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CPA FIRM STRATEGIC OUTLOOK

Why Partner Retirement Should Be at the Top of Your Firm's Strategic Plan

Ask the average CPA firm leader about the firm's owner retirement plan, and you are likely to get one of two responses: 1) we'll pay for it from cash when the time comes, or 2) we're planning to make a plan—even- tually. Given the increased emphasis on strategic plans—and on the succession planning that is part of this—the urgency to figure out how firms will fund the coming wave of partner retirements is becoming a necessary part of strategic planning.

Summer retreats and partner planning sessions are the prime time to tackle such issues, which inevitably intertwine with other major issues, such as staffing and growth. The aging population of owners means that the firms that have delayed "till we need to think about it" should consider the issue now.

Insights from our recent *CPA Firm Strategic Outlook Survey* can help your firm think about the difficult questions that must be asked before you can arrive at the answers for your firms' financial and partner retirement future.

Planning to plan. We asked CPA firm owners to discuss how their firms are addressing partner retirement now, since increasing numbers of partners will soon

reach retirement age. Of the responding firms, 30.7% will have one partner retiring within five years, and 15.8% will have two partner retirements within five years. Over the next decade, 26.5% said one partner will retire; 18.6% report two partner retirements are coming; and 9.7% said three partners will retire. Another 4.4% said four and five partners will be leaving the firm.

Despite the very obvious situation of growing numbers of partner retirements ahead, very few partner retirements are funded except through 401(k) plans, insurance, and cash, survey respondents said. Those firms that do fund retirement often choose to do so via deferred compensation or profit-sharing plans.

Attitudes toward unfunded retirement plans vary widely among the respondents. Some firms believe 401(k)s and insurance will be adequate. A shareholder and CEO for a local firm with fees of \$8 million to \$12 million and 97 FTEs believes the firm is handling things just fine by following this strategy. That firm has a 401(k) plan and profit-sharing, and the payout to retirees is spread over 10 years, based on a year's compensation. "The first two are funded; one-year comp is not funded. No problems,

it is meeting financial obligations,” said the shareholder.

A local firm’s managing partner said that the firm, with \$2 million to \$4 million in fees and 20 FTEs, has been “funding the plan with a cash-value life insurance and disability insurance plan. This has worked well to fund the retirement of three owners and should continue to work in the future.”

At another firm, a managing partner worries that such funding instruments won’t be good enough to underwrite future retirements. That firm has a 401(k) plan for partners and life insurance on owners and retired owners. “The bulk of the plan is non-funded. We are working on it as best we can,” said the managing partner, whose local firm has 15 FTEs and \$2 million or less in fees.

Will cash flow be enough? Some believe future cash flow will be enough to fund retirements—or that the issue is one that can be addressed beyond the 10-year mark. “We have an unfunded plan. We have scheduled out the cash flow as our partners retire and believe the firm can cash flow satisfactorily. New partners can realize solid income, if we can transition and retain clients,” said the managing partner of a local firm with \$4 million to \$6 million in fees and 52 FTEs.

The keys to succeeding with such plans are good transitions and healthy growth, as another managing partner wrote. “The founding partner’s retirement [is] to be funded from post-retirement revenues. The firm may have to revisit certain provisions, if desired growth is not accomplished.” That firm has four FTEs and fees of \$2 million or less.

Other respondents pointed out that their firms do not have retirements pending within the next decade, so this is an

issue they can safely delay acting upon. A local firm with \$4 million to \$6 million in fees and 50 FTEs has “unfunded buyout over seven years. No one is retiring in the next 10 years,” according to the managing partner.

“No retirement within 10 years. We are setting aside funds for retirement and will also look for a potential merger,” wrote the managing partner of a local firm with 6 FTEs and fees of \$2 million or less.

A few respondents said that although retirement is far away, they already are concerned. “Unfunded retirement, we will have problems in 15 years due to age of partners. We are beginning to address this,” said the managing partner of a local firm with \$2 million or less in fees and 19 FTEs.

Some respondents are worried about funding partner retirement and don’t see any clear answers ahead. One local firm with \$2 million or less in fees and 16 FTEs does not fund its partner retirement. “Yes, I foresee significant problems, as we don’t have a plan,” said the managing partner. “We have concerns, but are not sure what can be done,” said a partner with a local firm with \$4 million to \$6 million in fees, 47 FTEs, and an unfunded plan.

A few firms that are new to paying out retirement report that they are rethinking their strategy. The managing partner at a local firm with 85 FTEs and fees in the range of \$8 million to \$12 million fee replied, “Not funded. We are about to find out as the first partner retired last year and two more will retire within the next three years.”

“We are currently paying out a recently retired partner, which was not funded,” wrote the managing partner of a local firm with 17 FTEs and \$2 million or less in fees. “We are beginning to look at ways to fund

the next buyout.”

Merging or selling the firm is a solution some firms are planning, one that is expected to take care of partner retirement payouts. A partner with a regional firm of 65 FTEs and fees in the range of \$6 million to \$8 million said the firm has an unfunded plan. “We plan to sell/merge with a larger regional firm to provide our exit strategy.” A terser version of this sort of plan was expressed by a shareholder in a local firm with \$2 million or less in fees and 10 FTEs: “Sell the firm, or what is left of it.”

A few respondents believe it is the responsibility of the partner—not the firm—to handle retirement. “We have no program. We don’t need one either,” said a shareholder in a local firm with 20 FTEs and \$2 million to \$4 million in fees. “Partners make enough to take care of their own retirement.”

Payout formulas. Funded or not, how payouts are made to retirees varies widely among CPA firms, as seen below:

- 10-year payout based on income level at plan adoption; payouts capped per annum at 5% of gross fees: regional firm with 32 FTEs and more than \$20 million in fees.

- Twenty percent of practice fees over five years: local firm with 27 FTEs and \$2 million to \$4 million in fees.

- Ten-year payout for partnership interests, supplemented by partner’s 401(k) through the firm: local firm with 45 FTEs and \$4 million to \$6 million in fees.

- Two times annual compensation for five years prior to retirement and no percentage limit on net income that can be paid to retirees: local firm with 76 FTEs and \$6 million to \$8 million in fees.

- Eighty percent of average of two prior years’ fees collected multiplied by ownership percentage paid out over 120 months without interest: local firm with 14 FTEs and \$2 million to \$4 million in fees.

- Three highest years’ compensation (salary and bonus) computed; paid out over 10 years: local firm with 80 FTEs and \$8 million to \$12 million in fees.

For more information. Background statistics about the respondents to the *CPA Firm Strategic Outlook Survey* were published in the March 2007 AOMAR. A book with complete survey results will be available for purchase from IOMA later this year. □

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