

# The significance of role definition and specificity on performance-based compensation: the case of accounting partnerships

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## ABSTRACT

The objective of this research is to explore the impact of the failure of provision of clear and stable role definitions on performance-based compensation arrangements. A recent historical perspective on compensation agreements in CA partnerships revealed an unexpected instability, diversity, and a range in the roles undertaken by partners in CA firms. This report provides documentation of this instability, and suggests partnerships adopted performance-based compensation systems without consideration of the extent to which the success of such systems depended on stable role specificity. This research has implications for corporations where the interests of the entity may be best served when top management undertake diverse or previously unspecified roles and activities, on an ad-hoc or opportunistic basis.

## INTRODUCTION

Q: What should be the primary driver to profit sharing?

*A: Contribution to the profitability of the practice, with conceptually the base recognising an element of goodwill, which enabled an older partner to retire with dignity, and for a younger person to have a tax-effective way of paying something in order to get into an established practice. But the difficulty was recognising the manner in which the partners contributed to the profitability and the long-term development of the practice.*

*I have seen partnerships that allocate profits on the basis of gross fees produced. I've seen partnerships that allocate profit on the basis of time charged, hours worked, on productive work. Inevitably, those partnerships fail or become less crisp in their focus, because nobody wants to work on the development of the practice: the housekeeping, the quality control and the standards, because you don't get rewarded for it; and I think it is very foolish for any professional firm to have a blind eye to development and standards, and concentrate only on productive time" (retired Deloitte partner)*

The question of the extent to which the efficiency and benefits of performance-based compensation systems are dependant on both role definition and role specificity has not been widely addressed in business research on performance reward arrangements. In contrast to corporates, owner-operated businesses have little need of performance-related compensation

systems. The harder the owner-operator works, all other things being equal, the more their income increases. This is reflected in some income allocation methods in legal partnerships, basing the income for partners on the principle described by a lawyer as, “You eat what you kill.” The perfect alignment of owner with operator interests noted in such circumstances was observed early on to fail in corporate structures, where owners were separated from management. The agency problem was identified.

In response to the agency problem, a raft of measures to align the behaviour of management with ownership interests developed. One mechanism was the increasing popularity of profit-related bonus plans. Another, later on, was a stock compensation offer: either top management only, or to many staff in the organization. Where the organization was not suited to stock-based compensation as a means of recognition of meeting performance targets, then other financial and non-financial incentives may be used to construct a performance-related income allocation system. In either case, the widespread introduction of performance-related compensation arrangements provided the primary mechanism to overcome agency problems in non-owner-operated entities. On the other side of the coin, a wide range of large owner-operator businesses (such as taxi-cooperatives or legal partnerships) retained the direct relationship between rendering services and maximization of personal wealth. Accounting partnerships were taking a different route, and it is the route they took which is the subject of this report.

Using data from accounting partnerships, it is the objective of this study to identify the impact of the failure of provision of clear and stable role definitions on performance-based compensation arrangements. This is achieved using recent historical data on compensation agreements in CA partnerships, mainly from interviews with partners but supplemented with the data from a survey. These data revealed an unexpected instability, diversity, and a range in the roles undertaken by partners in CA firms. It is suggested that partnerships adopted performance-based compensation systems without a consideration of the extent to which such systems depended on stable role specificity. This research has implications for corporations where the interests of the entity may be best served when top management undertake diverse or previously unspecified roles and activities, on an ad-hoc or opportunistic basis.

In common with other professional partnerships, locally-based CA firms had often used an equal share system, up to the formation of national franchises. The advantage of this to an accounting professional in particular was that drumming up audit activities could generate income opportunities for a number of specialist partners, and result in higher income levels for all local partners. Even after merging into national franchises to serve national audit clients, many would have initially retained local profit pools, on the basis of the data further described in this study. Slowly there was a shift to national profit pools with remuneration shifting away from equal shares to a mixture of formula-based income allocation, and subjective assessment, usually by a management committee.

Accounting partnerships were moving from having characteristics of owner-operated business to “managed professional bureaucracies” (Brown *et al* 1996); and performance-based compensation systems were seen as the most appropriate mechanisms for a fair allocation of wealth. Accounting partnerships can be observed to have mimicked the adoption of performance-based compensation systems of their clients. The opportunity provided to partners for input into the performance-based earnings model parallels research where subjects have an opportunity to participate in setting budget targets. This study thus extends research where fair processes reflect the degree to which there is participation in setting “budget targets” (Lindquist 1995).

