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Pricing Issues for Small Firm Sales

What partners need to know to maximize proceeds when selling their practice

by Joel Sinkin and Terrence Putney, CPA

For CPAs looking to sell their accounting practice, it can be a big plus to be in a small firm. That's because small firms generally can command higher multiples than big firms, and external sales usually produce higher prices for accounting practices than internal ownership transfers.

Those are two of the trends that will be explored in a three-part series on valuation issues in accounting firms. This article focuses on small CPA firms. The next two articles will address valuation issues for large CPA firms and internal transfers of ownership.

Here are a couple of definitions specific to the series:

PHOTO BY WRAGG/ISTOCK

- Value is not meant to be consistent with the conclusions that a CPA Accredited in Business Valuation (ABV) would reach in a formal business valuation performed for, say, litigation or an estate. Instead, value refers to the price to be paid for the practice—which often is expressed as a multiple of revenues, as is discussed in further detail later in this article.
- Small firms, generally speaking, are those with four or fewer owners. This is because the vast majority of business combinations involving the acquisition of firms with more than four owners are at least partially a merger rather than a sale.

In a merger, some or all of the acquired firm's owners become owners in the successor firm. This is an important distinction because, in a merger, the successor firm's owners' agreement usually dictates the value of the equity for owners who are a party to the agreement (though not always, as will be explored in next month's article on large firm valuations).

In transactions with smaller firms, it is much more likely the transaction will be in the form of a sale. The sale can be immediate, meaning the payment of the proceeds commences at closing, or in the form of a two-stage deal, in which the proceeds are delayed for a few years, with the selling owners continuing to work full time while transitioning the practice (see "A Two-Stage Solution to Succession Procrastination," *JofA*, Oct. 2013, page 40).

The primary factors that drive the value of a small firm in a sale are (1) the terms of the transaction; (2) the number of buyers potentially interested in the practice; (3) the attributes that will affect the profitability for the buyer of the practice; and (4) the nature of the practice. This article explores those factors in more detail.

1. The Terms of the Transaction

As mentioned earlier, the price paid for a firm often is expressed as a multiple of revenues. However, the multiple a seller is willing to sell the practice for, and the buyer is willing to pay, is directly related to other terms of the transaction. The five primary terms that affect the multiple are (1) the upfront purchase payments; (2) the number of years the remaining payments are made; (3) the period during which the payments are subject to adjustment for retention of acquired clients and the extent of the possible adjustment; (4) the tax treatment of the payments; and (5) the potential profitability of the practice for the buyer. The more those factors favor the seller, the lower the resulting multiple will tend to be and vice versa (see "How to Value a CPA Firm for Sale," *JofA*, Nov. 2013, page 30).

Retention of acquired clients tends to be the factor that most significantly affects a small firm's value. The reason for this is that client relationships in smaller firms tend to be much more connected to the firms' owners. Those owners are often much more hands-on with clients, who often can't differentiate their relationship with the firm from their relationship with one of its owners. The larger the firm becomes, the more likely it is that clients will see their relationship as institutional. In those cases, the clients will have relationships with several key people in the firm and be less tied to a particular owner.

In virtually any deal that places value on the transfer of client and staff relationships, provisions restrict the seller from competing with the buyer firm for those relationships for a reasonable period following the sale. Without this type of restriction, the buyer has no assurance that the acquired relationships, which represent most of the practice's intangible value, can be sustained.

In most cases, the seller's direct involvement in the transition of client relationships is a key to transferring loyalty to a successor in the acquiring firm. To ensure that happens and to motivate the seller to execute the plan, most deals have clauses that directly tie the seller's purchase proceeds to the buyer's client retention over a certain period. For example, assume a buyer agrees to pay a revenue multiple of one times for a $1 million practice. The deal calls for the buyer to pay over five years based on the percentage of clients that stay with the firm for two years after the sale. If clients representing 80% of the revenue stay with the successor firm through the second year, the seller will receive $800,000 for the practice.

Retention periods tend to fall into three categories: (1) one-year retention periods; (2) two-or-more-year retention periods; and (3) full-collection deals. The duration and nature of the retention period can affect the final sale price in a variety of ways.

