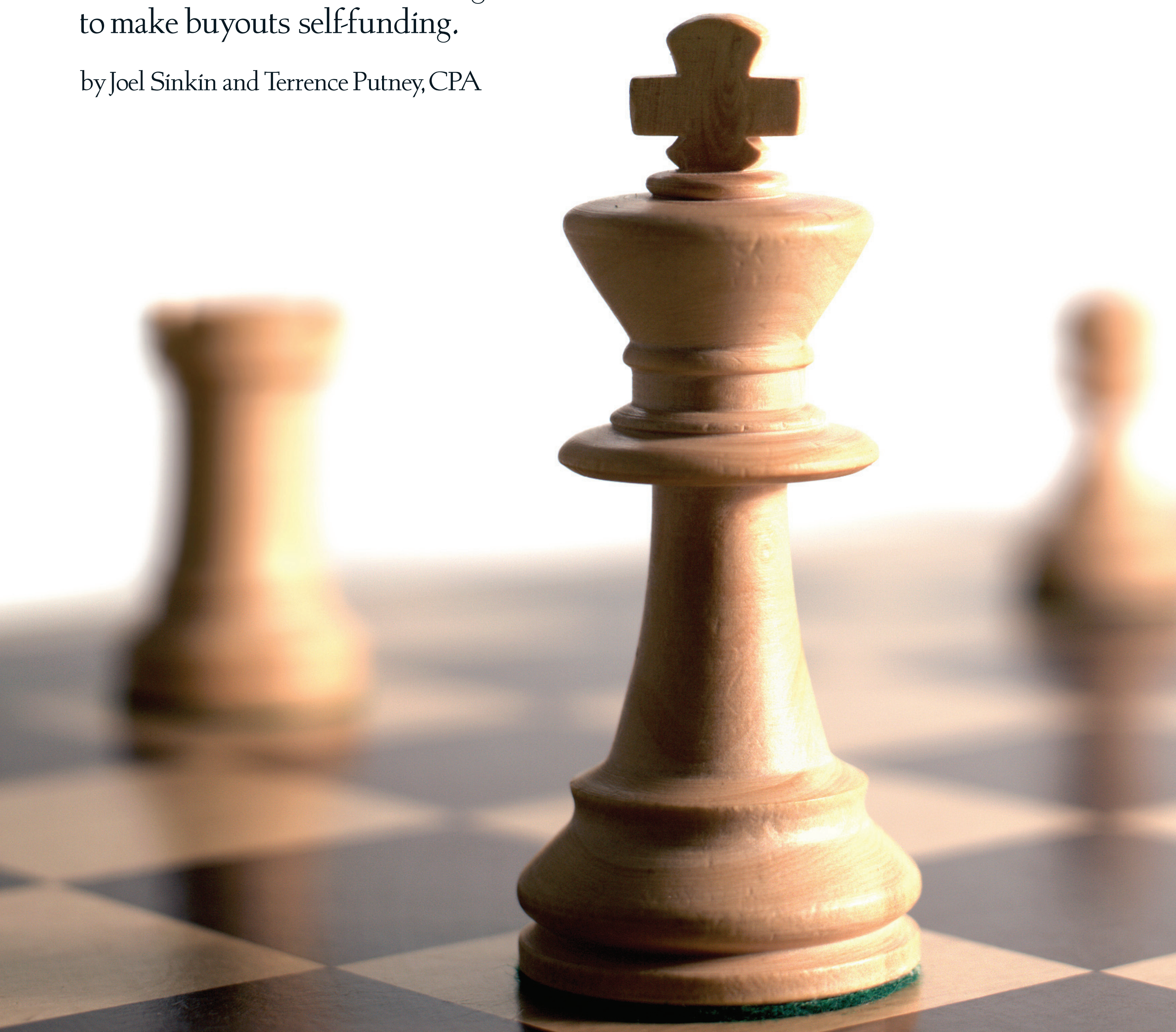
Planning and Paying for Partner Retirements

Structure internal succession agreements to make buyouts self-funding.

by Joel Sinkin and Terrence Putney, CPA



John was one of three founding partners in a firm formed 35 years ago. He oversaw the buyout of the other two founding partners and, as managing partner, groomed three young managers as his successors. However, when the time came for these managers to be admitted as partners, two of them declined, citing their reluctance to take on John's buyout.

What went wrong? The terms of the partnership agreement would have required the firm's new partners to either infuse capital into the firm or take a significant reduction in compensation over the next five years to fund John's buyout. Both managers felt they could find a better opportunity at another firm. John and his remaining partner were forced to find another firm to merge into, and John's retirement payments ended up being a lot lower than he had planned. How could John and the firm have avoided this result?

