Profit sharing in the Big 8 firms: accommodating the rainmakers

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Abstract

Further to a consideration of existing research on income allocation processes in CA partnerships, this report answers the questions: how was income allocated in the Big 8 and their predecessor firms in New Zealand, and why is stability for income allocation systems compromised by the need for these systems to accommodate the 'rainmakers'? The narratives of the views of survey and oral history interviewees participants on income allocation is complemented by a case study comparing and contrasting two firm changes, illustrated by partner narratives from two firms: Coopers & Lybrand and Deloittes Haskins Sells. The variety of income allocation models is attributed to the necessity for partners to undertake multiple roles in each partnership: "professional firms live or die by the rainmakers". It will be suggested that the previous advocacy of agency perspectives and theory of the firm theoretical perspectives do not provide a close fit with the data from this study. Instead, a population ecology approach (as adopted in organisational theory) is invoked to explain the constant flux in the choice of income allocation models in accounting partnerships.

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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-affected 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” (ex-Deloitte partner)

More than most professionals, accountants in public practice pay a great deal of attention to issues surrounding their own personal remuneration. But research on performance-based compensation arrangements has paid only infrequent attention to the issues arising from different income allocation methods in accounting partnerships. A textbook on partnership accounting, such as the recent book by Leonard Stokes on Accounting for Partnerships\(^1\) states only that: “the partners need to decide how the net income or net loss from operations will be allocated among the partners. As stated previously, the income or loss is divided equally among the partners unless the partnership agreement provides for a different arrangement” (2003: 7).

Partnerships are an ideal territory 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, vide section 5 of this report). How can performance-based compensation arrangements accommodate the need for CA firms to have partners who are prepared to drum up business clients who will eventually be serviced by a number of other partners? In a recent survey with responses from over 100 Big 8 partners, some respondents considered that fair income allocation systems were an important key to

\(^1\) Stokes L. E. 2003 Accounting for Partnerships. USA: Thomson Southwestern
survival of the partnership, as will be further described in this study.

The 1980s had been a tough time for CA firms. "Business raw in tooth and claw" would not be exaggerating the pressure from the boom and bust cycle. Two particular statistics displayed in the following chart are a reminder of the pressures on firms to adjust to changes in circumstances after the 1987 Crash.

[Insert "Figure 1: New Zealand: highs and lows" about here]

How did partners in the Big 8 survive the redundancies following the two big mergers in that period (Deloittes with Touche; Ernst & Whinney with Arthur Young) as well as the downturn in the economic cycle? The perceived significance of income allocation models by some survey respondents in the differential patterns of survival was probed further in interviews with 40 Big 8 partners. Some of the material from these oral history interviews addressed these issues, and provides a much-needed diversity in personal observations on the evolution and adaptation in systems of income allocation in CA firms in the last thirty years. This study reports on issues of income allocation and performance-based compensation in the Big 8 firms and their predecessors, reviewing drivers to changes in allocation systems in order to ensure that the remaining partners in the Big 6 of the 1990s got their fair cut of the cake.

Existing literature

An exploratory study of income allocation of the Big 6 in Australia by Burrows and Black 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;

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- 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 study further extends the first research question put by Burrows and Black: how do the Big 6 firms share profits; and also provides further data towards answering their third question: why do they use their particular profit sharing systems? Although Burrows and Black considered this third research question was not amenable to direct enquiry, the data utilised in this research do indeed provide some answers to that question.

Prior to Burrows and Black's study, there was some earlier research such as the review of systems in CPA firms in the USA by Steven C Hunt (1995)\(^3\). 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 Peirce (1995)\(^4\) 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. This study in particular 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.

**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\(^5\) looking at 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

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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 CPA firms as suggested by Brown et al in 1996.

Leibowitz & Tollison 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.

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 predetermined manner”.

**Practitioner literature**

The practitioner literature regularly provides reviews of partner compensation; an early commentary by Shaw reported on a survey of CA firms, which reflected divergence of practices for both the requirement for capital contributions, retirement programmes and bonuses for particular achievements. The arrangement for distribution of profits showed that 60% of the CA firms paid salaries before the profit distribution; and half of these paid all partners the same salaries. This survey also provides a range of adjustments; some firms in determining adjustments in partner’s participation used both economic and non-economic factors. The 1991 *Journal of Accountancy* reported a further review of selecting the best method for partner compensation by Martin, suggesting five methods, some of which may

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be used in combination:

- Arbitrary – sometime viewed as historical accident. It may be a stepped method, or all salaries determined relative to the top partner salary. A subset of this method is the “King” method, where the managing partner determines compensation for all partners.

- Objective formula: usually incorporating collected charge time, new clients, client load managed, years as a partner, and in some firms interest on contributed capital or a return on equity.

- Compensation by Objectives: based on negotiation between a management committee and individual partners, often on a points based system

- Component parts: where certain activities are each given a weighting, such as chargeable hours, practice development, client load, seniority, in-firm responsibilities, interest on capital etc.

- Paper Slip: when all partners write down how they believe the profits should be allocated, and averages applied.

Martin concluded that when the existing system breaks down, any new system should be chosen on the basis of being least disruptive; those systems which evaluate different aspects of contribution are preferable to those based on one performance measure.