However partnerships are an unusual site in which to study performance-based compensation arrangements because, as one Big 8 partner commented, “No one has really resolved how to fairly distribute professional income, because professional firms live or die by the rainmakers that they’ve got” (Coopers & Lybrand partner). A recent survey, with responses from over 100 Big 8 partners, indicated some partners considered that fair income allocation systems were an important contribution to survival of the partnership. This study provides an illustration of the need for stable performance-based compensation models to be explicitly supported by clear role definition and role specificity. This is achieved in this study by two related findings:

Firstly, Big 8 partners revealed in interviews that there is a demand for sharing of a multiplicity of roles by senior partners (minders, finders, and grinders), only one of which is directly related to income generation. Secondly, interviews revealed that the need for partners to attend to multiple roles results in instability and more or less constant change in the performance-based compensation systems in accounting partnerships. The implication of this research is that performance-based compensation systems in CA firms are weakened by multiplicity of roles taken by top partners. Therefore it is suggested that a multiplicity of roles by middle and top management in other types of institutions may compromise the efficiency of performance-based compensation systems, and may result in instability in such arrangements. This topic merits further attention in research on performance-based compensation arrangements.

## **PRIOR LITERATURE**

### **Performance-based Compensation Arrangements**

There has been extensive investigation into the efficiency of compensation arrangements that incorporate some performance-based component. Linkages between job-standard tightness and compensation arrangements were examined in an early study by Chee Chow (1983). This suggested self-selection of the compensation arrangement enhanced performance; a situation mirrored in partnership income allocation models where partners have a greater or lesser degree of input into the agreed model. Partner responsibilities are similar to “broad task assignments,” which Milgrom and Roberts (1992) suggest preclude tailoring the strength of incentives to the nature of the task. Broad task assignments therefore involve higher incentive costs. However, Li Zhang (2003) illustrated how “complementarity among diverse tasks can create an information externality that mitigates the increased incentive cost under broad task assignments” (2003, 226). Daily activities of partners in CA firms would provide them with opportunities to develop such complementarity, as directly enhancing fee-generating opportunities.

An examination of variables that may interact with financial incentives in affecting task performance was provided by Bonner et al (2000). Those negotiating performance-related compensation arrangements are often confronted with historic (prior year) role definitions. A performance-based compensation agreement with targets constructed on the basis of historic roles may provide little flexibility to adequately reward fast-moving role adaptations and expansions. The effects of both task type and incentive schemes in the laboratory-based study by Bonner et al demonstrated that as the distance between task complexity and skills increased, observation of a positive impact of financial incentives decreased. This was premised on Wood’s (1986) descriptions of the two elements of task complexity: “coordinative complexity” and “dynamic complexity,” both of which are typified in responsibilities of accounting partners, managing complex assignments.

This study aims to unbundle the impact of diffuse roles on the pay-off magnitude of the partners' propensity to take risks and act opportunistically, as prompted by Bonner and Sprinkle (2002). In their description of theories that suggest mediators of the incentive-effort relationship, Bonner and Sprinkle identified expectancy theory, agency theory (via expected utility theory), goal-setting theory and social-cognitive (self-efficacy) theory as all being topical to this issue. Although these all also inform this research, it is the self-efficacy theories which offer a primary framework for the analysis of the impact of dynamic role demands.

This is illustrated as follows: the incentive to take an opportunity incongruent with the pre-determined compensation framework for a CA partner depends on an opportunistic risk/reward evaluation. For example, following-up an introduction in order to engender a favourable relationship with a possible client requires a sacrifice of current role fulfilment. This opportunity may be followed, in spite of that sacrifice, when the future benefit to the partnership and the likelihood of credit for the new business are cost-efficient. Understanding such a spontaneous risk/reward evaluation is informed from insights provided by self-efficacy theories.

Because self-efficacy incorporates a broadened expectancy, the cognitive dissonance between current role specifications and current activity beyond those roles is substantively reduced or eliminated. This is consistent with the suggestion of Riedal et al (1988) that incentives affect valence and expectations, leading to spontaneous goal-setting and higher levels of goals and goal commitment. The effects of various factors on the relationships between incentives and efforts, and efforts and performance were further examined in detail by Bonner and Sprinkle (2002). The focus in this study was on task, environmental, person, and skill variables. Various dimensions of the incentive scheme per se affect performance, in particular multiple tasks, or tasks with multiple dimensions. Bonner and Sprinkle suggest, "incentives should not be muted in multi-dimensional tasks" (2002, 332), but they do not consider the impact of the loss of role specificity in more detail. The findings of Bonner et al were further extended in another experimental context by Fessler (2003), with his examination of the relations between task attractiveness, task performance, and monetary incentives. This provides further insights into the (sometimes) ineffectiveness of incentive-based compensation: task attractiveness must also be examined.

