"Eat What You Kill" Partner Compensation Plan

By Bill Reeb, CPA

In my last column, I discussed the differences between the "Eat What You Kill" versus the "Building a Village" models. In the next few columns, I want to spend some time talking through likely partner compensation incentives and the outcomes they encourage. I am going to start by focusing on typical "Eat What You Kill" (EWYK) incentives and then build from there.

Common incentive components found in EWYK partner compensation are:

- ☑ Interest on Capital
- ☑ Equity Ownership
- ☑ Partner Personal Charge Hours
- ☑ Partner Book of Business (or Run)

These four are the most commonly found. Certainly, there are others including Partner Collections, Realization, New Business, Profitability, and more. Every incentive has both positive and negative attributes.

I am going to start with the easiest of the four EWYK incentives – Interest on Capital. This one is very straightforward. The firm pays interest on the retained capital of each partner. If interest is reasonable (meaning the same or slightly higher than the firm's borrowing rate), then I have no problem with this one. Partners who leave their capital in the firm to maintain greater liquidity and manage debt should get something for their investment. However, recognize there is a big difference between a firm's savings and borrowing rate, so profit is automatically built into interest when the firm pays partners at the borrowing rate.

Unfortunately, often you will find firms paying partners an interest rate two to three times what the market is charging. The argument made by those reaping the reward – "Our money is tied up in a high-risk venture and therefore we should receive an interest rate commensurate with that risk." The reality is … it is usually the senior partners who say this because they are the ones who make the lion's share of the income or are among the highest paid and they typically have a great deal of control over the decisions being made, so they are simply investing in themselves. If they deem this money to be high risk, then they basically are saying that they don't have any faith in their own judgment.

When firms pay an excessive interest rate for capital, this often is just a disguised way for senior partners to take advantage of the junior partners. Why? Because 1) the senior partners have built up their capital over many years, so at this point, it is easy for them to maintain and grow their contribution; 2) since capital is often tied to ownership, this is just another lever to exploit to pay for equity ownership; and 3) the junior partners usually are trying to buy into the firm, are logically paid less, and therefore have a much more limited discretionary income, so they struggle just to get their capital accounts where they should be. Once again, I have no problem with paying interest on capital when the interest rate is reasonable.

The next easiest incentive to discuss is equity ownership. Just like with capital, I don't have a problem with equity being a factor in compensation. My preference is to let it reflect in the base salary. If you assume that partners have a similar base, and then make adjustments from there regarding their equity share, then this makes sense to me. Since I just mentioned base salary, I will digress to introduce this component.

Many EWYK firms pay a draw, but at the end of the year when partner compensation is calculated, all draws are thrown back into the pot and the pot is then re-split. I am not a fan of this method. I understand why firms do it. I get that someone can be paid a draw in excess of what they actually earn. So if a partner has an excessive draw and he/she doesn't achieve the objectives set, then these people can be paid more than they should have earned if you don't re-split the pot.

However, re-splitting the pot doesn't take into consideration that a skilled person, especially in a labor market like our profession is enduring, is worth a certain amount just because they do a day's work. In many cases, people become partners in a firm and are paid very little more than they were paid as a senior manager. And when you consider their buy-in to the firm, they actually make less. Firms say to me all the time … "it is hard to find people that want to be partners today." My response … "Yes, when you want people to volunteer to be raped and pillaged, it is difficult to sell that." The quick rebuttal is, "Well, what we are offering was good enough for me to buy into and it didn't make much sense to me either, but I did it." And my response, "And you shouldn't have done it either. The fact that you are such an over-achiever that you wanted to be a partner no matter how stupid the proposition does not bode well as a firm strategy." So, I have concluded that the only thing we can fault our younger partners of today is that many of them are simply smarter than we were and are asking for deals that make more sense.

Back to base salary. I think firms should pay a guaranteed salary. I think the sum of all guaranteed salaries should represent somewhere between 60 to 70 percent of the firm's budgeted profits. These guaranteed salaries (base salaries) should already be adjusted for equity interest so that the incentive system is applied equally to all partners from that point forward.

What I commonly see is base salaries adjusted for equity interest or seniority (depending on the firm) and then a chunk of the incentive pay is also allocated to equity interest as well. What this does is take away critical dollars from the incentive pool that is earned without any performance criteria. In other words, it is an entitlement payment. Once again, I think you should be paid for your equity interest – but not twice or three times.

On the other hand, some firms do not consider equity in the partner compensation formula at all. When this occurs, it creates the predictable behavior of partners wanting to buy-in for the minimum ownership which allows them to enjoy the benefits of partner compensation. And since equity has no impact on annual compensation, it is hard to motivate younger partners to increase their ownership.

The third incentive is partner charge hours. This is probably the most damaging of the incentives as it can quickly perpetuate and root the firm in the EWYK operating model. When partners get paid too much for charge hours, or personal billings, then you can predict that they will do all the work they can themselves. Every billable hour has a direct correlation to what they take home.

This incentive demotivates a partner from passing work on to others. When you couple this incentive with realization, profitability and others, partners will choose to do the work themselves because they can do it quicker and more profitably. They don't have to take time out of their schedule to train their people or review work, provide feedback and wait for corrections. Instead, they can keep their head down, pumping out work for as many hours as they want to sit at their desks, and slowly but surely, create a giant gap in talent between partners and managers or between partners/managers and the rest of the staff.

But the biggest negative occurs when a partner runs out of time. The scarcest resource of a firm is a partner's time. You strategically can not afford to squander one minute that you don't have to. Once a partner is working at full capacity, then the only way the firm can continue to grow is to either add another partner or free up capacity. Every charge hour a partner bills doing work someone else could be developed to do is lost leverage, lost profits and quicker firm stagnation. So, while I don't have a problem paying for some personal billings, there should be a cap on that number because partners should first - manage client relationships; second - develop staff and push work down, and third – perform high level advisory work. Any technical work should be delegated to technical partners, managers or staff.

Finally, it is time to discuss the grand Pooh-Bah -- book of business. Like all of the above incentives, there is a place for this. However, it is rarely handled in a fair and equitable way. I have no problem with one partner carrying a two million dollar book and earning more incentive pay out of this pool of funds than someone managing a one million dollar book. However, my statement assumes one thing – that the firm (often the managing partner) manages who has what size of book. When each partner controls his/her own book size, then empires are built. In most EWYK firms, book size is the driver of internal power, influence and compensation. The sad part is, most often, the person with the largest book is only able to manage it because he/she has turned over the bulk of the work to a younger partner. This, in turn, not only minimizes leverage (there is no leverage passing work from one partner to another – leverage only occurs when work is passed down to managers, seniors and staff), but it relegates the junior partner to remaining in a manager level role.

Firms that pay partner compensation using the four incentives above clearly want to remain an EWYK firm. Capital, Equity and Book of Business are all about entitlement – being paid every year for what you did and contributed in the past. And too much focus on partner billable hours creates a culture of "do it yourself" without a focus on training and developing others. With this compensation framework, at the end of the day, you can not only expect the firm to be more rooted in the EWYK model, but you can expect a talent gap to continue to expand between partners and everyone else.

I will pick up from here in the next column. Thanks for your willingness to hang in there with me.

Reeb is a keynote speaker, author, trainer, coach, facilitator, and management consultant with more than 20 years of business consulting experience. He has founded seven small businesses in the retail, software development and services sectors, including the CPA firm Winters & Reeb, PLLC in Austin, Texas. Reeb has also been internationally published with around 200 columns and articles to his credit.