Similarly, a consideration of compensation systems for legal partnerships by Weil et al (1987) described three main systems: a subjective performance-related system; the lock-step or equal sharing systems, and objective performance-related systems. They concluded that compensation systems need to be changing dynamically as partner needs and goals change.

A comparison by Landis (1986) between legal partnerships and accounting firms in Australia described the Hale & Dorr system applying to legal firms: this is a pro-rated income system where there is a pre-determined weighting given to: who obtained the business; who did the work; and how profitable it was. Landis concluded in much the same vein as Weil et al, going so far as to recommend use of outside consultants when changes had to be made to avoid proposals being viewed as self-serving.

The 1990 review of partner compensation by Lenz and Mudrick listed various systems as:

1. Democratic systems, such as the

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• Equal distribution system;
• Lock-step system, where groups of partners who enter as a cohort have the same compensation; or
• Seniority or Longevity systems.

For all these three the firm must not only experience steady and unabated growth, but also selectivity on partner admissions;

2. Buying and Selling Time: where each partner is assigned an inside hourly rate and an outside hourly rate, with various formula for allocation of overhead and centralised costs. The disadvantage of this is that client service becomes secondary, and it promotes individualism among partners;

3. Committee systems – using both objective data and some subjective assessment;

4. The "Benevolent Dictator" – when one person, usually the firm founder, provides leadership and determines income allocation;

5. Points and Percentage systems: usually formula systems including the Hale & Dorr systems as already described, business organisation, hours billed or hours worked;

6. Rough Justice, using a compensation committee and also tiers of compensation.

Further analysis by Lenz and Mudrick identified problems with each of these systems, and also that the size of the firm affects the choice of system. In the largest firms, management cannot know every partner personally and tend to rely mostly on formula and objective data.

Although nearly all of the above literature has been short on firm-specific data and differences between the firms, there was some discussion of this in Mark Stevens' 1981 book on the Big 8: he suggested that partner compensation in the Big 8 was 50% higher than that in the average small CPA firm (a suggestion which was not borne out from comments by New Zealand partners). Stevens also suggested that all partners in the Big 8 had to contribute capital when becoming a partner; again, this was not always the case in New Zealand in the largest firms. At that time, Stevens describes the PW partners as offering the highest average earnings to partners, and capital contributions are deducted from annual earnings.

In general terms this extant literature demonstrates a variety of descriptive and analytical methodologies to study income allocation systems, many of which may recognise the contribution that the 'rainmakers' make to the success of the partnership; and a few also link their results to firm characteristics. However, there is an absence in this research of linkage to

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firm-specific organisational change; in particular if the allocation methods changed as the firms were affiliated and then franchised to Big 8 names. Merger events were also significant, as one system has to be agreed upon by the newly merged firm.

In order to review how compensation systems were organized in the Big 8 and their predecessor firms in New Zealand, it is important to consider the impact of organisational dynamics in income allocation. This study covers the 30-year period when the Big 8 and their predecessor firms changed from local partnerships to nationally networked partnerships and then to franchises or offices of the Big 8. These processes are summarised in broad terms in Table 1. We will also document that when such organisations adopted similar corporate models, their income allocation models remained heterogenous and diverse.

The specific research questions addressed in this report are:

1. How was income allocated in the Big 8 and their predecessor firms in New Zealand?
2. Why is stability for income allocation systems compromised by the need for these systems to accommodate the ‘rainmakers’?

The following discussion will review applications of agency theory, and theories of the firm, as already described, and propose an alternative theoretical perspective.

These two questions will be reviewed using both findings from the survey of 108 Big 8 partners in May 2002; and interviews in 2002 with 40 partners from the Big 8 and their predecessor firms in the 1980s.

This study will proceed as follows:

- A description of the sources of the data: the survey and the oral history interviews
- Reporting what survey participants thought was significant about income allocation to ensure survival of the firms – one comment was ‘if you got it right, it would stay right’; but this was not supported by interview responses.
- A description of mechanisms for income allocation in the Big 8 and their predecessor firms, mostly derived from interview transcripts; identifying instead that such systems are characterised by constant flux;
- A case study comparing and contrasting two firm changes, illustrated by partner narratives from two firms: Coopers & Lybrand and Deloittes Haskins Sells;
- A discussion of the drivers to changing models, largely caused by the variety of
behaviours by partners necessary for the firms to survive: “professional firms live or die by the rainmakers”.

It will be suggested that the previous advocacy of agency perspectives and theory of the firm theoretical perspectives to explain income allocation processes do not provide a close fit with the data from this study. Instead, a population ecology approach (as adopted in organisational theory) is invoked to explain the constant flux in the choice of income allocation models in accounting partnerships.