Some of the findings of this prior literature have been applied to research in CA firms. Some focus on job satisfaction, such as Harrell and Stahl's 1983 examination of motivational differences within a trichotomy of needs: affiliation, power, and achievement, and how these needs relate to job satisfaction; and Gul's (1984) study of turnover costs in Australian accounting firms. Dillard and Ferris (1979) used a valence-instrumentality expectancy model of work motivation, with questionnaire responses from 306 accountants in 10 Southeastern U. S. firms. There were no mergers in these firms in the period of study. They suggested staff turnover decisions are multi-faceted, and did not establish any dominant examination of why professional staff decided to migrate. This was extended by Ferris, Dillard, and Nethercott (1980).

A further evaluation of an occupational goal-expectancy model by Dillard in 1981 found that professional accountants based their goals largely on three factors: the desirability of associated outcomes, the likelihood of obtaining these outcomes, and the perceived chances of obtaining a given position. At the same time, Ferris (1981) examined organizational commitment and performance in a survey of 186 auditors; he found that, contrary to prior research, personal characteristics did not significantly influence the level of each auditor's organizational commitment. Some distinctions (such as professionalism, organizational

commitment, and job satisfaction) occurring between different levels of employees were examined in research by Norris and Niebuhr (1983). From 62 survey responses, they found that partners showed higher 'scores' on all three aspects, whereas those employees with less congruence to organizational values were more likely to leave the CA firm. Again, there was no data in this concerning firm characteristics (such as growth, merger activity, retrenchment). Another study of professional commitment and job satisfaction by Aranya et al (1982) surveyed 1206 Canadian CPAs, and although they concluded that the occupational setting was of importance to an understanding of both job satisfaction and job migration, no attributes of any of the partnerships were provided. Smith and Langfield-Smith (2004) examined the impact of performance-contingent reward on accountants' organizational commitment, but this study was restricted to corporate accountants, as they believed mergers, downsizing, and litigation problems facing Big 4 staff might confound the variables used to analyse the results of their survey.

With more of a focus on the audit partners, Pratt and Jiambalvo (1982) considered leader behavior to better understand how leader behavior improves motivation, performance, and job satisfaction. There was also an ethnographic approach in research by Ferris (1982) in his study of employee performance in CA firms. He studied three offices of accounting firms to identify environmental uncertainty and coping mechanisms. However, no detailed information regarding which three firms, nor their structural characteristics, was provided. The 1992 study of organizational cultures in both large and small CA firms by Pratt and Bealeu also examined differences in uncertainty avoidance and risk taking in large, regional, and local firm. They suggested uncertainty avoidance was higher in smaller firms. The correlation of higher risk-taking with the largest firms was also identified from an examination of audit client characteristics and subsequent business survival by Hay et al (2007).

A more recent Canadian study based on equity theory, expectancy theory, and 'organizational justice' was undertaken through a survey of staff, with 76 usable responses from three of the Big 5 firms (Parker and Kohlmeyer, 2005). This sample (not restricted to partners) suggested that high turnover, low organisational commitment and low job satisfaction followed perceptions of unfairness or bias in income allocation. However, this study did not consider any unique characteristics of accounting partnership which impacted on performance-based remuneration.

## **PARTNERSHIP INCOME ALLOCATION MODELS IN CA FIRMS**

An exploratory study of income allocation of the Big 6 by Burrows and Black (1998) was based on telephone interviews with one partner from each of the Big 6 in Melbourne in 1995. They found that broad-scope profit pools were the norm; the extreme of this is the Arthur Andersen international profit pool. It was also the only firm with separate pools for consulting and accounting at that time. The interviews revealed some forward-looking comments, such as firms considering wider profit pools. They also reported some detailed data concerning the profit-sharing ratios for new partners and established partners. All the schemes were similar with regard to the process of determining the profit shares, with portions or units being allocated on an annual or biennial assessment process. Their five key findings related to:

- Absence of direct linkage between profit shares and short-run returns, and a generally broad pooling of profits; but suggesting risk-averse attitudes among partners;

- Support for an agency perspective, as there had occurred a shift away from equal sharing to variable profit shares;
- Diverse levels of shares for established partners;
- Binding effects of firm specific capital arrangements; and
- Comfort levels with a spread of profit shares, as long as the spread did not exceed the top partners receiving more than double the lowest receiving partners

This present study further extends the first research question put by Burrows and Black: “how do the Big 6 firms share profits?” and also provides valuable longitudinal data on changes in profit sharing arrangements over three decades. Increasing degrees of role diffusion and dynamism accompanied these changes. Prior to Burrows and Black’s study, earlier research included the review of systems in CA firms in the U. S. by Hunt (1995). The focus on performance evaluation in public accounting, and of auditors in particular, demonstrated that one motivation for performance evaluation is to improve practice. This was not making any link to income allocation models; but provided an illustration of the utility of a cognitive information-processing model.

At the same time, Otley and Pierce (1995) provided an analysis of the impact of leadership style on reactions to control systems in public accounting firms. This study used a questionnaire to all audit seniors in three of the large audit firms. Dysfunctional behaviours measured were under-reporting of time and audit quality reduction behaviour. In particular they identified the paradox of the more structured leadership by audit managers leading to ambiguity and conflict in their staff: when there was not enough time to complete a highly structured audit review, the apparent clarity of the process was compromised by uncertainty among audit staff as to how to complete the plan as required.

More recently, two studies of profit-sharing (Huddart and Liang, 2002; Liu and Simunic, 2005) apply some of the prior research (as described above) to accounting partnerships. Huddart and Liang see task specialisation as a basis for hierarchy, paralleling the finders/minders/grinders typology in this study. Although their analysis assumes linear sharing rules, it is of particular relevance to this study as it provides an illustration of how and why specialisation emerges in partnerships with the concomitant role specificity. Even temporary specialisation will enhance the stability of income allocation models.

Liu and Simunic (2005) modelled two audit firms with two audit partners geographically distinct, in order to try to identify reasons for differences in income allocation models in the large CA firms. They found the “equilibrium compensation strategy” differed, depending on whether client type is contractable or is not contractable. Because of the hypothetical occurrence only of the contractable audit engagement, such perfect competition is implausible. Instead, they suggest firms may “strategically differentiate themselves by choosing different profit-sharing rules in order to specialise in different types of clients” (2005, 697). They call for more research on actual profit-sharing arrangements, as will be supplied in this study, albeit from a semi-historic perspective.

### **Theories of the firm**

Other researchers have drawn on the economics-based literature for analysis of profit sharing methods. For example, Fama and Jensen’s theory of the firm was the basis for the 1998 Holmes and Zimmer study examining equal sharing compared with performance-based

methods. They predicted that local firms would share equally, and national partnerships on a performance basis. The data set was 16 interviewees, representing 30 firms. The analysis refined these responses into six variables, and of the 30 firms, nine used profit sharing based on percentage of equity, eight used equal profit sharing after an initial buying-in period, and 13 used performance-based methods. Their analysis indicated that the greater the teamwork throughout the practice and the more geographically dispersed, the greater the variance in profit shares. This study lacked any temporal dimension linking their analysis to changes in the firms other than geographic dispersion. Although this was the period when the Big 8 names were adopted by these firms, and some of the 30 firms would have been Big 8, they did not consider the effect of trends to more corporatisation or institutionalisation in the CA firms as suggested by Brown et al in 1996, nor the degree of role definition for partners.

Leibowitz and Tollison (1980) undertook a study basing the theory of the firm on the Alchian-Demsetz model, but specific to the legal profession, with some comparisons to the medical profession. This premised that as larger firms retained the principle of equal sharing of profits, one would observe increasing problems of monitoring inputs and free-riding behaviour. However this study lacked specific data on the types of profit-sharing arrangements in the two professions. Levin and Tadelis (2004) went so far as to compare the cost and benefits of profit-sharing partnerships relative to other organizational forms, such as a corporate structure. However, this was based on an assumption of equal shares, and did not extend analysis to consider differential income allocation models, nor role specificity, in professional partnerships.

