

Partner's Capital: How much is enough?

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As more and more professional service firms struggle to find balance in today's turbulent and recovering economy, some are finding the need to focus more attention on the balance sheet as opposed to relying primarily on the income statement to guide management decisions. While the income statement is often viewed as the most important decision making document available to the management and ownership of a professional services firm, the balance sheet offers critical insights into a firm's ability to weather tough times with financial strength and endurance.

In the context of this article, partner's capital is defined as the amount of tangible owner's equity on the enterprise balance sheet exclusive of the net equity in accrued receivables and work in process (ARWIP). There will be more on this key ARWIP aspect later. Working capital is defined as the net difference between the combined total of operating cash and marketable securities, net of short term interest bearing debt and certain trade payablesⁱ. Balance sheet leverage is defined as the proportion of interest bearing debt in relation to ownership equity. An overleveraged or undercapitalized firm has too much debt and not enough owners' equity. This is the primary focus of this article.

The key question we will attempt to address in this article is how a firm and its management can measure and manage its balance sheet leverage in order to insure it remains solvent and viable into the future. The amount of financial capital a firm should maintain is a challenging, yet important element for professional services firms to address. This is especially important when an anticipation of changes in ownership via retiring or withdrawing owners is paired together with setting proper expectations for the "skin in the game" that incoming owners should be expected to contribute to firm capital. Firms should also require a more robust amount of owner's capital during periods with turbulent conditions, such as what we have experienced since the fall of 2008, where many practice areas have been soft and clients have been slow to pay their

obligations to their professional service providers. The shifting landscape generally in many law firms, in terms of hot and cold practice areas (e.g. litigation generally remains strong in most corners while securities and real estate related legal needs are off substantially as compared to prior periods of economic expansion), has required firms to maintain more capital to weather through the retooling necessary to refocus people and resources between the areas of law supported by the enterprise.

In the context of a professional services firm, financial capital is often measured in terms of both hard and soft capital. Hard capital is the amount of owner's equity that is part of the fundamental balance sheet equation of assets = liabilities + equity. Soft capital also draws on this same fundamental equation but includes the firm's uncollected accounts receivablesⁱⁱ as part of the asset base of the enterprise. This aspect of measuring capital is somewhat beyond the scope of this article but important to distinguish given the objectives I want to address which focus more on the hard capital and cash based liquidity a firm should maintain at any given point.

Lending institutions often place covenants in loan documents that require a borrower to maintain certain financial ratios to stay in good standing during the term of a loan arrangement. Among other provisions, these covenants might include the need to maintain a current ratio of working capital of say 1 to 1, meaning current assets must equal or exceed current liabilities as of any reported period where the lending institution is provided financial statements. These same lending institutions typically also require other metrics to be met, such as provisions for limiting the amount outstanding on a borrowing or an operating line of credit. The financial institutions may not only set a maximum limit on the line of credit, but also base a limit upon the percentage of client accounts receivable under 90 days outstanding. We note this aspect as some firms have found themselves undercapitalized when they have a large outstanding balance on a line of credit, possibly used during times of slowness, and then when their receivables contract, their lender requires the debt to be paid down due to the calculated limits under the loan agreement.

Trends show more firms are requiring smaller contributions to firm capital by incoming members of ownership, as compared to prior periods when firms could command more from those looking to enter the ownership ranks. On top of smaller relative entry contributions, the incoming members are also maintaining owner's capital at a smaller amount in relation to peer group firms. These firms have taken an aggressive approach towards the manner in which they have chosen to capitalize the enterprise. Lending institutions were accepting of this in past periods of economic prosperity, but in today's tighter economy, these same lending institutions are now requiring more owners' capital to be maintained in order to protect their investment as a lender to the enterprise. This has made these same firms more vulnerable to the economic challenges of today.

Lease versus purchase option decisions is another issue closely related to capitalization. Attractive lease rates allow professional service firms to finance their furniture, fixture and equipment needs through either operating or capital leases, as opposed to funding such needs through owner's capital or traditional sources of debt. These burdens often do not even appear on the firm's balance sheet when characterized as operating leases. Lease versus purchase analysis and the related options between capital and operating leases and how they are treated both for income tax purposes and for financial reporting purposes is complex and beyond the scope of this article but readers are encouraged to seek competent counsel when these issues are at play with respect to evaluating the impact on owner's capital requirements.

Closely related to this is the commitment many firms make to long term leasehold arrangements for office space. These leases often have strict covenants and guarantees from all or some members of ownership that secure the overall obligation. The lease debt itself does not appear on the balance sheet for a going concern enterprise and is simply reflected as rent expense as the firm passes through each month and pays for the utilization of the space for that period. Assuming the firm has the right amount of space for its people and operating needs, this is a proper matching of the expense against the periods the space is utilized as part of the revenue producing process, but when the firm has excess

space the leasehold rent burden can become a significant obstacle to maintaining sufficient profitability and cash flows. Worse yet, if the firm defaults on its lease by too many people leaving, or not meeting other terms of the lease, the underlying liability can be triggered as a current debt, consuming ownership capital or even assets of individual owners who have provided guarantees to the landlord.

