What is a Fair Retirement Buyout Amount?

If a firm can theoretically be sold at a price equal to one times gross revenue, why should an owner's retirement buyout provision pay only 75 percent of gross revenue? In contrast, continuing partners/owners often feel that that percentage is too high. This paper looks at a buyout both from the near-term retirees' and the continuing partners' perspectives.

There are four basic options available for small-to medium-size firms that have one or more key owners contemplating retirement or phase down. The first is to develop a satisfactory retirement buyout agreement. Of course, this requires current continuing owners in place or the firm finding future additional owners, if no current owners are continuing on.

The second alternative is to merge into another firm or to sell the firm. In a merger/sale, the retiree often has added security that the retirement payments will be made since the other, usually bigger, firm has greater "hard assets" to secure the debt and more owners. In some cases, the acquiring firm's owners might even be willing to personally guarantee the debt. Splitting up is to ride it out to the end, the death or disability of the owners and the resulting closing of the firm. In such an instance, there should be a practice continuation agreement in place so value can be received for the practice.

The first alternative generally is the best, so let's see how fair retirement buyout can be obtained that will reasonably protect both the retirement-minded and the continuing owners.

The emotional issues that the retirement-minded partner faces include a strong service-oriented mentality, a need to be needed and productive, and a concern with "What will I do with my time?" As a result, there might be a desire to continue after retirement on a part-time schedule.

For example, when one of a CPA firm's founding partner reached age 65, (the firm's mandatory retirement age), he did not want to retire. Because he was a highly productive person with a significant client base, his partners agreed to let him continue as a full-time partner and defer his retirement and retirement payments. Unfortunately, this arrangement continued for over 10 years even though his productivity and value declined drastically during the last few years. He resisted client transition, and retirement, until finally ill health rendered him incapable of working. Recalling a conversation that I had with him over lunch one day, a few years after his official age 65 retirement date, I finally found out the main reason he would not retire. Apparently, he had a vivid memory of what actually happened to his closest friend after he retired (he had died six months later!). Clearly this represents incredibly heavy emotional baggage.

Beyond the emotional issues, there are the financial ones of:

1. A. drop in income from full-time partner’s compensation to that of a retiree,
2. A reliance on a retirement/buyout amount to live comfortably in the future, and
3. Uncertainty due to fear of financial consequences of inflation, health issues, recession, and the stock market.

Continuing partners also have their issues, but they tend to be much more financial and practical, rather than emotional. The financially related issues are:

- Can we afford to pay what the retiree is seeking?
- What is our financial risk if the firm or economy were to decline?
- Will we retain the retiree’s clients, many of whom are older or his personal friends?
- Can we pay the retiree for post-retirement part-time work?

The practical ones may revolve around absorbing the retiree’s work and/or developing and hiring someone to take over the retiree’s practice and responsibilities.

Because of these issues, the discussions can become heated and unpleasant. Firms are often driven to a merger or a split-up if they can’t reach an agreement. So get these matters resolved at least five years before any planned retirement date.

Post-Retirement Employment

Many retirees would like to continue to work on a part-time or seasonal basis after they officially retire. Firms usually like that. The key, however, is the financial terms. The continuing partners don't want to be paying both the retirement buyout amounts and a great deal of compensation. What seems to work well is arranging for a certain number of chargeable hours with a payment formula based on approximately 33.3 percent of the retiree's billing rate. For example, if the retired partner puts in 800 chargeable hours at a billing rate of $300/hour. She or he would be paid $80,000(33.3 percent of $300=$100/hour x 800 hours). Although, there are many variations and issues to consider, this formula is a good starting point.

When debating what constitues a fair amount for a retiring partne, the issue often hinges on each owner's view of what is a retirment buyout. A near-term retiree might view it as:

1. The share of the current value of the practice that they helped to build.
2. An amount that the retiree needs to live on during retirement.
3. The purchase of the retiree's current cliente base as if that practice were sold to an interested third party.

On the other hand, the continuing owners might look at it either as a reasonable amount that the firm can afford to pay or the purchase value of the reiree's client base that they will be able to retain after the retirement.

These diverse needs and views often create wide differences. For example, a person may have a small client base by the time they retire. This may be the case if the firm required that a person, prior to retiring, transition his or her client base gradually over the years so that at the time of retirement the client base controlled by the retiree is quite small. Similarly, in a mid-size or large firm, an owner might have served as a specialist (e.g., tax partner), or a managing partner, and therefore, has a small client base. Obviously, if the continuing partners view a retirement payment as an acquisition of a person's client base upon retirement, the individuals described above might not be fairly rewarded.

There is an additional issues that has surfaced in recent years, especially in small firms. If all of the continuing partners are so busy servicing "their" current clients, and there are no future owners waiting in the wings, the continuing partners may not place much value on the retiree's client base if they can't absorb all the work, and are concerned the size of the practice will decline because they don't have the available time or experienced personnel to properly service those clients.

Historically, firms have generally recognized that upon retirement, there are certain assets that should be considered in arriving at the amount of payout. The first is the accrual basis capital (”ABC”) calculated under normal GAAP methods. The major portion of this asset is usually the accounts receivable and work-in process (WIP). A preset formula should be established by agreement so that the values are automatically determined. The formula should represent a reasonable expectation based on past experience.