Modelling the budget exercise in partnerships was considered by Narayanan (1995) to require a multi-period model, instead of a single-period game. This was mainly due to the difficulties in observing individual partner outputs. Narayanan recognised that remuneration could not be tied exclusively to outputs; and the larger the practice, the greater the moral hazard problem created by budget balancing constraints. Narayanan did not specify how distribution of profits occurred, merely observing that they were distributed in “a pre-determined manner.” In contrast, the modelling of performance evaluation practices in four United Kingdom firms earlier undertaken by Moizer and Pratt (1988) was based on perception of performance being a function of perceptions of effort, ability, and luck. They considered that this modelling exercise indicated that chartered accountants were motivated by work values consistent with the concepts that underlie other economic models of individual decision-making.

The extant literature demonstrates that a variety of descriptive and analytical methodologies have been used to study income allocation models. But mostly the work has concentrated on existing practices that are assumed to have static compensation models. There is an absence of studies addressing the problem of the lack of specificity of roles of partners in CA firms, nor studies of factors that may increase instability in these models within accounting partnerships.

## **DATA COLLECTION AND INTERVIEWS**

This study builds on semi-historic research examining partner movements between CA firms in New Zealand between 1976 and 1994 (the last year for which the New Zealand Society of Accountants published a Yearbook). The annual Yearbooks provided the names of 514 partners during the 1980s in the Big 8 and their affiliated firms. Addresses for 488 of these partners were obtained from the Institute of Chartered Accountants address database. Surveys were mailed to the partners, and 108 partners responded to the survey.

The replies to the survey by 108 partners were in response to three questions:

Question 1. “What would you consider were three key factors which contributed to the survival of CA firms after 1992?”

Question 2. “What do you consider were key factors which contributed to the reduction in size or disappearance of large CA firms during the late 1980s?”

Question 3: “What do you consider were key issues in large firm mergers?”

The survey indicated that partners identified income, or income allocation, as a major issue in answer to each of the three questions asked. The level of income, its growth, and its equitable division among partners were stated as key factors contributing to the survival of accounting firms after 1992. Likewise a factor that contributed to the reduction in size or disappearance of large firms during the late 1980s was identified as the inability to retain partners with key expertise. The inability to sustain income levels, and a mismatch of the ability and aspirations of partners, were cited as causes in this situation. The key issues in large firm mergers identified by partners included the relativity of size and income, perceived inequity of income distribution among partners, and a move towards running accountancy practices as businesses with the emphasis on income, its growth, and distribution.

### **Interviews**

Incorporated in the survey was a question asking partners if they were willing to be interviewed for an Oral History component. 40 current and retired partners agreed to do so. Those interviewed worked for both large and second-tier firms, in a total of 76 partnerships, in part reflecting partner movements and firm consolidations. All of New Zealand’s large firms were represented, from both urban and rural practices scattered throughout the country.

The objective of the interviews was to further discuss, and review the reasons for, the survival of the remnant Big 4 firms, and to discuss factors that had contributed to the collapse of other large firms in New Zealand in the 1980s, in the light of the initial survey results. In particular, the interviews focused on the subjects’ opinions on income-sharing models, as the survey had identified a diverse range of opinions on the significance of financial integration as a key to survival of each firm. It had been initially anticipated that partners from the successful surviving firms would relate some stabilisation in their income allocation models, and that partners would express more satisfaction with the models used by the surviving firms. This expectation was not substantively supported in data from the interviews.

### **FINDINGS (1): DYNAMISM AND VARIETY**

A description of the income allocation models described by the interviewees from the Big 8 firms is compiled in Table 1. It can be seen that there was periodic change in all the models. They were only rarely described as stable by any of the interviewees, usually alluding to a much earlier period. It is suggested that processes of adaptation, and change in income allocation models, are comparably critical for the survival of the firm, as each firm weathers offshore mergers, client losses, and the swings and roundabouts of economic cycles. These irregular events demand flexibility and ad hoc opportunistic behaviour by partners.

