Industry Trends

# Best Practices on Firm Governance

The four corners of firm governance and the critical factors influencing it.

*By Allan Koltin*

**Q: You have advised many CPA firms on best practices related to firm governance. What specifically are we talking about when we discuss firm governance?**

**A:** The four corners that one needs to consider when looking at firm governance or management are:

1. CEO suite (CEO/managing partner, COO/firm administrator);
2. board of directors/executive committee;
3. management committee/department heads/team leaders; and
4. partner group (equity and income).

**Q: Can you briefly share the factors that you believe influence governance over the life of a firm?**

**A:** There are 12 factors that influence governance over the life of a firm. The first factor is the size of firm (See Exhibit 1). The size of the firm will affect governance more than any other item. In its simplest terms, firms of two to five partners are typically very "hands on" in the management of the firm. Whereas, once a firm gets to 10 to 20 partners or greater, it moves to a corporate model of management. The difficult part is the journey between these two firm sizes when firms are stepping out of the partnership model and into a corporate model of management.

***Exhibit 1: 12 Critical Factors Influencing Firm Governance***

1. Size of firm;
2. Trust and respect;
3. Business savvy of the partner group;
4. Firm history;
5. Leadership talent;
6. Available time to lead;
7. Speed and quality of decisions;
8. Firm culture;
9. Single- vs. multi-office firm;
10. First vs. second (or greater) generation firms;
11. Compensation/value placed on leadership position; and
12. Firm's life cycle and gas in the tank.

The second factor would be trust and respect. Firms with great trust and respect in leadership will out-perform all other firms in their peer group. The reason is that these types of firms can essentially run "baggage free," implement more changes, and take advantage of more opportunities. Once leadership loses the trust and respect of the partners, it can take many years, sometimes even a decade, to recover. To me, trust deals with, "Will they (the leaders) cover my backside in the bunker?" and respect is, "Do I believe our leaders are sharp, decisive, and know how to run a business?"

The third factor is the business savvy of the partner group. Case in point: there is a CEO I worked with in a Top 100 CPA firm who, after a couple of bumpy years, was asked to step down from his role. What about the 10 to 20 years of great leadership that preceded the last two? Unfortunately, CPA firm partners often have short memories when it comes to evaluating CPA firm leadership. Ironically, some of the best leadership shown by managing partners happened between 2008 and 2011. Yet, many of them were criticized by their partner group for any losses in revenues and profits. Unfortunately, we haven't developed the metric in our profession that evaluates leaders on how well they do when "containing the bleeding or managing through turbulent times." Some partner groups truly "get it" when it comes to measuring great leadership, while others struggle. Combine this with a partner group that does a lot of "Monday morning quarterbacking" and finger pointing when something goes wrong and you have what I refer to as the "imperfect storm."

The fourth factor is firm history. Let's face it, firms are a byproduct of their past experiences—and even more so—their experiences at their existing firm. Ask a firm about a previous failure, such as maybe having been in wealth management or hiring a professional salesperson. They will be quick to tell you not only why it was a bad idea, but also why they were against it from the beginning! Unfortunately, they have lost the ability to revisit the issue and see the great opportunity. It is possible that their failure in wealth management was simply due to the wrong champion or their failure in hiring a professional salesperson was that they simply hired the wrong person. Unfortunately, all too often, partners let historical events (and failures) determine their future, and it blinds them from looking at an opportunity through a different lens.

The fifth factor is leadership talent. When it comes to governance, there are two big issues involving talent. The first is the talent of the leader. The second issue (and maybe as important) is whether or not the partners will let the leader lead. Often, when it comes to firm governance, I categorize it in three distinct areas:

1. *Leadership.* This involves carrying out the strategic plan and vision of the firm.
2. *Management.* This means coaching others (typically partners and department heads) to get to a performance level that they may not get to on their own.
3. *Administration.* This involves essentially managing everything except for the partners and/or making the really tough decisions.

In our profession, we have many who have the title of "managing partner" but, truth be told, the firm will only let them be an administrative partner. Yet, those same partners will complain when the firm is not growing, performing, or making tough decisions and will typically point the finger at the managing partner, rather than take a hard look in the mirror at their limited governance structure.

The sixth factor is available time to lead. There are some great leaders in CPA firms who also happen to be great rainmakers, client handlers, and builders of talent. Unfortunately, when it comes to managing the firm, they treat it as a part-time, after-hours job or something they address on Saturday morning (especially in firms with revenues between $2 million and $10 million).When I have asked them why they don't treat the firm as their number-one client, the typical answer revolves around the compensation plan (which rewards production and not management) and/or the fact that their other partners simply don't value leadership. This is really a sad scenario because the partner group is really hurting itself due to its closed-mindedness of what firm leadership is and how it could benefit the firm (and them financially!).

The seventh factor is speed and quality of decisions. When I talk to firms, I usually inquire about their decision-making process and ask whether they would characterize it as a high-powered speedboat or more resembling the Titanic. Usually, there is a chuckle, but unfortunately all too often decisions are made in a slow and inefficient manner. Worse than that, often the decisions are watered down so that the ultimate decision is not only made slowly, but also has very little effect on the firm. As firms grow and transition from "the partners running the firm to the firm running the partners," they need to do a better job of "letting go" and letting the speedboat take over. It's an absolute that leadership won't be right on all of their decisions, but if they're right on more than half of the decisions, they will outperform a majority of firms in their peer group. This in no way is to suggest that firms make uninformed or uneducated decisions. Remember, perfectionism is the death blood of profitability, and firm partners need a greater willingness to be managed (and let others manage the firm).