> In most cases, the seller's direct involvement in the transition of client relationships is a key to transferring loyalty to a successor in the acquiring firm.

One-year retention period. In deals with this term, the final purchase payments are based on the collected billings from the seller's clients for the first year following the closing. While many sellers believe a shorter retention period results in less risk for them (due to less time for clients to leave the buyer firm and lower the seller's proceeds), that has not been the authors' experience. When the deal locks in the price after the first year, most buyers counter (if they will even consider the deal) as follows:

- They offer a reduced price multiple because of increased perceived risk.
- They are less patient with the transition and tend to institute changes quickly. Most buyers understand they are much better off losing a client during the first year than shortly after the retention period expires. An aggressive transition can cause greater client attrition.

Two-or-more-year retention period. Retention periods for less than the full payment period can be defined many ways and must be drafted carefully. For instance, in a two-year retention deal, the retention adjustment may be based on the average of two years' collections or on the second-year collections for clients *retained* at the end of that year. Collections from repetitive services might be the only ones included in the calculation, with special one-time services treated entirely differently.

Two-year retention periods tend to work better than one-year periods because buyers understand that most clients retained *after* the first year have affirmed their transition to the successor firm. Thus, there is less risk of losing clients in subsequent years. A two-year-or-longer retention period can often lead to a better offer and a more gradual transition, resulting in better retention. It should be noted that very large clients (for instance, those individually making up more than 10% of an acquired firm's fees) may require longer retention periods due to the concentration of attrition risk.

Collection deals. An example of a collection deal is a transaction in which a seller is paid 20% of collections from a sold client list for the full payment period of five years (a 100% multiple). Using the same multiple if the seller is paid over four years, the price would be based on 25% of collections during the payment period. The advantage this approach has for the buying firm should be obvious. The firm pays only for the clients retained based on fees generated during the payment period.

This is advantageous for the selling firm. First, the seller often is in a position to negotiate a higher multiple due to removing the risk of client attrition from the transaction. Second, though some loss of clients is inevitable, if the seller selects the right successor firm, there is a good chance fees will increase for the clients that are retained. In a collection deal, the seller usually sees an increase in purchase proceeds due to an uptick in fees, especially from increased services. It is not unusual for the most successful combinations to result in higher fees and much higher purchase proceeds than the seller would have received even if the price had been fixed at closing.

2. The Number of Buyers Potentially Interested in the Practice; and 3. The Attributes That Will Affect the Profitability for the Buyer of the Practice

Why can owners of small firms expect higher multiples for their practices than most of their big firm counterparts? The answer is pretty basic: the law of supply and demand. There simply are many more firms able and willing to snap up a firm with four or fewer owners than there are firms looking to acquire larger operations. Consider the following reasons:

- The vast majority of accounting firms are small, as shown in the 2012 AICPA Private Companies Practice Section (PCPS)/Texas Society of CPAs Management of an Accounting Practice (MAP) Survey. That study split firms into seven categories by annual revenue. Of those categories, only the top two, composed of firms with at least $5 million in revenue, had an average number of partners per firm of at least five. Only about 6% of the firms that participated in the survey had at least $5 million in revenue. That leaves precious few firms with the resources to absorb an accounting practice with five or more partners.
- It is usually easier and quicker to profitably add a small accounting firm than a large one. That's because small firms tend to have less overhead. For example, the authors have encountered many firms capable of absorbing a small firm with little extra costs, if the small firm is not tied down by a long lease and does not demand the retention of redundant administrative staff. A $3 million or $4 million firm often can absorb a $500,000 practice without having to add office space or nonbillable staff. Firms with five or more owners usually require the acquiring

EXECUTIVE SUMMARY

- **Small firms generally command higher multiples of revenue in sales than large firms do.** Small firm deals also tend to produce higher value than internal transfers for ownership.
- **Four primary factors determine the price paid for a small firm.** These factors are the transaction's terms, the number of interested buyers, the firm's profit potential for the buyer, and the nature of the firm.
- **Client retention is essential to maximizing proceeds from a small firm sale.** Most CPA firm sales calculate the amount paid to the seller based on the percentage of clients the buyer retains during a certain period after the sale closes. Small firm clients tend to be more loyal to partners than to the firm as an institution.
- **CPA firm sales have three main types of retention periods.** Full collection deals and retention periods of two or more years tend to produce higher multiples for the seller than one-year retention periods.
- **It's usually easier and quicker to profitably add a small firm than a large one.** That's because small firms generally have less overhead that acquiring firms have to absorb.
- **Baby Boomer retirements are putting more small firms on the sale block.** This increase in supply is driving down values, though the demand for small firms remains high.

