

PARTNER'S REPORT

THE MONTHLY UPDATE FOR CPA FIRM OWNERS

ISSUE 07-11

WWW.IOMA.COM/CPA

NOVEMBER 2007

INCREASING MARGINS

How CPA Firm Owners Are Paid Now— and How They Would Like to Be

Most CPA firm partners agree that there always is room for improvement in their compensation plan. Although firms often revamp their compensation plans aiming to modernize and adapt to changing requirements, the right solutions may still seem to be just out of reach.

But no matter how content the majority of the owners might be, you probably will continue to tweak your owner-compensation strategies. This is because your firm is changing, and as the pace of change accelerates, your pay practices should change along with the firm's mix of partners, specialization, and responsibilities. Though personality and philosophical differences are always part of the picture, you and your fellow owners need to begin to approach compensation as one more strategic issue.

Of course, if many of your fellow owners are unhappy with the current plan, that is a reason in and of itself to reconsider partner compensation.

Research that is part of a new book on CPA firm partner compensation indicates there is a disconnect between current pay plans and what partners would like to see emphasized in determining their compensation. *Compensation as a Strategic Asset* by August Aquila and Coral Rice also discusses reasons for changing trends and offers suggestions for implementing new plans.

How firms pay partners now. Rice and Aquila asked CPA firm partners about the criteria they use now for partner compensation and to rank the factors on a scale from "very unimportant" and "somewhat unimportant" to "somewhat important" and "very important."

The top five criteria identified as "very important" in determining compensation are book of business (26% cited it), fees collected (25%), personal billable hours (18%), new business development (17%), and ownership percentage (17%) (see the figure).

These may sound like the "traditional values" of a CPA firm practice, but owners are taking new approaches toward the activities for which they believe they should be compensated. They also are increasingly results-oriented, including:

- **Book of business.** While the revenue that each partner brings in will always be a key part of compensation—as well as a measure of performance—firms increasingly are looking at profitability, not just total dollar amount. The authors suggest you can easily calculate profitability by taking a 12-month period and determining the cash received from each client and the amount of time at cost spent on the client, including owner time. The result is the gross profit. To determine net, allocate a general overhead expense to each client.

● **Firm management.** Some professional services firms still don't recognize the contribution of effective firm management to overall success. The authors recommend that a significant portion of compensation for management be based upon their achieving goals for the firm rather than for themselves. "By doing this, the firm sends a message to owners that management responsibilities have similar importance to billable hours or client work," the authors state. "Billable hours pay us today while effective firm leadership and management pay us in the future."

● **Industry experience and expertise.** The authors note the growing trend toward experts in a particular market who are able to make specialized contributions to the firm. These should be rewarded in the compensation program.

● **Managing hours.** Owners who increase the hours they manage by cross selling or expanding services to existing clients should be recognized. They are as important to the firm as the "rain-makers" who attract and land new business, the authors maintain.

● **Mentoring and training.** Your firm's future depends on developing employees who are professional, technically competent, and future leaders. Those who participate in mentoring and training must be rewarded for those activities that will ensure the firm's future.

● **Seniority.** Some firms still perceive value in tenure and seniority, but this value can be hard to define, and newer compensation plans often drop this criterion altogether, the authors explained. This change is significant and is a result of firms' increasingly seeking to put a financial value on any and all partner activities in the quest to follow a strategic plan and to achieve accountability among owners.

Below are questions the authors suggest can help in reviewing an owner's contributions over time. As you can see, the questions have more to do with what an owner does for the firm than the length of time during which he or she does it:

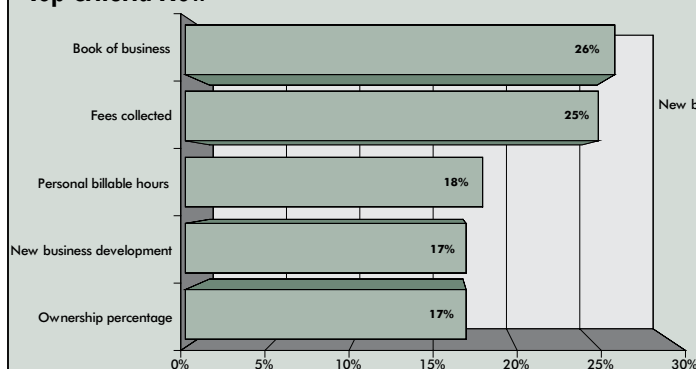
- What has been the owner's contribution in growth and name recognition?
- How has the owner developed new clients and maintained existing ones?
- What has the owner done to enhance the firm's reputation?
- How has the owner helped develop and train younger staff members?

