Ways to Improve Your Partner Compensation Plan

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One key difference between successful and unsuccessful financial service firms is the way that partner compensation amounts are determined. Successful firms have strong compensation plans that help retain their top performers and motivate all partners to do their best. Other firms have plans that encourage average or below-average performers to stay, and send the best looking for greener pastures.

The partner compensation plan serves many purposes and risk mitigation may be the most important. Business valuators understand that all professional service firms face many risks, and the defection of a top performer can be one of the most difficult risks to manage.

One of the worst ways to compensate partners (or other owners) may be to share pay equally regardless of individual results. This type of plan is not a motivator and does not give everyone enough incentive to go the extra mile. In today's highly-competitive environment, each owner needs to be fully incentivized. Although there are exceptions, firms paying all owners equally usually do not achieve the long-term stability, growth or profitability that the owners desire. Even for those who are not motivated primarily by money, being paid equally can be a powerful de-motivator.

"When performance is irrelevant to compensation, the organization gets less than it pays for," says compensation expert E. James Brennan.

A better approach may be to keep base salaries (aka show-up pay) to no more than about 70% of total expected pay. This allows for sizeable bonuses, which are powerful motivators.

Incentive bonuses are effective not only because of the financial reward, but also because everyone appreciates having their hard work recognized and rewarded. For both of these reasons, well-designed incentive bonuses can bring out the best in everyone.

Ala Weiss, an advisor to consultants, warns against trying to manage (lower) the amount paid to a partner. Instead, he suggests trying to manage (raise) the partner's value.

Weiss also reminds firms to design their plans for the future, not for the past.

"You want to foster an environment where everyone believes that one partner's success is best for the firm rather than detrimental to another partner," says James "Jim" George CPA, CVA, JD.

One of the first questions to answer is: who will design and update the partner compensation plan? Larger firms often have an executive committee or a compensation committee which is charged with that responsibility. For smaller firms, it may be most appropriate for the managing partner to make these decisions. Regardless of who handles this important task, the following reminders may be helpful.

Pay bonuses often. Annual bonuses are golden handcuffs which may keep employees on board until the annual bonuses are finally paid. But in today's want-it-now society, a year can be a long time. More motivation can be derived from quarterly bonuses because the longer the interval between the desired performance and its reward, the less affected the bonus is. Paying a bonus as soon as practical after the amount has been determined will surely help morale. One CPA firm saw attitudes sour quickly when they postponed payment of "tax season" bonuses until June.

Early in my career I learned the hard way that coming between someone and their paycheck was a quick way to lose a friend. Once someone feels that they have earned their money, they do not want to wait for a committee to meet or for any other delay.

Customize. Although it takes some time and thought, the best way to achieve fairness and maximize profitability is to customize a bonus plan for each owner annually. All owners do not perform the same services or bring the same amount of value to the firm. Someone spends more time on administrative matters, for example, and deserves to be paid for that. Another may be the best rainmaker and someone else will have the most billable hours. Therefore, one bonus plan may not fit all.

Start by determining what is needed from each partner. This usually includes a mix of client service, recruiting, staff development, business development and firm administration. The priorities may change from one year to the next. This year the firm may need extra attention on business development, and the next year it may need more emphasis on recruiting. Just be careful what you promise to pay for, because you will surely get more of it, and you probably prefer quality over quantity.

Mike Gregory, an independent consultant who championed the IRS team on reasonable compensation years ago, says, "We get what we measure. If a partner is being is given an incentive to prioritize certain actions, ensure the actions are clearly articulated orally and confirmed in writing."

Try to balance fairness, simplicity and transparency. It is best for everyone if bonus plans are kept fairly simple. For good reasons, professionals are skeptical of anything they do not fully understand. You also want the plan to be straight forward so you can compute bonus amounts quickly after quarter end.

Jim George adds, "I would make sure that any creative bonus plans are in writing and explain the rationale for how they are calculated. This will be important later, if any disputes arise between partners or if the partnership needs to be valued. Many times disputes occur and without proper documentation it may be difficult to remember or justify why a certain partner's bonus was larger than others."

And, as with other aspects of managing a firm, transparency among the partners is also important.

Components. Despite the need for simplicity, a bonus plan could be made up of multiple components. Therefore, each bonus could actually be a combination of small amounts from the various components. For example, one owner may have a component for client service, and that may be measured in part by billings and collections. That component of her bonus may be equal to 30% of the amount by which her collections exceed her target for the quarter. When designing the components, remember that most workers focus their attention on the specific areas that directly affect their compensation. And be sure that bonuses are based on individual performance, not on seniority or equity ownership.