2. Sources of data: a Survey and Oral History interviews

This study commenced with an examination of partner movements between CA firms, tracking these from Yearbooks published by the New Zealand Society of Accountants. 1976 was the first time the Yearbooks provided the names of partners in each firm; the last occasion this was published was the June 1994 Yearbook. This process of partner identification resulted in 514 partners to be surveyed: this comprised of all 124 partners who moved between Big 8 firms, plus all other partners anytime 1982 – 1992 in the firms:

19 in Lawrence Anderson Buddie – affiliated to Andersens
86 from Touche Ross
30 in KMG Kendons

• plus 83 partners who stayed in one firm from 1982 - 1992:
  11 - Kirk Barclay/Spicer & Oppenheim
  5 - Price Waterhouse
  30 - Coopers & Lybrand
  14 - Peat Marwick
  23 - Deloittes
• plus 171 Partners who were in Ernst & Whinney or Arthur Young over the merger period at least for more than one year in the 1986 - 1990 years.

From this total of 514 names, 488 addresses were identified from the Institute of Chartered Accountants address database. 108 partners responded to the survey. Within the survey those members who were retired were asked, as part of the survey, if they were willing to be considering being interviewed for this Oral History Project. 36 expressed a willingness to receive more information on this stage. All 26 retired members who consented to Oral History participation were interviewed (July – September 2002). There were some gaps in the
cohort, in that there was insufficient coverage of all firms. A further 31 non-retired respondents who had answered positively to the question: “Are you willing to be contacted further for any clarification of points raised in your response, or for meeting in group discussion with a focus group, if appropriate?” were asked if they would like to be part of the Oral History cohort. Fourteen of these agreed, resulting in a total cohort of 40. These had not worked for just 40 firms; the number of firms in which this cohort had worked, including both large and small firms, totalled 76 CA partnerships.

Interviewees in the oral history project were from all the large firms, and the length of the country, both urban and rural; ‘from Cape Reinga to the Bluff’. The objective of the interviews was to 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 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. Analysis of the survey and oral history transcripts provide the foundation for the following sections of this study.

One issue raised by Burrows and Black was the difference between the Big 8 and second tier firms in income allocation models. This report is not extended to second tier firms, but the data gathered from firms outside of the Big 8 as part of this study, such as KMG Kendons, may be deemed non-Big 8 and would provide comparisons, although that is beyond the scope of this report. The Big 8 and their predecessor firms and partner numbers are shown in Table 2. The 108 respondents to the survey based their responses on their experiences in these firms.

3. The Survey

The questions asked in the survey were:

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

Overall, 10% of the respondents considered that income issues were one of the three most important factors, either describing this as being financially integrated; a true national firm, or in terms of income growth / satisfaction for partners. There was some variety in the level of responses from different firms when disaggregation was undertaken (see Table 3).
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?

   Overall, 8% of the respondents considered that income allocation models were one of the three most important factors, either describing it as lack of financial integration; dissatisfaction with income for partners, or succession issues. There was a general consistency in the level of responses from different firms when disaggregation was undertaken (see Table 3).

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

   Overall, only 3% of the respondents considered that income allocation models were one of the three most important factors in large firm mergers, either describing it as financial integration of income model; income for partners or succession issues. There was considerable variety in the level of responses from different firms (see Table 3) with half the firms out of the 6 firms for which disaggregation was undertaken showing it being considered insignificant i.e. less than 1% of reasons given; while others perceived it as important.

[Insert “Table 3: Responses from survey disaggregated by firm” about here]

Coopers and Lybrand partners showed consistently high levels of identifying financial aspects of partnership activities as important to survival, and also Ernst & Young partners. Coopers and Lybrand and Arthur Young were the two firms that had a long tradition of complete financial integration nation-wide and respondents from those firms appeared to see this as contributing to their successful survival more than in firms that retained local office profit pools. The Arthur Young model was adopted after the merger to Ernst & Young. These results from this survey, and the range of opinions concerning the significance of income allocation models in the differential survival of the Big 5, led to this aspect being addressed in the Oral History interviews. One objective of the questions in the interviews was to identify how profits were distributed in the Big 8. It had been anticipated that partners from the successful surviving firms would relate some stabilisation in their income allocation models, and that some reflection of partner satisfaction would arise in the interviews with members of the surviving firms. This prediction as not substantively supported in data from the oral history interviews.

4. Oral History interview data
A summary of the income allocation systems, as described in the interviews, is compiled in
Table 4.

[Insert “Table 4: Income allocation systems in the Big 8” about here]

It can be seen that there was a dynamic underpinning all the systems; they were only rarely described as stable by any of the interviewees, usually alluding to a much earlier period. However, this Table does not provide information on the drivers to these changes. In order to illustrate the drivers in two cases, more detail is provided by the following comparison of extensive narrative, concerning Deloitte Haskins Sells, and Coopers and Lybrand.

5. The narratives: A comparison of two firms.

1. Coopers and Lybrand (and its predecessor firm Barr Burgess & Stewart) changed from a nationally integrated equal-share remuneration system to a formula-based:

“The original old Barr Burgess & Stewart, the very beginning, was an old style “we look after you” type approach, a family approach, very much a family approach. It gradually evolved into a reward system. There were masses of refinements over a long period to try and make it fairer and fairer and acceptable to everybody, so everybody felt that it was fair... Initially Barr Burgess & Stewart had a very structured approach, new partners came in at what they called fixed salaries for the first three years, and maybe it went to five years after a while. So they just came up, gradually, on steps, and then there were another series of other steps for the main partners, but they were very broad steps, and you just got paid what was called your basic salary for that, and then you had a share of profits at the end. It was very non-abrasive in that there wasn’t a lot of discussion about individuals’ incomes; it was you were on a level.

