

# SUCCESSION ADVISORY

## *Case Studies and Benchmarking Data*

### **The results for the second Succession Advisory Survey are in!**

The question was:

*Is the buyout for retiring partners of your firm based on Equity percentage applied to overall firm value or a Multiple of historical compensation?*

Of the 120 firms with more than one partner that responded the results are:

- 58% paid completely or heavily based on equity ownership
- 24% on paid heavily or exclusively on compensation
- 5% have no formal plan
- 5% tie the buyout exclusively or heavily to the book of business a partner manages/owns
- 8% were spread over many areas although most of them had elements of the top two
- Many responses mentioned capital accounts in addition to the above formulas, which is very much the “norm” although one response stated the only thing partners gets upon retirement is their capital account, which is not a traditional approach in the U.S., but one you find in Europe frequently
- Many firms included language tying the payout period to client retention. Most were silent on the subject.

According to our experts, Joel Sinkin and Terrence Putney, CPAs from Accounting Transition Advisors, it is impressive that 95% of the respondents have a formal plan as that is not the norm in the profession. They add that within the profession, the trend is toward compensation based plans as firms increase in size. For the largest firms that use equity ownership as a basis for determining buyout/retirement, a unit approach is often used and the larger the firm, the smaller the variance between high and low equity ownership.

Terry Putney shared with us that for those firms that do not tie buyouts to post retirement client retention, it may be important to manage the risk associated with retention by requiring an adequate notification period to allow for a proper transition of client relationships. Firms considering this issue should make a judgment on whether the client base is brand loyal or partner loyal in setting a proper notification period. The more brand loyal clients are, the easier the transition should be and the less time that will be needed for the transition. Firms that have clients that are primarily partner loyal, should allow more time, and require a longer notification period to assure long-term client retention, often no less than two years. This can be coupled with a two year post retirement payment adjustment period tied to retention in the event adequate notice is not provided in order to manage the risk associated with potential client loss.

Joel Sinkin told us that far more important than the basis for determining the payments, (compensation, equity, etc.) is to assure the formula was economically fair and reasonable for both the firm and the retiring partner. Mr. Sinkin shared that his experience has shown that an accountant would not advise a client to buy a business that will lose money for 5 years or more. Because a partner buyout is in essence an internal acquisition, it isn't

prudent to expect the firm and remaining partners to lose money while buying out a retiring partner. A plan structured that way is not usually viable for any of the parties. An internal sale of a partner's equity must provide the remaining partners upside while still providing appropriate compensation for the retiring partner's years of sweat equity. Joel provided us his litmus test to see if the buyout formula worked from a pure value perspective without consideration to client retention and to other concepts.

Sinkin said, "Let's assume a partner is making \$300,000 in total compensation per year including perks, benefits, etc. Let us also assume, for this example, it will take a total compensation package of \$100K to replace a retiring partner's labor (usually based on the cost to replace his productive capacity). That leaves \$200,000 which needs to be used for both the retiring partner's buyout and an adequate upside for the remaining partners so they remain motivated to undertake the obligation. Based on that simple analysis, you can assess whether the structure and level of commitment to retiring partners make sense. When the obligation appears to be too onerous, in addition to reducing the total value assigned the retiring partner's equity, the problem can be addressed in other ways such as extending the payment period."

Sinkin and Putney continued by suggesting that if your current buyout doesn't pass this litmus test, it may be critical to re-evaluate it sooner than later. They also reminded us that the buyout/retirement terms are a package including the tax treatment of payments, duration of the payment period, treatment of capital accounts, and retention period, if any, plus other issues that need to be addressed when structuring your partnership agreement.

Our new Succession Advisory membership option will help guide members through these waters by providing a free market valuation of your firm, market updates and much more critical information to help our members navigate through these issues.