Compensation systems still vary, with formulas (17.7%) and equal pay (15.8%) the most popular methods, followed by the managing partner deciding upon compensation (12.5%) and all owners making the decisions (10.9%).

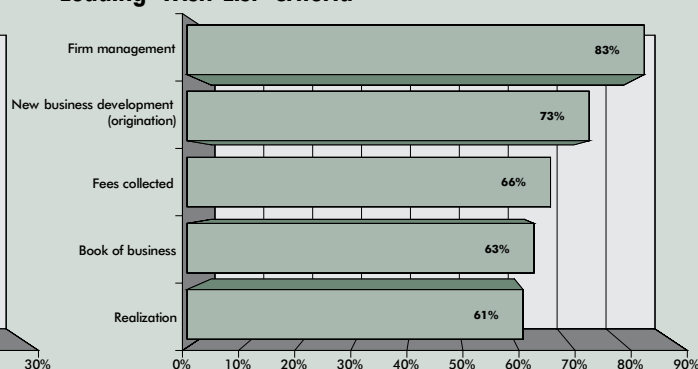
Why partners see a need for change. The authors asked the survey respondents to indicate how

How Partner Compensation Is Computed Now—& What Owners Would Prefer

Top Criteria Now



Leading 'Wish-List' Criteria



(Source: 2006 Compensation Survey, August Aquila and Coral Rice)

satisfied they are with the current criteria. The results show that many want a new approach: Only 29% are "very satisfied," and 44% are "somewhat satisfied."

When asked which criteria *should* be used in owner compensation, respondents provided answers that are very revealing. An overwhelming response rated firm management (83%) the top criterion they would like to see used in their firms' owner compensation system. The others in the "top five" wish list were: new business development (origination) (73%), fees collected (66%), book of business (63%), and realization (61%) (see the figure).

One size won't fit all. There is never "just" one answer to the best approach to compensation, the authors caution, observing that "each compensation system can succeed, and each can also fail. There is no perfect compensation system. The real challenge is to design a compensation system that aligns financial reward with the firm's strategic direction."

How to do so will vary by firm, but the authors hold—and PR agrees—that compensation should be linked with performance to best achieve this goal. The concept of linking these two factors is certainly not new and not unique to the professional services environment. It still creates discomfort for CPA firm owners who operate in a partnership-style milieu, because the thought of "judging" your fellow partners for success or failure is understandably unsettling.

Why should your compensation be linked to performance? The answer is a number of what Aquila and Rice call "paradigm shifts in owner compensation." These include customized criteria for evaluation partners, rewarding performance, ensuring fairness, providing a solid safety net for owners, and creating a new culture.

Bringing pay for performance into your plan. Aquila and Rice offer suggestions for how firms should begin to consider adding performance measures into the partner compensation plan.

As with all strategic initiatives, they urge owners to consider key questions that will help the firm set parameters that are helpful and productive to the firm's goals:

- Will the performance measures apply to owners only, or will there be performance requirements and assessments at the levels of staff CPA and administration as well?
- How will payouts for owners be set and made?
- How will bonuses be paid, including thresholds to be met (or not) for bonus achievement?
- What are the plan's measures and targets?

As to what is rewarded, individual firms will make that determination. Rice and Aquila believe there are three key areas that should be part of a pay-for-performance plan. Character and competence should be rewarded, as well as leading and lagging measures of success. Also, both independent and interdependent behaviors and outcomes should be rewarded, as partners operate both singly and as part of the greater firm.

The authors provide additional details on building a pay-for-performance plan and how to align such a plan with your firm's goals.

For more information. *Compensation as a Strategic Asset* by August Aquila and Coral Rice (product 090493) is available at the AICPA's Web site, www.cpa2biz.com. Cost: \$57 for AICPA members; \$71.25 for nonmembers. □

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