Admitting New Partners

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Transition Advisors
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Transition Advisors, LLC has several free CPE courses remaining this year

**Upcoming Webinars:**

October 27 - Succession Planning and Valuing Your Firm

November 10 - Preparing Your Firm for an Upstream Merger

November 10 - 2016 Roadmap to Succession Planning for Firms in the Southeastern U.S.

December 15 - The Urge to Merge: How, When, Why and With Whom

Visit transitionadvisors.com/upcoming-courses.php for more information.
Transition Advisors

National Consulting Firm working exclusively with accounting firms on issues related to ownership transition
Polling Question

How many equity partners do you have in your firm?

1) 1
2) 2 to 4
3) 5 to 9
4) 10 to 19
5) 20+
Today’s Agenda

1. Valuing equity in your firm
2. Basic financial terms for owner agreements
3. Techniques for admitting new partners
4. Alternative approaches
Total Value

• Tangible pool of equity
  – Accrual basis book value
  – Receivables, WIP, other assets, less liabilities

• Intangible pool of equity
  – Client list is the predominant asset
  – Also workforce, brand, etc.
Valuing Intangible Equity

Methods for Valuing Intangible Equity

- Book of business
- Equity multiple
- Compensation multiple
- AAV/unit method
- Other
Valuation Methods-Intangibles

Valuation methodology-for those w agreement* 2-4 ptnr firms

• 28% use a multiple of equity
• 9% use managed book of business
• 30% use a multiple of compensation
• 18% use AAV method
• 15% use something else

*2016 Rosenberg Survey
Valuation Methods - Intangibles

Valuation methodology-for those w agreement* 13+ ptnr firms
• 8% use a multiple of equity
• 3% use managed book of business
• 58% use a multiple of compensation
• 17% use AAV method
• 14% use something else

*2016 Rosenberg Survey

Leading CPAs Through Transition With Succession and M & A Strategies
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### Valuation Benchmarks-Intangibles

**Average intangible value to revenue**

<table>
<thead>
<tr>
<th>Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;100%</td>
<td>8%</td>
</tr>
<tr>
<td>100%</td>
<td>22%</td>
</tr>
<tr>
<td>90%-99%</td>
<td>8%</td>
</tr>
<tr>
<td>75-89%</td>
<td>25%</td>
</tr>
<tr>
<td>50-74%</td>
<td>22%</td>
</tr>
<tr>
<td>&lt;50%</td>
<td>15%</td>
</tr>
</tbody>
</table>

*Combined effective rate for all valuation tactics*

*2016 Rosenberg Survey*
## Total Valuation-Example

*Equity method*

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Revenue multiplier</td>
<td>85%</td>
</tr>
<tr>
<td>Intangible value</td>
<td>$2,550,000</td>
</tr>
<tr>
<td>Accrual basis book value</td>
<td>$600,000</td>
</tr>
<tr>
<td>Total value</td>
<td>$3,150,000</td>
</tr>
<tr>
<td>Equity %</td>
<td>30%</td>
</tr>
<tr>
<td>Owner’s value</td>
<td>$945,000</td>
</tr>
</tbody>
</table>
Total Valuation-Example

Compensation method
Compensation* $300,000
Comp multiplier X2.5
Intangible value $750,000
Accrual book value-total $600,000
Equity % 30%
Tangible allocation $180,000
Total owner’s value $930,000

*often annual average of 3 highest of past 5 years
Basic Financial Terms

*Other than the valuation multiple*

- Term for payment of
  - Intangible equity/retirement
  - Tangible equity/capital
    *Most agreements pay intangible over 8 to 15 years and tangible over 5 up to same as intangible*

- Tax treatment
  *Most treat payments as deductible as paid*
  *Longer payment terms and proper entity type can justify cap gain treatment*

- Interest often not paid on deferred payments
  *6% interest adds 33% to the total payments over 10 years*
Valuation Assessment

• Use external benchmarks as a guide
  – PCPS Survey
  – IPA Benchmarking Report
  – Rosenberg Survey
  – Association surveys

