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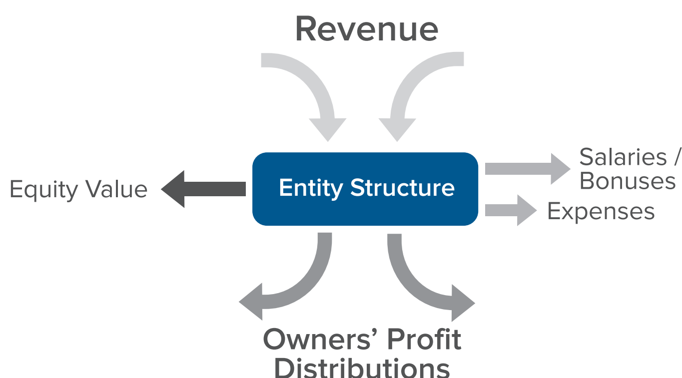
REMODELING CASH FLOW

In order to build an enduring business–something that can outlive you while providing a lifetime of benefits and income–a practice needs to be powered by next-generation talent. In fact, as the value, cash flow, and complexity of the business grows, most succession plans involve not just one next-generation advisor, but a succession team with two, three, or more owners filling specific roles in the enterprise, collectively replacing the founder(s).

To assemble this team, a founding owner has to be able to draw younger, talented advisors into the ownership circle and help them answer a couple of important questions: 1) "What am I investing in, and why?" and 2) "Where does the money come from to enable me to buy into the business and, one day, to buy out the founder or senior partners?" Proper cash flow modeling (and professionally prepared financial statements) is key to helping next-generation advisors invest their money and careers in the business in which they work, because it helps to create a bottom-line, or profit distributions, in an LLC or an S-corporation. Profit distributions, actual profit distribution checks issued several times a year (preferably on a quarterly basis) to all owners, serve as the practical answers to those questions. Creating those distributions is one of the key steps in transforming your practice into an enduring business.

Let's start with how cash flows through an independent advisor's S-corporation (or an LLC taxed as a partnership or an S-corporation). Basically, there are two ways to get money out of an independent business–wages, and profit distributions. But there are four ways to build wealth from the same model: 1) wages, which include bonuses; 2) profit distributions; 3) equity income from the gradual sale of equity, and; 4) equity value, or stock appreciation.



The addition of equity or business value to the equation is essential and part of the business-building process, because the growth of equity value has the lowest tax rate of the four wealth-building tools, and we're not talking about long-term capital gains rates. Think instead about the tax on the growth of equity in your business, or for comparative purposes, your home; you don't pay taxes on the growth of equity in either case until the equity is realized. As a growth tool, as building tools, equity is what separates an independent business from a wire house or employee model.

Step One: Revenue

A properly constructed and valuable business relies on a strong, centralized entity structure that pays out competitive-level compensation (wages and benefits) for work performed. First, it must collect ALL incoming revenue from everyone who works under the same roof and deposit every last cent of that money into the corporate (or LLC) bank account (whether directly or by assignment as is now common in virtually every IBD). This is a normal function in a fee-only RIA model where a client can contract directly with the advisory firm; in a FINRA model, this can be a more challenging aspect as the money paid to the individual advisors must be assigned into the entity in a two-step process, sometimes augmented with a Service Provider Agreement (SPA).

The point is, if revenue is siphoned off through a revenue-sharing arrangement or a commission split, or it goes directly to the producer under some form of an eat-what-you-kill compensation approach, it does not count toward the value of the business. That is the difference between cash flow and equity. That is also the difference between a collection of separate books and a single business with enterprise strength. All revenue belongs to a business, without exception, is set forth on a formal Profit & Loss Statement and is subsequently distributed as follows:

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Step Two: Competitive Wages

Competitive wages at the ownership level are determined by relying on two information sources: 1) the producer/advisor's trailing 12 months compensation level, and; 2) operational benchmarks for practices or business of similar size and composition. However, with few exceptions, no succession plan or business plan should start with a pay cut to a next-generation advisor who is about to become a new owner. Accordingly, determine what the competitive wage is for a particular role in a particular geographical area, but regardless, don't reduce take-home pay. Making the leap from a revenue-sharing arrangement, for example, to a salary and bonus structure is hard, but you don't have to do it all at once; we often include a tapering element in the planning and implementation process (as pertains to the compensation element).

Once salaries are determined, lock in the most recent level of compensation, and don't change it for the next couple of years–and that applies to all owners including and especially the founder(s). This creates a budgetable, predictable base-level compensation for the ownership team that is recurring, just like the income stream in most fee-based structures. Over time, as the founding owner begins to reduce time spent in the office, his or her wages tend to remain flat even as the business grows–a benefit of ownership and being the founder who sacrificed his or her salary in the early years.

Alternatively, depending on the circumstances and the planning parameters, the founder's wages can gradually be reduced as the founding owner works less and as he or she receives incoming payments from the succession team (equity income) as they continue to purchase equity as they buy-in. Connect the dots: As the founder's wages decrease or level off even as the business grows on the shoulders of the successor team, profits should increase, triggering a faster buyout of equity from the founder at preferential tax rates–all excellent reasons why you should plan first, and thoroughly, before implementing your succession plan. There are a lot of moving parts.