Assessing an Internal Buyout Plan's Financial Viability

External and internal sales of accounting firms have significant differences (see sidebar, "External vs. Internal Transactions"). The most important objective in structuring an internal buyout or retirement plan is to make it self-funding. This goal is the reason some firms are moving toward partially prefunded plans. However, the overwhelming tendency remains not to prefund owner retirement. The AICPA's *2008 PCPS Succession Survey* found that 79% of firms did not fund owner retirement and that another 7% funded 20% or less of the retirement.

The primary capital a firm has available for funding buyouts and retirements is the departing owner's foregone compensation. Compensation has to be used for three things for the plan to be considered self-funding. Those are:

- Replacing the retired owner;
- Paying for the buyout/retirement; and
- Creating some upside for the remaining owners to motivate them to take on the obligations created by the buyout.

A failure to meet all three objectives can lead to: (1) loss of business, (2) the necessity to infuse capital from external sources such as borrowed funds or contributed capital, and (3) the remaining owners'

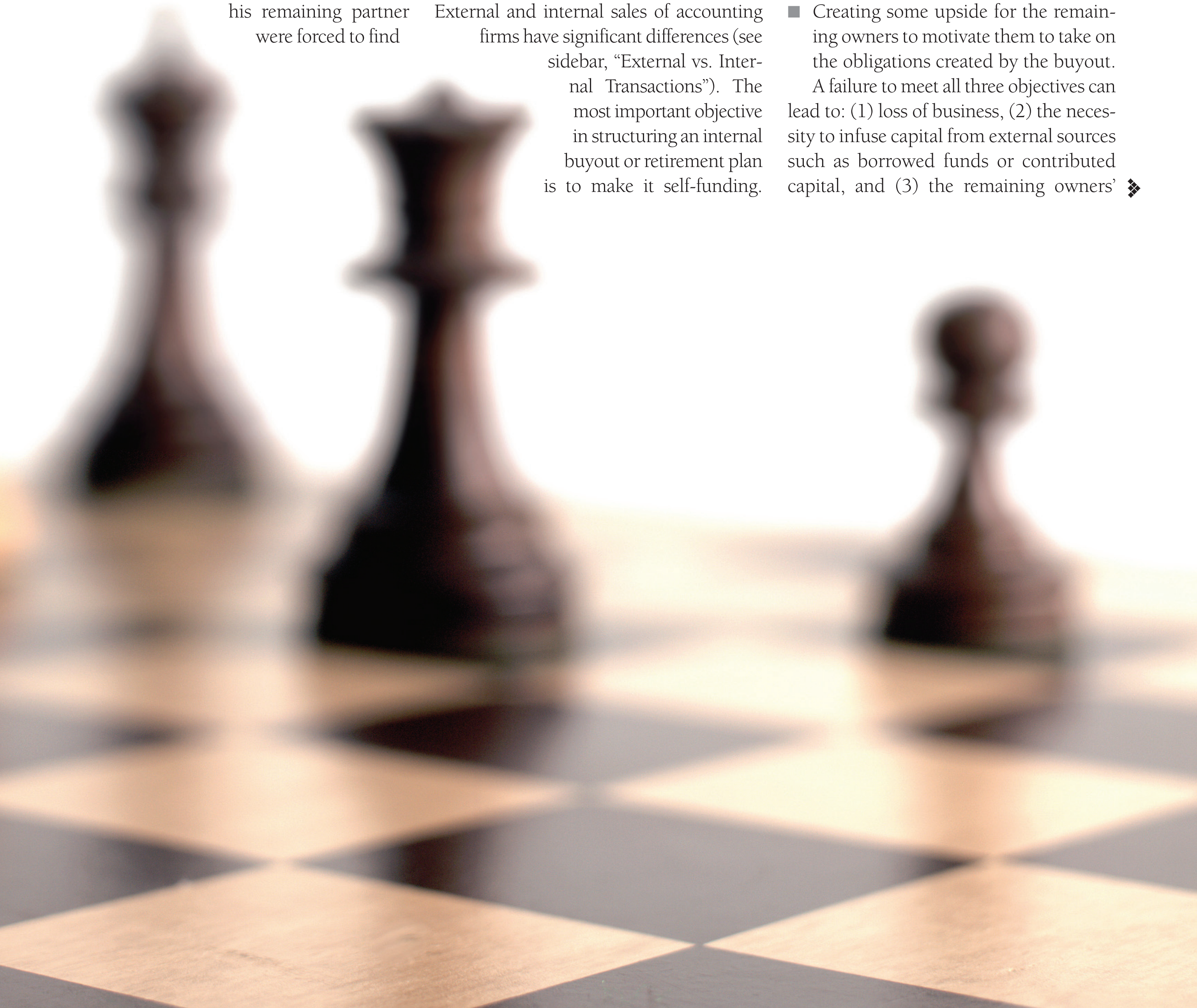


Exhibit 1 5-Year Payout at 100%; Capital Fully Paid in Year 1

	Year 1	Years 2–5
Available funds	$ 270,000	$270,000
Payout of capital account	(175,000)	N/A
Retirement payments	(180,000)	(180,000)
Replacement resources	(140,000)	(140,000)
Annual shortfall	$(225,000)	$ (50,000)

Exhibit 2 10-Year Payout at 80%; Capital Paid Over Five Years

	Year 1	Years 2–5	Years 6–10
Available funds	$270,000	$270,000	$270,000
Payout of capital account	(35,000)	(35,000)	N/A
Retirement payments	(72,000)	(72,000)	(72,000)
Replacement resources	(140,000)	(140,000)	(140,000)
Annual surplus	$ 23,000	$ 23,000	$ 58,000

Exhibit 3 10-Year Payout; Capital Paid Over Five Years at Prime Rate

	Years 1–5	Years 6–10
Available funds	$350,000	$350,000
Payout of capital account	(45,000)	N/A
Retirement payments	(96,250)	(96,250)
Replacement resources	(140,000)	(140,000)
Annual surplus	$ 68,750	$113,750

working harder for no additional, or even decreasing, compensation. Even the perception that this might be the outcome of a buyout plan can sink the deal if the owners who would be required to take on the obligation decide their future prospects are not desirable.

The expectation that the firm's owner retirement plan is not viable is the biggest reason we see that firms seek third-party sales and mergers—to avoid taking on internal buyout obligations. This concept can be demonstrated by two case studies.

Case Study 1