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firm to pick up the costs of additional office space and administrative personnel. Those costs affect the acquired operation's profitability. The target for cost synergies in an accounting firm sale or merger is 10% to 15%. Those goals can be hit in a large firm merger, but it usually takes a few years. Many firms won't consider an acquisition that isn't cash flow positive (net revenue minus costs, including acquisition costs) in the first year or two.

4. The Nature of the Practice

Certain types of practices tend to command a lower multiple. Some client bases are viewed as difficult to transition because of the unique relationship between the clients and the seller. Litigation support practices are sometimes seen as creating this kind of obstacle.

Another factor driving down the multiple is a practice with a low profit margin. A common example is an outsourcing practice with a relatively low markup on labor costs. A practice with a 20% profit margin (before owners' compensation and benefits) is not going to command the same multiple as a practice with a 40% profit margin.

Certain types of practices also can command a higher multiple, usually because of the opportunity for significant synergy that a specific type of buyer can exploit. For instance, practices that have a significant number of high-income and high-net-worth individual clients often can obtain a premium valuation from a firm that offers wealth management services. The same holds true for firms with client bases that offer the opportunity for cross-selling high-value services by a specific buyer firm. However, a buyer firm that primarily focuses on business services may view a firm with a concentration of high-income and high-net-worth clients as less valuable. Value is always in the eye of the beholder.

Trends in Small Firm Valuations

A flood of Baby Boomer accounting firm owners nearing retirement has created a surge in the number of small firms seeking buyers. The net result is the authors are seeing firm values dropping to some extent in almost every market nationwide. Whereas revenue multiples of 1.5 to 2 were common 15 to 20 years ago, multiples today tend to range from 0.75 to 1.2. Again, the law of supply and demand is in effect, and trends point to growth in the supply of sellers seeking external solutions, which is outstripping growth in the number of buyers interested in providing those solutions.

The good news for small firm owners is that they likely will always be in position to command higher multiples than large firm owners—thanks to the supply-and-demand issues explained in this article. In addition, because large firm acquisitions tend to be at least partially in the form of a merger, the value of the acquired firm is determined at least in part by the successor firm's owners' agreement. As will be explained in greater detail in the third installment of this series, internal valuations are usually lower than external valuations. For those reasons, the authors have seen many more small firms acquired for multiples of one times or higher—a big plus for small firm owners. ❖

AICPA RESOURCES

JofA articles

- "How to Maximize Client Retention After a Merger," April 2014, page 42
- "Managing Owner Transition Through an Owners' Agreement," March 2014, page 42

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Pricing Issues for Midsize and Large Firm Sales

Big deals come with more complexity, but size has its advantages.

by Joel Sinkin and Terrence Putney, CPA

It's no simple task for accounting firm owners to figure out how much they should be paid when they are looking to sell. The job is especially complex for firms with at least five owners.

The reasons for that are examined in this article, the second in a three-part series on calculating the price that should be paid for owners' equity in accounting firms. The first article ("Pricing Issues for Small Firm Sales," *JofA*, Oct. 2014, page 24) covered the factors that determine the final sale price for small accounting firms. The final article, which will be published next month, will examine the valuation issues with internal transfers of ownership.

For this series, the authors use the following definitions:

- The term *value* refers to the price to be paid for the practice—which often is expressed as a multiple of revenues. Value is not meant to be consistent with the conclusions that a CPA Accredited in Business Valuation (ABV) would reach in a formal business valuation.
- Large accounting firms are those with five or more owners. That's because firms of that size are much less likely than small firms to be sold outright. With larger firms, at least part of the acquisition is likely to be structured as a merger, with some or all of the owners becoming long-term partners in the successor firm. In those cases, the value of their equity usually is determined by the successor firm's owners' agreement, though not always.

