Brain Drain and Employee Ownership: The Case of PA-consulting

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Spiral of brain drain

Mr Moynihan, Chief executive at PA Consulting Group, got notice in 1992 that PA's Banks would withdraw their loans within 12 days, had nothing been done to change the direction of the company. He was aware of the condition the company was in when he first took the job, but nothing could prepare him for the message he was given this morning. For some time the company has been unable to participate in the overall growth in the consulting industry – in part, because consultants were jumping boat and left to competitors and clients. Some immediate changes would have to be considered. However he was not sure whether the board of directors would be willing to make the necessary changes. After all, they had spent most of their lives in the same organisation, without ever making changes to the initial governance structure of the company. Mr Moynihan felt a little bit anxious about his plan to re-construct PA Consulting Group. He knew that most of the board members would oppose his plan, but he intended to go through with his plan anyway. What could they do? Fire him? Well, the thought was not too far fetch given his plans for radical change. Mr Moynihan looked out his window at the prestigious office in London's Victoria. He considered possible projects for the future of the company or perhaps, when it is time to search for a new job.

Teaching case: PA Consulting group

PA Consulting group company description

Today, PA Consulting Group has regained strength and is one the worlds leading professional services firms. It has a broad range of services such as, Information Technology, Strategy, Human Resources, Performance Improvement, Technology & Innovation and Programme & Project management. PA Consulting Group has been around for approximately 60 years. It has a worldwide coverage with some 50 offices in 20 countries. The total amount of employees at PA Consulting Group are 2700 employees.

Services	*Industries served*	*Company facts*[1]
• *Technology and innovation Strategy* • *Human Resources* • *Performance Improvement* • *Information Technology* • *Programme and Project management*	• *Chemicals* • *Financial services* • *Government and Public services* • *Information industries* • *Manufacturing* • *Oil and Gas* • *Pharmaceuticals*	• *Countries: 22* • *Offices: 50* • *Employees: 2700* • *Founded: 1943*

Human resource management and limits to growth

In the early 1990's PA had severe problems in keeping its staff and almost went bankrupt due to the bleed of talent[2]. Many consultants including partners were only too willing to hire with competitors and clients because they did not feel that they would be rewarded according to effort, investments in firm-specific skills, and current performance.

On the partner side, less productive partners where encouraged to stay with PA Consulting Group, while more productive partners left the firm. But what was wrong with the traditional partner structure PA deployed? This type of

[1] The Sunday Times, John Waples, 7th March, 1999
[2] The Economist, London, 28th Aug. 1998

structure is very common, in the consulting industry ever since McKinsey & Company adopted this governance structure from the typical U.S. law firm (see compensation of consultant jobs). At PA Consulting, however, every year the profits were shared among partners in proportion to their salaries. So, the structure encouraged old partners to hang on, even if they themselves did not contribute a great deal to current performance and new project acquisitions. With assured income, PA consulting partner's had limited incentives for bringing in new business, but rather enjoyed their ownership positions acquired through past performance.

More severely, the governance system at PA Consulting Group created a brain drain of senior employees who had been with the firm for approximately five to ten years. These were employees who had learned the business and contributed to a great deal to the firm's profits as well as coaching of rookies. At the senior consulting level there where plenty of productive employees, not receiving the bonuses and salaries they felt they were entitled to and could obtain elsewhere. Until the crisis occurred, PA has followed an "up or out" principle so that the employees either move up in the organisation or are forced to leave, either by being fired or leaving voluntarily. Such systems only reward a minor part of "survivors" in the organisation. While this can have the advantage of credibly signalling to employees that the company values employee's investment in firm required skills, up-or-out systems also run the risk of wasting the firm-specific human capital of those who do not make the mark.

Moreover, to benefit from a traditional partner system, there need to be some incentives to elicit current efforts - even for those who get eventually fired. Otherwise, the organisation may bleed its best talent, and employees leave, when they are unsure whether and when becoming partner is desirable and possible. As a senior consultant put it: "With difficulties in reaching the partner level for the majority us, and others being area experts being forced to

assume managerial responsibility of a traditional partner role, the firm runs the risk of loosing both groups." Before Mr Moynihan joined PA Consulting Group, many employees though that the current incentive structure where the lucky few could become partners after slaving for a number of productive years were ill headed and chose to leave the company.

