PROFIT SHARING - USING PROFIT SHARING TO INCREASE PROFITS

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We share profits equally – always have done

How many times have I heard that said?

Well, most of the times those who have made that statement have deep down wanted to change the basis of profit sharing. So why don't they? There are often a number of historical reasons, whether it is the inability to agree on change or even the unwillingness of firm owners to have a sensible discussion about how profits are shared. It may be that some partners fear they would lose out while others think that changing from a simple basis to something more formulaic or performance-based would cause division in the ranks. However, they assume that division does not exist, don't they?

This bonus report is not the place to explore a way forward - that is, I think a little unrealistic. However, let me advance the view that firm owners are accustomed to discussing these issues with clients so why not be prepared to do so with your own business? This is where self-interest needs to be set aside and the best interest of all considered. Traditionally, in those firms where profits were shared partly on performance it was normally the managing partner who was the highest paid, receiving two or even three times the amount of the lowest remunerated partner. Today, that is no longer the case as many firms have embraced an approach to profit sharing that is more performance-based. As a consequence the managing partner is not always the highest remunerated firm owner.

Do you need to split profits differently?

Why should we continue with the belief system that advances the proposition that what worked yesterday will work tomorrow? The fact is that tomorrow looks very different when compared to yesterday. So are we not in danger of carrying on with policies that worked to some extent? Maybe there were still profits that might not have been left on the table if a reward system had been in existence? Often it is the baby boomer generation that resists change contending that they honoured those who have gone before so why shouldn't they be treated in the same manner?

Hold on, maybe we could devise an approach to profit sharing that isn't just about changing how the pie is split but rather concerned with *increasing* the size of the pie. That way we can look at rewarding those for great performance while not diminishing the profit share of yesterday's super heroes.

The real reason to move on

The way I see it is that the goal of a partner profit sharing plan is to inspire each of the firm's principals to a profit summit and thus promote firm growth. When an accounting firm's success depends on partner contributions other than technical expertise, such as bringing in business, developing a specialisation or being an effective manager – its remuneration plan has to encourage and reward those qualities for both the fairness and health of the firm. A plan that connects agreed goals and an evaluation that links profit share to accountability is a powerful motivator. Those firms that have clear communication with the owners about their progress help partners stay focused on practice development as well as the bottom line. The catch? Well, the reality is that there is no one-size-fits-all formula. Let's look at a few approaches that some firms I know have adopted.

One firm I worked with was reluctant to make any changes. So here is what was agreed. There were three owners past 50 and three below. So, I had three partners who controlled policy who were reluctant to make any changes. I met with these three separately and had them agree that they would not stand in the way of a new arrangement provided their profit share did not reduce. They understood that one threat they faced was that they might lose the three younger partners but their counter-argument was that they would just sell out when the time suited them.

They agreed to a 15 per cent bonus pool and also that their time on, billing and recoverability would remain at not less than 95 per cent of that achieved in the previous year.

The younger partners wanted to be incentivised for time on and bringing new work in. The result – in the first year this was adopted was an increase in profits of 20 per cent with all partners increasing their profit share. Two years later the partners agreed to change the partnership agreement clause on profit sharing to simply allow the partners in a general meeting to agree in advance the basis on which the profits are to be shared. Since then the firm has more than doubled in size and their profit sharing is now based on a salary and performance model.

If you already have a performance-based approach to profit sharing it may well be that yours is already more advanced than the principles we are going to discuss.

"It is remarkable how frequently professional firm compensation systems fail to accomplish a simple goal – motivating partners to focus on those aspects of performance that will make the firm successful."

David Maister
Managing the Professional Service Firm

Start with a base salary

Most firms have a base salary approach whereby each partner has a salary – this may account for 50 to 70 per cent of the firm's profit sharing. The second tranche of profit sharing is allocated to return on capital – this may be three to six basis points above base/prime while the remainder, let's say this is 20 to 40 per cent, is performance-based. Performance may be determined by a remuneration committee in some firms and in smaller firms by all the partners. The purpose of a performance-based system is to *increase the size of the profit pie for all* and give regard to those who have been the major drivers of the profit increase. The reality is that not all firm owners are driven – there are those who perform well who just do not wish to add any more to their firm effort. The performance-based system for these people relieves pressure in that they don't have to force themselves to achieve performance levels they feel put them under undue pressure.

> *"Expenditure rises to meet income."*
>
> **C. Northcote Parkinson's second law,** Parkinson's Law and Other Studies in Administration (1957)

I detail some of the areas that an executive committee might evaluate, but would stress that the areas targeted must be intended to enable the firm to achieve its strategic and financial goals.

Business development: The firm should encourage rainmakers by giving them the flexibility to go looking for new business. These are the ones who are out there making new contacts and cross-selling services. Part of what is monitored should also include work that goes to other partners. As business developers they must not fall into the trap of gathering all the work for themselves.

Extension services: All partners should be incentivised to cross-sell (or cross-serve as I prefer to call it) to their clients. Are they targeted to produce work for other specialist partners?

Billable hours: Elsewhere in my programmes I have highlighted the vast range in billable hours delivered by line partners varying from 300 to over 1600. Use the bonus pool incentive to encourage further productivity although care should be taken to ensure recoverability does not suffer.

Hours managed: How many total hours is each partner managing?

Realisation: Has work been undertaken efficiently? It is important for partners to manage and bill time aggressively.

Managing the firm: This category applies primarily to the firm's managing partner and/or executive committee, who must

answer for firm profitability, growth and overall culture. This is a subjective area to gauge and partly looks at net profit against budget.

Account management: Here partners are measured on whether they bill regularly and assist in collections. Maybe the firm has a target of, say, 15 or 20 per cent lock up with points being won or lost based on performance.

Firm support: Partners are expected to be a positive force with other principals and staff.

Bringing this altogether

As I have mentioned before annual remuneration is largely made up of two components – salary and bonus pool. Some smaller firms without remuneration or executive committee award salaries based on a polling system whereby each partner awards a salary to all of the others and then the salaries awarded are based on averaging out the results. The bonus pool is then crafted using a points system which is then used to 'earn' a specific profit pool or used against a global bonus pool.

Some firms think monitoring points involves too much effort and detracts from the partner's overall performance. In these circumstances taking a bonus pool and targeting maybe three or four key result areas and then having the partners allocate the bonus pool based on a straw poll might be an appropriate solution.

There are many ways to score a goal and just as many ways to split the profits. I remain committed to the belief that equal profit sharing is a [pre]historical approach and has little merit other than it is simple to operate. It can and does cause friction between younger and older firm owners. It is the younger generation that holds the firm's future in their hands and I encourage the older generation to allow the firm's profit sharing model to be updated so it truly reflects the needs and demands of the 21st century.

"Partner compensation is one of the most difficult topics to discuss within accounting firms. Owners have struggled for years to find a system that reduces conflict and the wrong behaviour among owners. Over the years, accounting firm owners have developed at least 10 different compensation systems. These systems can range from totally entitlement-based to completely performance-based. Each one has positive and negative elements. Which one is best for your firm? Only you can decide that."

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