One factor adding to the complexity of large firm acquisitions is the frequent need for different deals for groups of owners in the acquired firm. For instance, a six-owner firm may have four owners who will sign on as partners with the acquiring firm. The other two owners may be seeking a short-term transition of their duties and monetization of their ownership. The deal for those owners may be treated as a sale in a transaction that is mostly separate from the agreement governing the admission of the rest of the owners as equity partners in the acquiring firm.

Another alternative is a two-stage deal for owners seeking transition within five years but who want to continue working full time for a while (see "A Two-Stage Solution to Succession Procrastination," *JofA*, Oct. 2013, page 40). In some cases, owners of the acquired firm who are not admitted for other reasons (sometimes for not meeting the acquiring firm's book of business or skill requirements for partners) may also go through a sale to deal with their equity.

Use of Acquired Firm's Owners' Agreement Terms

Most large firms have an existing owners' agreement. Some of those agreements contain terms for the buyout of retiring partners that are not financially viable, making the internal succession plan impractical. However, a lot more internal succession strategies fail because the firm's pool of internal successors cannot replace retiring partners. If the motivation for a firm seeking an upstream merger is finding replacements for retiring partners, it may become reasonable to use the terms of the acquired firm's buy-sell agreement for the buyout of owners leaving soon after the merger. This is because the primary concern of the owners in the selling firms is not *what* they will be paid but *that* they will be paid.

For example, a firm owner might be more confident that a $20 million firm could pay for his or her buyout than a $5 million firm. Let's say the buyout in the acquired firm's owners' agreement calls for the owner to receive $100,000 for the next 10 years. The owner's stake in the acquired firm might be worth more than that on the open market, but to ensure that he or she receives payment, the owner would be happy to keep the payment structure outlined in the acquired firm's owners' agreement.

ILLUSTRATIONS BY ARTQU/ISTOCK

Dealing With Imbalances Between Agreements

A problem the authors routinely run into is differences between the method of valuing equity in an acquired firm and the firm it is merging into. For example, in a recent deal, a firm with five partners used the percentage of equity owned by a partner multiplied by the firm's revenues to determine the value of a partner's interest at retirement. The firm had five owners, and one owned 60% of the equity.

The acquiring firm used a compensation multiple to determine retirement buyouts. The majority owner in the acquired firm would have been required to take a substantial reduction in the retirement buyout using the acquiring firm's method. However, the acquiring firm concluded it would eventually substantially overpay retirement benefits to all the merging partners if it used the acquired firm's buyout method for the majority selling owner and its standard arrangement for the other merging partners.

The solution was to have all the merging partners sign on to the successor firm's partnership agreement. A separate agreement was established, creating a premium for the majority selling partner (who did not become an equity partner in the successor firm) using

the value he would have been paid from his old firm. A discount was allocated to the remaining four partners merging into the successor firm equal to the "premium" paid to the majority partner in a side agreement with them.

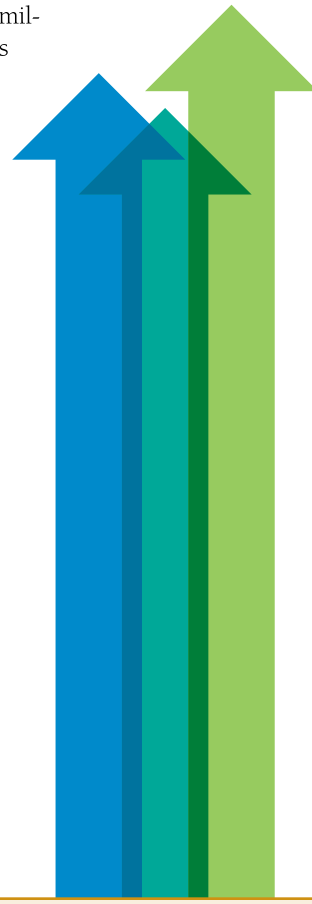
LARGE VS. SMALL

As covered in the first part of this series, the multiples paid in small firm sales tend to be higher than those in large firm transactions. The payout periods also tend to be shorter. The main reason for that is that acquiring firms tend to absorb less overhead with small firms than they do with large firms. This helps the acquisitions become profitable more quickly.

