How to admit new partners: A fresh approach

The AAV method can help accounting firms find the right formula for bringing in new owners on terms everyone can live with.

By Joel Sinkin and Terrence Putney, CPA

The long-term viability of accounting firms depends on providing a path to partnership that is affordable for new partners and not too costly for current owners. Firms that fail to admit new partners cannot afford to buy out and fund departing partners' retirements. This often leaves firms with little choice but to seek a succession solution that includes a firm sale or merger.

Fortunately for firms seeking long-term independence, several approaches can facilitate a successful ownership transition. This article illustrates a method called average annual valuation, or AAV, which can bridge the gap between those seeking admittance into a partnership and those already holding ownership stakes.

THE COMPLICATED CASE OF BCDC

Consider the following scenario, which is a hypothetical based on the experiences of several accounting firms: BCDC CPAs is a four-partner, \$3.8 million firm formed 15 years ago when two senior managers of a large local firm joined with a senior manager and a young partner from another local firm. The combined firm has grown nicely. Because the partners do not want to be forced into a merger to fund partner retirements and because they are keenly interested in retaining a pair of talented young managers, the partners need to find a way to admit the managers as owners.

It has not been an easy process. Julie Bean, the managing partner of BCDC, informally proposed to the new partner candidates a plan to sell each of them a 10% stake in the firm. It made sense to her that, because the firm valued its goodwill at one times revenue and the firm had about \$1 million in tangible equity, it was fair to price the buy-in at 10% of those values, or \$480,000 (see "Equity Method for BCDC New Partners"). She even offered to let them spread the buy-in over four years, so she was surprised when the response she received was tepid at best.

Julie consulted with several of her peers at other firms and found that they require new partners to invest no more than \$100,000 upfront. One firm was using a multiple of compensation for partner retirement valuations, and the other used something called AAV. Julie couldn't understand how these firms could justify bringing in new partners at that level of investment without feeling as if they were giving away the store.

This article addresses the financial issues associated with new partner admissions. The concept of pricing the equity in a CPA firm that this article uses should not be confused with the value a CPA holding an Accredited in Business Valuation (ABV) credential might place on an accounting firm in a formal business valuation. Rather, this article addresses the set of terms and underlying

As the new partners participate in growing the firm, their sweat equity would be recognized as they accumulate a portion of newly created revenue units.

business plan associated with buying out retiring partners and structuring new partner buy-ins.

When addressing value in setting the price for a CPA firm, it is helpful to break down the value into two pools: tangible and intangible. The tangible equity is most often approximated by the accrual-basis net equity. In BCDC's case, Julie asked the new partners to contribute $100,000 of capital based on 10% of the firm's $1 million accrual-basis net equity. She further asked them to buy 10% of the firm's $3.8 million of total intangible value as defined by BCDC's owners' agreement.

BCDC's owners' agreement bases its intangible firm price valuation on 100% of revenues. That method puts the firm in line with the results of the 2012 AICPA Private Companies Practice Section (PCPS) Succession Survey, which found that 43% of the respondents set intangible value based on 100% of revenues. The trend in the profession is toward lower multiples as firms seek to ease the financial burden that the retirement of Baby Boomers poses; this helps explain why 46% of the survey respondents used a valuation multiple below 100%.

Equity method for BCDC new partners

Total capital	$1 million
Firm volume	$3.8 million
Total value	$4.8 million
Cost of 10% stake	$480,000
Annual investment (4 years)	$120,000

Julie considered offering the new partners a guarantee of enough additional compensation to fund their four-year buy-in. However, when she floated the idea of a $120,000 increase in compensation, her other partners shot it down. The senior partners thought the decrease in their compensation to fund this increase for the new partners wasn't justified, based on what the senior partners would be receiving for selling a partial interest in the firm and the new partners'

IN BRIEF

- Those pricing an accounting firm's equity often consider that value in two pools—tangible and intangible. Approaches used to calculate a fair price for intangible equity include the equity method, the multiple-of-compensation method, and the average annual valuation (AAV) method.
- Many firms that price firm shares using the equity method often run into problems balancing the equity owned by partners over time. Partners who start with large ownership stakes tend to gain disproportionately more of the firm as new partners buy in to the firm.
- The AAV method, also known as the revenue units approach, expresses a firm's price or value in units tied to revenue. In this article's hypothetical, the firm has $3.8 million in revenue and prices its intangible equity at one times revenue. The result is 3.8 million revenue units. The number of revenue units grows or shrinks with the firm's revenue.
- The use of revenue units lays the groundwork for buying out and admitting partners. In some cases, new partners can initially buy into a firm with only their capital contribution—a more affordable option that also keeps current owners happy because they don't have to allot any revenue units to the new owners. The new partners can later earn their own revenue units by helping the firm grow revenue.