Lenz and Mudrick hypothesised that changes in systems are driven by firm size. That seems unlikely from these data. All of the firms went through growth in partner numbers in the late 80s, and then shedding of numbers in the 1990s. None of the respondents attributed



**TABLE 1: Income Allocation Systems in the Big 8**

<p>Deloitte Haskins Sells</p>	<p>Younger partners gained units until a maximum was reached; it took seven years to achieve equality with other partners; then each office divided its revenues up on the basis of units held by each partner. It gradually changed; now based on the contribution to the firm. Reviewed ever 3 – 4 years with a management committee deciding on the allocation of units for each partner.</p>
<p>Touche Ross</p>	<p>Each office was autonomous, with a national levy.” <i>We went to profit-share locally, we went to, of course, a variety of things, but Gisborne, which was the main one there ended up with a differential profit-sharing basis in the end. . . it was so-called performance based, and experience based.</i>” There was a major shift in 1985 – 1986 to the Trupac system, which divided the firm into its metropolitan offices with one profit pool, and others. Trupac was to be a performance-based assessment; it was initiated before the DTT merger, but its implementation as interrupted by that merger.</p>
<p>Ernst &amp; Whinney</p>	<p>Local offices operated independently of each office, and contributed to a national levy. Partners in local offices were placed on a progressive share; and moved from 60 to 100 points. This changed to a more subjective system of points allocation based on contribution. There was usually a two-partner profit sharing committee in each office.</p>
<p>Arthur Young</p>	<p>From very early on they had had a nation-wide system of income allocation; there was a 3-tier division of profits: (1) A salary was paid to each partner; then (2) interest on capital contributed; “<i>The older you were the more capital you had to contribute. And you’d be in, say, A group, which had to contribute £20, 000 or something [per annum], B group had to contribute £15, 000 and C group £10, 000. And that depended upon your age.</i>” (3) The remaining surplus was split equally. This changed to remuneration based on fees generated, controlled by a national remuneration committee, and this system was continued after the merger with Ernst &amp; Whinney.</p>
<p>KPMG</p>	<p>Each office was a separate autonomous partnership for profit sharing, with a national levy for national costs. Smaller offices usually had their remuneration worked out on the fees earned.” <i>Once you had been partner for 5 years you earned the same.</i>” The calculation was based on a movement over five years from 60 – 100 points. This system changed to Auckland and Wellington having one profit pool.</p>
<p>Coopers &amp; Lybrand</p>	<p>The previous firm, Barr Burgess &amp; Stewart, was nationally integrated, as with Arthur Young, but with a simpler system of allocation of profits once national costs had been deducted.” <i>It was close to equal, it was five to ten per cent either side of a mean for a mature partner. A new partner coming in was on a lower rate for about five years. When I came in, [in 1971] initially goodwill was paid. Goodwill was based on 90 per cent of your first year’s income; that was scrapped shortly after I joined.</i>” This changed to a system of local office profit-sharing. Each partner received a base amount, topped up by a bonus depending on the performance of the office. It was largely formula-based, considering fee loads, performance, and profit contribution</p>
<p>Price Waterhouse and Arthur Andersen</p>	<p>These two firms had systems very different from the other firms. Arthur Andersen started with a small firm of five Auckland partners who had all come from Peats. This firm started in 1987, and took the AA name in 1989. It is not included in this comparison. Price Waterhouse had an Australasian system; all partners were Australasian partners. The share allocation was initially based on seniority, this changed to remuneration based on responsibility and performance. Even when it was seniority based, it reached the maximum level quite early.</p>

later changes in income allocation systems to changes in firm size or organizational type. It was only earlier that, as a firm opened multiple physical offices, the “equal-sharing model” typical of local firms was replaced by a combination of (1) subjective assessment and (2) the more objective formula-based models.

Interview data reveal that there was a necessity to adapt to constantly changing patterns of partnership behaviour. Partner outputs that were most valued changed over time. These shifting patterns were essential for the firms to survive and thrive, and constitute one of the key drivers to the observed disequilibrium in partnership compensation models. These changing partnership roles were described as ‘finders, minders, and grinders’.

### **FINDINGS (2): FINDERS, MINDERS, AND GRINDERS**

The maintenance of equity between partner shares is aggravated by the steady change in the business environment in which public accounting firms operate. There are three problem areas specific to partnership organizations, which destabilise any extant balance in partner roles and income allocation. The first of these is growth through mergers of partnerships. All of the Big 8 firms grew through mergers during the time studied. Mergers typically destroy or alter at least one of the existing allocation models, and demand a renegotiation of enlarged roles and responsibilities for all partners.

Secondly, specialisation of services. As partnerships grew larger and sought to offer a wider range of business services over a larger geographic area, some specialisation by partners was essential in order to meet changing technologies and audit systems. In contrast to the first event, this would result in a contraction of roles as partners shifted into specialist areas.