Phantom income can be a huge problem in a firm that has decided to take on higher levels of bank debt in relation to owner's capital. This happens when a firm draws on a line of credit, often secured by uncollected receivables, and uses the funds for current period expenses or distributions to owners. The rub comes when the debt is paid down in future periods using fee revenues as the source of funds for paying down the debt. It all nets out as simply a timing difference in terms of the tax impact except when there are changes in ownership or ownership shares. When an owner benefits from tax deductions or distributions in one period and then exits the enterprise without being held accountable for his or her share of this use of debt based funds, the new owner's effectively assume the tax burden of using taxable revenues to pay down the debt without the benefit of the deductions taken in the earlier period.

The author cannot count the times he has had to explain why a new member of a firm has significant taxable income from an LLP/LLC or S corporation, which exceeds their cash distributions due to the creation of phantom income in a given year. At the same time, even continuing members of ownership who are subject to the same phantom income, are often quite forgetful of the prior periods when they had received distributions well in excess their allocated share of taxable income. Low borrowing rates have contributed to the problem as some firms have been tempted to take advantage of low borrowing rates if their banking relationships are strong enough for the firm to be able to borrow typically against some stated level of uncollected receivables that are pledged as collateral.

One common principal that many firms follow, in different gradients is to require the members of ownership to have some minimum amount of "skin in the game".

For example, a senior partner at or near the top of the firms compensation scale may be required to have a larger investment in place in firm capital or the allocation of capital that is maintained might be a function of the partners percentage share of profits with the capital floating up or down as the share of profits changes.

Many firms are in the midst of dealing with a bubble of baby boomers that are beginning to retire or otherwise exit as productive members of the practice, causing a strain on firms that have not adequately budgeted for the payout of capital to these individuals in accordance with underlying agreements and expectations, further causing a strain on the balance sheet capitalization.

Today's economic circumstances have also created problems in some firms wherein clients have stretched the time they are taking to satisfy billings from their professionals causing client receivables to grow as measured by metrics such as the days of production invested in accounts receivable. At the same time, firms have tactically decided to offset this by delaying some of the trade payables when there are no penalties to doing so.

The question of how much is enough when it comes to the appropriate amount of equity capital to maintain will be primarily determined by the volatility of the need for such capital in relation to the philosophy of the owners toward maintaining a conservative financial position. Obviously, this needs to be coupled with a close eye toward identifying capital needs for things such as partner redemptions, office renovations, technology budgets, enterprise growth and beyond. This last element is a prime example of how proper planning can greatly assist as it is common practice for financial analysts to provide a provision for expansion of working capital to support the growth of an enterprise when preparing financial projections. In other words, as the business grows, a portion of cash flows needs to be retained as working capital to support expanded operations.

Arguably the biggest reason why companies fail is due to being undercapitalized. Statistics from the US Department of Commerce bear this out. Life in a law firm

is no different, particularly in today's ever complex and challenging environment where practitioners and clients are moving between firms with ever increasing frequency. A firm's ability to be nimble and acclimate to change can be critical as not only people and clients leave, but likewise opportunities arise to take on many of those same practitioners and clients. Many metrics can be put forth as measures of how much is enough, such as 3 to 6 months operating expenses, but these rules of thumb are nothing more than general guidelines for how a firm might budget for how much net working capital to maintain. Coupled with maintaining a positive current ratio, these guidelines might nonetheless be an appropriate target for a law firm in today's turbulent and challenging environment, tempered with an eye toward specific cash flow needs, such as funding the buyout for retiring owner's or needed investments in infrastructure.

It is important to determine how responsibility for the equity portion of invested capital will be shared when planning for the proper capitalization of the firm. In many instances, it will make sense to have this sharing be based in proportion to each individual's rights to enterprise profits. Since this sharing can change by period, it may require some amount of flexibility in how the sharing of capital floats up or down as an individual's sharing of profits floats up or down. The point being made here is to understand the linkage between owner's equity in the fundamental $\text{Assets} = \text{Liabilities} + \text{Equity}$ balance sheet equation and the liquid portion of Assets available to pay debts as they come due. While this linkage is not direct, it is often where an enterprise gets off course when difficult times require more liquidity and in turn, more owners' capital.

While the focus of this article has been on economic capital, it is also critically important to focus on the firm's investment in intellectual capital. I wanted to make note of this as I have seen firm's with a strong focus on maintaining sufficient economic capital upon the exit of retiring partners lose sight on the critical importance of the intangible capital that exits the firm with the retirement of seasoned practitioners. Namely, in terms of the seasoned practitioner's rainmaking abilities and technical expertise and experience that leaves the firm with insufficient bench strength to maintain prior levels of activity.

No amount of economic capital can replace a loss of sufficient work opportunities continuing to flow into the firm and often a significant proportion of these opportunities are tied to the individuals who may be exiting for whatever reason.

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ⁱ Working capital is often calculated and evaluated on an accrual basis of accounting, which would include accounts receivable. Using an income tax/modified cash basis of accounting, receivables and most trade payables are not considered as part of the computation of net working capital.

ⁱⁱ Accounts receivable and work in process (ARWIP) in most law firms can be the largest economic assets of the enterprise. Most professional services firms elect to report income on the income tax basis of accounting, which is also referred to as the modified cash basis of accounting wherein only collected revenues are recognized in a particular tax period offset by expenses that have been paid. ARWIP is tracked and analyzed separately as part of the capital entitlements of the owners of the firm and much has been written about this in terms of how to manage and maintain the equities and returns on ARWIP for exiting partners.