Understanding What Your Partnership Agreement Should Include

Terrence Putney, CPA, CEO
Transition Advisors

NASBA CPE Earned Credit Guidelines

Transition Advisors, LLC is a sponsor on the National Registry of CPA Sponsors per the National Association of State Board of Accountancy (NASBA).

In order to receive your one CPE credit – You must complete two requirements:

1) **Participate in three of the four polling questions during the presentation.**

2) **Complete an online evaluation after the webinar.**

Attendee Control Panel

Take a moment to familiarize yourself with your Go To Webinar control panel on the right hand side of your screen.

The orange arrow on the top of the control panel is to minimize the control panel.

All participants are muted during the presentation, but you can communicate with us using the question box towards the bottom of your control panel.

Just type your question in the box and click send.

The presenter will answer all your questions during our presentation and we welcome your participation.

Upcoming Webinars

Transition Advisors, LLC offers FREE monthly CPE courses

Upcoming Webinars:

September 25 – The Seven Steps to Make Your Merger or Acquisition Occur

October 23 – Admitting Partners and Valuing Equity When Selling to Partners

November 13 – Roadblocks to Avoid in M&A of Accounting Firms

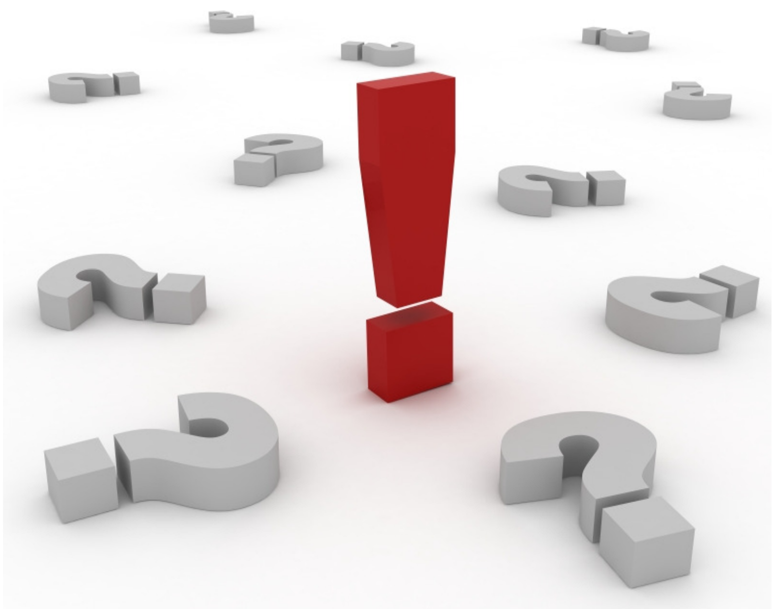
Visit transitionadvisors.com/upcoming-courses.php for more information.

Transition Advisors

National Consulting Firm working exclusively with accounting firms on issues related to ownership transition

Key Elements to a Partnership Agreement

1. Compensation
2. Equity-define and allocate
3. Governance
4. Retirement & other terminations
5. Partner admission
6. Other matters



Polling Question

Does your firm have an owner agreement?

1) Yes, and it is signed by all owners
2) Yes, but not all owners have signed it
3) No, but we need one
4) No, and we aren't sure we need one

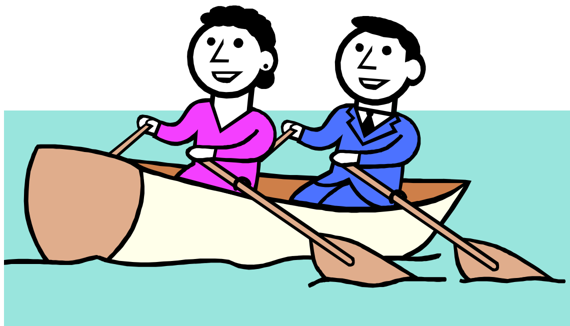
Types of Compensation Plans

- Equal
- Seniority
- Pure Formula
- Cross Evaluation
- Equity-based
- Committee-based
- Leader-based

Types of Compensation Plans

◇ Equal

- Often used in new partnerships formed from scratch
- Promotes collegiality
- Requires substantially equal contribution to be sustainable
- Long term, often fails to promote high performance



Types of Compensation Plans

◇ Equity-based

- Often used in new partnerships formed with existing books
- Promotes short term stability
- Requires substantially static contribution to be sustainable
- Long term, often fails to promote high performance; easily can get out of balance

Types of Compensation Plans

- Seniority
  - Based on tenure
  - Often similar to Equity-based as equity normally accumulates based on seniority
  - Unit-based plan where units accumulate over time
  - Tends to reward for past performance more than current

