Results and Rewards in The Multi-Group Firm

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Among professional firms there exists a wide array of systems for measuring and rewarding partners who operate in different locations or different practice groups.

At one extreme, some firms operate their separate locations or practice groups as distinct profit centers with minimal sharing of profits.

At the other extreme are firms who try to avoid creating intergroup competition by treating office or group results as irrelevant. Some avoid even calculating office and group results for this reason.

The vast majority of firms operate between these two extremes. The results of the group to which the partner belongs are usually treated as an influence (or a contributing factor) in assessing performance and awarding compensation, but they are rarely determinative.

It is a difficult juggling act to examine group results without giving off the dysfunctional signal that only local group results are important, thereby destroying intergroup cooperation.

However, I believe that it can be done and that it is important to examine group results, whether groups are defined by location, discipline or industry. (It is wise to examine the results of all three types of groups.)

Without such analysis intergroup cooperation is hard to encourage, and a firm must understand its economics at levels below that of the whole firm.

Most firms attempt to deal with this problem by avoiding a short-term (year by year), formulaic approach to group results, and take a longer-term, more "judgmental" approach. There is rarely a strict formula saying that local group results have the following weighting in rewards.

On the other hand, most firms recognize that no group can be treated as either a "cash cow" or a "permanent sink" for an extended period of time.

With varying degrees of formality, most firms will ensure that over a three-to-five year period, for instance, the compensation awarded to the partners in a group are commensurate with the profits earned in that group.

To monitor this, many firms explicitly use and compare three- or five-year averages of aggregate compensation and performance in each group. However, these three-year averages will still only be used as guidelines, as a check on the system but not as a strict formula.

In addition, firms need to be conscientious in demonstrating that a star partner in an unprofitable office can be rewarded like a star, while an underperforming partner in a stellar office does not get a free ride.

Measuring Results

If local office or group results are to be considered, the question arises as to how these should be measured. The answer is not as obvious as it might appear.

First, there exists the issue of developing a "balanced scorecard" that tracks not only financial results but also the other goals that any professional group needs to achieve to be deemed a success.

Included in such a balanced scorecard would be measures of client satisfaction, the group's ability to develop its people, its contribution to firmwide assets such as shared tools and research, and the group's contributions to firmwide success.

Few if any firms have a balanced scorecard organized in a formal way, although most claim to make judgmental assessments of these factors.

Even on the financial front, much confusion exists. At this point most firms have progressed to using "profit per partner" (or "profit per officer" in firms that are not partnerships) as a measure of practice group success, although even this is not always a clear guide to which groups have performed well and which have not. (To see this, consider Figure 1.)

What this reveals is that profit per officer is the simple multiplication of four key submeasures: margin, rate, utilization (also referred to as chargeability or billability) and leverage.

Two of these four factors are what I term "hygiene" issues, while two others reflect changes in fundamental profit "health." The two hygiene factors are margin and utilization, while the two health factors are rate and margin.

To understand the difference between these categories, consider (as an illustration) two of the four ways of improving profit per officer: increasing utilization or increasing rate. One group may have improved its profitability by working more hours per person. Another may have achieved exactly the same profit improvement by working the same number of hours per person as the previous year but by raising its rate per hour through some combination of client service, specialization, innovation or the bringing in of higher-rate transactions.

These two groups may have achieved the same profit per officer improvements but their accomplishments are not commensurate. Increasing utilization (or hours worked) means you made more money because you worked harder.

It is a nontrivial accomplishment, but it is primarily a short-term achievement. I call it the donkey strategy—achieving more by pulling a heavier load.

However, a group that made more money, not by working harder but by getting the market to place a higher value on each hour worked, has accomplished something much more profound and longer lasting by definition because they have made themselves more valuable in the marketplace.

The same argument can be made for the difference between margin and leverage. Improving margin is (mostly) about controlling overhead expenses—important, but nevertheless hygiene. But a group that finds a way to deliver its services with less senior and more junior partner time must, by definition, have built an asset: It has found a way to get work done by using lower-cost people. To have leveraged successfully, it must have found new ways to deliver its services, to train and manage people to handle what they could not before and to establish new methodologies.

To show how these categories can be used, examine Figure 2, which shows the financial results for a firm of six (fictional) groups.

It can be seen that all offices improved their profitability but in very differing ways. It is even easier to see what happens if all results for each office are expressed as a percentage of the respective firmwide averages, as is done in Figure 3.

For example, it is clear that Group 1, with the highest firmwide profit per officer, achieves this result almost entirely by being in a high-fee-level market, with none of its other performance measures being particularly noteworthy. Are the officers to be rewarded for good performance or does this reflect good fortune and good location?

Group 2 shows good overall results, but these are achieved mostly through hygiene factors of chargeability (utilization) and margin control. Neither is strong, although leverage improved a little in the latest year.

A final productive way of summarizing and presenting this information is to calculate a Hygiene Index (multiply the margin index by the utilization index) and a Health Index (multiply the rate index by the leverage index). This is done in Figure 4.

It is now easier to see what has happened in each office. Group 1 has increased its profitability by pushing even further on its fundamental health, but its hygiene continues to deteriorate relative to the rest of the firm. It may be the most profitable office but clear guidance for further improvement could be given.

Group 2 has done a good job of improving its profit health and should be commended. Group 3, while it improved its cash profit per partner, has slipped relative to the rest of the firm and in particular has let its profit health decline badly.

Group 4 has done a good job of profit health but lost its superior position in hygiene; it still has work to do.