The third problem area is finding the right mix of partner specialisations and matching remuneration to reward them appropriately. Views were often expressed in interviews that you could not reward partners in accounting firms solely on a formula based on billable hours or hours charged. A firm needs to devote resources to finding new business constantly, otherwise it will not survive.

“The way Buddle & Co developed in its profit-sharing [was] largely at my behest, and the approximate equal input was a subjective assessment of the manner in which partners’ talents were applied. You can have a partner who plays golf every Wednesday afternoon, networks well, and attracts and secures a vast amount of work. You can have the hardworking partner who’s technically sound but not a good networker, who doesn’t attract work but produces work. . . I think a good description is the finders, minders, and grinders description of partners in professional firms.” (Deloitte Haskins Sells partner).

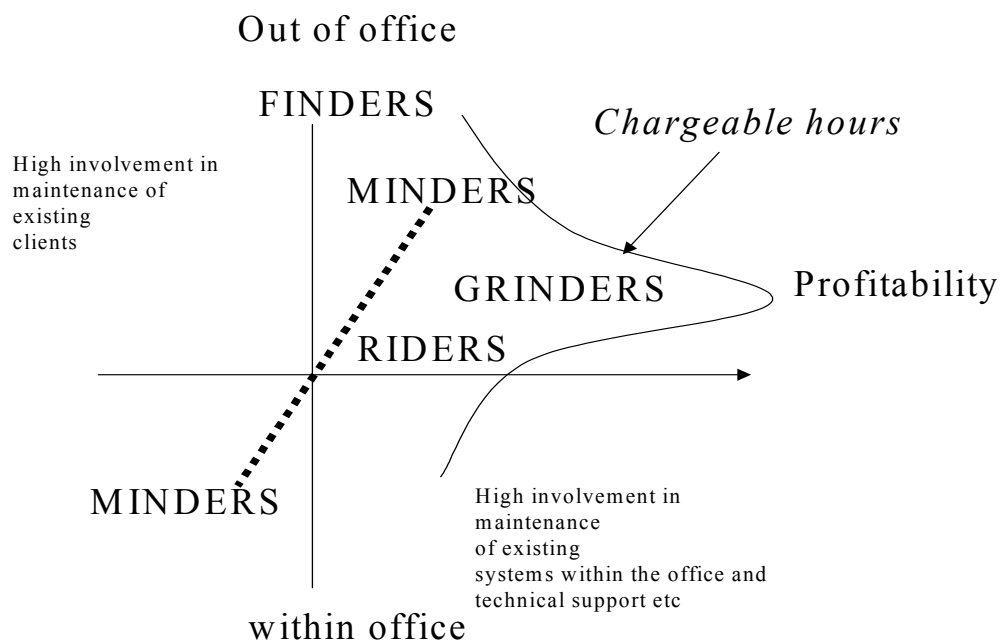
Another partner now in a small firm separate from the Big 8 noted:

“In this team here, we’ve got a couple of stars, and their skills are amazing in acquiring new work. It’s something I’ve never had the gift of doing. I guess I’d fit into the grinder one, I would think, I’d have to admit that. . . some of the guys in this practice generate huge fees, and generate new work, and I really admire the skill. It’s amazing, you know, they work hard at it, long hours.” (Kendons KMG partner)

A schematic representation in Figure 1 acknowledges that these descriptors are not tight boundaries, and partners may need to move rapidly between different activities as other partners retire, or enter, changing the relative weighting of each role. Given that these three functions need to be attended to in any sized partnership, the problem is that a model based solely on the number of hours of work charged, or revenues earned by a partner, overlooks the necessity of all three roles to be continuously and opportunistically fulfilled within a partnership.

“No one has really resolved how to fairly distribute professional income, because professional firms live or die by the rainmakers that they’ve got and the rainmakers can be either individuals or they can be associations. So you can never say why a firm is successful in achieving specific work. It was the initial contact that gives you that. If you do it properly then it builds on that. . . The rainmakers are the finders. The minders are those who make sure that the risks are managed properly; and that things don’t go off the tracks; and the grinders are those who are sitting there down in the middle, working, with the wip [work-in-progress] over them. . .” (Coopers & Lybrand partner)

**Figure 1: Finder, Minders and Grinders**



The roles could change, for example, even when one audit manager shifted to take more responsibility for internal operations in the partnership. That change would drive slight changes in the balance of work undertaken by all other partners. The significance of such shifts is that as each partner moved through the different roles of finders, minders, and grinders, they would seek to be rewarded the same as, or more than, previously, but all the

while the management/remuneration committee is required to use a formula that could still be seen as equitable for all three types of activities.