Down the track it became Coopers & Lybrand; further on the firm became much bigger, and there was a lot more dissimilarity about the offices and the contribution made by partners, [it] became a much more complicated system, where every year the meeting, there’d be meetings by the executive which would decide on the base salary, if you like to call it that, or base profit share, that everybody was on. It became more and more complicated. It became what we call local office profit-sharing, so that you got your base, but then depending on how well your office did at the end of the year, your final remuneration or your bonus or whatever you’d like to call it, tended to relate to how well your office did. It [was] a huge change from the original.
(Q: Why was that?)

Mainly to keep partners happy, particularly city partners;...the city offices tended to do a lot better than the provincial offices, although they would fluctuate, and there was a lot bigger demand on the young particularly, and all I suppose, city partners, to perform. They could see that their return to their office was quite significant. Plus there was comparison to other partners in other firms in the cities, and therefore there was a push that they needed greater reward to keep them operating in the cities. Most of the provincial partners were very good in my opinion, and they accepted the philosophy of it, although there would sometimes be some complaints"

"If we go back to this change in the remuneration policy, it was well after I'd been in Barr Burgess & Stewart. So it went on in its old way for quite a long time. But once the change came, it was a small change and then became tighter and tighter as people accepted the way it was done, and felt it fair as a remuneration policy could be, and it had a little bit of a carrot in it, in [that] it made people: "they want to get ahead, try harder." At the same time [it] made some partners perhaps comfortable, in that they didn't want to work long hours and control big staff bases. Then they didn't feel uncomfortable, the fact that they were allowed to do that, although an incentive was on most partners; the general incentive was to try and get everybody going like rockets"( ex Managing Partner, Coopers and Lybrand)

From the other side a partner who was never on the remuneration committee commented:

"Coopers, you got your income distribution at the end of the year [and] you knew what every partner earned. You never knew what the formula was that got there; I mean we had an idea; they told you the sort of issues that were considered: there's the financial ones in terms of fee loads, and partner performance and profit contribution and all those sort of things...it's just you've just got to make sure it fits in with everybody...

The only downside I can see in some of the ways profits have been split is that.... partners that appear to be overloaded in terms of their fee base have been reluctant to maybe release fees to partners who aren't in that position; and they've held onto them because they know it's going to generate maybe a bit more profit at year end rather than spread it around. Again, I know Coopers used to recognise skills too, contribution in terms of skills; some of the guys, as you would know, are in these particular cases highly skilled. Some of the corporate finance guys, and so forth, and tax guys. I mean, they were big income earners when I was there." (Coopers and
Lybrand partner)

2: Deloitte Haskins Sells (and its predecessor firm Hutchison Hull) retained individual offices determining their own distribution for many years after other firms had become integrated nationally; it moved to a national system only five years ago

“When I became a partner [in 1980] Auckland had its own profit pool. Hamilton had its own profit pool. We had offices in Napier, Palmerston North. In the South Island we’ve only ever had Christchurch and Dunedin... It was just pure sort of parochialism. People were saying ‘Well, hang on, we don’t want to be swamped by something that happens in the big Auckland, Wellington offices’... They’d say ‘Well, if we keep our own office profit pool, then what I do influences what I get’. Whereas when you go into a national profit pool, if you work another hour a day it doesn’t make any difference at all; or no perceived direct difference. But that’s a very small-minded way of looking at the thing...

When I first joined back in ’80 I think you started off on a set number of units, and it took you seven years to get to a quality, once you’d been there seven years - some of us got there faster than that. Once you became a full partner, then everybody apart from the managing partner got the same income; the same units. That, over the years, has gradually changed, so that now profit-sharing is done on a perceived contribution to the firm as a whole, and there is a much wider range of income levels between the lowest earning ‘full’ partner to the highest earning full partners... we ran as a national firm but separate office profit pools, until relatively recently, probably it would have been about ’98, maybe. (Deloittes partner).

[Now] 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 everyone 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 very difficult”. (Deloittes
Although these are examples of only two firms, from all the interviews it is clear that all the firms show constant flux in the manner in which income was allocated. Furthermore, some firms were reverting to systems previously typical of smaller second-tier firms, in that each office of Big 6 firm would have its own profit pool with a national levy. Some second-tier offices were found to have identical systems, in particular those which affiliated to national franchises at the level below the Big 8; in such cases these would have some national levy to cover centralised costs, and after that organise their own distribution according to decisions of each local office.

