New Jersey Law Journal
STATEWIDE LEGAL AUTHORITY SINCE 1878
An ALM Publication
MARCH 23, 2015 NJLJ.COM

Solving the Mystery of Partner Compensation

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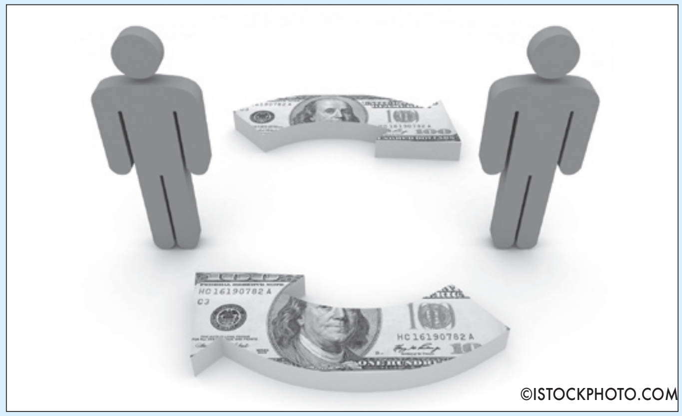

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As a partner in a successful law firm, you deserve to clearly understand the connection between your fee generation and your compensation. That understanding starts with:

- Studying your partnership agreement;
- Reviewing your firm's financial statements;
- Reviewing your firm's compensation formula; and
- Reviewing industry standards to assess how your firm's practices line up with the industry.

In our 25-plus years of providing accounting and tax services to small, closely held businesses, we have found that attorneys are not entirely in the loop when it comes to connecting payments received for services rendered relative to what appears on their partner K-1s. Even those partners who receive a W-2 do not clearly understand how their compensation relates to the fees they generate or what their paycheck is based upon. Many times, firms do not have a partnership agreement or financial statements for partners to reference.

As CPA tax preparers, we typically prepare partner personal tax returns based on the limited information we are provided. Usually such information simply includes a partner K-1 or a W-2. We then prepare tax projections which entails a review of past tax returns and a discussion about a firm's outlook for the new year. Personal tax engagements are not designed to discuss the finer points of partner compensation (that is usually addressed by the law firm's CPA). That being said, many times when we meet with partners and ask general business questions, the answers are quite revealing. For example, partners typically know how much their clients generate in fees; however, they don't typically know how those fees are specifically connected to their compensation. Often, they do not know their firm's overhead or how partners' compensation is actually structured. These conversations are usually met with the following typical responses:

- We are a growing firm and we don't have a partnership agreement.
- Asking questions about compensation can be a challenge.
- We don't have access to our firm's financial records.
- We don't have the time to review our firm's financial records.
- I'm a new partner and not comfortable asking questions about my compensation arrangement.

Clearly, the above facts and circumstances demonstrate the need for firms to do a better job with their partnership due diligence. Talking to their firm's CPA is an important part of this process. Financial statements should be up to date (tax basis and financial basis) and all partner tax activity should be presented in a year-end report that identifies all elements of taxable compensation. Firms should ensure they have a partnership agreement in place, that all partners have a copy of the agreement and fully understand their respective roles and entitlements.

Partner K-1s and W-2s tell a story, a story most partners may not be familiar with. That story includes (but is certainly not limited to):

- Total of payments you received throughout the year (guaranteed payments or net payroll checks);
- Your pro rata portion of your firm's capital expenditures (via section 179 deductions);
- Your pro rata portion of the firm's net income;
- Funds placed in your retirement plan;
- Your portion of charitable contributions; and
- Health insurance premiums.

You will only understand the story when you are able to reconcile what you put in your pocket relative to what is on

New Jersey Law Journal

that form (K-1 or W-2), and how those amounts relate to the fees you generate. Make it your mission to know your numbers, you work hard and deserve to know how every dollar collected by your firm "*for your clients*" is processed. Don't wait for an illness or an issue with a partner to be the trigger for a better understanding.

Often, [partners] do not know their firm's overhead or how partners' compensation is actually structured.

Annual retreats (you do have annual partner retreats?) are a great way for partners to discuss matters like these in a relaxed atmosphere. During your retreat, you should review your firm's partner agreement (even if a draft, you can clarify, update, revise and add provisions), tax returns, financial statements, employee payroll journals, partner and employee time reports, partner billable time, partner administrative time, compensation and bonus formulas, overhead amounts, terms of credit facilities, lease terms and the like. Use this time together to scan "comparative" financial statement reports to assess revenues, expenses, liabilities, distributions, cash flow, etc. Develop analytical schedules which compare partner billings (and collections) to costs incurred (administrative costs, labor costs, etc.) to generate those billings.

Discuss the type of activity you would like to track, and develop reports like a customized income statement that tracks each partner's activity (decide on key line-items to track) and decide on procedures to employ that would ensure such activity is monitored on a monthly or quarterly basis.

Add a monthly review of your aged receivables in total and by partner; this will help you vet collection issues and identify lax collection practices. Aged receivable monitoring is an important control that should be in place.

Consider monitoring revenues, this effort could include a report that tracks monthly partner billings, collections, aged receivables, time incurred versus time billed, and tracking realization (how much of actual time incurred is billed and collected). Study low realization rates to determine cause. Include a review and analysis of partner compensation for the past fiscal year. Assess the merits of partner compensation to partner time reports, billings, collections, costs to generate those billings and assess each partner's activity accordingly.

Once you have systems like this in place, you can then discuss and develop partner base compensation formulas (and/or modify existing formulas) and then establish bonus criteria (and/or modify existing formulas/criteria). Create a time line for these reports, ensure that all activity is reconciled through a set date (as spelled out in your partner agreement) and establish a predefined list of reports that are to be prepared, analyzed, reconciled and reviewed by all, in a formal gathering, *before* bonuses are issued. As part of your bonus program, you should consider the importance of establishing a minimum reserve for contingencies and working capital. Doing so will ensure that bonuses consider this minimum reserve pool.

Once you have spent the time to develop these controls and practices, maintenance and updating becomes a standard routine. When you have these controls in place, you will always have a solid financial understanding of your practice activity within the context of your firm's results. An organized, well thought-out financial system is the cornerstone to partner accountability, profitability and continued practice development. When your activity is accounted for, monitored and presented in an understandable and timely fashion, many questions are answered before they are asked. In addition, challenging conversations will never be considered subjective; they will always be a function of the numbers, and numbers have an amazing capacity to keep everyone accountable in an objective and impartial way. As these controls and reports mature, patterns will develop. Those patterns will help you control negative trends and confirm positive practices.

Put an end to the mystery of partner compensation. You deserve it, your partners deserve it, and your family deserves it! ■

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