The eighth factor is firm culture. Ask a firm about firm culture and most firms will tell you that they have a "family-friendly culture." Explore this more with them and it's not that they provide daycare services, but rather it's their belief system in how fairly they treat their people. This always leads into an interesting conversation when one asks how the firm deals with underperforming partners or associates. At some firms, there is a precise process of notification, counseling, and coaching to improve performance, an adjustment process downward on compensation if the individual's performance doesn't improve, and then, lastly, a termination of the individual's services with the firm. Another firm that would also claim to have a "family-friendly culture" might look at this process and say, "We dabble in it, but we don't like confrontation, and therefore have a much greater tolerance level for underperformance." The difference here, on the surface, may be culture. However, embedded even deeper is governance and accountability for how the firm wants to be managed. When it comes to culture, I often refer to firms as country clubs or countries. Country clubs typically sit around the table and talk about policies and changes, but unless all the partners are on board, it dies at the table. Countries, on the other hand, have a culture of making decisions, even if it involves some partners not being happy with the changes. A great question to ask at your next partner retreat is, "Are you are a country or a country club?" I guarantee it will allow for a lively discussion!

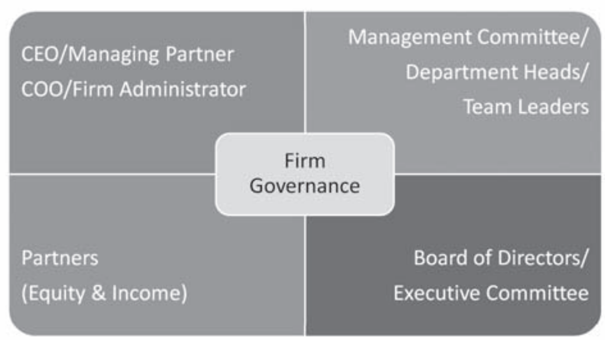
The ninth factor is the single- vs. multi-office firm. I work with a handful of Top 200 CPA firms that are single offices, and I always chuckle when they complain about issues between audit and tax, or the different cultures on the 17th vs. the 18th floors. If they only knew the degree of difficulty that multi-office (and often multi-geography) firms face, I think they would laugh. Multi-office and multi-geography firms present a whole different challenge and, at a minimum, require the firm to have multiple individuals capable of leading partner groups and teams. It also opens up an entirely different issue dealing with firm vs. office profitability, as this will be a significant driver in determining partner compensation.

The tenth factor is first vs. second (or greater) generation firms. In analyzing the Top 500 firms, it is always interesting to isolate those that are first-generation firms. Their playbook on governance is completely different than that of second-generation firms. Often, the leadership group (who can have the same names as those on the door!) have a lot more power to rule and operate the firm than that of multi-generation firms. The biggest problem with second-generation firms is that frequently the leader was previously part of a peer group and struggles with now being the "boss." It is even more complicated when these leaders try to take on more power, and there is a feeling amongst the partner group that the first-generation leader was very autocratic, and the partners now want more of a team approach to running the firm. Unfortunately, many of these firms are also now double or triple the size they once were and, at a time when they should be moving to more of a corporate style of management, are actually reverting back to a management style (partner and committee run) that no longer fits the current size of the firm.

The eleventh factor is compensation/value placed on leadership position. I am not of the belief that the CEO has to be the highest-paid partner of the firm, but it sure should be close. After all, this individual is not just managing a book of business or a group of people, but rather is overseeing the entire firm, its growth, and its profitability from both a short-term and long-term perspective. I always cringe when I see managing partners get paid a stipend of $25,000 or $50,000. Nothing makes a louder statement to a leader that the job isn't that important than when a modest stipend is the best they can do. I have advised many firms that when it comes to firm governance you must have someone with leadership skills that everyone can trust and respect. The second hope, however, is that the partners are also smart enough to pay this individual to run the firm at a compensation level at least equal to what other successful peer firms are also paying for this role.

The twelfth and final factor is the firm's life cycle and gas in the tank. Let's face it; the one absolute in business (and CPA firms) is that nothing is forever. All businesses go through life cycles and hit glass ceilings as it relates to leadership, growth opportunities, and talent. Also, although I can't measure it on an income statement or balance sheet, I always take note of the "gas in the tank" of the current partner group. If the firm is in cruise control, they probably don't need a heavy-duty leader, but rather more of a maintainer. Alternatively, if the partners have a lot of gas in the tank and want to keep climbing the mountain, they probably need a heavyweight leader to run and guide the firm. Nothing can be more frustrating for all than having a heavyweight leader when all the partners want to do is simply cruise. Bottom line—be sure your leader matches the acceleration level of your partners' gas pedal.

***Exhibit 2: The Four Corners of Firm Governance***




In closing, once we have digested these 12 critical factors influencing firm governance, we then need to focus on the structure itself (see Exhibit 2)—the relationship of power and decision-making that the CEO/managing partner has vs. that of the other three groups (board/executive committee, partners, and management committee). For me, I can learn a tremendous amount about a firm's governance and culture when I learn where and how decisions get made. Does the CEO really have power, or is he or she just the set-up act for the board to truly make the decisions? Does the board really carry weight and have the requisite skills, or is it just a group of individuals who are elected based on the size of their book of business or seniority with the firm? Do the department heads and team leaders have true responsibility and authority, or are they just "place holders" for the time being? Clearly, the relationship the managing partner has with these other three groups and the latitude they have for making decisions will ultimately determine how successful the firm's governance model will be.

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