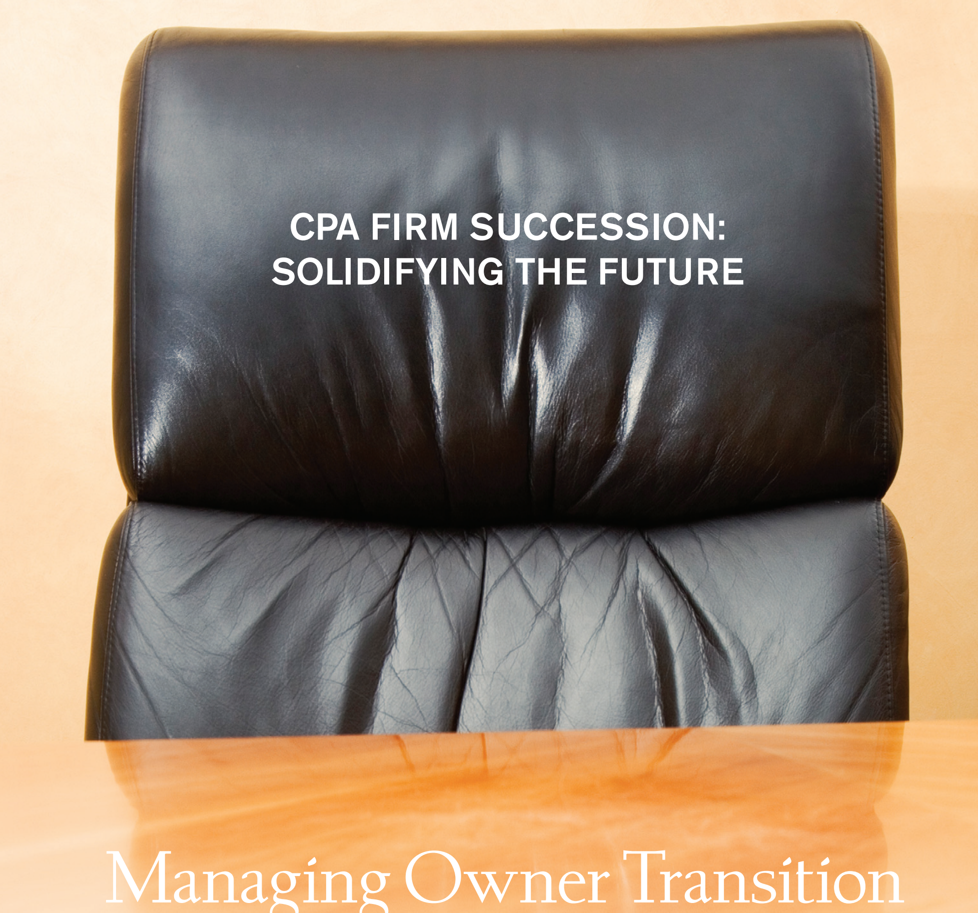
CPA FIRM SUCCESSION: SOLIDIFYING THE FUTURE



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Managing Owner Transition Through an Owners' Agreement

This pact can play a key role in establishing a framework for a successful succession deal.

by Joel Sinkin and Terrence Putney, CPA

> ### About the Series
> Powerful forces are transforming the accounting profession in the United States. The Baby Boomers are heading into their retirement years. Baby Boomer CPAs are in charge of most U.S. accounting firms, and most of those firms don't have a signed succession plan or practice-continuation agreement in place.
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> The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month's installment, the ninth in the series, examines how the owners' agreement can impact succession plans.

For accounting firms dealing with partner succession, the owners' agreement can be one of the most important tools for (1) managing the transition of ownership and (2) establishing a culture for owner performance. Managing the transition of ownership is usually the reason a firm drafts an agreement in the first place. Often, establishing a culture for owner performance is an accidental outcome of how the agreement was structured, and unintended consequences can result if care isn't taken to understand this.

Valuation Methodology

The 2012 PCPS Succession Survey, a joint project of the AICPA Private Companies Practice Section (PCPS) and Succession Institute LLC, identified three primary methods for determining the value of an owner's interest in a firm: (1) a multiple of revenue for an owner's managed book of business; (2) a multiple of revenue for the firm as a whole allocated based on ownership; or (3) a multiple of historical compensation. The survey found that of the responding firms that have an agreement to retire owners' interests, 75% use one of those methods.

Experience shows that as accounting firms grow, they tend to migrate from the book-of-business method to the equity-ownership method. The largest firms have the greatest tendency to use the compensation method, although smaller firms are increasingly considering this approach as well. All three methods affect a firm's culture.

Whereas the book-of-business method can be a fantastic motivator to building up a client base in a newly formed firm, it tends to create a silo mentality, which is the antithesis of the "one firm" concept. Over time, emphasizing books of business as the only true measure of value creation can get in the way of a firm's realizing its potential.

The equity method has the advantage of being more team-oriented and encouraging growth of the firm as a whole. It can be a good transition from the book-of-business method. However, it sometimes leads to hoarding equity to the point that equity no longer reflects an owner's true contribution to value creation. Imbalanced equity can cause the breakup of a firm or the need for an upstream merger as the other owners resist the cost of buying out a supermajority owner.

One of the ironies of equity in mergers is the parties occasionally place an inordinate amount of emphasis on the allocation of ownership when, for instance, due to the combined firm's use of compensation as a means for determining retirement value and a one-person, one-vote approach to governance, equity should mean very little to an owner. Many larger firms have leveled out the equity allocated to owners to achieve close to complete equality.