• Internal economics is the true goal
  – Terms of the agreement
  – Cash flow impact on the firm
Polling Question

Does your firm have an owner agreement?
1) Yes, and it is signed by all owners
2) Yes, but not all owners have signed it
3) No, but we need one
4) No, and we aren’t sure we need one
Techniques for New Partner Admission

Traditional approach—*handle like you are selling a portion of the firm*

- Value the firm as a whole
- Select a portion to sell to the new partner
- Allow new partner to pay over time often with compensation adjustments
Example

Firm volume $3,000,000
Valuation multiple 100%
Total capital $600,000
Total value $3,600,000
10% interest $360,000
Five year compensation adjustment $72,000
Techniques for New Partner Admission

Potential issues

• Cost to new partner
• What is the right amount of compensation to allocate to justify—
  – What the new partner invested?
  – What the existing partners were paid?
• How and when do you deal with acquiring more equity?
• When you do sell more equity to them, how do you consider the value they have helped create?
Conundrum

What is fair to the selling or senior partners?

• How do we make this affordable for the new partners without giving away all the value we have created over many years?
• If we are going to increase new partner compensation so they can afford to make the investment, what are we accomplishing?

What is reasonable to expect from the new partners?

• If I am going to make a significant investment, shouldn’t I have a significant return?
• I am not interested in making the same or less money to buy into this firm
Benchmarks-New Partner Buy-ins

Average Capital (Buy-in) for New Partners*

- <$3M: $71,545
- $3M - $10M: $94,408
- $10M - $20M: $105,013
- >$20M: $116,515
- Average all: $102,564

*2015 IPA Benchmarking Report
New Partner Buy-ins

Potential issues

• Cost to new partner
• What is the right amount of compensation to allocate to justify:
  – What the new partner invested?
  – What the existing partners were paid?
• How and when do you deal with acquiring more equity?
• When you do sell more equity to them, how do you consider the value they have helped create?
Polling Question

I believe our approach to valuing our owner’s interest in the firm is
1) Fair and affordable
2) Fair, but I’m not sure we can afford the buyouts
3) Not fair, too rich
4) Not fair, too low
5) N/A, we don’t have an agreement
Are You Ready?

Profitability Metrics-Avg Net Income Per Equity Partner*

- <$3M: $307,600
- $3M - $10M: $385,469
- $10M - $20M: $483,306
- >$20M: $645,375

*2015 IPA Benchmarking Report
Are You Ready?

Revenue Metrics-Revenue Per Equity Partner*

<table>
<thead>
<tr>
<th>Revenue Range</th>
<th>Revenue</th>
</tr>
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<tbody>
<tr>
<td>&lt;$3M</td>
<td>$1,068,979</td>
</tr>
<tr>
<td>$3M - $10M</td>
<td>$1,264,319</td>
</tr>
<tr>
<td>$10M - $20M</td>
<td>$1,668,975</td>
</tr>
<tr>
<td>&gt;$20M</td>
<td>$2,368,440</td>
</tr>
</tbody>
</table>

*2015 IPA Benchmarking Report

[Company Logo]

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Are You Ready?

Leverage Metrics-Professionals Per Equity Partner*

- <$3M: 5.6
- $3M - $10M: 6.5
- $10M - $20M: 8.0
- >$20M: 10.0

*2015 IPA Benchmarking Report
Assess Your Firm’s Succession Readiness

Two Issues to Focus on Regarding Partner Succession

• Need to replace
• Timing
Assess Your Firm’s Succession Readiness

Two ways to replace a partner in your firm

• Role re-allocation

• Role succession
Assess Your Firm’s Succession Readiness

Partner Succession Projection

<table>
<thead>
<tr>
<th>Partner</th>
<th>1-3 yrs</th>
<th>4-7 yrs</th>
<th>&gt;8 yrs</th>
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</thead>
<tbody>
<tr>
<td>A</td>
<td>RR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td>RS</td>
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<td>C</td>
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<td>RS</td>
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<td>D</td>
<td></td>
<td></td>
<td>RR</td>
</tr>
<tr>
<td>E</td>
<td></td>
<td></td>
<td>RS</td>
</tr>
</tbody>
</table>