Firm A has five owners. One owner is retiring in two years. She earns $270,000 per year and owns 30% of the $3 million firm. Her retirement is based on her ownership percentage multiplied by the firm's annual fees billed for the 12 months preceding her retirement, which would be $900,000 (or 30% of $3 million). This total is to be paid over five years without interest, a total of $180,000 per year. In addition, she would be paid the full amount of her accrual-basis capital account, which is $175,000 at the date of her retirement. This owner generates 1,400 billable hours per year at an average billing rate of $250 per hour.

The firm's remaining owners believe they would be able to assume her duties for managing client relationships as well as other key duties. However, to replace her productive capacity ($350,000 of billable

EXECUTIVE SUMMARY

■ **The vast majority of CPA firms do not prefund partner retirement plans,** resulting in internal successor partners' bearing the responsibility for funding retirement from the firm's future cash flow.

■ **When structuring a retirement strategy or internal buyout, the No. 1 goal is to ensure the plan is self-funding.** A self-funding plan must replace the retired owner, pay for the buyout/retirement and produce benefits for the remaining partners so they are motivated to do the deal.

■ **Buyout or retirement plans that aren't self-funding can result** in loss of business, the need to pump capital into the firm and the remaining partners' having to work harder for the same or declining compensation. Even the threat of that happening can kill an internal buyout or retirement plan.

■ **The main source for funding buyout or retirement plans** is the compensation the firm no longer has to pay the departing partner.

■ **Strategies to make a plan self-funding include** reducing the revenue multiple used to determine the buyout price and increasing the number of years over which retirement and capital account payments are made.

■ **Firms facing the retirement of multiple partners can institute a cap on the amount of payments that can be made to all owners.** This helps keep the firm financially viable if there is a drop in profits. The cap usually is a percentage of revenues ranging from 3% to 20%, and payments to the retired partners generally are deferred until the firm has the funds available.

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External vs. Internal Transactions

Many firms, when setting terms in a buy-sell or partnership agreement, refer to what they believe they could obtain if a third party bought the firm. However, some significant differences between the two types of transactions should be considered. These include:

- An external sale often emerges from a bidding process that may include several potential buyers; an internal succession involves one potential buyer and no negotiation at the closing of the transaction, if it is governed by a pre-existing agreement.
- An internal "sale" usually is, in effect, a put option granted to the seller. The firm or its owners are contractually obligated to make the acquisition. Therefore, it is justifiable that there be a cost for the right to "put" the interest, which is often reflected as a discount in the pricing of the firm or a variance in the terms compared with an external deal. For example, given the choice between (1) looking for a buyer for an equity position with no certainty of what would be available in the market or (2) having the opportunity to exercise an option to sell at a predetermined price to a buyer compelled to make the purchase, most sellers would elect the latter. A buyer would likely expect to pay less and on different terms in exchange for assuming that obligation.
- The package of terms for an internal deal often are dramatically different from those for a third-party sale. For instance, it is rare that the terms for a pure acquisition include (1) setting the price at closing and (2) a payment period of 10 or more years. It is common for those terms to be the basis for an internal transaction.
- Clients and staff are not being asked to change firms in an internal transition as they are in a third-party sale and, therefore, there is a higher probability of retention in an internal transition.
- In firms that have unbalanced ownership, a retiring owner can sometimes have a disproportionate stake in the firm. Sometimes, that ownership does not reflect the value that has been created by the remaining owners who will be responsible for the buyout. For example, Sue owns 60% of the equity in her four-partner firm. She is in that position because she is the longest-serving partner, and equity for retired partners always was redistributed pro rata to existing equity holdings. The reality is that Sue manages less than 25% of the firm's business, and her compensation is less than 25% of overall partner compensation. Paying her for her equity based on 60% of the firm's overall value, as defined by the terms of the agreement, may be unrealistic for the other partners.

As a result of the above factors, the normal range of multiples is often lower in internal buyouts and retirements than in third-party sales. In the work we do with accounting firms nationally, we routinely see pricing for internal purposes of between 50% and 100% of revenues for equity-based plans and between two times and three times annual compensation for plans based on owner compensation. The trend, based on our work with hundreds of firms, is a decrease in pricing multiples as firms prepare themselves for an unprecedented increase in baby boomer retirements. (This mirrors the downward trend in external transactions, where pricing can vary widely based on the market, firm size, client mix and other factors.)

Ten years ago, internal pricing of less than 100% of revenues or three times compensation was much less common. According to the AICPA's *2008 PCPS Succession Survey*, 42% of firms using a revenue multiplier for internal valuations used 100% as the metric, and 7% used a higher multiplier. About 38% of firms using a compensation multiplier used three times annual compensation, and 8% used a higher multiplier.

time), the firm would have to hire additional personnel at an annual cost of $140,000 including benefits.

Using the $270,000 of compensation as the available funds, there would be $130,000 of cash flow remaining after the cost of replacement resources. The additional capital the firm would have to invest in the first year to make this plan work is $225,000 (including $175,000 to pay out the capital account) and $50,000 per year for the next four years (see Exhibit 1).

Because the funds available from the retired owner's foregone compensation are inadequate to cover the required payments, the plan is not self-funding and may not be viable as a result.

To make the plan self-funding, this firm should consider:

- Reducing the valuation multiple of trailing revenues from 100% to a lower multiple (see sidebar, "The Premise of Worth in an Accounting Firm");
- Extending the payment period for the retirement payments to more than five years; or
- Stretching the payment period for the capital account.

If the multiple for retirement payments were decreased to 80% from 100%, the payout period for the retirement payments were increased to 10 years from five years, and the capital account were paid over five years instead of one year, the cash flow for the firm would be as shown in Exhibit 2. This approach is self-funding and, as a result, more viable.

Case Study 2

Firm B has six owners. The firm pays retirement over 10 years based on 2.75 times the average of the past five years' compensation, eliminating the low and high of those years. Capital is paid out over five years with interest at *The Wall Street Journal* prime rate (as of this writing, 3.25%). One owner is retiring in two years. His average compensation for calculation of retirement is $350,000, and his capital account is $210,000. Based on his productivity, the firm believes it can replace him for about $140,000 per year.

The annual payments to him for the "intangible value" (see sidebar, "The Premise of Worth in an Accounting Firm") portion of the buyout would be $96,250 per year for 10 years, and the payout of his capital would be approximately $45,000 per year for five years. The cash flow for this plan would be as shown in Exhibit 3.

The plan is self-funding for all the years of the payout because the retiring partner's foregone compensation covers all of the firm's obligations.

Another key element that assists in making an agreement financially viable is instituting a cap on the amount of payments that can be made to all retiring owners at one time. The cap is often expressed as a percentage of revenues, although profit before owner compensation is also used. In large firms, this number can be as low as 3% of revenues; in smaller firms, this number can grow to as high as 20%. The usual rate is 6% to 8%.

The purpose of this provision is to ensure that the firm remains a viable debtor in the event of a decrease in profits. Usually, any retirement payments prevented by the cap are not relinquished permanently but rather deferred to a later period, when the threshold is not exceeded. This kind of protection is mutually beneficial for the firm and its retired owners. Firms that are burdened with more retirement debt than the current owners can handle might be unable to retain the owners necessary to keep the firm healthy enough to satisfy those debts.