The trend in valuations nationally, regardless of methodology, is decreasing multiples. Whereas 10 to 15 years ago, most firms were using one times revenue or three times historical compensation, PCPS survey respondents indicate that roughly half now use less than one times revenue. Firms that use less than three times historical compensation now slightly outnumber those using three times or more (52% vs. 47%).

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Affordability of Retirement Terms

A common concern for younger members of firms is that they won't be able to pay for senior partners' retirements. In a recent merger negotiation, the younger partners of the smaller firm determined that paying for the retirements of the senior partners in the acquiring firm would require reducing their compensation or borrowing externally during the four-year payout their agreement specified. The deal didn't happen as a result.

Increasingly, firms are looking at a modification in retirement terms to motivate younger partners to carry through with the plan for senior owner transition. Experience shows that developing affordable terms for retirement requires meeting this simple test: A retired partner's compensation less the sum of the annual payment obligation (including the payout of capital) and the cost of replacing that partner has to leave enough upside in cash flow to motivate the remaining partners to want to take on the obligation. If the terms don't meet that requirement, consider restructuring them. Five-year payouts for retirement payments are often hard to accommodate in this type of analysis unless the overall obligation is small. This is why the trend in the profession is to longer payout periods, often between eight and 15 years, with 10 years as a frequent choice.

The possibility that several owners will retire in a short period of time is also likely in many firms due to the concentration of ownership within the Baby Boomer generation. Establishing a cap on the amount of total retirement payments the firm is required to make helps ensure that the firm maintains a reasonable obligation. These caps are usually set at between 6% and 10% of revenues or up to 20% of profits. Larger firms tend to have a smaller percentage as their cap than smaller firms.

Attracting the Next Generation

Owners' agreements can significantly affect a firm's ability to attract and retain young partner candidates. Obviously, the cost for a new owner to buy into the firm can be an impediment. So can the lack of a mandatory retirement age in the agreement.

Setting the terms for buying in is usually a compromise among (1) making sure the new owner has "skin in the game"; (2) not giving away value that has been built up by senior owners over many years; and (3) an investment requirement that makes economic sense and creates an upside compensation opportunity for the new owner. The authors have seen few successful arrangements whereby a new owner obtains a 20% ownership stake in a firm and pays a proportionate amount of a valuation based on one times revenue plus a pro rata capital contribution, although those are terms a firm's senior owners might expect in an external sale.

A more effective approach is to limit the initial investment to as little as a pro rata capital contribution and then control the accumulation of intangible value through a number of approaches. The true accumulation of value for most new owners

EXECUTIVE SUMMARY

- **The owners' agreement can play a significant role in two main areas affecting partner succession:** (1) managing the transition of ownership and (2) establishing a culture for partner performance.
- **The trend in accounting firm valuations,** regardless of the methodology used, is one of decreasing multiples.
- **More firms are looking to modify retirement terms to make the deals affordable for younger partners.** Among the trends in this space is the lengthening of payout periods from five years to anywhere from eight to 15 years, with 10 years as a common choice. Firms are also establishing annual caps on the total amount of retirement payments.
- **The lack of a mandatory retirement age in the owners' agreement** can deter young partner candidates. While many older partners want to work indefinitely to maximize income, potential new owners seek certainty as to when they will be able to buy a partnership position.

__Joel Sinkin__ (jsinkin@transitionadvisors.com) is president, and __Terrence Putney__ (tputney@transitionadvisors.com) is CEO, both of Transition Advisors LLC in New York City.

To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

comes through the additional income they receive after buying out senior partners and moving into ownership themselves. Another tactic, especially in the case of plans that use compensation as the valuation metric, is long-term vesting, which ties value accumulation to the long-term successful transition of owners. The authors are seeing vesting periods for newly admitted owners of at least 10 years and as long as 20 years. Vesting retirement benefits often help ensure that the younger owners stay through the payout of the senior owners' retirement.

The debate about mandatory retirement ages in owners' agreements is raging in the profession. Many Baby Boomers aren't ready to walk away from the lucrative compensation they have recently experienced as senior owners. Plus, the new age 65 seems to be 72 or even older as life spans continue to increase. There is pressure from senior owners to extend mandatory retirement ages or to scrap them altogether. Keep this in mind: The lack of a mandatory retirement age leaves the firm totally in the dark with respect to ensuring an adequate number of successors will be available to take over for retiring owners when they are needed.

With the current severe competition for young CPAs who are viable candidates for owner status, don't assume that the best people are going to hang around with no idea of when you'll be ready to give them an opportunity. You may wake up one day having maximized your earning years with no one there to take the reins from you.

The Transition Plan

The value of an accounting firm is not innate. It is usually directly related to the firm's ability to transition the key duties from an owner to another person, usually a new owner. Especially in smaller firms, the most important duties of the retiring owner that need to be addressed are client relationships. Therefore, a key component for many owners' agreements should be motivating an effective transition of client relationships.

Many owners' agreements tie retirement payments to post-retirement client retention in a similar fashion to what would be expected in an external deal. Although this approach has the advantage of protecting the firm from a financial obligation that is not supported by ongoing revenues, it can have the opposite effect of what was intended. The fear of losing clients sometimes motivates an owner approaching retirement to hold onto relationships for as long as possible because "no one can replace me." A better approach is to require adequate notice be given for an owner who wants to retire coupled with a clear plan for transition of client management responsibilities. Usually, it takes at least a two-year notice to provide enough time for clients to become familiar—and comfortable—with a successor. If the new relationship doesn't stick, the firm has time to assign a new successor. ❖

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