RR=Role Reallocation  RS=Role Succession
Characteristics of a Partner

- Leadership: Provides guidance and is a role model for other partners and staff
- Client Management: Can manage an expected level of client relationships and has a loyal following of clients
- Personal Productivity: Is productive in producing services to clients
- Growth: Is able to develop new client relationships and expand services
- Firm Management: Participates in the overall management of the firm
- Technical Skills: Has developed technical skills and is known as an expert in an important area of service
- Teamwork: Puts the firm’s interests ahead of their own interests
- Staff Development: Assists in recruiting new talent for the firm and in the development of staff
- Community Involvement: Is the face of the firm in the community
- Professional Involvement: Is involved in the profession
- Passionate: Has unwavering loyalty to the firm; doesn’t see this role as just a job
- Communication Skills: Excels in both written and spoken communication skills
- Personal Investment: Is on a constant journey to improve
Polling Question

Does your firm have adequate talent on the bench to replace retiring partners?
1) Yes, and we are confident our approach works
2) I think so, but we don’t know how to admit them
3) No, we don’t have the talent we need
4) We don’t plan to pursue internal succession
Alternative Technique for New Partner Admission

Two alternative approaches -

• AAV/Unit system
  – Separate the intangible value from the tangible value in your agreement
  – Sell/invest the tangible portion only
AAV/Unit System

Intangible value is expressed in units tied to firm volume

• New partners not required to buy units up-front
• Sometimes awarded small allocation in recognition of prior efforts
• New partners earn unit allocations through
  – Participating in the firm’s growth
  – Participating in buying out retired partners
• Upfront investment limited to tangible value
AAV/Unit System

Example-
Volume $3,000,000
Units 3,000,000
Partner A 1,200,000 units
Partner B 1,000,000 units
Partner C 800,000 units
New partner No units
AAV/Unit System

2 years later
Volume $3,600,000 (600,000 new units)
Partner A 1,350,000 units
Partner B 1,150,000 units
Partner C 950,000 units
New partner 150,000 units
Agreed upon value per unit $.90
AAV/Unit System

3 years later-Partner A retired in beg of year
Partner A was paid $121,500 for 135,000 units
Partner B  1,150,000 + 45,000 units
Partner C  950,000 + 45,000 units
New partner  150,000 + 45,000 units
Vesting Programs

Refers to long term vesting in retirement benefits for new partners

• Works especially well with compensation based systems
• Effectively delays accumulation of value until
  – Senior partners are retired
  – Value has been earned through tenure with firm
• Promotes retention of succession team
• Allows for more flexibility on initial buy-in; no worry giving away accumulated value
Vesting Programs

Example-

• New partner invests in tangible equity portion only-*fully vested*

• Intangible value vests 50% after 10 years as a partner

• Additional vesting of 5% per year for next 10 years
Articles

How To Admit New Partners: A Fresh New Approach
December, 2015
www.transitionadvisors.com/Ownership-Agreements.php

Planning and Paying for Partner Retirement
April, 2012
www.transitionadvisors.com/Ownership-Agreements.php

CPA Firm Succession Series
July, 2013 thru June, 2014
www.transitionadvisors.com/succession-planning.php

CPA Firm Valuation Series
October, 2014 thru December, 2014
For More Information

Visit the AICPA Succession Planning Resource Center
http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/StrategyPlanning /center/Pages/default.aspx
• Gary Adamson, Adamson Advisory
• Bonnie Buol Ruszczyk, bbr marketing
• Sarah Dobek, Inovautus Consulting
• Angie Grissom, The Rainmaker Companies
• Dustin Hostetler, Boomer Consulting
• Rita Keller, Keller Advisors
• Roman Kepczyk, Xcentric
• Tamera Loerzel, ConvergenceCoaching
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