Thoughts on Firm Governance

By Tim Bartz, Director, Upstream Academy

As we work with CPA firms around the country, it's clear that managing partner performance and keeping everyone headed in a unified direction has become an increasingly difficult task. During the exceptionally good times of the late 1980s until 2007, firms seemed able to succeed in spite of themselves. Work appeared to be limitless and firm profits and partner income were at all-time highs. The biggest struggle was hiring and keeping sufficiently staffed to handle the work demand.

When the recession hit, troubled economic times functioned like a magnifying glass to reveal the management challenges that existed in firms everywhere. Overnight (it seemed), clients became increasingly demanding and less loyal. Profits could not be maintained due to reduced volume and firms faced layoffs and dismissal of some underperforming partners. Spending had to be monitored more closely. Leading became a lot less fun.

It has become abundantly clear that effective firm governance—the organization and structure that allows firms to address important matters and make significant decisions—is more important now than ever before. The myriad effects of the recession require firms to address matters more adeptly, using processes that ensure decisions are based on quality data and have the firm's best interests in mind.

Three essential components form the foundation of an effective governance system:

This Is a Business

First, a firm is a business and it's there to make a profit. I recall my first partner meeting; it seemed we didn't understand the basic truth that profitability and professionalism are not mutually exclusive. As we reviewed the financial statements and the firm's pathetic performance, one of my partners spoke up and said, "We have to do something about our business." A founding partner in our firm who rarely raised his voice in a meeting stood up, slammed his fist on the table and sternly said, "Oh, that's what we've become, a BUSINESS!" and promptly walked out of the room.

Tough decisions are required to ensure the firm remains healthy.

I am somewhat troubled by the focus placed on partner income. This often comes across as greed and a sense of entitlement, and it seems to forget about other people who do great work every day to help ensure the firm's success. Leaders must, however, look out for the well-being of the firm's finances. The firm's client work must be properly valued, billed and collected. Expenses must be managed to obtain good value for what is spent. Tough decisions are required to ensure the firm remains healthy.

Trust

Second, there must be trust amongst the partners. As Warren Bennis once said, "Trust is the lubrication that makes it possible for organizations to work." Trust is very difficult to recover once it's lost. Lack of trust can consume valuable resources.

When there is trust, people are willing to let management make important day-to-day decisions, knowing leaders are looking out for the best interests of the firm. Partners are willing to give firm leaders the benefit of the doubt and willingly support them when questioned by staff.

When there is a lack of trust, partners feel they must be involved in every debate and decision to protect themselves or those they care about from firm leaders. There are endless questions of motive. The negative energy in such an atmosphere reduces effectiveness, not only in firm decision making but also in partner and staff performance.

David Maister observed, "It is important to recognize that failure in building trust is rarely a result of poor ethics or bad intention. Rather, trust is too often destroyed by thoughtless behaviors: not getting back to people, failing to consult people who have a stake in an issue, overly focusing on your own duties and not being considerate of others."

One area Maister didn't address in his comment is the damage done to the trust relationship when leaders lack the courage to deal with difficult decisions. These are the elephants that seem to hover over every situation. People lose hope because issues are not addressed. Lack of resources, intolerable behaviors, or continued performance failures are not addressed by those with the authority and responsibility to do something.

If trust is at a high level in your firm, value it and guard it; it will get you through many challenging times with the least amount of difficulty. If the trust level is low, however, be prepared to earn it back one decision at a time. Trust is worth the time and energy to recover it, but remember it will be very slow to return. If you persist, you can win this battle.

Communication

The third fundamental component of firm governance is communication. Communication is the element that ties trust and business together. Firm leaders destroy trust when they fail to communicate. Partners hear things from others and feel slighted that they're the last to know what is going on.

Having served as a managing partner for 19 years, I understand the challenges of effective communication. Unfortunately, I made numerous mistakes as a communicator. My intentions were good, but lack of information at critical times caused doubt and concern in the minds of my partners. What I discovered in retrospect is that you can rarely over-communicate. Straightforward talk, facts simply delivered, and transparency about decisions made or to be made are welcomed by everyone.

As firms grow larger, firm governance often becomes more centralized. Partners that were once part of the decision making process are no longer involved and struggle to know what's happening in the firm. They lose their pride of ownership when they don't understand all of the activities in the firm.

Effective communication keeps everyone in the loop and maintains a sense of unity in the activities that are taking place. Although good communication requires a significant time commitment, the firm operates so much better in this environment than when the poor communication habits of firm leaders produce a lack of trust.

Levels of Governance

Firm governance often evolves as firms grow larger and add offices. A firm that begins small and grows to a substantial size will likely pass through five different levels of firm governance.

Level I: All partners participate in virtually every decision. There is some division of responsibility in administrative areas.

Level II: A managing partner (MP) is elected. This individual manages nearly everything but the partners. The entire partner group votes on key issues.

Level III: An executive committee (EC) is created and makes many of the decisions. The entire partner group continues to vote on the most important issues.

Level IV: The MP functions as a CEO. The EC focuses on long-term issues of strategy. The entire partner group continues to vote on the most important issues.

Level V: Firm management (CEO, COO, CFO) provides day-to-day direction, with oversight from an EC or board of directors. EC/Board members are elected by the partners and the EC has the authority to set strategic direction and make key decisions.

Documentation of Governance Processes and Leadership Positions

Regardless of the size of your firm, the objective in firm operations should be efficiency. If *everyone* needs to weigh in on *everything*, efficiency is lost. The firm is likely operating as a group of professionals sharing office space and not really as a firm.

