

Tiers of Compensation

There are many advantages for veterinarians to operate under a partnership arrangement. However, there are a multitude of issues that strain the relationship of partners. The most common strain on veterinary partnerships is the issue of fair compensation.

Compensation for partners of veterinary practices consists of two components:

1. Compensation for efforts expended as a practicing veterinarian, and,
2. Division of practice profits.

Currently, the most common arrangement for compensation of partners in veterinary practices is a division of practice profits proportionate to ownership interest. This division of profits works well as long as all partners have equal ownership interests and contribute equal amounts of effort to the practice operation. However, division of profits proportionate to ownership interest becomes a contentious issue when partners own varying practice interests or when partners contribute unequally to the operation of the practice.

It is common for practitioners to sell associates a minority interest, often in the 5% to 10% range. The advantage for the majority practice owner is the commitment of the minority owner and the stability it affords the practice. It is typical for the minority owner to be paid a salary comparable to that of an associate with comparable experience and skills. Compensation for the minority owner beyond this base salary is often a share of the practice profits that is proportionate to ownership interest. However, it is very probable that the efforts of the minority owner contributed significantly greater than 5 to 10% to the overall practice profit. Fair distribution of practice profit for the minority owner would be far greater than the 5 to 10 percent.

Lifestyle and health issues are two of many reasons why a partner may not be able to contribute equivalent efforts, as do other partners. An extreme situation is a partner who does not work in the practice at all. Ownership of a practice does not generate profit. It is the operation of the practice that generates profit. In cases of unequal ownership, distribution of practice profits proportionate to ownership interest, is not equitable.

Compensation of partners on a tiered basis attempts to achieve:

1. fair compensation for professional efforts of partners,
2. fair compensation for managerial efforts of partners,
3. fair return for capital invested by partners, and,
4. fair distribution of residual profits to partners.

Following, each compensation tier is discussed.

Tier 1: Compensation for Professional and Management Activities

Compensation for Efforts as a Veterinarian

The first tier of compensation rewards partners for the effort expended as a practicing veterinarian. This tier of compensation must reflect the effort expended by the partner.

It is common for veterinarians to be compensated for professional activities on the basis of a percentage of revenue generated. The actual percentage of revenues that is reimbursed to owner veterinarians typically ranges from 20 to 25%. While it is inarguable that compensation as a percent of revenue generated is equitable for each partner, this compensation scheme can change the atmosphere of the practice. Partners become motivated to:

1. attend to cases that generate more revenue,
2. book patients at a time that will allow them to provide care, regardless of whether this scheduling is most advantageous for practice operations, and,
3. encourage clients to become bonded to a veterinarian rather than bonded to the practice.

Many veterinarians feel that the behaviours associated with percentage-based compensation have a very detracting affect on practice operations. An alternative to percentage-based compensation is a scheme based on time scheduled at the practice. Partners are compensated proportionate to time spent at the practice; typically measure as some unit of time, which is most often a half day. This scheme assumes that each partner is equally productive in the time spent at the practice.

Compensation for Management Efforts

If individual partners are active in the management activities of the practice, they must be compensated relative to the efforts expended. It is common for a designated percentage of practice revenue to be dedicated to the compensation of those owners active in the management of the practice. The total salaries allocated to management, owners and practice managers combined, would not normally exceed 5% of practice revenue.

Tier II: Reinvested Capital

Each practice must maintain earnings sufficient to reinvest in depreciated assets and sufficient to accommodate the growth of the practice that is not funded by financing. These earnings must be held by the practice prior to distribution of earnings beyond fair compensation for professional activity.

Tier III: Return on Invested Capital

Each partner of a veterinary practice has capital invested in the practice. Whether the capital is sourced through equity or financing, the investing partner should expect a return on the capital.

The earnings of a veterinary practice, after compensation for partners professional and managerial activity, and after reinvestment should be committed to a fair return to partners relative to their invested capital. The fair rate of return for partners' capital is not directly observable in the marketplace.

A large portion of the capital of the partners is invested in goodwill. Rooted in theory is the view that the rate of return on goodwill (an intangible asset) must be at or above the high end of a range of reasonable rates. An investment in intangibles is void of any investor protection in the form of tangible assets, which can be sold; hence, an investment restricted to intangibles is riskier. Therefore, the rate of return on intangible assets must be greater than the rate of return on tangible assets.

The relationship of a fair return on intangible assets compared to the rate of return on tangible assets combined with intangible assets suggests that the rate of return on partners' capital should be in excess of that of the return on tangible assets. Thus that rate of return on invested capital is likely to be in the range of 10 to 12%.

Tier IV: Distribution of Earnings

Profitable veterinary practice should experience earnings in excess of that required to compensate partners for their professional and management activities, reinvestment and a fair return on invested capital, i.e., the Tiers I thru III,

This final level of earnings is commonly distributed to owners proportionate to ownership interest. However, the earnings are directly proportionate to the professional and management efforts expended by the participating partners. It is becoming more common that this level of earnings be distributed proportionate to revenue generated or proportionate to compensation for professional activities.