“Every several years, like about every three or four years, we review our profit-sharing scheme and change it, because it’s a zero sum game, profit-sharing is a very difficult task to go through and it’s an unpleasant thing. You never get a position where everybody’s happy, and we continually seek to find a system that’s fairer than the one we’ve currently got. People perceive themselves as making a contribution to the firm that is different from the perception that almost every one of their other partners will have of their contribution. It is a very difficult thing to do, to find a way to share profits that everyone’s happy with. So we finish up with a system; well, we have continually finished up with systems where probably 70 per cent of partners say ‘Yes, that system’s sort of broadly fair’. 30 per cent say ‘No, I don’t think it’s right’. The people who earn the top normally think they should get more. The people who earn the bottom think that they should get more. . . It’s a very difficult task”.  
(Managing Partner, Deloitte Touche Tohmatsu)

This reflected a very common theme in the interviews when partners thought further about income allocation models: the significance of relativity. Some went as far as making a case for equal shares. They felt it helped reduce “free riders”—those partners who may be drawing a salary incommensurate with their contribution irrespective of the three areas in which they may have earlier established their reputation and seniority.

### **The Case for Equal Shares**

As described above, this research has identified that the fast-changing nature of the business environment in which public accounting firms operate frequently destabilises income allocation models. This is further aggravated by problems caused by a larger number of partners, increased specialisation by partners, and retaining the mix of ‘finders, grinders, and minders’. In views expressed by some of those interviewed, the shift from equal shares to performance-based systems in partnerships does not appear to have ‘delivered’ on its promise of stability and equity.

“Equal sharing has got that strength, that it culls out the non-performers. . . you see, if you’re judging people on chargeable hours, that’s no good because some people work more efficiently than others. Some people are out there creating the contacts, not putting in the time in chargeable work. We’ve found in the consulting practice, as soon as the consulting partners got into higher levels of chargeable hours, the practice started going down. You had to have them out there, developing the new opportunities, not slaving away at the coalface.” (Ex-Managing partner in Peat Marwick Mitchell)

“It seems to me that there are two opposing philosophies, and you’ve got to subscribe to one or the other. One is a true meritocracy where you get paid for your performance, however it might be measured; and if you don’t perform you don’t earn much. Compared with ‘we’re all in this together and we earn the same for approximately the same sort of performance’, according to your talents; and if you’re not performing you go.” (Retired Deloitte partner)

These particular senior partners both recalled equal-share models as more effective in culling out non-performers than performance-based models. Performance-based models (whether on formula or a more subjective committee assessment), are characterised by instability in partnership income allocation models, and appear to tolerate non-performers for

longer periods than equal-share models. This is consistent with the suggestion by Holmstrom and Milgrom (1991) that when measuring performance of waged employees becomes very difficult, a flat-wage contract may be optimal in such multi-dimensional task situations.

## **DISCUSSION AND CONCLUSION**

This study did not find any support for an agency perspective favoured by Burrows and Black (1998): larger firms did not exhibit adoption of any particular model on a consistent basis. Considering also drivers to variance in profit shares discussed in the 1998 Holmes and Zimmer study, this evidence would suggest instead that the greater the teamwork (i.e. number of partners) throughout the practice and the more geographically dispersed (with more need for finders in each geographic area) there would be a greater variance in profit shares because the models have to recognise the diverse and changing roles partners are required to undertake. Overall, these findings illustrate the instability and dynamism in the performance-based compensation systems in accounting partnerships; and these systems are weakened by multiplicity of roles undertaken by top partners. It is suggested that a multiplicity of roles by middle and top management in other types of institutions may compromise the efficiency of performance-based compensation systems, and may result in further instability in such arrangements. This topic merits further attention in research on performance-based compensation arrangements.

This research also provides evidence that any uncritical acceptance of the superiority of a performance-based model over an equal shares model may need to be reassessed. Equal share systems may well have different advantages and disadvantages from performance-based models. The recognition by interviewees in this study that an allocation model of equal shares offers a means of reducing tolerance of non-performance challenges the application of agency theory to partnership organizations, and has not been recognised in other studies to date. Further research is necessary to examine such arguments, in order to improve our understanding of optimal income allocation systems where those at the higher levels of the organization have multiple and dynamic roles.

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