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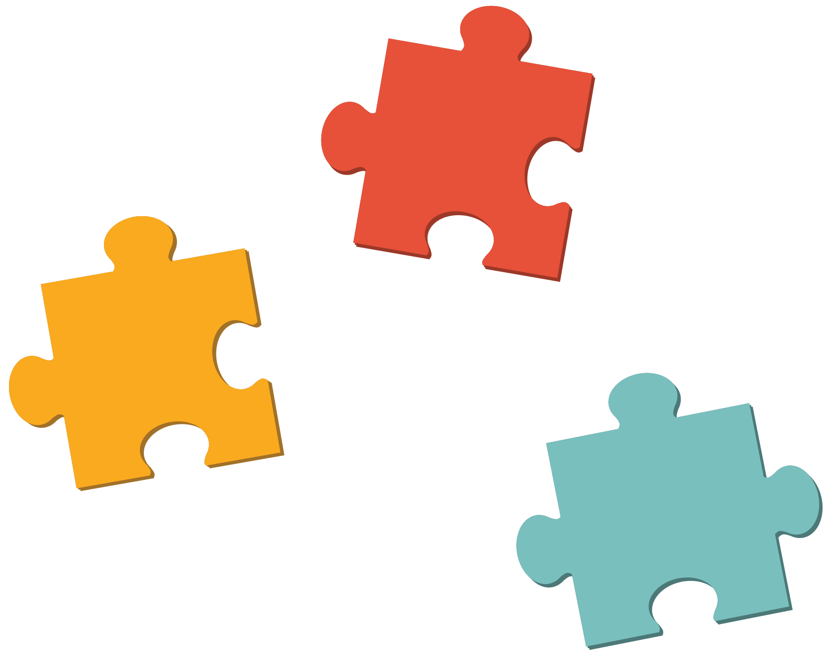

expected performance at the outset. One of BCDC's partners put it this way: "This doesn't make sense to me. I'm taking a $60,000 annual cut in pay without much else changing. Plus, aren't I really funding the new partners' buy-in with my compensation? Why can't they borrow the money they need at a bank?"

INTERNAL PRICING OF CPA FIRM EQUITY

Three common approaches are used to price an accounting firm's intangible equity. One is the equity method, which is what BCDC used in the example above. Another is the multiple-of-compensation (or compensation) method. A third is the aforementioned AAV method, which might be considered a variation on the equity method because it also relies on revenue as a valuation metric.

An example of the compensation method is total retirement payments calculated as three times average historical compensation paid over 10 years. The 2012 PCPS Succession Survey found that about twice as many respondents use the equity method compared with the compensation method.

We have found that the larger the firm, the more likely it will use the compensation method (see "Compensation Method for BCDC New Partners").

Compensation method for BCDC new partners

Total capital	$1 million
Cost of 10% stake	$100,000
Annual investment (4 years)	$25,000
Annual compensation	$150,000
Valuation multiple	3X
Total potential intangible value	$450,000
Total potential value	$550,000

A common problem firms using the equity method encounter is balancing equity owned by individual partners over time. Smaller firms tend to start off with a small ownership stake for new partners compared with senior partners, often set at a level to make the initial investment manageable. These firms tend to change the equity allocations only in conjunction with a buyout of another partner. For example, if a partner who owns 20% of the equity retires, the remaining partners would accumulate more equity pro rata based on what they own prior to the retirement. A partner who started off with 5% ownership would see hardly any increase, at least compared with a partner who already had a significantly larger stake. As a result, we often run into situations where an owner who has outlasted several buyouts owns a vastly disproportionate amount of the firms' equity. Even if firms try to address this issue proactively, the partners who would be giving up equity don't want to do it for free, while the partners who need to acquire more ownership resent having to buy something they might have spent several years building through sweat equity.

A prevailing perspective is that a firm's true value is created through the collective efforts of its key people, who are usually its owners. This is especially evident in a small firm where client relationships can depend a great deal on specific owners. If there is a sufficient connection between what owners are paid in compensation and their performance relative to other partners, then the value of the firm is fairly allocated if it is based on relative compensation. That is a key benefit of using the compensation method compared with the equity method.

THE AAV METHOD

The AAV method also is sometimes referred to as the revenue units approach (see "AAV Method for BCDC New Partners"). In this method, the intangible value/price is expressed in units that are usually tied to revenue. In this hypothetical, BCDC would recognize 3.8 million revenue units. If the firm prices its intangible equity at one times ▶

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revenue, each unit would be worth $1. Partners are bought out based on the number of revenue units allocated to them. As the firm's revenue rises or falls, new units are created or units are reduced. Each partner is allocated a share of the overall units and a share of any new units created.

In BCDC's case, the existing partners would likely be allocated all of the revenue units existing when the new partners are admitted. The new partners' investment, therefore, could be limited only to their capital contribution, a much more manageable obligation. This allows the new partners to participate in the firm's growth without immediately having to "buy" any of the equity previously built up. Further, as the new partners participate in growing the firm, their sweat equity would be recognized as they accumulate a portion of newly created revenue units. New units might be allocated equally to all partners or based on performance criteria or relative compensation.

In some cases, new partners might receive a disproportionate share of new units as a method of motivating them to accept the plan and increase their ownership share. As all partners participate in the firm's retirement buyouts of senior partners, the revenue units reacquired should substantially increase the allocation of intangible equity to younger partners. The retired partners' units can also be allocated disproportionately as a tool to increase minority partners' AAV shares.