PA's problem, however, was not only having too few productive partners and loosing senior consultants; additionally, newly hired or grown talents at PA Consulting Group choose to jump boat as soon as outside opportunities occurred. There were simply too many junior consultants with not enough senior consultants to coach and guide them into the profession. No surprise, rookies were only too happy to increase personal learning curves at other places. Then when PA Consulting Group tried to hire new people to participate in external growth opportunities, not enough experienced people could be attracted to guide rookies into the job of being a successful management consultant. As Mr. Moynihan comments: "many people felt compelled to leave again, because the system and human capital structure was so bad."

Mr Moynihan, PA's new Executive Chairman, reasoned: "Do high fixed salaries attract mediocrity disguised as talent? Does this mean that the best people are attracted only by variable pay? Will they only work for you and give their best effort if they have a fair chance of seeing their current efforts pay off immediately? Would more profit sharing in the form of bonuses or ownership stakes improve matters?"[3] Given external growth opportunities and internal growth constraints, three governance problems required immediate attention and action. The old governance systems (1) rewarded old veterans in hanging on, (2) it discouraged top consultants from joining, and (3) it encouraged talented consultants to search their luck someplace else.

[3] The Economist, London, 28th Aug. 1998

Strategy consulting and other service firms

The consulting industry has been growing for more than a decade and the boom does not seem to end. Companies like Andersen Consulting and others like them, grow both in size and turnover rate. In the management consulting industry, a wide array of salaries for different kind of employee levels is used. One must also recognise that there are just a few years between the different career steps, except maybe going from the top level without ownership to ownership. The average salaries for employees without ownership are approximately $65,000 and the average salaries for employees with ownership interests are approximately $129,000. This gives a huge difference in annual salaries between employees with ownership and employees without ownership. The employees without ownership at consulting firms only earn about half of what employees with ownership make. To motivate top consultants with no ownership interest can be hard - especially when they bring in lots of money to their firms. Not surprisingly, at times productive people in consulting firms choose to leave when they are at their productive peaks.

McKinsey & Company, Boston Consulting Group, Bain & Company, Andersen Consulting, Booz Allen & Hamilton, Mercer Management, Arthur D. Little, Gemini Consulting, AT Kearny, The BIG five (Price Waterhouse Coopers, Ernest & Young, KPMG, Deloitte Consulting, Arthur Andersen) etc. are all competitors to PA Consulting Group. Most of the direct competitors have the same type of governance structure, with a partner system that does not really reward its employees until they reach partner level – however differences are subtle. KPMG is about to reconstruct its governance system and follow other professional service firm’s example of going public (e.g. Goldman & Sachs and AT Kearny). It is, however, only the Consulting division of KPMG that can go public, since the U.S. authorities will not allow an accounting firm to let its shares float.

Compensation of jobs in consulting firms

Presidents (CEO owner, Partner or major stockholder)	*$140,000*	Average salaries for employees with ownership interests	*$129,000*
Senior or Executive Vice presidents (ownership interest)	*$128,452*	Average salaries for employees without ownership interests	*$65,000*
Vice Presidents	*$117,983*	Branch Managers (branch with under 10 consultants)	*$79,000*
Senior or Executive Vice Presidents (little or no ownership interest in firm)	*$110,000*	Presidents (Little or no ownership interest in firm)	*$74,500*
Principal Consultants	*$79,721*	Chief Human Resources Executive	*$63,562*
Senior Consultants	*$63,139*	Chief Marketing/Sales	*$59,100*
Chief Financial Executives	*$60,183*	Consultants	*$51,500*
Junior Consultants	*$40,000*	Research Associates	*$30,788*

Source: Steve Langer, "Compensation and benefits in consulting firms",Journal of Management Consulting; Milwaukee; Nov. 1998

