Partnership compensation

Literature

I. Introduction

There are numerous models for sharing income in a partnership entity. In a partnership there maybe senior and junior partners. The decision regarding how the partners should be remunerated depends on the agreement of all partners. A firm must be mindful of the different considerations in setting up compensation models for the partnership. Based on the five articles that had been included in this paper, most firms disagree on the partnership compensation because some perceive the compensation model as unfair. Different firms in the industry have formulated many models, each model has its own weaknesses and strengths. There is conflict between partners when the partnership is dissolved. This review of articles should help the reader understand the different concepts related to partnership compensation.

II. Review of Related Literature

There are five articles that are discussed in this paper. The author combines the ideas from the article to show a better discussion on the subject matter. First I would discuss the considerations in selecting a partnership compensation model.

A. Considerations in a compensation model

Two of the articles discuss the various considerations in selecting a compensation model. The article from the New York State of Certified Public Accoutants (2005) suggests four considerations. First, the model must be fair for all partners. Second, the model must be safeguarded from bankruptcy upon the retirement of senior partners. Third, the model must include a reward system based on performance. Lastly, the model must be flexible to change in order to adapt to the changing environment in the business. Martin (1991) says that the model must also consider the financial structures and time. These factors are the chargeable and collectible time for the compensation, the client load managed per partner, the number of clients referred, community visibility, professional and association involvement, skill proficiency, capital infused, equity, seniority, firm management responsibilities and administration assignments.

B. Admission of a Partner, Compensation Models and Partnership Retirement Compensation

Questions may arise as to how an individual becomes a partner in a firm, The article from the New York State of Certified Public Accoutants (2005) discuss the different ways for the admission to the partnership. The first method is the immediate contribution and the second is the graduated contribution. Immediate contribution is a lump sum is given upon joining the firm. Graduated contribution is a method where the partners are required to contribute a percentage of their over a period of time.

The article also discusses methods of compensation such as using a corporate structure, partnership apprentice compensation, traditional similar to standard partnership structures. Under the corporate structure plan partners are paid a “ guaranteed salary” and partners are also given an extra reward for a good performance. Profits at the end of the year are distributed based on ownership percentage of the firm. The partnership apprentice plan admits a partner to the partnership but the partner is ineligible for profit sharing until he had proven his worth for the firm. Traditional similar to standard partnership Structure is a model where partners share in the firm's residual income based on their share of the ownership.

The article also discusses methods on how the retired partners are dismissed from the partnership. Some firms may require a partner to give notice of leaving for a certain period of time. The example in the article is noticing 2 years. Other firms may require partners a ten-year service period before being eligible for retirement. If a partner leaves before the minimum retirement age has been reached, entitlement of capital would only include the money from the bank account of the person retiring. There are two types of retirement discussed in the article. Funded retirement is a retirement pay funded by either the individual or the firm. Unfunded retirement compensation is paid by the firm out of current earnings before distributing share to the current partners.

C. Other Compensation Models and Considerations

Dunn (1989) had also shows several methods and considerations in his article. He states that traditional partnership structure is not always the best model for a partnership firm. He reiterated that the strategy must direct how a partnership is formed, and as stated in the article of New York State, the model must be flexible. He also recommends the use of a reward system based on performance, since he believes that talented partners are hard to find. If these people decide to leave because of unfair compensation, then it is the company's loss. Similar to Martin, he also includes regular allocation, requisite skill level, and time allocated for the firm.

Martin (1991) discusses methods of compensation which the cases historical accident, the King, objective formula, compensation by objectives, component part, paper slip, percentage assigning and combination. Historical accident is the compensation based on seniority. The king is compensation where a key person selects the type of compensation that the partners will receive. The objective formula compensation model ties compensation to an objective measure or set of them. Martin considers compensation by objectives as the most flexible method. This method encourages each partner to use his or her time in a beneficial way. It also sets up accountability of time spent in the firm. Component part is compensation based on the activity done by the partner.

Each activity has a percentage of profit assigned to it. At the end of the year, each activity for the partners is evaluated, and this would be the basis for the compensation for the partner. Percentage assignment depends on the perception of the partners. Paper slip is a type of compensation where all opinions of the partners are considered. Opinions are averaged to get the final allocation for the compensation. Martin states that this method is best if used in firms that have 3 to 10 partners. In the combinations model, the firm combines the methods discussed previously. Combinations are done to tailor the needs of the firm to the compensation models available.

E. Partnership Dissolution Issues

It is important for firms to examine the operating agreement for their partnership, because this would be their basis if the partnership dissolves. Reinsten and Johnson (2004), a present law firm partnership that had been faced with the problem of how to divide the compensation among the partners. The firm was divided into formula partners and non-formula partners. In order to have a fair division of compensation, the firm hired an accounting consultant to help resolve matters between the partners.

General Rules for accounting like the GAAP (Generally Accepted Accounting Procedures) was used by the accountant in order to solve the problem. The GAAP are the rules that accountants use to make the financial statements of the company. The accountant noted that the Operating Agreement of the partnership does not have any provisions regarding the partnership disbandment. This in turn had created several conflicts in the partnership. GAAP was used to solve the conflicts. Through the principal rules on equity, the shares had been divided among the formula partners and non-formula partners.

III. Conclusions and Recommendations

As a conclusion, it is important in a partnership entity to not only consider the compensation benefits but also to consider the side of the law and accounting. In accounting, the different models that would be used in giving the partners their share of compensation must be noted. These in turn would determine what type of compensation and how much would the partners receive during the partnership, when a partner resigns or when a partner joins and if the partnership becomes dissolved.

Legal issues in partnerships are the operating agreements set by the partnerships. Operating agreements must give provisions regarding the terms related for senior and junior partners as stated above, if a senior partner is leaving what is the minimum requirement service and the like. Other issues requiring attention for operating agreements is what are the rights of the senior partners and the junior partners in the partnership.

Both accounting and law would help straighten out how the partners would be compensated. Some partnership entities may have considered all regarding profit sharing. However, they must also consider the matter of partnership dissolution to avoid more conflict between the partnerships. All partnerships are eventually dissolved if a partner dies.