Conclusion

There is much more to managing succession for an accounting firm's owners than just the buyout's financial terms. Certainly, developing a strong team of professionals who can replace retiring owners is paramount and is an area in which many firms fall short. A financial plan that creates a reasonable obligation for the firm and its remaining owners is key to ensuring long-term stability. Owner agreements governing retirement and other forms of buyout payments

The Premise of Worth in an Accounting Firm

Generally, net assets in accounting firms have two components: tangible and intangible. Net tangible assets comprise the assets less the liabilities on an accrual-basis balance sheet. Those assets consist primarily of cash and investments, billed and unbilled receivables, and fixed assets. There may be valuation allowances that warrant consideration, especially for the receivables. However, it normally is not difficult to arrive at net tangible assets.

Issues usually arise with intangible assets. Intangible assets comprise what is often referred to as "blue sky," which includes goodwill, workforce in place, and brand names, as well as, potentially, other intangible items. It is not unusual for intangible assets to be two to five times the value of tangible assets. Blue sky is based on the future earnings capability of the business. In most accounting firms, the biggest factor affecting future earnings is retention of clients and staff following a change in control, whether that is due to an owner's retirement or a sale.

Effect of Tax Treatment and Interest on Deferred Payments in Buyout Terms

Assume the benchmark for a pricing multiple in a firm sale is one times revenues and the payments are tax neutral to the buyer, meaning they can be deducted as paid. If the total obligation is $1 million and the payments are made over 10 years, the firm would pay a retired owner $100,000 per year. However, if the firm is required to pay 6% annual interest on the deferred payments, the total obligation increases to $1,332,246 (assuming monthly payments). This is, in effect, a 1.3 times multiple, which is very high for any transaction, let alone an internal one. If interest is calculated on deferred payments, it is normally advisable to reduce the multiple of revenues or compensation to take into account the full cost of the buyout.

Retirement payments usually are deductible by the firm as compensation, and they are taxed as ordinary income to the retiring partner. However, there is an increasing trend in the profession to treat at least a portion of buyout payments to retired partners as for the acquisition of goodwill or another asset amortizable for tax purposes under Sec. 197. This allows the retiring partner to treat the portion of the payment that is attributable to the goodwill buyout as capital gain, taxable at lower rates than ordinary income. But this treatment means that the firm cannot deduct that portion of the payments immediately; instead, it must be amortized over 15 years under Sec. 197. This increases the cost of the buyout to the firm. For this reason, the most common approach remains treating internal buyouts as retirement payments or, for firms that wish to find a more desirable tax treatment for retired owners, stretching the payout period to 10 years or longer so the payments can be treated in a manner that gives the retired owner capital gains treatment without creating an unacceptable cost to the firm.

are more likely to successfully manage a firm's ownership transition if they:

- Promote an orderly transition of an owner's responsibilities to successors within the firm;
- Motivate the successors within the firm to assume those responsibilities by creating upside for those successors (see sidebar, "Notice Required for Retirement"); and
- Provide for and protect the firm's long-term health and viability by allowing the firm to manage the buyout obligations internally, using the funds already available through the firm's operations. ❖

Notice Required for Retirement

Most agreements allow an owner to retire from the firm in a range of ages with full benefits or to leave at any time as long as adequate notice is given. It is recommended that partner agreements require an owner to provide as much as two years' notice of an intention to retire or otherwise leave to receive full benefits. This usually leaves enough time to plan and execute an orderly transition of duties and key relationships.

In the event adequate notice is not given, the preferable consequence is to subject the buyout payments to adjustment for the firm's loss of business during the two years following the owner's exit under the premise such diminishment of value was due to the lack of time to adequately transition the retiring partner's duties and relationships.

Example. A partner leaves the firm without giving the notice the partnership agreement requires. During the subsequent two years, the firm loses 10% of its business. The partnership agreement could require a 10% reduction in that partner's buyout payments. The agreement could require measuring the "lost business" on a firmwide basis or restrict the measurement to the portion of the business the departing partner was responsible for managing.

AICPA RESOURCES

JofA articles

- "Traps for the Unwary in CPA Firm Mergers and Acquisitions," Aug. 2011, page 36
- "Accounting Firm M&As: A Market Update," Nov. 2010, page 30
- "Mergers & Acquisitions of CPA Firms," March 2009, page 58, and "Keeping It Together," April 2009, page 24 (two-part article)

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