Admitting New Partners

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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+

Recent Example

Jeff Jones and Jimmy Vigliaturo

Jones CPAs Data

- $1M annual fees
- Jeff, sole proprietor, 58 years old
- Jimmy, 44 years old

Jones CPAs Situation

- Jeff wants to retire in about 10 years
- Jimmy has been with firm for about 10 years and appears to have what it takes to replace Jeff
- Need a buy-in plan for Jimmy
- Need a shareholder agreement between them
- Need a buyout plan for Jeff

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

What's Your Firm Worth?

1X?

.75X?

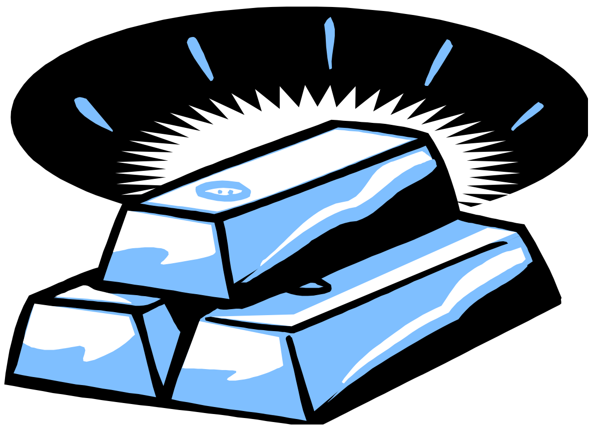
1.2X?

.5X?

1.75x?

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

- 33% use a multiple of equity
- 10% use managed book of business
- 33% use a multiple of compensation
- 15% use AAV method
- 9% use something else

**2017 Rosenberg Survey*

Valuation Methods-Intangibles

Valuation methodology-for those w agreement* 13+ ptnr firms

- 0% use a multiple of equity
- 5% use managed book of business
- 60% use a multiple of compensation
- 24% use AAV method
- 11% use something else

**2017 Rosenberg Survey*

Valuation Benchmarks-Intangibles

Average intangible value to revenue*

>100%	7%
100%	22%
90%-99%	8%
75-89%	28%
50-74%	22%
<50%	13%

Combined effective rate for all valuation tactics

**2017 Rosenberg Survey*

Total Valuation-Example

Equity method	
Revenues	$3,000,000
Revenue multiplier	85%
Intangible value	$2,550,000
Accrual basis book value	$600,000
Total value	$3,150,000
Equity %	30%
Owner's value	$945,000

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

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

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

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*

<$2M	$142,000
$2M - $10M	$173,000
$10M - $20M	$171,000
>$20M	$147,000
Average all	$168,000

2017 Rosenberg Survey

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

Alternative Technique for New Partner Admission

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 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

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

Owner Agreements

Salient Business Terms-

Restrictive Covenants

Governance

Vesting

Transition business plan

Valuation

5 ways to terminate

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

Jones CPAs Solution Concepts

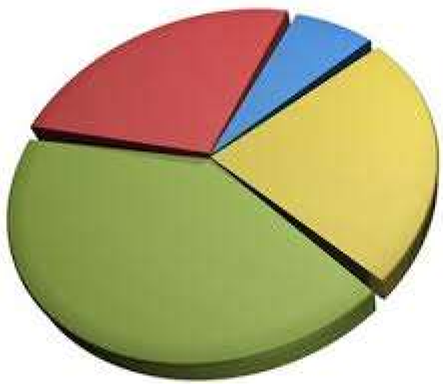
- Intangible value will be based on 1X fees
- Tangible value will be based on accrual basis equity
- Value in three buckets: stock at cash basis, tangible and intangible via deferred comp
- Terms of a buyout need to meet affordability test
- Corporation should be buyer, not Jimmy

Jones CPAs New Shareholder Buy-in

- Sell Jimmy 20% of outstanding stock for cash basis value over 5 years
- 20% of remaining tangible value (A/R & WIP) acquired through compensation adjustments over 5 years
- Intangible value acquired long term through growth and buyout subject to vesting

Jones CPAs Value Allocation

- Jeff sells Personal Goodwill to corp for 1X current fees
- Any additional value based on future growth shared equally between Jeff & Jimmy
- Tangible value allocated based on stock ownership



Jones CPAs Value Allocation

Based on future growth to $1.5 million and $400,000 tangible value

	Jeff	Jimmy
Stock ownership	80%	20%
Personal Goodwill	$1,000,000	$0
Tangible value	$320,000	$80,000
Net Intangible value	$250,000	$250,000

Jones CPAs Buyout Terms

- Personal Goodwill payments to Jeff start at retirement
- PGW and Deferred Compensation (both) paid over 10 years
- No interest on payments (imputed interest required for PGW)

Jones CPAs Shareholder Agreement

- Used units for net intangible value
- Vesting-10 year 50% cliff, 100% at 15 years

  Current shareholder 100% vested
- 2 year notice required for termination
- Restrictive covenant-2 year professional, 10 years for clients
- Compensation plan-performance based on productivity, growth in existing clients, client retention, practice development, admin

Jones CPAs Affordability Test

Based on current financial metrics

Shareholder comp/benefits	$380,000
Less: replacement cost	($160,000)
Less: Payments PGW acq	($100,000)
Less: Deferred comp-tangible	($25,360)
Residual	$94,640

remainder

Articles

Journal of Accountancy

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
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