Three Steps to Valuing Your Practice for Partner Retirements

By Gary Adamson, CPA

There are 76 million Baby Boomers in the United States, defined as those of us born between 1946 and 1964. Accounting firms across the country are full of Boomers with 61% of all partners now over the age of 50, all marching toward retirement.

Every survey you look at highlights succession as one of the top issues of almost every firm. As firms begin retiring and buying out partners at a pace never seen before many of us are looking at our partner agreements and firm valuations for the first time in a long time. Have we structured the buy out provisions in a way that remains fair to all and affordable to the firm?

It is not just the value that we place on the practice but as important, how we cut up the pie and the terms under which that value is paid to a retiring partner. This article explores the three steps that you should be considering as you tackle this important issue in your firm.

Step One is determining the value of your firm. Remember we are describing an internal structure, not an external sale or merger. Values are typically higher for an outside deal and that discussion is beyond the scope of this article. Also, this is a process/transaction that is between the firm and the retiring partner; not a deal that is done outside the firm between individual partners.

Let’s start with the typical structure. There are two pieces: capital and goodwill. Capital is pretty simple. It is the firm’s accrual basis capital adjusted for the fair market value of real estate, valuation reserves for work-in-process and accounts receivable, etc. It is allocated to the retiring partner based on their ownership percentage in the firm and paid out as cash or an interest bearing note, over a relatively short term.

The second piece is the goodwill of the practice and this is where most of the conversation centers. Goodwill value is almost always expressed as a multiple of revenue and the generally accepted value historically was one times revenue.

The value discussion here is for traditional accounting firm revenues. If you have significant revenue in your firm from non-traditional businesses such as financial services, insurance products, pension administration, IT services, etc., then these should be valued separately.

The surprise for many of us Baby Boomers may be that the overall average goodwill value out there has been about 80% of revenue for several years. The latest 2014 Rosenberg MAP survey of 364 firms puts the average at 81%. It is also interesting that the size of the firm makes a difference. The largest firms in the survey, those with over $20 million in revenue, are valuing themselves lower on average at approximately 76% of revenue. Many of us have had a one times revenue expectation for a long time but clearly, we need to re-think that.

So, once we get our heads around what is perhaps a lower value for our firms, Step Two is determining how we split up the firm's goodwill among the owners. The choices here include allocating it based on ownership percentages or books of business which you tend to see in smaller firms. In larger firms there is a process called average annual volume or AAV which is still pretty popular. Last but not least, and the direction that firms of all sizes are trending, is to allocate the goodwill based on owner compensation.

Also called the Multiple of Compensation method, it uses relative owner compensation to allocate the goodwill value of the firm. The presumption here, and it is a critical one, is that the firm has a performance based compensation system in place and that the relative levels of compensation reflect the relative contributions of partners to the firm. Normally, a firm will use an average of the last three to five years of a retiring partner's total compensation (not including fringes) as the starting point. The average comp is then multiplied by a factor to arrive at the partner's share of the firm's goodwill number.

In a fairly typical example, if a firm is netting 33.3% profit before any partner compensation and they are using a goodwill value for the firm of 80% of revenue, then the calculation of the goodwill value is 2.4 times total partner comp. If we assume that our retiring partner's average compensation was $300,000, then the total retirement benefit for that partner using the 2.4 multiplier is $720,000. Note that the multiplier and the methodology is normally the same for all partners in the firm.

Step Three is the process you utilize to pay out the value to the retiring partner. As we said above the capital is usually paid out in cash or over a short term with interest. The vast majority of firms are paying out the goodwill in the form of deferred compensation (ordinary deduction to the firm and ordinary income to the partner). We see terms ranging from seven to ten years, with no interest. Ten years has become the norm. All of the CPA's reading this are now thinking "but with no interest, the value used for the firm is really less than 80%"! Yes, that is correct!

There are best practices and trends in several related areas that you should make sure that you consider for your firm when you are updating your partner retirement provisions. Those areas include the process you use for new partner buy-ins, vesting schedules for age and year's of service, death and disability provisions, mandatory retirement ages, post retirement employment parameters, client transition expectations with potential penalties and overall caps on payouts to protect the firm.

It is probably time to pull those agreements out of the drawer, dust them off and take a look!

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