CPA FIRM PARTNER RETIREMENT/ BUYOUT PLANS

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Introduction

Show me the money!

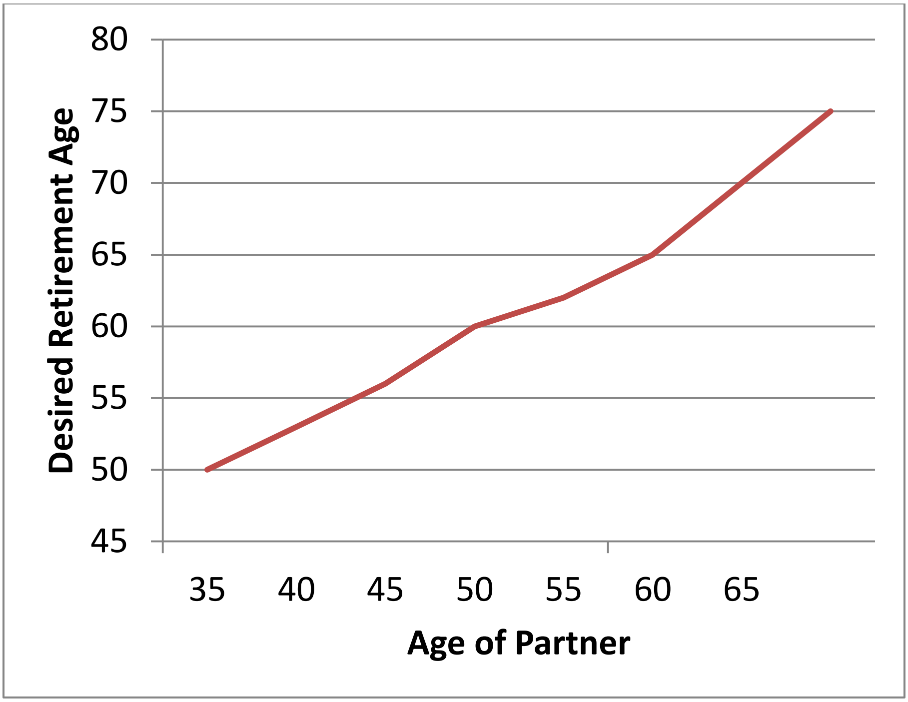
The concept of retirement for CPAs is rather amusing.

Younger partners (say, under 40) insist with unshakable confidence that the oldest they will ever work is 50 or 55. They have other things to do with their lives (own another business, do charity work, pursue hobbies, etc.) besides working at a CPA firm and they want to pursue these interests while still young.

Older partners (say, over 55) see themselves working indefinitely, with 65 being the earliest age that they will even *consider* retiring. This thinking is shaped by various influences, not the least of which are the realities of their financial burdens - college education, caring for elderly parents and the sobering calculation of the nest egg needed to continue the style of living to which they've grown accustomed.

Then too, as partners move north of 50 or 55 they realize how much they love their jobs and can't imagine giving them up. Plus, "65 ain't what it used to be." Medical advances and healthier lifestyles now make it quite possible for people to remain physically vital and mentally sharp well past 65. This concept is illustrated on the next page.

TARGETED RETIREMENT CHANGES AS CPAs AGE



So, owners of CPA firms are faced with two of the biggest challenges of their professional lives as they approach traditional retirement age:

1. They don't want to retire and they don't want anyone to make them retire. We'll address this a bit throughout this monograph, but #2 below is the primary focus.

2. When they *do* retire, they want to "cash in" their share of the firm's value. But how is the firm's value determined? And how is their share of that value calculated? In many cases the partner's share can range from $750,000 to$2M.

   How CPA firm owners meet this challenge is the primary focus of this book.

Why CPA firms have partner retirement/buyout plans

Owning most businesses provides owners with two paydays:

1. Annually, in the form of compensation.

2. Upon retirement, when the owner's interest in the firm is redeemed, either in the form of a buyout by remaining owners or an outright sale.