McKinsey & Company

At McKinsey the annual growth in people during the last 25 years have been approximately 10-15 %. Also McKinsey choose only to grow organically and not by acquisition. Some competitors like Andersen Consulting grow 25-30 % in people a year including growth by acquisition. This is not the McKinsey way of organic and stable growth, however. According to the managing director at McKinsey & Company, Mr Rajat Gupta, the issue is not to be able to find talented young recruits but rather to be able to train and educate them according to the McKinsey culture[4]. The assumption is, that the company's reputation and recognition in the business would also makes it easy to find and

[4] Tony Jackson, Financial Times, 27th Sep. 1999

retain talented people. There would be benefits even for those who get eventually laid off. It is considered an achievement in itself just to last a few years in the company. Additionally, the alumni association for former McKinsey employees is widely recognised. This is a rather unique securitry feature and serves both the company and its former employees. First, it creates an incentive for graduates to apply to McKinsey despite the small chance of making it to partner level. Second, McKinsey can sell services to former McKinsey employees even if they have been abolished earlier. Even though employees may be required to accept deferred payment schemes, a consulting firm may find ways to create an alternative incentives structure that can contribute to motivate young and mid level consultants.

Quality is important to McKinsey. However, there is also the question of measuring it. McKinsey’s main measure of performance is the impact on clients’ business. Are the clients improving their business as a result of McKinsey’s work and is McKinsey serving leader institutions which contribute to the firms reputation? Furthermore, when assessing employee's performances McKinsey looks at entrepreneurial skills and initiative besides customer satisfaction. This seems partly subjective, but is though of as important to motivate employee effort for the firm. The firm has some 80 cells divided into three different areas: Some 30-plus geographic cells, 30-plus industry cells and around 12 functional cells. An employee can belong to a cell from each category, depending on the person's interest and skills[5.] At large, McKinsey follows a traditional partner structure, where a few lucky get promoted to the partner level by working extremely hard for a number of years. There have been discussions in McKinsey, whether they should change their governance structure into a more corporate model with regional and business units. These discussions resulted in reaffirming McKinsey’s present partner structure, however. Even though McKinsey does not want to go public, the limits of partner structures to keep outstanding talent require

recognition: only recently McKinsey lost part of it's German investment banking practices to Deutsche Bank.

Goldman & Sachs

The main issue for the leading people at Goldman Sachs when going public has been: "How much will you get?" Greed is why investment banks open for business each morning. Still talk of $100 million for each of the firm's senior partners from its planned flotation this autumn, upsets the chairmen, Henry Paulson, who argues that Goldman Sachs decision to go public was for strategic reasons, not personal enrichment[6]. The decision made in June 1998 was a historical step for Goldman Sachs. They have debated for some 27 years whether they should go public or not[7.]

At first blush, that might seem odd. On the same day Goldman announced its sale, the firm said it had earned a record Dollars 1.04 billion in the second quarter of this year. So far this year, the bank has trailed only Merrill Lynch for the value of initial public offerings it has underwritten. Its monolithic (some say oppressive) culture, which has earned Goldman bankers the nickname 'moonies', has been genuinely successful in placing the interests of the firm above the individuals who work there. Along with Merrill and Morgan Stanley Dean Witter, Goldman belongs to the super-group of investment banks, which divide a large slice of industry profits between them.

By going public, Goldman is tacitly acknowledging the tactics of its peers, most of which floated a decade or more ago. But in other ways, it still seems stubbornly old-fashioned. For a start, it has neither sold itself nor bought a large competitor. As a result, Goldman will barely make it into the top ten investment banks ranked by market capitalisation, assuming the firm manages

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[5] Tony Jackson, Financial Times, 27th Sep. 1999

[6] Financial Times, 16 Jun 1998: *"Goldman Sachs plans to use flotation as spur for growth"* , Tracy Corrigan and William Lewis, New York

[7] The Economist, 20 June, 1998

to sell itself for a generous four times book value. That is also because Goldman lacks another modern attribute, namely diversity.