Business development. To encourage on-going business development, consider a component that pays the generating partner 5 to 10% of any fees collected from a new client during the first year. This strongly encourages the rainmaker to help get invoices out, and cash payments in, during that first year. However, since it is easy to bring in poor-paying clients, it may be wise to provide that the 10% is not paid if realization on a client is below a set level.

However, there may be disputes when new clients come in. Perhaps two or more owners may each claim that they helped attract a new client. To avoid fistfights, it may be feasible to split the bonus component between them. However, one successful firm simply assigns each new client to the person who "received the initial email or answered the phone call." Other firms have allowed their managing members to determine which owner was the principal rainmaker in these situations. Just decide how you to want to handle this scenario; put it in writing and then follow your policy. And don't forget to prepare for those situations when a member of your staff, and not an owner, is really the one who brought in the new client.

Recruiting. For many financial service firms, attracting great employees is currently a significant challenge. To encourage owners to help find qualified candidates, bonuses could include a component which is based on the starting salary of any new hires they personally locate. The amount may not need to be more than 30% of what would have been paid to a placement firm. Consider paying this component on the six-month anniversary of the new employee's start date and make it contingent on that new employee performing satisfactorily up to that time.

Use the bonus plan to unify, not divide, your team. Even though each owner does not have the same bonus terms, be sure each plan includes firm-wide incentives. To create a team that

works together, the bonus plans must give each owner an incentive to see that the whole firm succeeds. Otherwise, you may be creating a collection of sole proprietors.

One way to create teamwork is to agree that every owner's bonus will include a component each time the firm's collections exceed the total for the same quarter of the prior year by more than 10%.

Example	
Collections in Q2 of current year	$1,000,000
Collections in Q2 of prior year	800,000
Increase	200,000
10% of prior year collections	80,000
Increase in excess of 10%	120,000
Bonus divided among the owners (50%)	$60,000

If every owner gets a cash bonus when the whole firm exceeds budget, they will pull together. Even a small cash bonus can be a big motivator since it acknowledges successful effort.

Client service. Owner bonuses should also reflect client service. One component I seldom see, but highly recommend, is based on client satisfaction surveys. Consider having your managing member send out client surveys regularly, or use an independent firm to perform the survey. Add a certain amount to the bonus of the owner receiving the highest scores each quarter.

Flexibility. Include some flexibility and subjectivity so the managing partner or executive committee can adjust the amounts upward or downward for hard-to-measure attributes like ethics and attitude. You do not want to be contractually committed to paying a bonus to someone who undercut team incentives for personal benefit. One firm was contractually obligated to pay a large bonus to a former partner who had just been kicked out of the firm for committing an ugly crime.

It really is the thought that counts. Give the managing member the authority (and the responsibility) to award small, impromptu bonuses. These "spot bonuses" quickly recognize someone's unexpected, extraordinary performance through an at-the-moment reward. These bonuses are effective in showing immediate appreciation for exceptional accomplishments. They should be completely subjective.

Minimize risk. To help encourage owners to exercise due care, consider requiring the responsible owner to pay all or most of the deductible if and when a lawsuit is filed against the firm. Such payment could be made by reducing that person's next bonus by the amount of the deductible. If one owner is negligent, or agitates a client, the other owners will not want to share in the payment of the deductible.

Delivery. Rather than simply having the net bonus amounts electronically deposited, consider hand-delivering paper checks. The managing member could look the other owners in the eyes, shake their hands, and say "Thank you!" while handing them their checks. Or, she could mail hand-written notes to their homes with the checks. We live in an electronic age, and that makes the old-fashion personal touch more special.

However, even with these minor details, there are advantages and disadvantages to every option. For example, one valuation professional heard of a company who once mailed bonus checks to the employees' homes thinking it would impress their spouses and make the employees feel more proud. Instead, one employee's spouse asked how many other bonuses the employee had received over the years that she didn't know about. She discovered that the prior bonuses had been deposited into a secret account that had never been disclosed to her, and the valuation professional got to work on their divorce case!

Delays. If bonuses must be delayed for some reason, be very careful. Employment agreements and state laws may limit an employer's ability to postpone payment of wages. Also, strict requirements must be met to avoid tax problems associated with nonqualified deferred compensation (see Internal Revenue Code section 409A).

Compliance. Get legal counsel on any obligation your firm makes to its owners (or other employees) and be sure your firm keeps the right to modify the incentive plan going forward.

Final thoughts. Give all owners a chance to provide their input on any changes to the compensation plan. Be sure it is clear and put in writing. Ensure that you are paying for performance and avoiding perverse consequences such as encouraging internecine warfare or intra-employee rivalry. Teamwork is the foundation of profitability.

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