Types of Compensation Plans

◇ Pure formula

- An accountant's dream
- Relies mostly on pre-determined, objective measures
- Promotes clarity and certainty
- Leaves out hard to measure, subjective elements of performance; tends not to be team oriented
- Can be manipulated in many cases

Types of Compensation Plans

◇ Cross Evaluation

- Relies on each partners evaluating each other
- Appearance of fairness-democratic
- Requires knowledge of other partners' contribution
- Tends to lump most partners into an average rating
- Tends to avoid hard discussions about performance

Types of Compensation Plans

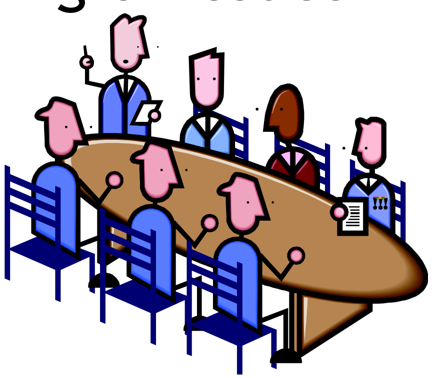
◇ Leader-driven

- Managing Partner decides
- Requires strong managing partner in their decision-making ability
- Most flexible … can be very effective
- In closed system, can lack transparency which can lead to mistrust and lack of needed feedback

Types of Compensation Plans

◇ Committee-driven

- Appropriate for large firms
- Works well when knowledge of all partners' contributions is not readily available to each partner or the managing partner
- Allows for flexibility and fair vetting of issues
- Can lack needed transparency
- Can be inefficient

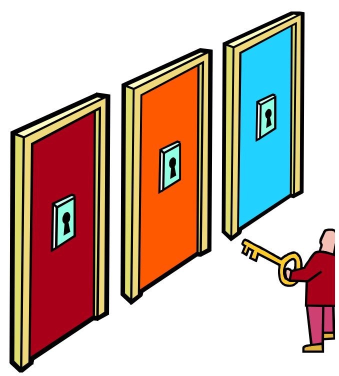


Types of Compensation Plans

How do you choose which is right for your firm?

What culture do you want to create?

How do you move from one system to another without too much turmoil?



Equity: What Does It Mean?

- Compensation
- Profit Sharing
- Decision making
- Internal buyouts
- External buyouts

Equity-What Does It Mean

- Be aware of the consequences of too much equity owned by one partner
  - Affect on succession planning
  - Affect on internal transfers of ownership
  - Affect on mergers & sales
  - Interrelationship of compensation and value

Polling Question

The number of owners in my firm is:

1) I’m a sole proprietor
2) We have 2 to 4 owners
3) We have 5 to 9 owners
4) We have 10 or more owners

Different Types of Partners?

- Full Equity – Senior v Junior
- Income/Non-equity partners
- Contract partners
- Of counsel/Emeritus

Non-equity Partners

- 80% of firms over $20M use this tactic; 46% of all firms use it*
- Path to equity?
- Permanent status
- Use in mergers

*2013 Rosenberg Survey

Governance

- Decision making
- Unanimous vs

  Super majority vs

  Simple majority
- Financial Commitments

Governance

By way of example …

- Super majority
  - Admission of new partner
- Simply majority
  - Expenses in excess of certain amount
- Unanimous
  - Dissolution or sale

Governance

Pros and Cons of Unanimous Decision Requirements

Retirement

Mandatory retirement age

Should your agreement include one?

If so what should it be?

Retirement

Vesting

When is it appropriate?

How long should it be?

Retirement

Methods for Valuing equity

- Book of business
- Equity
- Compensation
- Hybrids

Polling Question

I believe our approach to valuing our owner's interest in the firm is

1) Fair and affordable
2) Fair, but I'm not sure we can afford the buyouts
3) Not fair, too rich
4) Not fair, too low
5) N/A, we don't have an agreement

Internal Valuation Methods

Valuation methodology-for those w agmnt

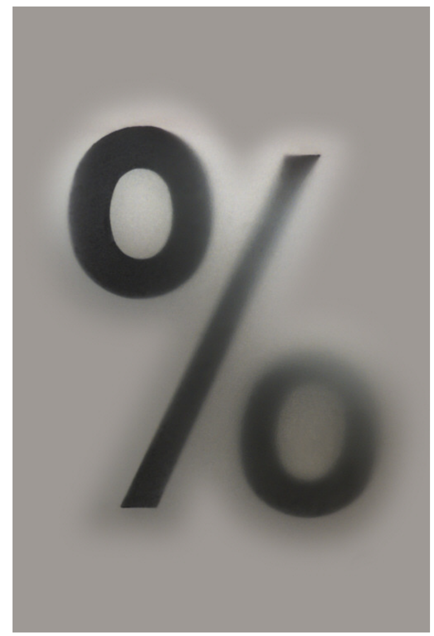
Of those responding to recent AICPA survey*