The investment-banking cycle is brutal. Buoyant earnings depend on three things: low short-term interest rates (which trim banks' funding costs and encourage savers into higher-yielding securities), higher bond yields (so traders earn a spread on their funding costs) and a buoyant stock market (which encourages mergers and more investing). During an economic downturn, all three can deteriorate sharply. Geographical diversification should offer some protection, particularly from a downturn in the mature American market.

Goldman has a big operation in Europe, where the underlying demand for investment-banking services should continue to grow for some time. But it trails some of its peers in the emerging markets of Asia, Latin America and Eastern Europe. More important, perhaps, Goldman lacks product diversity. With Dollars 168 billion on its books, its asset-management arm lags rivals like Morgan Stanley Dean Witter (Dollars 356 billion) and Merrill Lynch (Dollars 449 billion). Both rivals do plenty of other business-such as private banking, retail brooking and credit cards-whose supposedly more stable earnings could be used to buttress the rest of the firm during a downturn. In 1994, during the worst bear market in bonds for 60 years, scores of Goldman partners left the firm after big bond-trading losses. Merrill, on the other hand, made an 18% return on equity.

KPMG

The American auditing firm KPMG Peat Marvick is trying to go public with their Consulting division. The problems arise form the fact that they are also doing auditing as an independent accounting firm with a partner structure. The main reason for KMPG to go public is that they want equity to be able to take up the war for talent and business. They have also been poached from rival

accounting firms as Arthur Andersen and Price Waterhouse Coopers trying to take over part of KPMG's divisions in different countries.

At KPMG in Belgium there have been problems with employees not feeling as a part of the whole of KPMG. This has led to the poaching from rival consulting firm Price Waterhouse Coopers to try and take over the consulting practice in Belgium[8]. The people in control at the Belgium consulting practice did not like the global KPMG's efforts to integrate the different practices into a more global practice. They felt that their independence where threatened. KPMG managers in Belgium also wanted the benefits of having a wider range of services that could be provided to their clients ones they had joined PWC. The same attempt was made in Canada where Arthur Andersen tried to poach the entire KPMG practice and make it an Arthur Andersen affiliate. This did not succeed however since KPMG made a counter offer to 600 partners of the Canadian practice[9.]

Nothing concentrates the mind like a letter from the Securities and Exchange Commission (SEC)- senior US financial regulator. The recipient of this particular one was KPMG Peat Marwick LLP of New York. The sender was Lynn Turner, chief accountant at the SEC. The subject was KPMG's possible equity offering of 20-30 per cent of its consulting business. Deciphering the letter needs the skills of a good Criminologist. But KPMG seems relaxed about its contents and points out that it is just part of a long-running correspondence and meetings between the parties[10.] The SEC does not elaborate, but its decision to publish this particular letter - and no others - indicates that it wishes to put something on public record. What? There is no

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[8] Financial Times, Jim Kelly, 10th May 1999 :PWC poaches KPMG management consulting: London

[9] Financial Times, 7th Apr. 1999: *"KPMG International made own offer to block poachers"*, Jim Kelly, London

[10] Financial Times, 25th Mar 1999: *"SEC's sting in the tail: The US financial regulator has warned KPMG over a possible equity offering",* Jim Kelly, London

doubt the SEC is now treating KPMG's initiative as a test case. The rest of the Big Five will be watching closely, both in the US and Europe. Most would like to unlock some of the value from their fast growing consulting businesses while market conditions are so favourable.

KPMG partners are talking excitedly about a multiplier of 2.5 times revenues for the value of any flotation. That would represent Dollars 4.5bn (Pounds 2.8bn) for the whole business. Such largesse could fund investments in IT - or secure the long-term services of partners or staff. According to the letter, KPMG plans to create an affiliate, "K Consulting", in which it will retain a controlling interest. The rest will be sold by public offering or private placement. KPMG says it will "comply with the commission's independence rules and interpretations". The letter says SEC staff believes ownership by an audit client, or affiliate, of an equity interest "is inconsistent with the language and purpose" of federal security laws. Such a relationship with a client, or affiliate, "would affect the independence of the auditor in both fact and appearance". The letter indicates that late last year KPMG promised to bar audit clients from investing in K Consulting. The SEC wants to see a quality control system in place to monitor this promise and it wants its own staff to check it before an offering is made. If a client slipped through the net, KPMG could not audit the affected accounts - "disposal of the shares by the client or affiliates would not cure the lack of independence". The whole system should be subject to peer review. The SEC's definition of "affiliate" includes officers, directors or substantial stockholders as well as controlled subsidiaries of the client and "material investees". The SEC raises questions about KPMG's independence from those involved in any offering. The SEC asks it to consult before undertaking audit engagements with certain underwriters and broker-dealer firms if they have close links to any offering[11].