For example, the acquirers of small practices often have enough excess capacity in terms of staff/partner time and infrastructure that they can absorb the practice with little incremental increases in overhead. In contrast, it is unlikely any acquirer can absorb a $10 million firm with 60 employees and 10 owners without inheriting the overhead costs associated with administrative staff, leases, etc. To keep the cash flow of the deal positive, the transaction is more likely to have a lower multiple and longer payout period for the portion of the deal that is treated as a sale.

Not all the terms are worse for the seller in large firm transactions. Deals involving larger firms tend to have shorter retention periods. There are two reasons for this.

First is the nature of the relationships clients have with the firm. A larger firm tends to have more "brand-loyal" clients. These are clients that do not depend for their services on a personal relationship with an individual at the firm, usually a partner. The clients of smaller firms are much more likely to be loyal to a partner in the firm. Once that partner leaves, there is more risk the client will leave, too.



To motivate the transitioning owner to properly transition client relationships, the transaction will normally be tied directly to the fees generated by the seller's clients for up to the entire payout period. In the acquisition of a larger firm, there often is less perceived risk of client loss due to the exit of one person from the firm. The acquiring firm may be much more willing to structure the terms using a shorter retention period and even allow some client loss with no adjustment in price.

EXECUTIVE SUMMARY

■ **Large firm sales are much more likely than small firm sales to be at least partially a merger.** In those deals, younger partners from the acquired firm become partners in the acquiring firm, while partners ready to cash out come to terms on a buyout or sale of their stakes to the acquiring firm.

■ **Owners' agreements often are used to determine partner compensation.** Many times, merging partners will sign on to the terms of the acquiring firm's owners' agreement. In other cases, the acquired firm's agreement is used, or different terms are negotiated.

■ **Large firm sales usually have smaller revenue multiples and longer payout periods than small firm sales.** This is because acquiring firms almost always have to add overhead to accommodate large firm acquisitions. As a result, it takes longer for the acquiring firm to see a return on investment, which leads to the payouts to the acquired firm taking place over a longer period of time.

■ **Large firm sales tend to have shorter client retention periods than small firm sales.** Large firm clients are more likely to be brand-loyal than small firm clients, who tend to be partner-loyal. Brand-loyal clients are less likely to change accounting firms. Also, in more large firm mergers, at least some partners with the acquired firm stay with the successor firm, maintaining a presence that can help retain clients.

■ **A couple of main factors have created a buyer's market for larger firms.** The return of organic growth after the recession has relieved the pressure on large firms to expand through M&A. More importantly, the rising tide of partner retirements, coupled with the shallow pool of available replacements, is pushing firms to seek upstream mergers to shore up succession.

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The second reason is tied to the tendency the transaction will be structured at least partially as a merger. At least some of the owners in the acquired firm will become long-term partners in the successor firm. These partners will often be in a position to directly mitigate the risk of client loss and frequently even succeed to the client relationships that were managed by retiring owners who are being bought out. This approach can drastically reduce the potential for client loss and allow the deal for the selling owners to contain less retention risk for them.

However, note that the specific circumstances affecting a firm's potential client attrition will dictate how this is handled. For example, if a selling owner manages an extraordinarily large client in terms of fees, or if the firm has operated in silos—essentially several sole practitioners sharing space and managing separate and distinct books of business—the retention terms may be the same as those for a $500,000 one-owner firm.

More and More a Buyer's Market

While for years it was a seller's marketplace, this is no longer the case in many markets. This is especially true for most large firms seeking sales or mergers. The larger a firm is, the fewer viable acquirers are available. Immediately following the economic downturn in 2008, most growth-oriented accounting firms turned to mergers and acquisitions as an alternative to organic growth, which went dormant as the economy faltered. A feeding frenzy of sorts emerged for firms of all sizes. The M&A market tilted toward sellers. Two things have happened since. The economy improved, and large firms began to grow again organically. More importantly, many more firms of all sizes, other than the largest, are now experiencing succession pressure due to insufficient talent below the partner level.

The firms that are potentially relevant acquirers of large firms remain motivated to grow through M&A. However, the ratio of buyers to sellers has decreased because some of the acquiring firms have themselves been acquired, and the supply of available firms seeking an upstream merger has increased dramatically. As a result, most acquirers of large firms have tighter criteria for a deal. Another result is that acquiring firms are pushing the terms they are willing to use in the transaction more in their own favor. Hence, the authors are seeing much more of a buyer's market among large firms.