37% use a multiple of equity

16% use managed book of business

22% use a multiple of compensation

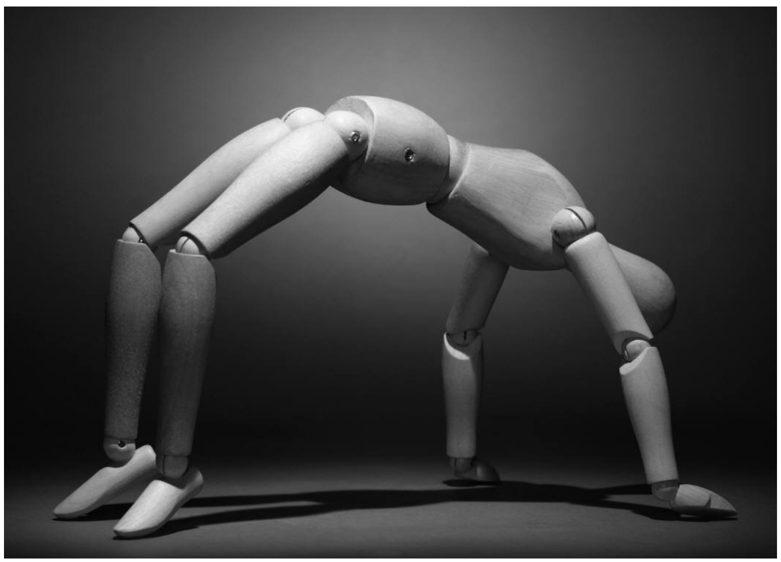
25% use something else



**2012 PCPS Succession Survey*

Right Financial Arrangement

Backwards Valuation



Reward your retiring partners fairly for their years of sweat equity

BUT

Don't expect your remaining partners to borrow or take a step back in compensation to do it.

Right Financial Arrangement

Available capital is the retired partner's foregone compensation.

Three uses for that capital:

- Pay the retiring partner off.
- Cost of replacing that partner.
- Some upside for the remaining partners for assuming the obligation and the extra work.

Right Financial Arrangement

Example:

Retiring partner comp and benefits	$300k
Replacement resources	$120k
Remaining capital	$180k

You need to decide how much can be used for buyout and how much should be left behind.

Example

• Firm volume	$1.9 million
• Retiring partner equity	45%
• Retiring partner comp & ben	$275,000
• Capital account	$175,000
• Payout retirement over 5 years (works out to $171,000 per year)	
• Cost of replacement resources	$125,000

Example

- Year 1 net cash flow:

  $275,000 *less* $125,000 *equals* $150,000
  of available capital

  $150,000 *less* $175,000 (cap acct) *less*
  $171,000 (retirement) *equals*
  $146,000 of negative cash flow

- Years 2 thru 5 net cash flow:

  $150,000 *less* $171,000 *equals* $21,000 of negative cash flow

Example

Alternative plan:

- Pay capital over 5 years
- Pay retirement over 10 years

Example

- Years 1 thru 5 net cash flow:

  $275,000 *less* $125,000 *equals* $150,000

  of available capital

  $150,000 *less* $35,000 (cap acct) *less*

  $85,500 (retirement) *equals*

  29,500 of positive cash flow

- Years 6 thru 10 net cash flow:

  $150,000 *less* $85,500 *equals* $64,500 of positive cash flow

Internal Valuation Benchmarks

Valuation methodology of those using multiple of equity or book

- Less than 10% used more than 100% of revenues
- Over 40% use 100% of revenues
- Almost 30% use between 75% and 100%

Internal Valuation Benchmarks

Valuation methodology of those using compensation

- Almost 40% use three times
- About 15% use two and one half times
- Between 15% and 20% use two times

Retirement

◇ Terms

- Payout periods
- Retention periods
- Tax structure
- Caps
- Penalty buyouts
    - Premature exit
    - Exit without appropriate notice
    - Getting “booted” out

Polling Question

Does your firm have adequate talent on the bench to replace retiring partners?

1) Yes, and we are confident our approach works
2) I think so, but we don't know how to admit them
3) No, we don't have the talent we need
4) We don't plan to pursue internal succession

New Partner Buy-ins

Terms

How much to charge?

How much equity?

What is fair?

Vesting

Compensation

New Partner Buy-ins

Consistently between $120,000 and $160,000 for all size firms*

*2013 Rosenberg Survey

Termination

- Voting
- Grounds
- Non-Competes
- What is cause?

Other Thoughts

- Death & Disability
- External Sale/Dissolution
- Non-competes
- Leaving with or without clients

For More Information

Please visit our website for resources including FREE reports, whitepapers and case studies.

Terry Putney

tputney@transitionadvisors.com

1-866-279-8550

www.TransitionAdvisors.com