[11] Financial Times, 19th Mar. *"KPMG is warned over IPO"* Jim Kelly, 1999

The SEC is not saying no - a possibility when it responded to the initial announcement of the offering with a brisk shot across the bows pointing up the potential dangers. But it is clear that a structure could be put in place - and a Big Five firm probably has more skills than most to engineer it - which could safeguard investors and auditor independence. But it is in the chief accountant's last few paragraphs that the sting comes. The SEC says the issues raised by KPMG's plan are related to "alternative firm structures", a subject it had asked the Independence Standards Board to consider. The board, set up by the SEC and the accountancy profession, is to set standards to ensure auditor independence. The SEC has asked the board to deliberate on KPMG's plan - and to come back by December 1999. If it does not meet that deadline, the SEC staff will do it themselves.

In the event that KPMG goes ahead before the ISB or SEC gives its verdict, there is a "risk", says the letter, that KPMG's structure will be "inconsistent" with the independence expected of a firm to comply with the law. Further, "we would vigorously oppose suggestions that, by going forward with this transaction, the firm has become 'grandfathered' or not fully subject to such standards". Whose "suggestions"? KPMG has not said it would seek to move until the regulatory processes are complete. The message is clear. KPMG should not jump the gun or it may find it unable to audit public companies. Perhaps the SEC's warning is designed for the whole public audit sector. To some extent the firm has been caught in the crossfire between the SEC, and its chairman Arthur Levitt, and the US audit profession. Mr Levitt has said US auditors have been guilty of letting "hocus pocus" accounts go unchallenged. He is also, reportedly, unhappy with the performance of the ISB. "It's been seen as too close to the profession," said one Big Five global senior partner. The SEC may have passed the KPMG issues to the ISB as a poisoned chalice. Last year it warned, after the merger, which created PWC, that it might have to review self-regulation of the audit profession. Unless the ISB deals robustly

with KPMG its own future may be in doubt - not a cheery prospect for continued self-regulation in Europe[12].

New governance structure and change at PA

Before Mr Moynihan took action, the problem was that productive and highly skilled employees at the mid-range level left the firm because they did not feel that they where being rewarded properly. Instead the less productive employees would stay, creating a brain drain that negatively affected performance. Moreover, as with many partnerships, one of the questions PA faced was how to divide each year's profits between bonuses (which reward people for their contribution to that year's performance) and payments to owners (who have accumulated stakes based on longevity and past performance). Dismissing the option to go public (which would result in substantial payments to outsiders), Mr Moynihan, first action was to make the trade-off between bonuses and payments to ownership explicit: 58% of each year's profits are now paid to employees as performance-related bonuses (of which over 50% go to younger employees); the rest, after taxes, is distributed according to ownership shares. Additionally, since the shift in governance structure, even mid-level consultants can acquire stocks in PA. Moreover, people who left the organisation where required to sell back their shares of PA Consulting Group, keeping all the stakes of the company in-house.

The new governance structure at PA Consulting Group was different both in terms of payments and in terms of career development. First, more employees had a chance of becoming co-owners earlier. Now, younger employees gained greater impact on how operations are managed. Instead of having to work for PA Consulting Group for several years, fearing being fired (the old structure was that of up-or-out) they could instead see a much shorter path to success in the PA environment. Second, the career development schemes changed from the previous up-or-out politics to a more individually based career

[12] Financial Times, 19th Mar. 1999

development allowing to make better use of talent and individual inclination. Before the governance change at PA Consulting Group, employees could either move up on the hierarchical latter, or they would have to leave the firm. Now they could instead choose to not move up in the organisation but remain part of specialized consulting practice. Specialists in certain areas did not necessarily have to become managers, but could rather concentrate their efforts on a certain area of excellence. Employees with other obligations (private or other) could choose to move sideways in the organisation instead of managing at an increasing level.