6. Why the constant flux?

In common with the findings from Burrows and Black, the data from the Big 8 firms in New Zealand and their predecessor firms show diverse levels of shares for established partners. As Burrows and Black had not the opportunity to track changes over several decades, this research adds to their findings by demonstrating that methods of dividing partnership profits did not stabilise. Was this, as Lenz and Mudrick claims, a result of the size of the firm affecting the choice of systems? An examination of the numbers of partners in 1994 (as provided in Table 2) would not support this claim as all firms went through the growth of partner numbers in the late 80s, and then shedding numbers in the 1990s; none of the respondents attributed changes in systems to changes in size. Additionally, the Case study in Section 5 of this report shows two firms of similar sizes moving in opposite directions in the income allocation models. At the most simple level, as soon as a firm has multiple physical offices any equal-sharing systems typical of small firms is moderated by combination of subjective assessment and the more objective formula based on billings/chargeable hours/recovery rates and the year-end wips. Instead, the interview data providing the foundation for this study reveals that there was a necessity for constantly changing patterns of partnership behaviour, patterns that were essential for the firms to survive and thrive, and this was one of the drivers to the constant flux in partnership income allocation models.

7. Variety in partner activities necessary for the firms to survive: “Professional firms live or die by the rainmakers”.

This comment by a partner from Cooper and Lybrand reflects ideas 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. One description of those partners who can generate work is rainmakers, elsewhere three categories are described:
"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 2 acknowledges that these descriptors are not tight boundaries, and partners may need to move rapidly between different activities as other partners retire, enter or change the relative weighting of their roles. It ignores a possible fourth group: the free-riders (or almost free-) who may be drawing a salary incommensurate with their contribution, irrespective of whichever of the three areas they may have earlier established their reputation and seniority. The improbability of shirkers is further discussed in Section 8 of this report.

"I had a lot of very wealthy clients, who were very well connected; and I suppose, in crude terms, I knew how to work it...when you have the sort of assessment systems they [PW] have... 'cos a lot of them don't like to do it on subjective bases, they won't take the risk of doing it. I did take that risk; and was amply rewarded, by two people who I had huge respect for...I trusted them; and they trusted me to bring the bacon home". (PriceWaterhouse partner)

Given that these three functions need to be attended to in any size partnership, the problem is: any system 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 fulfilled within a partnership. Another whose father was in a small sole practice recalled:

"Some firms had arguments was that your contribution is based on your fees. Others
it's based on the chargeable hours; both of which are subject to all sorts of manipulation if you're not very careful. Again, quoting my father, he always used to say, "If I'm short of work I'll go for a walk down Hereford Street and I'll pick up a job before I get back to the office". Now how do you measure that contribution to the firm? He had that ability because of his name [Ray Holland] (Ernst & Whinney partner)

And from a larger firm:

“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 whip [wip?] over them...” (Coopers & Lybrand partner)

Herein lies one possible answer to the conundrum: just as the professional firm needed to have all three types of partners in order for the firm to survive, the extent to which any particular partner would be involved with any one of the three activities would vary year by year. The change even when just one major audit manager shifted to take more responsibility for the operations of the partnership would drive slight changes in the balance of work undertaken by all the other partners. As each partner moved through the different roles of finders, minders and grinders, so they would seek to be rewarded the same as, or more so 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. It is suggested from this study that the constant flux in income allocation models in Big 8 firms were partly caused by the necessity for the model to reward partners as they adopted different roles in the partnership, with none losing out significantly.

8. Discussion

It is clear from the data provided from the survey and oral history interviews that attempts to examine and explain the differences in partnership profit allocation systems by firm size (Lenz & Mudrick, 1990) were not supported by this data. Secondly, attempts to examine partnership profit allocation systems by agency theory are also not supported by this research.

15 Work in progress
Agency theories posits that the standard agency problems of shirking and monitoring will arise in partnerships; however, to describe this as typical of agency relationships overlooks that shirking and monitoring can be directly detected in outputs by partners, due to the individual partners (or more likely the manager under the partner) maintaining records of their chargeable hours, billings, recovery rate and wip. A partner who shirks will not be in a position to fabricate a claim to same earnings capacity as one who maintains a higher level of chargeable hours. Two other agency problems identified by Gibson and Mnookin16 (1985) are (1) grabbing – i.e. threatening to depart if they do not get more than their fair share; and (2) leaving and taking clients with them. The widespread establishment of remuneration committees and the desire of partnerships to shed partners and improve leverage would give few partners the opportunity to effectively exercise this type of threat to the extent of gaining the rights to an extra-formula allocation. The increasing prevalence of restraints of trade clauses in partnership agreements is also an inhibition to this behaviour.

Burrows and Black predicted that an agency theory was supported, as there had occurred a shift away from equal sharing to variable profit shares in their study. However, any such driver clearly identifiable as an agency-type was not indicated in any comments by interviewees as a driver for the changes, nor supported by the illustration in section 5 of this report. One might have expected partners to explain the causes of the changes reflecting the phenomena of “grabbing, leaving, shirking or monitoring” if the agency framework is useful in understanding these phenomena. None such explanations for the constant flux in allocation models were identified in the interview transcripts.

One further aspect which requires discussion in this study is the trend claimed by Brown, Cooper, Greenwood and Hinings (1996)17 of CA firms to move away from the professional partnerships to what they call Managerial Professional Bureaucracy, characterised by hierarchical structures, strategic planning processes and other corporate-type features. This could be viewed as one type of survival strategy, or as a process whereby the CA firms were mimicking, albeit a delayed response, to the rise of the professional manager in their clients. It is valid to view the introduction of remuneration committees in the CA firms as an increase in hierarchical structure, but the constant revolution of membership on these committees, and the essentially democratic processes universally adopted in the appointment of the managing partner do not mimic the corporate world so closely as to completely validate the suggestion of the shift to such “managerial professional bureaucracies”. They are most closely seen in

the CA firms which have international or Australasian partners (such as Arthur Andersen or PricewaterhouseCoopers) where there is necessarily an increased hierarchical organisation to enable control to be adequately exercised over the geographically distant offices controlled by one managing partner.