Conclusion

For large firm owners contemplating a sale, it's seller beware. The market favors buyers, and small firms are seen as more attractive for upstream buyers. Nonetheless, large firms can have advantages at buyout time, with more "brand-loyal" clients and the possibility that retained owners from the acquired firm may smooth the transition for retiring partners' clients. ❖

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■ "Pricing Issues in Small Firm Sales," Oct. 2014, page 24
■ "How to Maximize Client Retention After a Merger," April 2014, page 42
■ "Managing Owner Transition Through an Owners' Agreement," March 2014, page 42
■ "Alternative Deal Structures for Succession," Jan. 2014, page 42
■ "How to Value a CPA Firm for Sale," Nov. 2013, page 30
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How to Price an Owner's Interest in a CPA Firm

Dramatically different demographic and market conditions require new strategies to pay for buyouts.

by Joel Sinkin and Terrence Putney, CPA

Here's a scenario playing out in partner meetings across the country. Dewey, Kowntem & Howe LLC (DKH) is a five-partner, second-generation firm. John Howe is one of the founding partners. Over the years, the firm bought out Chuck Dewey and Alice Kowntem using terms the three partners agreed to when they formed the firm. It was difficult paying for those buyouts, but the firm got through it. Because of the way the firm reallocated equity following Chuck's and Alice's buyouts, John's equity share is now 65%.

John announced at a recent partner meeting that next tax season would be his last. However, his partners let him know that they didn't think they could afford the buyout terms dictated by their operating agreement. John was

PHOTO BY DEBBISMIRNOFF/ISTOCK

shocked and hurt to learn his partners did not share the same commitment to the agreement he had made when buying out Chuck and Alice.

What went wrong for John?

The tremendous number of Baby Boomer owners of CPA firms is causing many firms to reconsider the agreements they negotiated 20 or 30 years ago. Younger partners often are wondering how the firm will survive as they take on the burden of paying several senior partners simultaneously on what appear to be onerous terms.

This article addresses current trends and techniques for setting the price for ownership stakes in internal ownership transfers in CPA firms. The two previous articles in this three-part series addressed valuations of small CPA firms ("Pricing Issues for Small Firm Sales," Oct. 2014, page 24) and larger CPA firms ("Pricing Issues for Midsize and Large Firm Sales," Nov. 2014, page 50).

The concept of price in this article should not be confused with the value that a CPA Accredited in Business Valuation (ABV) might place on an accounting firm in a formal business valuation. This article addresses the set of terms for the buyout of an owner and the business plan that backs up the transition of that owner's key responsibilities.

Although many internal buyout terms are structured in a way that tries to mimic the external market, the trend is clearly toward lower prices for internal transfers. There are several reasons for this, in addition to the increasing reluctance of younger partners in firms to take on large retirement obligations. Those are:

- An owners' agreement is, in essence, a put option. The firm and your partners are contractually obligated to buy you out once you have met the criteria in the agreement. There is no such obligation in an external transaction. Just like in the stock market, where acquiring a put option has a cost for the person receiving the option, your cost for that feature may be a lower sales price.
- One of your firm's objectives in an internal buyout is its long-term viability as an independent entity. Otherwise, you would sell. The trade-off for that is terms that make that possible. You aren't typically as interested in the viability of the buyer in an external transaction once you have been paid.
- The terms for an internal sales transaction are normally different from those for an external one. A key difference is that internal payments are often fixed at the date of retirement whereas external transactions almost always have post-closing contingencies. That difference, as well as other differences in terms, explains a lower valuation with regard to the pricing.

Transition: The Underlying Basis for Value

One of the things that bothered John Howe's partners about his buyout was the close relationship he had with some of his major clients. John had always bragged that no one could ever replace him, and he made no effort to introduce his clients to his other partners. As an example, one of John's clients was billed about $150,000 per year in fees that were generated to a great extent by the time John spent personally advising the client's owners. DKH's agreement required no adjustment for business lost after John's retirement. John's partners feared they would, in essence, be paying for clients they wouldn't keep.