Another big change at PA Consulting Group was that the previous partners who had left the firm where required to sell their shares back to company so that all the stakes of the company would lie in the hands of those who contribute to the current success of the firm. This was a rather delicate decision. Previously, some 70 % of PA Consulting Groups share where tied to the Butten Trust, named after PA Consulting Groups founder Ernest Butten. The Trust served not only present employees, but also former employees at PA Consulting Group. By dismantling the Butten trust Mr Moynihan turned PA Consulting Group into an independent firm that is owned by its current employees. This was not achieved without resistance. Mr Moynihan had to resign from his post first in order to get his way - before his gamble finally succeeded. Shortly after his resignation PA Consulting Group followed his demands and split up the Butten Trust. There was a price for this, however. When he dismantled the trust he agreed that, if PA did float, the value of the company above book value would be handed to the trust and redistributed among thousands of past staff. [13.]

[13] The Sunday Times, 7th March, 1999, “Inspirational chief works wonders for PA Consulting”, John Waples, London

Top consultants were also required to invest in the firm to assure their loyalty. They where required to invest some pound100, 000 each at a 40p a share[14] to ensure that they would stay with the firm for a number of years. Of course, some of choose to leave the firm, but those who did not made a small fortune. Today, PA is employee-owned, and the hope is that all 2,700 people on the rolls, from the chairman on down, have a stake in how well PA's practices perform. The size of PA has grown ever since Mr Moynihan took over and the long-term intent of PA Consulting Group is to be a player among the top consultancy in the world.

With the new structure consultants are encouraged to use the help of other consultants although they are in fact competing for the same bonuses. To avoid exaggerated competition, PA bases employees' bonuses on the clients they bring in, those they serve, and on subjective reviews by peers, subordinates, superiors and clients. If a consultant acquires a project or helps finishing a project for another division, it has as big an effect on his own bonus as on the consultant doing the work. Thus, the new reward structure encourages co-operation between consultants, rather than boosting in-house competition. [15.]

Looking back and future challenges

Mr Moynihan was a satisfied man. He had accomplished what he set out to do. Changes in PA's governance structure attracted and kept more young consultants; additionally PA hired 84 top-level consultants in 1996 and 1997 (compared with 29 in the two previous years). Additionally, the firm's turnover rate has fallen by half, to 15%, roughly the industry average.[16] Revenues grew by 20% from 1997 to 1998 (from US$373 million to US$440 million), accompanied by a 50% jump in profits (from US$26 million to

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[14] The Sunday Times, 7th March, 1999, "Inspirational chief works wonders for PA Consulting", John Waples, London

[15] Financial Times, 26th March, 1998, "PA Consulting's belief in fair shares for all: The ownership structure of the organisation", Tony Jackson, London

US$39 million).[17] Back in 1992 the firm owed £30m to its banks, today PA Consulting has cash in the bank of £125m. For Mr Moynihan, it was time to step down and let someone else take over. Jeremy Asher had been with Mr Moynihan all the way and he knew what future challenges would lie ahead. The governance issue had been resolved and a lot of good things had come out of it. Both teams as well as individuals where more prone to co-operate, the "good" people stayed with PA Consulting Group, free riders where almost extinguished and the company was making more money than it had ever done before. However, there are still problems attracting top consultants due to a lack of reputation. There would still lie a tremendous amount of work ahead for Mr. Asher, the new chief executive. When Jeremy Asher was assigned to his new job he wondered: *"The current governance structure seems to work, but what other decisions would have to be made to ensure PA's success in the future? Would it be possible to maintain employee ownership while growing PA's head count not just through recruitment but also through acquisitions or mergers."*

Sources

The following sources have been instrumental in compiling this teaching case

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