

Transforming Compensation Models in Service Businesses: From Individualistic to Team-Oriented Approaches



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In the competitive landscape of service businesses, traditional individualistic compensation models often fall short of fostering long-term growth and sustainability. This article explores the challenges of individualistic compensation structures and provides actionable steps to transition to a team-oriented model that aligns with modern business needs.

— Challenges of individualistic compensation models

As businesses form, the model may look something like this:

1. Sell a client a service you can provide
2. Perform the work
3. Receive payment for your services
4. Pay your expenses
5. Pay yourself
6. Repeat

As the business grows, the owner brings on employees to perform the work so that the owner can market the business. In a billable service industry, such as consulting and accounting, the incentive structure is often based on productivity—the more work you perform leads to more billings, which will lead to increased compensation.

While beneficial in many respects, individualistic models can put upward pressure on key-person risk, thereby driving down the value of the enterprise. There may be employees who are excellent business developers (“rainmakers”) who may not necessarily be fit to manage a firm. Not all leaders need to be rainmakers and not all rainmakers need to be leaders.

One of the biggest errors business leaders make is promoting someone for the job they performed in their current role, as opposed to promoting them for being able to excel at the job they will perform in their new role. So, who can the owner point to as the next leader of their business if everyone is compensated primarily for individual contributions?

The issue many businesses face as they grow and become engulfed by the model is the sheer differences in mentality between the owner(s) and the rest of the employees. As an employee in this model, they are primarily focused on one

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component, billing. Whereas the owner(s) must focus not only on billings, but the costs of the business, development of younger associates, marketing, and other areas of growth. Getting a business to transition away from an individualistic model to a team-oriented model can be a cumbersome, lengthy process, but for businesses with aging ownership groups, it is a worthwhile endeavor to preserve value in the business.

— **Steps to transition to a team-oriented model**

To shift from a primarily individualist compensation model to a team-oriented structure, first consider the following action items:

Identify the strengths and weaknesses of everyone in, and considered for, senior-level positions (or all positions if in a smaller firm).

This process helps the owner understand who are the individuals that have the characteristics to lead the firm into the future, and who are the individual contributors, and may not be great leaders. (Both types of people are needed, and not one is more crucial to the organization than the other to drive future growth).

Understand the firm's desired service delivery workflow.

This process is often overlooked when working through a compensation structure transition. Understanding how the work gets done can help shape an effective compensation model. For example, what level of involvement does the client manager/leader need to have in the work being performed? If the client manager/leader only engages with the client at the beginning and end of a project yet receives a large bonus, this will present a different firm profitability than the client manager/leader selling and performing the work.





Identify internal firm initiatives for improvement.

Being able to determine which areas of the firm's operations need improvement can help shape how compensation incentives lead to firm results. For example, some firms have a strong set of qualified associates, therefore recruiting may not be as integral for near-term success. However, that same firm with individualistic compensation structures may be struggling with training the associates to help both the individual and the firm, grow. Incentivizing a senior-level employee to train and develop younger talent may be difficult in an individualistic model.

Perform financial analysis to determine the impact of a redefined compensation model.

Any changes to a compensation model cannot be analyzed in a vacuum. A crucial component of the change is determining the impact on the company's financial statement. Some items to review may be operating margins, the timing of cash flow, and the working capital requirements needed to support the changing compensation model. Growth in revenue may not lead directly to growth in compensation, as there are other factors of the financial picture that may be impacted.

— **Successful Team-Based Compensation Structures**

In the points below, we touch on some of the components we have seen achieve success in team-based models.

Bonus Pools

Bonus pools are an effective way to incentivize employees for firm-wide achievements. In short, if the firm wins, everyone wins. The firm then can allocate the pool on a discretionary basis, based on a formula, or based on a combination of formulas plus discretion. Challenges with bonus pools may include a lack of clarity on the direct impact on pool participants as well as an inability for stakeholders and participants to gauge performance during the year.

Equity

Equity can be a very effective tool for business owners to use. However, it can be a challenging process. Determining the appropriate valuation of the entity, navigating the financing of the deal (if applicable), whether equity is earned versus paid for, whether equity is earned versus paid for, tax consequences, and creating room for future partners can create a complex endeavor for business owners. It may also be hard for current owners to measure the expected impact on their bottom lines.

Administrative Initiative Leaders

This approach is more suitable with a slightly larger employee base (15+). It enables your senior leaders to have ownership over a component of management while not straying too far away from an individualistic model. For example, say you have an accounting business that has identified three keys to future success: onboarding/training, service delivery/workflow, and marketing. The owner(s) can identify a senior-level employee to lead each of those pillars for future success.



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Rather than billing a client, the employees bill the firm an agreed-upon rate (or administratively bill their time as a non-dollar performance metric) for working on their pillar. If the benchmarks set forth by management at the start are achieved, then the pillar leader's overall compensation should take this into account. The model requires stipulations and agreements with the pillar leaders, but if conducted appropriately, can maintain an individualistic model and achieve firm growth.

Tiered Compensation

Tiered billing is a good method for service firms that need to focus on developing younger talent. Think of this model in a similar manner to federal income tax brackets—you pay X amount within a range, and then another X amount within the next range, and so on. In this model, there is robust bonus potential for participating employees.

There are two components to the model: personal billings and managed billings (i.e., billings from other people). If an employee does not work in a team and does not have big enough clients to demand assistance on projects, then their capacity, and thus their bonus, are directly impacted. However, for employees who strive to create more business for all, and train younger associates to perform the work, then these individuals have greater bonus potential.

— CONCLUSION

Making the Transition

With many seasoned business owners contemplating the exit door, an admirable goal would be to both get a return on their life's investments and make sure to leave a lasting business behind. To leave that company in a good position, you need people to care about all aspects of the business, not just their own. Creating an effective compensation model that helps achieve both individual and firm objectives can be integral to creating a lasting, valuable business.



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