An accounting firm's value is made up of two asset pools: tangible and intangible.

The accrual-basis net equity in most firms can be considered the tangible value. The intangible value can be made up of the client list, workforce in place, brand name, and goodwill. Usually, the client relationships the firm has are considered to be the bulk of the intangible value. In most transactions, whether internal or external, the total price of the transaction is the sum of the firm's tangible book value and intangible book value, however intangible value might be determined.

What often is missed in the evaluation of value is that it is also tied to the firm's ability to transfer client relationships from an owner who is selling or retiring, to other key people in the firm, probably partners. The value should reflect how effectively the transfer can be made under the circumstances and the risk that the transition might eventually fail.

Many internal buyouts fix the payments at the date of retirement. That makes sense if the firm has brand-loyal clients or a strong plan for the transition of partner-loyal client relationships and the plan is given time to be executed. For instance, a logical approach to this might be to require a retiring partner to (1) provide a minimum of two years' notice ahead of a retirement date or of when he or she intends to otherwise sell his or her owner interest, and (2) execute a formal transition plan. If either requirement is not met, the payments might become contingent or be subject to a predetermined discount. (See the *JofA* article, "The Long Goodbye," Aug. 2013, page 36, for more information on the timing of initiating the transition.)

Smaller firms tend to have many more partner-loyal clients, which means their clients are loyal to an individual partner in the firm (like John Howe). A properly executed transition in this type of firm is critical.

Backward-Pricing Analysis

You may have helped clients evaluate potential acquisitions. Can you imagine suggesting to a client that it acquire a business knowing the terms of the deal would not be cash flow positive for a significant time? The buyout terms for the owners need to meet the same test. When an owner retires, the firm has the compensation that owner used to be paid as "capital" to help pay for the buyout and transition. Capital needs to be used for three things: (1) The owner's labor has to be replaced; (2) his or her owner interest has to be paid for; and (3) an adequate amount of additional profit has to be left over to motivate the remaining owners to undertake the increased responsibility and assume the risk of the obligation.

In John Howe's case, his partners performed a backward-pricing analysis. The result was that John's intangible value (based on using one-time revenues for the firm multiplied by his 65% owner interest) was $1.95 million, which was calculated as 65% of the firm's $3 million in annual revenue. However, owner compensation in the firm was much more equally allocated than the equity, and John's compensation was about $300,000 annually. On top of that, John was to be paid $390,000 for his share of the firm's tangible book value, which totaled $600,000.

Because the payment term required for John's capital account was one year and the payment term for his retirement was five years, the firm would pay $390,000 per year for five years for retirement on top of another $390,000 in the first year for the capital. The negative cash flow for the full five years was significant. Said one of the remaining partners: "I'll spend the next five years paying John off, making less compensation, and the firm will be borrowing. Then it will be my turn to retire. Why am I not excited about this plan?"

Often this problem can be addressed by changing the buyout's terms, although it may also be necessary to change the total pricing scheme. For instance, rather than paying John's capital account upfront or during the first year, DKH might consider stretching the payments over five or even 10 years. The same holds true for retirement payments. Retirement payments made over five or fewer years seldom meet

EXECUTIVE SUMMARY

■ **There is downward pressure on pricing for internal transfers of ownership in CPA firms.** Among the factors are the enormous number of Baby Boomer accounting firm partners at or near retirement age, decades-old buyout agreements with terms that now seem onerous to younger partners, and younger partners' reluctance to take on large amounts of debt to meet those terms.

■ **Two asset pools, tangible and intangible, make up an accounting firm's value.** The tangible value can be considered to be the accrual-basis net equity, while the intangible value can consist of the client list, workforce in place, brand name, and goodwill. The firm's client relationships generally represent most of the firm's intangible value.

■ **Unlike most outside sales, internal buyouts often fix payments at the date of retirement.** This works if the clients are firm-loyal rather than partner-loyal. Being able to transfer clients is essential to the buyout's success and value to the firm.

■ **A good way to assess a buyout package is to do a backward-pricing analysis.** This can show what the cash flow will be for the deal at the proposed terms.

■ **Many firms are stretching out capital account and retirement payments to as long as 10 years.** This improves a firm's cash flow.