As a result of this cash flow remodeling, the role of variable-level compensation is shifted to profit distributions–an element to be reserved for those who actually invest their money and careers into the building of the enterprise. It is essential that the founder pays at least competitive wages in order to attract and retain exceptional talent for the long term, but it is a mistake to overpay significantly (which almost always occurs when you use a revenue-sharing arrangement or any form of an eat-what you-kill compensation system), thereby making an investment in ownership unnecessary by the employee or producer/advisor. Why invest and take the risk of going into debt to buy equity when a share of the profits automatically comes with the paycheck?

Step Two & A Half: Bonuses

The immediate push-back in a sales-based organization is that a pure base salary coupled with profit distributions does not properly incentivize employees to achieve the results needed to grow the company. If that is the case, and you believe your business's goals cannot be met without production-based or oriented compensation, then we suggest using bonus structures to specifically target the behavior that the practice is trying to encourage rather than to simply tie it to a blanket revenue goal or production from an individual. Using a bonus incentive tied to bringing on new clients or to increasing so-called share of wallet is better than using revenue-based splits or commissions, which often reward advisor employees for simply participating in a good market rather than achieving the goal of building value. By using appropriate base compensation combined with profits to the owners, bonuses gradually become a smaller component of an advisor's compensation package and one that serves more to focus on the right objectives while keeping things interesting and competitive among your junior advisors.

Step Three: Profit Distributions

A flatter wage level means that after operational expenses are paid and a suitable reserve is on hand, all remaining monies as well as all future revenue growth will be channeled out of the pass-through entity structure as profit distributions to the advisor/owners. Remember, in an S- corporation tax structure, profits flow to owners in direct proportion to ownership (i.e., a 15-percent owner receives exactly 15% of the profits (or losses)). Profits serve three distinct functions: 1) a return on investment; 2) the variable component of take-home pay, and; 3) the means of paying for the equity being acquired from the founder.

Flattening the founder's W-2 wages also means that the founder can't take out all the growing profits as a bonus to him or herself. Instead, by paying those monies out as profits, an important business-building function is attained: advisor/owners are driven to think and act like owners, focusing not only on production (which is still job number one), but on profitability as well – it does no good to grow if it isn't scalable and efficient. This structure reflects the

philosophy that owners of small but growing businesses are not motivated only by a paycheck, but by the increasing size and share of their profit distributions, and by the growth in value of their investment, or equity–multiple ways to build wealth as a business owner.

Of course, in order for advisors to increase their share of the profits and to increase the amount of their variable compensation in terms of actual dollars, additional ownership must be purchased, and that is exactly the mentality needed to create and sustain a succession team. But there are two additional and easier ways that next-generation owners can increase their take-home pay as equity partners. One is to nurture the top line–help make the business grow and take on more of that responsibility as a member of the succession team (think 10% annual top-line growth or more). The second is to watch the bottom-line: How profitable is this business? How does it compare with other businesses of similar size and structure? What expenses can be cut without affecting growth? Are you paying too much, as is commonly the case with revenue-sharing arrangements?

Simply asking these questions is a step in the right direction for the next-generation team of owners. But you have to get them to focus on production and profitability simultaneously; that is what owners must learn to do. And owners learn very quickly, because production and profitability immediately and directly impact their take-home pay in an equity-based model. The greatest failing of a revenue-sharing or eat-what-you-kill arrangement is that these compensation methods make the bottom line completely irrelevant to all but the founder, who alone, late at night, worries about the increasing overhead even as the business grows.

Step Four: Equity Investment

Building a practice requires a focus on production. Building an enterprise, or a business, requires that current and future leadership make the connection between a growing cash flow stream (production) and the costs of such growth (profitability); it shifts the focus to the bottom line. Having and distributing profits attracts next-generation talent who can, in turn, provide continuity and longevity. At this point it bears repeating: structure your business and its organizational, entity, and compensation systems so that there is no way for an individual to do well unless the organization succeeds as a whole.

In general, here is a good formula to consider as a goal for the business you're building: About 33 percent of all incoming revenue should be allocated toward overhead (business expenses, not including ownership level compensation); about 33 percent of all incoming revenue should be allocated to ownership-level compensation; and about 33 percent of all incoming revenue should find its way to the bottom line to be allocated to profit distributions – as a starting point; strong, steady growth anchored by a flattened ownership comp structure will drive higher profits.

Many owners don't or can't start with these performance ratios, but by taking control of the "wage line" for all owners, advisors, and producers through a salary and bonus structure it means that, in time, with sustained growth, things will change, and improve. All you have to do is plan thoroughly and take the first step.

Remodeling your cash flows means that things are going to be different – perhaps very different. You will have to learn to produce and use your financial data more effectively, and that function will make you a better owner and advisor. Once these systems and processes are in place, however, most owners find that the cash flow structure is not more complicated–it is more sophisticated, more profitable, and more valuable.

Above is an excerpt from our book "Succession Planning for Financial Advisors." VIsit www.fptransitions.com/book for more information and purchasing options.

FP Transitions is the nation's leading provider of equity management, valuation, and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

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