Group 5 has the opposite (and a much worse) problem. It has fixed a hygiene problem but at the expense of dealing with profit health. While it, too, improved its cash profit per partner (up from $276.5K to $305.6K), it still has problems.

Group 6 has made little progress. Hopefully it is clear that analyses such as these will give much more guidance to a management committee when appraising the performance of an operating group than would a simple comparison of profit per partner figures.

Earnings Per Share

When it comes time to turn performance evaluation into reward setting, even the powerful measure of profit per officer has its limits. Its biggest problem is that it relates profits to the number of officers (head count) while it makes no distinction regarding a group of younger partners from whom there might (appropriately) be lower profit expectations.

Similarly, a high profit per officer does not necessarily mean that a group deserves an increase in compensation (or share of the profits). It might well be the case that the partners in a high-profit-per-partner group are already fully compensated for their high levels of profit and that a low-profit-per-partner group is staffed with low income partners who do not deserve to be reduced.

As a number of firms have discovered, there is a simple ratio that overcomes these issues—the use of an earnings per share (EPS) ratio. Here, share refers simply to the share of firm profits held by the partners in the office or group.

Some firms have a "unit" system for dividing partnership profits, with each partner holding a certain number of units and each unit representing a fixed percentage claim on the firm's profits. In such a case, one would calculate the earnings per unit of the group (EPU).

Other firms do not use the term "units" but allocate percentage points, which is effectively the same thing. If a partner has a claim to 3.6 percent of the firm's profits, then he or she can be said to hold 3.6 units out of a total of 100 units.

Under any of these systems, the EPS ratio can be calculated by dividing the profits of each group by the sum total of units, percentage points or even cash compensation held by the partners in the group. (Any one of these approaches will work as long as it is consistently applied.)

The virtue of the EPS ratio is that it gives an immediate guide to which groups are candidates for increased profit allocation and which are candidates for reductions. Consider a group that on a three-year average basis has sustained a high EPS. By definition, this group has high earnings (profits) relative to the number of profit shares allocated to the partners in that group. A greater profit-share allocation might be in order.

Similarly, any office with a low EPS (particularly if this is a three-year average) would have earnings that are low relative to the aggregate profit shares held by the partners in the group. In such a situation a (relative) share reduction might be called for.

Of course, there are other action possibilities. Perhaps the firm has partners in that group who are too high powered to be working there (relative to the earning potential in that market), and they might better serve the firm by being deployed to better markets.

A third possible action is to conclude that the low EPS is the result of a conscious strategic decision to invest "expensive" partner resources in a market that the firm is trying to nurture.

Whatever the conclusion, the EPS ratio provides a convenient way to relate profitability to the set of decisions about where the firm's "equity" should be located. Just as in industry, EPS is a measure of return on equity investment and provides guidance as to whether the firm is placing its valuable resources in the correct markets.

As we noted above, no approach to partner reward should be formulaic and none should be conducted on a single-year basis. However, a three-year average of EPS for each office and practice group, together with the use of the Health and Hygiene Indexes, will give a firm a good basis for discussion of how well it is matching results and rewards in a multigroup environment.

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See Graphs on pages that follow.

Figure 1

PROFITS / **OFFICERS** =	**PROFITS** / **FEES** x	**FEES** / **HOURS** x	**HOURS** / **PEOPLE** x	**PEOPLE** / **OFFICERS**
=	**MARGIN X RATE X UTILIZATION X LEVERAGE**			

Figure 2

Last Year This Year

Margin	Rate	Utilization	Leverage	PPO*		Margin	Rate	Utilization	Leverage	PPO*
0.318	$190.8	1425	4.3	$371.8K	Group 1	0.299	$186.6	1503	4.6	$385.7K
0.390	$115.2	1710	4.6	$353.4K	Group 2	0.387	$117.1	1720	4.9	$381.9K
0.413	$127.2	1500	4.5	$354.6K	Group 3	0.414	$128.1	1612	4.2	$359.1K
0.398	$ 91.2	1725	4.7	$294.3K	Group 4	0.425	$103.7	1472	4.8	$311.4K
0.356	$121.2	1335	4.8	$276.5K	Group 5	0.368	$117.1	1612	4.4	$305.6K
0.375	$112.8	1740	3.2	$235.5K	Group 6	0.341	$115.3	1658	3.9	$254.2K
0.377	$122.7	1560	4.5	$314.3K	FIRM AV	0.379	$124.3	1599	4.5	$334.5K

* PPO= profit per officer

Figure 3: Results Expressed as an Index of Firm Averages

Last Year This Year

Margin	Rate	Utilization	Leverage	PPO		Margin	Rate	Utilization	Leverage	PPO
84	155	91	96	118	Group 1	79	150	94	102	115
104	94	110	103	112	Group 2	102	94	108	108	114
110	104	96	101	113	Group 3	109	103	101	93	107
106	74	111	105	94	Group 4	112	83	92	106	93
95	99	86	107	88	Group 5	97	94	101	97	91
100	92	112	71	75	Group 6	90	93	104	86	76

100	100	100	100	100	FIRM AV	100	100	100	100	100

Figure 4: Health and Hygiene

Last Year				This Year		
Hygiene Index	Health Index	PPP Index		Hygiene Index	Health Index	PPP Index
77	149	118	Group 1	74	153	115
113	96	112	Group 2	110	102	114
105	104	113	Group 3	110	96	107
117	78	94	Group 4	103	92	91
81	106	88	Group 5	98	92	91
111	66	75	Group 6	93	80	76