■ **As firms increase in size, they tend to change their method of calculating buyout payments.** The migration usually goes from multiple of book of business to percentage of ownership to multiple of compensation.

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the objectives of the backward-pricing analysis. Increasingly, firms are stretching payment terms to 10 years or more.

Market Trends for Internal Buyouts

There are three common ways of pricing an owner's interest in a CPA firm. The *2012 PCPS Succession Survey* for multiowner firms discovered the following (percentages are of respondents with an agreement to pay a retirement benefit):

- 16% set value based on an owner's managed book of business.
- 37% set value based on ownership multiplied by a value for the whole firm.
- 22% set value based on a multiple of the retiring owner's compensation.
- The remaining 25% use another method, which likely includes a fixed value or a hybrid of the above methods.

The authors' experience is as firms increase in size, they tend to migrate from the book-of-business method to the ownership method and finally to the multiple-of-compensation method.

The multiple-of-compensation method is inherently linked to the other two methods when considering how it portrays the firm's overall value. The classic average ratio of owner compensation to revenues is 33%, so three times compensation is theoretically the same as one times revenue. The key difference is the compensation method allocates value on the basis of a much more dynamic metric, compensation, rather than what might be considered an arbitrary metric, ownership percentage. Many firms believe compensation reflects a more current measurement of contribution to the firm's value.

Whereas, 10 years ago, CPA firms using the book-of-business and ownership methods routinely valued revenue at one times and even more, and firms using the compensation method used a multiple of three times or higher, the trend today is for much lower valuation multiples as demonstrated by the following data from the PCPS survey:

- 43% of those respondents using revenue multiples use one times revenue, 8% use more than one times revenue, 22% use between 80% of revenue and one times revenue, and 24% use less than 80% of revenue.
- 35% of those respondents using compensation multiples use three times compensation, 12% use more than three times, 17% use 2.5 times, and the remaining 35% use less than 2.5 times.

(Note that, in most agreements, the above multiples address only the retirement or intangible value, with capital accounts or book value paid in addition to these amounts.)

The authors have worked with dozens

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- "Pricing Issues for Small Firm Sales," Oct. 2014, page 24
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Survey report

- *2012 PCPS Succession Survey* for multiowner firms, tinyurl.com/qzhabug

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of firms over the past 20 years, and there is a common theme. Primarily in an effort to (1) make the prospects of taking over for retiring partners more attractive to younger partners, and (2) increase the probability that firms can make good on their retirement obligations to former partners, many firms have modified the pricing multiples in their agreements to reduce the overall retirement benefit. The alternative route some firms have taken, especially smaller firms where selling is an option, is to look for a third-party buyer if (1) the younger partners are unwilling to execute the terms of their firm's owner agreement, or (2) the senior partners lack confidence that the younger partners will be able to make all the payments.

When assessing what is right for your firm, the best approach is the backward-pricing analysis discussed above. However, the survey data can provide insights to how your agreement compares to the market and what other firms may have done to address affordability.

Death and Disability

Most agreements will require an owner's interest to be acquired in the case of death or permanent disability, and often the terms and pricing will be the same as an orderly retirement. However, consider the following. The disruption this kind of event causes the firm, and the potential for lost business, is not much different than if an owner were to abruptly quit. The clients will experience a sudden loss of their trusted adviser and, if the client base is predominantly partner-loyal, the effect can be dramatic.

Fortunately, insurance usually is available for this type of event. The authors recommend that insurance be used as much as possible to cover the obligation the firm will have to the owner to mitigate the effects any loss of business might have. If insurance is not obtained, it may be advisable to treat the buyout under the same terms as would be used for a termination without adequate notice.

Conclusion

So how did DKH resolve its problem with John? He delayed his retirement by a year, and the firm instituted an aggressive plan for his transition. Under the assumption that John probably was more replaceable than he thought, the remaining partners agreed to fix his payments at the date he retired if he executed the transition plan to their satisfaction. Rather than asking John to take a substantial reduction in the pricing of his retirement, DKH suggested extending John's retirement payment period to 12 years (it was five years) and his capital account payout to five years (previously capital was to be paid upfront). John agreed, giving this story a happy ending. ❖