It is suggested instead that the data in this study shows:

1. Constant change in allocation systems

2. This lack of stability caused by dissatisfaction with the negotiated formulae or management committee decisions e.g.

   "How you split the income, and that was always the most contentious issue. Never the quantum. But if you were a partner and I'm a partner, and you got $10, $5 000 more than me, why were you better than me? You could have doubled the payout, but if you got $1,000 more than me, you'd still be wanting to know - I'd want to know why, you know - When I was on the management board: you would allocate the income; you would have input from the managing partner, each office, and you'd go away as a board and say this is how we're going to allocate the income for the year. Then the partners had the right to come back and appeal, and we'd spend more bloody time on the allocation of income and trying to explain to partners how we saw, perceived someone to be better than someone else, or not performing as well, than anything else" (Arthur Young partner)

3. Systems changed in the relative importance of component parts to the allocation, and the relative importance of subjective performance assessments vis-a-vis formula based.

4. An absence of any pure objective performance-related system in the Big 8 - 4 in New Zealand, although there was historic evidence of one such system occurring before 1970 (See Appendix 1).

Instead of a theory of the firm or agency perspective, it appears more fruitful to apply a population ecology approach (as adopted in organisational theory) to examine the dynamic patterns in income allocation models. A population ecology approach is also supported by the evidence from the interviews that although changes occurred in the firms, it was not a steady change, but showed the characteristics of a punctuated equilibrium, with intervening periods of statis, as modelled by evolutionary biologists19. Punctuation equilibrium theory explains

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that evolutionary patterns depend on the ‘differential success’ of individual stable species types, in this case, the individual firms competing with each other for clients and retention of personnel, and supports the invocation of a population ecology approach\textsuperscript{19}. This requires unbundling three aspects of income allocation models.

Firstly, an examination of variations in behaviour is presented, identifying distinct and different strategies adopted by the chartered accountancy firms over the period of study. Variations may be intended or unintended; it does not matter. This has been represented in earlier sections of this report.

Secondly, some differential survival (selection) within the cohort of chartered accountancy firms is identified, including the disintegrations of firms and the appearance of a dominant firm during a merger event. The dominance of Arthur Young in the Ernst & Young merger, and the dominance of the Deloittes Haskins Sells partners in the Deloitte - Touche merger is an example of this\textsuperscript{20}. KMG Kendons disappeared after losing the KMG affiliation when the transatlantic merger of KMG with Peat Marwick Mitchell occurred. Lawrence Anderson Buddle also disintegrated, after losing the Andersen’s affiliation and the defection of the Auckland office to Deloitte Haskins Sells.

Third, the question remains whether or not this study was able to identify retention mechanisms that allow the income allocation models of those firms that have survived to be retained or copied by other chartered accountancy firms. This is an elusive issue. There may be been some mimicry, but the responses to the survey indicated that it was only the most successful firms which saw income allocation models as important in their survival, and respondents from less successful firms did not. However, copying of systems would be encouraged by contributions to the common knowledge about suitable methods, such as CPD courses, partner movements, and articles in practitioner journals as cited earlier in this report.

A population ecology approach enhances the understanding of the constant flux in income allocation processes, because these can be most usefully viewed as a series of survival strategies in response to (1) any externally-imposed merger, (2) disequilibrium in the pecking order among partners which may follow (1); (3) the activities of other chartered accountancy firms, mergers in particular, and (4) external factors. In particular, from the interview transcripts some of the factors contributing to the instability include the impact of externally imposed mergers, the effects of the rapid inflation in the 1980s followed by the subsequent economic downturn, the effects of the 1987 Crash, and the rapid reduction in the number of


new audit clients (as illustrated in Figure 1).

Distinctive and different categories of income allocation processes can be observed from the data presented in this paper. Retention mechanisms would have permitted income allocation models perceived as successful to be mimicked, but no system appeared to be retained for a long period. (The cases of PriceWaterhouse and Arthur Andersen are not included in this discussion, because these firms were both very small and dominated by international or Australasian partnership numbers.) We observed the most adaptive and successful firms used changing income allocation models as one adaptive process in their ‘basket’ of change mechanisms. A dynamic ‘pecking order’ is not to be disparaged. It has the capacity to both pacify and empower partners as they move through age profiles and are required to take changing roles. Although the use of the term ‘pecking order’ appears fundamentally contrary to the notion of a partnership of equals, it is human nature to need status to be transparently accorded with the confirmation from peers. Thus the dynamic pattern of income allocation models appears as one part of adaptive behaviour in CA firms.