Entity agreements usually address major issues such as the admittance/dismissal of partners, key management positions, terms of service on committees/boards, etc. Frequently, the missing link is clearly defined position descriptions identifying authority and responsibility for each position (MP, CFO, EC/board, technical directors/department heads, etc.). Make sure you're operating in harmony with your agreements or change the agreements. Then create the appropriate position descriptions to ensure all of the major areas of leadership authority are clearly defined.

One area where we often observe great weakness in firm ownership agreements is in the authority of leaders to deal with partner performance. In many firms, it takes a unanimous or nearly unanimous vote of the partners (exclusive of the partner to be disciplined) to discipline or dismiss a partner for anything short of illegal activities or the loss of professional licensing. Partner issues are like a cancer in the firm. If you don't deal with them in a timely fashion with appropriate discipline, firm performance will suffer and planning for the future will be an exercise in futility until the cancer is gone.

Efficient firm governance requires firm leaders to have the authority and responsibility to deal with a partner who is causing problems in the firm. The MP and EC are the right people for this difficult assignment. Be assured that no one will take this responsibility lightly, so it does not demand the attention of the entire ownership group.

It's costly to change leadership on a regular basis. Not everyone is suited to leading the firm or other important operating divisions in the organization. Identify leadership talent and begin developing people for their expected roles using this process:

1. Identify every key leadership position in the firm.
2. Create a job description for each position.
3. Develop a written evaluation process for every key position.
4. Create a training plan for each key position and determine an appropriate training period.
5. Approximately one year in advance, identify the next individual who will fill the position and use your training plan to prepare that person.
6. Decide when to communicate (both internally and externally) the planned change.

Here are some best practices in firm governance efficiency and effectiveness:

1. One partner is elected as MP or CEO and manages a team of administrative professionals to take care of day-to-day operations. The MP/CEO is elected for a three to five year term with the possibility of being re-elected at the end of each term.
2. An EC is elected with two or four members in addition to the MP/CEO. The terms of the EC are staggered over a three-year period to allow continuity of leadership. EC members may be elected to a second term but must take a one year absence to encourage diversity of leadership.
3. The MP/CEO meets with the EC on a regularly scheduled basis to address important issues in the firm. If the MP/CEO has the proper level of authority, the EC shouldn't need to meet more often than quarterly. Special meetings can be called to address pressing issues that arise outside the normal meeting cycle.
4. A compensation committee (CC) is elected by the partners and has a similar number of partners and terms as the EC. The sole function of the CC is to deal with all matters of annual compensation and bonus allocations. While there may be some duplication, the EC and CC must not be identical to avoid the perception of too much power in one group of individuals.
5. Administrative professionals are included in some portion of the EC meetings to report and to participate in discussions of specific issues that affect their responsibilities.

Selection of MP/Compensation for Services

If you want your firm to grow and prosper, the partners must elect a leader who is passionate about the success of the firm and who is willing to continually learn best practices in leading a professional service firm. An MP cannot be expected to maintain a full client responsibility load and still treat the firm as her/his number one responsibility. Depending on the size of the organization, the MP may have client responsibility ranging from 10% to 50% of the normal load of production partners.

Compensation must be appropriate for the MP based on the income of the partners in the group. Contrary to what you may hear in some settings, the MP doesn't have to be the most highly compensated individual in the organization. If s/he is doing the job at a high level, compensation should be near the top of the scale because the firm is prospering as a whole. The EC must keep in mind that those selected as MPs are frequently among the most effective partners prior to their election as MP. No one will want to accept the challenges of leadership if they're going to be "punished" in the compensation process or feel they could do much better as a production partner than as MP.

6. The management team is responsible for overall firm management, including addressing strategic endeavors developed by the EC in the firm's strategic plan, the annual budget and financial performance against that budget, and partner and staff evaluations and goal setting. The management team is accountable to the firm's EC.
7. The EC's focus is generally at the 40,000-foot level. The EC's responsibility is to hold the management team accountable for executing the strategic plan and for financial performance. It is also responsible for approving the budget and for setting compensation for management team members.
8. The EC is vigilant to ensure it's not trying to manage the firm from the boardroom. Members of the EC work diligently to ensure they represent the entire partner group.
9. The EC typically votes on the firm's MP/CEO and is responsible for the transition and replacement process of the MP/CEO.
10. The entire partner group typically meets together once or twice each year. Decisions that require the vote of the entire partner group include:
    - election of EC and CC members
    - addition of new partners
    - mergers/acquisitions of a designated size
    - renaming the firm
    - selling the firm
    - incurring significant debt
    - opening or closing offices

Conclusion

Each firm has its own style, but to accept inefficiency and lack of effectiveness in the governance process with the excuse "that's just who we are" is akin to allowing an unruly child to opt out of changing behaviors because he is "just being himself." Firm governance should be evaluated each year with these basic questions in mind:

What should we keep doing? Any decision-making process that is working efficiently and delivering quality results.

What should we stop doing? Any decision-making process that is taking an inordinate amount of time and involving a large number of partners on a recurring basis.

What should we start doing? Any refinement to a decision-making process that will reduce the time and energy necessary to produce a quality result.

If you're willing to evaluate and make change, the firm will grow in efficiency and effectiveness allowing partners to spend the bulk of their time with clients, prospective clients and staff– making money for the firm while at the same time developing their own successors.

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