION: THE ART AND SCIENCE

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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

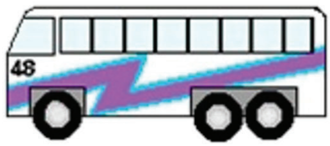
Partner compensation is obviously very important to partners. Some misguided firms feel that partner compensation is the most effective way to run a firm. Their reasoning is that running a CPA firm is simple:

> ***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.