Partners in CPA firms are no exception. CPA firms have a substantial value that builds up over time. There is a strong market for the purchase or merger of CPA firms, making firms' values fairly liquid.

So, given the substantial "street value" of a CPA firm, when partners retire, they want to cash in their share of the firm's value. And they want to do this in a way that enables the firm to continue as a successful, viable entity. This is accomplished by creating a partner retirement/buyout plan.

A partner retirement plan results in a win-win situation for all stakeholders:

- The retiring partner receives his/her share in the value of the firm.

- The remaining partners are able to pay off the retiring partner without having to liquidate the firm.

- One of the firm's most valuable assets – its clients and the accompanying revenue stream – is retained.

The other valuable asset - the firm's people - is retained because the firm is able to survive the retirement of key owners while providing its personnel with continuity and stability, not to mention the opportunity to eventually replace the retired partners.

What CPA firms are worth

To illustrate a CPA firm's value, let's use an example of a "vanilla" or average firm:

- Annual revenues: $6M.
- 6 partners with ages spread evenly between 45 and 62.
- Average partner income: $350,000.
- Ratio of professional staff to partner is 3.5.
- Firm is located in a city with a population in excess of 1M.
- Clients are all in common industries such as manufacturing, real estate, health care, etc. No niches or specialties.
- Services are all traditional annuity types such as accounting and tax.
- The firm's accrual basis capital, primarily WIP & A/R, is $1.2M.

This firm has a value of $7.2M, computed as follows:

$6.0M	Goodwill value (also referred to as intangible value)
$1.2M	Capital (the tangible value)
$7.2M	Total

For purposes of this simple example, we have assumed that the goodwill is valued at one times fees, a common rule of thumb. Later in this monograph, we will discuss goodwill valuation in more depth and address how the one-time-fees convention, though still common, varies widely and is in no way universally accepted or guaranteed.

As the above calculation shows, the biggest component of a firm's value is its goodwill or intangible value. This is because a CPA firm practice is a very low capital-intensive business. Other than a small investment in office furniture and computers, little additional investment is needed to start and operate a firm. Most firms' largest tangible assets are their WIP and A/R.

Substantial goodwill value is directly linked to the annuity nature of most CPA firm revenues. Revenues from audit, accounting and tax services are routinely provided to the same clients for many years. This revenue stream is quite valuable because:

- It virtually guarantees a significant, steady cash flow for years to come, even if the firm doesn't add new clients.

- It significantly reduces (but doesn't eliminate) the need for CPA firms to bring in new business, a skill at which a majority of CPAs do not excel.

<u>The demand to acquire smaller firms is limitless</u>

An ample supply of willing buyers is a critical factor that strengthens and confirms the value of *any* asset, let alone a CPA firm. Virtually every firm, from sole practitioners to the Top 100, is eager to acquire a smaller firm. Why is this?

1. **Acquiring a CPA firm is inexpensive.** It's far less expensive to buy new clients, via merger or acquisition, than to develop them organically, from scratch. Also, since virtually all firm acquisitions are paid from earnings of the acquired firm, there is usually little upfront money that the buyer needs to invest.

2. **Bringing in business is very difficult for CPAs.** Acquiring smaller firms is a much-preferred growth strategy for many CPAs than engaging in practice development activities.

3. **Bigger is better**. Statistics consistently show that the greater a firm's revenue, the higher their profitability. This isn't guaranteed, but it's a safe bet.

4. **The return on investment for acquiring a CPA firm is huge.** Purchasing a CPA firm for a mere one times fees often results in a return on investment (ROI) of 50-80%, a result that would cause most people to describe the acquisition as a *steal.* If a firm were to pay as much as <u>two</u> times fees (an unheard of price), it would <u>still</u> be a good deal for the buyer. Later in this monograph, we will expound on the ROI calculation for purchasing a firm.

5. **Mergers are a great way to acquire talent**. The CPA firm industry is in the throes of a near-permanent labor shortage.