A firm might use the following formulas:

Accounts Receivable	
Under 30 days	**90%**
30-89 days	**75%**
90-179 days	**50%**
180-360	**25%**
Over one year	**0**
WIP	
Under 30 days	**90%**
30-119 days	**75%**
120-179 days	**50%**
180 days and over	**0**

Upon retirement, the retiree's ownership share of the ABC is usually paid over a period of five years, occasionally with interest at prime rate. Although five years is common, the payment period could be anywhere from three to 10 years.

The other asset of value is usually much larger than the ABC. That is goodwill and it primarily represents the value of this practice due to the firm's reputation, background, referral network, people, and most of all, its client base. This client base, especially in a traditional accounting firm, provides a continuing revenue source due to the ongoing nature of the work. Clients, once established, annually continue to need accounting, financial statement, tax, and other recurring work. Accordingly, the accounting firm's revenues typically continue, assuming a reasonable pre-retirement transition period, so that the client base is generally understood to provide annuity type continuation of revenue.

The determination of the valuation amount of this asset, to fairly pay the retiree, has evolved over the years. Larger firms have utilized a formula based on either a multiple of earnings or of the retiree's compensation. Small-to mid sized firms, however, almost always utilize a calculation based on the firm's gross professional fees. The typical formula today pays a retiree over a 10-year period, 75 to 80 percent of the firm's gross professional fees (usually computed on a cash basis). So for example, if a firm's gross revenue was $2 million and a partner owned 25 percent of the practice, she or he would receive (assuming an 80 percent valuation formula), $40,000 a year for 10 years (i.e., $2,000,000 x 25 percent = $500,000 x 80 percent = $400,00 divided by 10 years = $40,000/year). Interest, is usually not applied to the payment, although a small percentage of firms might provide a cost-of-living annual adjustments to the amount utilizing the CPI.

In certain situations, such as a partner who is involved in a transactional specialty, such as litigation support services, the client base really doesn't exist. The key to continuing this service niche, is the reputation of the firm, the transition of the referral source relationships (usually attorneys), and the existence of other partners (or experienced staff) to maintain the relationships and to perform the work. As indicated above, a "fair" retirement buyout isn't necessarily based on the value of a particular partner's client base.

Death and disability buyouts present additional challenges. The death buyout amount can usually be equal to the normal retirement amount because this can be covered at a reasonable cost (assuming insurability) with a life insurance policy. Long-term disability can also be covered by a disability buyout insurance policy, but this is often quite expensive. Accordingly, many firms might pay a reduced buyout amount in a disability situation.

Most agreements provide for an annual cap to protect the continuing partners. It might apply only to the goodwill payment or to both payments. It is usually in the five to 10 percent of gross revenue range. As long as revenues don't decline significantly in the future, the cap should rarely come into play. If revenues do decline sharply, it limits the amount of the retiree's payment.

For example, assume a retiree is receiving $90,000/year from a firm that had gross revenue of $1.5 million at the date of his retirement, and that the cap was set at seven percent of gross revenue. So, it the firm's revenue in the third year after retirement was $1.4 million, the retiree would receive his full $90,000 payment since the cap calculation (seven percent of $1,400,000) puts the cap amount at $98,000. If, however, in the following year, revenue dropped to $1.2 million, the calculation produces an $84,000 amount, so the retiree only gets $84,000 that year with the remaining $6,000 carried forward to a later date.

Talking about the White Elephant

Even though a fair retirement buyout provision had been developed many years before, circumstances may have changed considerably causing the retirement-minded or the continuing owners to raise the issue that the amounts or terms may no longer be viable. For example, the number of owners potentially to be retired at the same time might have changed due to changes in individuals' personal health, family, or financial issues. The possibility of changing the agreement can be very upsetting

The retiree wants to maximize the payout with maximum security, whereas the continuing partners want to minimize their payment and their risk. So, why would an internal retirement buyout be calculated at 75 percent of gross revenue, while an external sale/acquisition possibly be at 100 percent of gross revenue?

There are several reasons for this, but the most relevant focuses on the client retention issue. In a sale to an outside party, client transition and retention is critical. Accordingly, an acquirer who may be willing to pay 100 percent of gross revenue will only pay that based on retention (e.g., 20 percent of cash collected in each year for the next five years). The retiree is now somewhat at the mercy of the buyer's interest and ability to retain all the clients. As a practical matter, many times the retiree doesn't end up receiving the 100 percent of gross revenue. In comparison, if there is a retirement within the firm, assuming that a comprehensive two-year pre-retirement transition program had been effectively implemented, most of clients would be retained and so the continuing partners don't require a retention clause in the agreement (i.e., the retiree doesn't need to worry about the long-term retention issue). In actuality, the 75 to 80 percent retirement amount can be perceived to protect all parties from some client attrition.

The key to success is assuring that an agreement is put in place at least five years before any owner is to retire. A full discussion of what a retirement payment is must occur. The financial terms should be explored, utilizing formulas similar to the ones amounts described above. Remember, the firms that don't get these issues resolved on a timely basis may be forced to seek a merger/acquisition or will be forced into a separation/split up.