An advantage of the revenue unit approach is that it automatically adjusts much of the firm's equity pricing over time. We have found that some firms are willing to cap the allocation of any new revenue units to senior partners to avoid a disproportionate accumulation of equity. Changing ownership of *capital* can be done at face value, either through cash infusions or retaining compensation, and usually requires only a reasonable level of additional investment.

AAV method for BCDC new partners

Total capital	$1 million
Firm volume	$3.8 million
Revenue units	3.8 million
Revenue units allocated to new partner	50,000
Cost of 10% stake	$100,000
Annual investment (four years)	$25,000

THE IMPORTANCE OF VESTING

The 2012 PCPS Succession Survey found that one-third of firms that use vesting in their owners' agreements require less than 10 years to fully vest in retirement benefits, 28% (singularly the most popular choice) require 10 years, 16% require between 10 and 20 years, and 23% require 20 years or more. The same survey found that roughly 29% of firms with minimum age requirements for retirement allow full benefits at ages 55–59, 35% set the minimum at ages 60–64, and 28% set it at 65 or older.

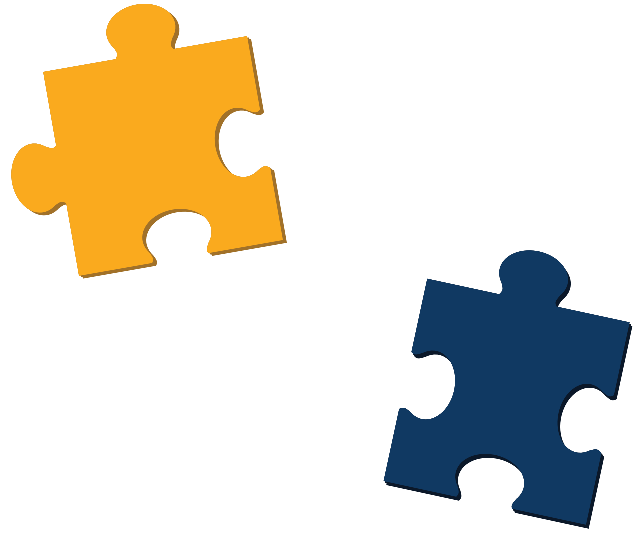
A firm's long-term viability depends on its ability to create future generations of owners to buy out retiring owners. If the younger owners accumulate too much value too quickly, they might be motivated to cut short their careers at the firm, undermining the long-term plan. Going back to BCDC's predicament, if the newly admitted partners were to make the full investment that Julie proposed, it would only be fair to consider them fully vested in the value they had paid cash for. As a result, BCDC would lose its ability to tie its long-term succession business plan into its owners' agreement because it would not necessarily be promoting a long-term commitment from the succession team.

With long-term vesting in place, one of the obstacles to more aggressively allocating equity to new partners is also diminished. The firm enjoys much more flexibility if it knows a younger partner can't cash in his or her chips until the older partners are already in buyout mode. It is imperative to use vesting when the compensation method is employed and usually recommended in the case of the AAV method even though the concept is essentially built in.

THE CASE FOR MANDATORY RETIREMENT AGES

We have found that new partners are increasingly concerned about the timing of senior partner retirements. Owners' agreements without a mandatory maximum age result in too much uncertainty. Senior partners can't plan for when replacement partners need to be in place. Younger partners can't assess how lucrative the opportunity the firm is offering really is.

Most CPAs with client bases made up of privately held businesses work with many that are family-owned. Chances are you have seen situations where the second generation became disenchanted with the prospect of ever taking over and left before the founding generation, causing the succession plan to fall apart. Invariably, this leads to the demise



or sale of the company. A similar outcome may result in a firm with senior partners hanging on past a reasonable age. The 2012 PCPS Succession Survey found that 54% of firms that had a mandatory retirement age in their agreement used age 65, while 15% of the respondents used ages 66–69 and 14% used age 70.

Keep in mind that in most situations mandatory retirement refers to the time at which an owner is required to be bought out and relinquish ownership. It is common for firms to allow "retired" owners to continue working part time. Young partner candidates have this issue in mind as they look forward to the career opportunity a firm presents.

BCDC'S SOLUTION

Admitting new partners is an investment in a firm's future and essential to remaining independent. Unless a firm is in a hyper-growth mode, increasing compensation for new partners likely means decreasing compensation for existing partners. Hopefully, that adjustment is short-lived as new partners spur accelerated growth in the firm. The key is to find a compromise between requiring "skin in the game" for the new partners and providing a lucrative opportunity for them while not giving away the store.

BCDC realized its approach to partner admission was unworkable. The firm adopted the AAV method and even went so far as to allocate 50,000 revenue units to each of the new partners in recognition of their past practice development efforts and as a "signing bonus." The senior partners determined that if the new partners couldn't create enough growth to justify a $30,000 bump in compensation, they weren't truly partner material. The new partners happily agreed to a capital contribution of $100,000 paid over four years as they were guaranteed at least enough additional compensation to fund that investment. ■

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