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

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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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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. ❖