9. Conclusion

It was the objective of this preliminary report on income allocation theories and evidence from New Zealand to answer two research questions: how was income allocated in the Big 8 and their predecessor firms in New Zealand, and why is stability for income allocation systems compromised by the need for these systems to accommodate the ‘rainmakers’? The material from interviews and survey responses shed new information which has not been previously documented to the same depth in other jurisdictions. Future research on gathering statistical data such as changing levels of leverage in the different firms (partners/non-partner staff ratios), revenues, changing patterns of capital contributions and exit rules, organisational shifts and the relative importance of different income streams to the CA firms would all assist in gaining a deeper understanding the drivers to these largely hidden, but dynamic, processes.

Appendix 1: A pure performance based system

The firm of Adamson, Francis and Harrington, (later Broad Christie, affiliated to Ernst & Whinney), in Invercargill was rare among firms in that the income allocation to partners was based precisely on fees earned. As Cliff Broad remembered in the early post-Second World
War years:

Part of the deal when I came back to a partnership (aged 24 or 25) was that those who did the work would get the money. Now that was very unusual. So that before Morris Christie and I were 30 years of age, we were earning more money in the firm than anyone else. Alan Harrington, [one of the partners] as a hobby, used to analyse all the staff timesheets, and say, that of the six partners in the firm, you had 17.23% of Betty Brown’s time, you had 6.9% of Charlie Smith’s time. They worked out all the wages, and he divided the wages up between six partners. He analysed the fees you brought in, which were £21,231-8-6 and if we took off your direct staff costs your proportion of the administration staff, would be so much. And therefore your share of the profit for the year was £13,250, as I say, 8/6.

I mean it was unbelievable. He loved it....and everyone was happy, ’cos Addie and Charlie were wanting to play a bit of bowls and they were good hardworking Scotch Presbyterian, and they definitely wanted what was theirs, and they weren’t going to [have more]....it was because Charlie Francis was always fair and decent - it was his idea, not Alan Harrington’s. It wouldn’t be Addies, that was Adamson. But Charlie was able to do it, because he had Harrington who wanted to do it. “This is a problem, it’s something to be overcome”.

Of those three partners Cliff recalled:

Charles Francis....probably 40 years before I did, he represented Southland as the Councillor for the Southland district. He was a good fellow, a most unusual looking man. You wouldn’t give two bob to look at him, but he was bright....Francis, as I said, was an unusual man, but very bright and progressive.

Harrington was a different kettle of fish altogether. He was a great athlete, rugby player, Master of Science, First Class Honours in Mathematics and various things. And he could have been brilliant, but he wasn’t interested. I think my friend Charlie Francis used to despair of Alan Harrington, because he could have done anything he wanted to do, but all he wanted to do was enjoy his wife, family, his kids, his golf, playing cards, and he was just happy with his lot in life.

Adamson was a very well known man, he was in a lot of things. He had no qualifications at all. But of course, in those days, you didn’t. You were just starting [having] qualifications being essential. He was Mayor of the city; everyone knew him. At one stage after I became a partner, it was sort of recognised that, "oh well, that’s our civic contribution"; he didn’t do much else. But he was Mayor of the city.
Figure 1: New Zealand: highs and lows

![Graph showing the number of partners in medium and large firms (on the right-hand axis) and the number of new audit clients (on the left-hand axis) over the years 1975 to 1994.]

Figure 2: Finders, Minders and Grinders

![Diagram illustrating the relationship between externally focused, internally focused, profitability, and chargeable hours.]

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<table>
<thead>
<tr>
<th>What might drive a CA partner in order to secure individual wealth?</th>
<th>Client Company characteristics</th>
<th>Significance for audit activity</th>
<th>Mergers: 1982-83</th>
<th>Mergers events: 1983</th>
<th>Overseas CA firms</th>
<th>NZ CA firms activity</th>
<th>Key events</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976 – 1983</td>
<td>Profit driver: Expanding economy, growing firms, low leverage</td>
<td>CA firms looked to establish a national network, usually in an umbrella form of organisation in order to minimise cross-selling audit activity to other centres</td>
<td>Merger of type 1</td>
<td>Merger of type 1</td>
<td>There was considerable cross-audit merger activity but formed the basis of the Big 8, although some had light European presence.</td>
<td>Large firms gaining dominance in the US and UK, NZ CA firms affiliated with a variety of names overseas.</td>
<td>Period of emerging economic expansion in NZ, spurred by UK joining the EEC. Exchange rates tightly controlled.</td>
</tr>
<tr>
<td>1983 – 1987</td>
<td>Profit driver: International affiliation for audit referral, increasing in-range within firms “Big is Better”</td>
<td>Increase in takeovers by multi-national firms drove a significant amount of auditing to the firm affiliated to the parent auditors</td>
<td>Merger of type 1 &amp; 2</td>
<td>Merger of type 1 &amp; 2</td>
<td>Lawrence &amp; Anderson merged with PriceWaterhouse after the Auckland partners went to Deloitte Haskins Sells</td>
<td>Big 8 stable and attracted affiliations with worldwide network of branches.</td>
<td>1982 – 87 the Society permitted internationalisation of firm names.</td>
</tr>
<tr>
<td>1987 – 1994</td>
<td>Profit driver: Rationalisation of partners and; bloating, highly levered partnerships</td>
<td>After the crash here was a huge reduction in land companies and unlisted companies</td>
<td>Merger of type 2 &amp; 3</td>
<td>Merger of type 2 &amp; 3</td>
<td>Ennis &amp; Whiteman and Arthur Young</td>
<td>The driver to large mergers within the Big 8 was tempered by SEC concerns of concentration of audit industry.</td>
<td>Big 8 became Big 6 increasing leverage</td>
</tr>
<tr>
<td>1994 – 2002</td>
<td>Profit driver: Globalisation as one-stop shops for audit clients offering specialisation, IT consulting</td>
<td>Recovery of NZ economy saw increasing Trans-Tasman movement; Head Offices continually shifting north to Auckland or to Melbourne left the more southern cities in NZ with a weaker business base.</td>
<td>Merger of type 2 &amp; 3</td>
<td>Merger of type 2 &amp; 3</td>
<td>PriceWaterhouse and Coopers and Lybrand Andersons in NZ merged into Ernst &amp; Young</td>
<td>Decrease in leverage as part of risk management. Some mergers in affiliations between provincial partnerships.</td>
<td>Variations ended in 1994 – later records a.s.</td>
</tr>
</tbody>
</table>

Table 1: Time-chart of macro-economic and client company changes and impacts on CA firms in NZ.
<table>
<thead>
<tr>
<th>1976</th>
<th>Big 8 name changes</th>
<th>1994</th>
</tr>
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<tbody>
<tr>
<td>1983 - 1984</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wilkinson Wilberfoss</td>
<td>64 Arthur Young</td>
<td>merged in 1988</td>
</tr>
<tr>
<td>Hunt Duthie &amp; Co</td>
<td>27 Ernst &amp; Whinney</td>
<td></td>
</tr>
<tr>
<td>Barr Burgess &amp; Stewart</td>
<td>57 Coopers &amp; Lybrand</td>
<td>90</td>
</tr>
<tr>
<td>Hutchison Hull &amp; Co</td>
<td>44 Deloitte Haskins Sells</td>
<td></td>
</tr>
<tr>
<td>McCulloch Butler &amp; Spence</td>
<td>40 merged in 1979 to McCulloch Menzies</td>
<td>Touche Ross</td>
</tr>
<tr>
<td>Clark Menzies</td>
<td>24 merged in 1989 to Deloitte Touche Tohmatsu</td>
<td></td>
</tr>
<tr>
<td>Gilfillan &amp; Co</td>
<td>38 merged in 1977 to Gilfillan Morris &amp; Co</td>
<td>KPMG Peat Marwick</td>
</tr>
<tr>
<td>Morris Patrick &amp; Co</td>
<td>19 KPMG Peat Marwick</td>
<td>67</td>
</tr>
<tr>
<td>Price Waterhouse</td>
<td>13 KPMG Peat Marwick</td>
<td>37</td>
</tr>
</tbody>
</table>

Table 2: Partner numbers in the Big 8 firms and their predecessor firms
Table 3: Responses from Survey disaggregated by firm

(There were too few responses from PW, Deloittes or KPMG partners for this disaggregation to be undertaken)

<table>
<thead>
<tr>
<th>Questions</th>
<th>What would you consider were three key factors which contributed to the survival of CA firms after 1992?</th>
<th>What do you consider were key factors which contributed to the reduction in size or disappearance of large CA firms during the late 1980s?</th>
<th>What do you consider were key issues in large firm mergers?</th>
</tr>
</thead>
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<td></td>
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</tbody>
</table>

| Percentage of number of reasons from those who responded that they considered financial issues were among the top three reasons |
|---|---|---|---|
| All responses | 10% of 267 | 8% of 243 | 3% of 225 |
| Arthur Young | 9% of 54 | 11% of 57 | 7% of 72 |
| Ernst & Whinney | 11% of 46 | 12% of 41 | <1% of 20 |
| LAB (AA) | 4% of 27 | 15% of 39 | <1% of 22 |
| Touche Ross | 6% of 44 | 7% of 27 | <1% of 45 |
| C & L | 17% of 29 | 23% of 21 | 11% of 19 |

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Table 4: Income allocation systems in the Big 8

<table>
<thead>
<tr>
<th>Firm</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deloitte</td>
<td>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.</td>
</tr>
<tr>
<td>Touch Ross</td>
<td>Each office was autonomous, with a national levy. “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”. 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.</td>
</tr>
<tr>
<td>Ernst &amp; Whinney</td>
<td>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.</td>
</tr>
<tr>
<td>Arthur Young</td>
<td>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; “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.” 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.</td>
</tr>
<tr>
<td>KPMG</td>
<td>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. “Once you had been partner for 5 years you earned the same”. The calculation was based on a movement over five years from 60 – 100 points. This system changed to Auckland and Wellington now having one profit pool.</td>
</tr>
<tr>
<td>Coopers &amp; Lybrand</td>
<td>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. “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.” This changed to a system of local office profit-sharing. Each partner receives a base amount, topped up by a bonus depending on the performance of the office. It is largely formula based, considering fee loads, performance and profit contribution.</td>
</tr>
<tr>
<td>Price Waterhouse and Arthur Andersen</td>
<td>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.</td>
</tr>
</tbody>
</table>