



Succession Planning and Incentive Compensation

Trends and Best Practices White Paper



STRATEGY

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Impactful interactions for success

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outsourcing, tax, and advisory services in a cohesive, personal, and customized manner.

Introduction

CLA has just completed the 2015 LeadingAge-CEMO Leadership Compensation Survey© (the study) that encompasses multi-site aging services organizations. Over 129 multi-site organizations were surveyed as part of the study, and participants represent a broad geography and size.

The purpose of the study was to provide multi-site aging service organizations with data on executive compensation trends, practices, and levels. Although there are a multitude of different analyses presented in the study, this white paper focuses on two areas that we thought would be of immediate interest to boards:

- Succession planning; and
- Incentive compensation.

In addition, we have provided a sample methodology for applying incentive compensation.

Over the coming years, we hope to publish additional white papers that focus on some of the unique needs of organizations relating to their compensation practices.

About the Authors

Mario Mckenzie, CPA, Partner

Mario is a partner with CLA specializing in aging services. In that role, he leads the executive compensation services group along with Bob Morrow. Mario also has extensive experience in:

- Strategic planning
- Financial feasibility studies
- Market analyses
- Strategic capital planning
- Facilities master planning
- Operations assessments and benchmarking
- Acquisition or sell side due diligence

Mario received a masters degree in accounting from the University of South Florida. Prior to his studies Mario served in the US Army as a medic.

Robert Morrow, MS, NHA, Principal

Bob is a principal with CLA specializing in aging services. In that role, he leads the executive compensation services group along with Mario McKenzie. Bob Morrow also has extensive experience in:

- Operations assessments
- Executive search
- Compensation planning
- Succession planning
- Facilities master planning
- Affiliations and acquisitions

Bob holds a masters degree in health services administration from Gannon University and has held a Nursing Home Administrator’s license since 1977.

Succession Planning

One of the findings in the study is that a large percentage of CEOs will be retiring in the next five years. The table below highlights the current average age of the CEO, CFO, and COO positions within the surveyed organizations.

Job/Level	2015 Count	2015 Current (average) Incumbent Age	2015 Current (average) Years of Service	2015 Average of Years of Service at CEO Retirement	2015 Average of Remaining Years at CEO Retirement
CEO	113	58.2	16.5	23.3	NA
CFO	107	53.3	11.0	17.8	5.4
COO	66	53.6	12.8	19.6	5.9
Overall	286	55.3	13.6	20.4	3.4

*It is important to note that in the table above, those executives (CEOs) greater than 65 have been excluded. Of the surveyed organizations, 16.8% were already past 65 years of age! Including these individuals, **forty-three percent (43%) of the CEOs in the 2015 analysis are already or will reach age 65 in less than five years**, less than the forty-eight (48%) noted in the 2014 study, but still a very large cohort.*

The aging of this group of CEOs is likely to mirror that of the population at large, and, anecdotally, single site aging services organizations appear to be mirroring these trends. With that said, the overall average age of the CFO and COO relative to the CEO is also cause of concern. Although the most likely candidates for succession (if chosen internally), the CFO and COO will exhibit an average remaining tenure that will be minimal.

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As such, it would appear that now would be a good time for boards to focus on the evaluation (or re-visiting) of succession plans. We will discuss elements of a succession plan, but as organizations develop those plans, it is clear that organizations (whether focused just on CEO or the full C-Suite) will follow one of the following courses of action:

1. Develop a succession model that “favors” internal successor development;
2. Hire externally, but within the industry;
3. Hire from outside the industry; or
4. Affiliate with a similar minded organization to access executive talent.

Internal succession

There has been a proliferation of leadership programs (e.g., LeadingAge) and other organizations that are helping develop leadership programs for individuals within organizations. Coupled with internal programs that promote rotations and different defined roles within organizations, such programs should allow organizations to have the ability to create internal succession programs.

External hires

Absent a logical internal candidate, most organizations undertake executive searches hoping to attract and create opportunities for individuals within the industry who may be looking for greater challenges or opportunities. As the survey notes, there will likely be a lot of competition for those candidates within the industry.

CLA, for example, has helped many organizations place senior executives, and the process is time consuming and laborious, and challenging for all parties involved. A big part of the challenge is the seemingly smaller pool of candidates who are available for these positions.

Outside of the industry

A lesser choice for the CEO and COO (although more common for the CFO position) is to look for leaders outside of the aging services industry. Although this is not often seen, it could prove to be an effective option if organizations have rich traditions and processes and strong board leadership.

Strategic affiliation

A recent option for boards has been the exploration of strategic affiliations where leadership may be transitioned as part of an affiliation with another organization. One would not recommend that the succession planning be the impetus for an affiliation, but a strategic benefit of such affiliation may very well be to deepen the executive ranks and build a succession organization that can also benefit from the immediate transition in leadership. If the strategic plan indicates that affiliation is a logical step for the organization, it may very well then align with a succession plan as well.

Succession planning practices

The following are areas of focus that can be introduced (if not there already) into current succession plans to improve the likelihood of a successful transition:

- **Board involvement** – The succession plan has to be directed by the board and, ultimately, has to achieve the board’s objectives. For example, beyond ensuring that a plan is developed, boards should be looking to gain familiarity with their full executive team and others within the organization who may be future succession candidates. This then affords the board the ability to gauge depth of the knowledge within the organization while getting to know who is coming up the ranks. Ensuring that other leaders present and are familiar with board workings is one way that boards can make sure

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they are able to spend time with potential succession candidates.

- **Strategic** – The plan needs to contemplate where the organization is headed. The successor profile must be determined based on that heading. Without a meaningful strategic plan, it is questionable whether development or other programs can be put in place to grow the right type of successors that will have the skills and experience to guide the organization, or create this profile of the successor candidate.
- **Accountable** – What exactly is being measured relative to the plan? It will be important to make sure that there are measurable elements of the succession plan if they are required. For example, if the plan is to rotate certain leadership candidates through different departments or experiences, how do you measure that it is happening?
- **Documented** – It goes without saying that most hope they don't need to implement a succession plan suddenly. However, it is important that a plan be in place for unexpected transitions. Whether through death, poor performance, or mobility, C-suite individuals do leave their organizations. How redundant are the roles and what is the interim plan?

Conclusion and Recommendations – Succession Planning:

It is never too soon to develop a succession plan. Like all planning endeavors, a well thought out plan should consider how the organization will pursue the succession plan. For example, one of the tasks of the CEO may very well be to help identify and mentor one or more potential successors early in the process. Even though most organizations will also evaluate external candidates when the time comes, having internal candidates will only improve the odds of a successful transition. Therefore, perhaps developing incentive pay or

other criteria to measure the development of the talent pool may be an area that would align boards and their executive teams.

Developing individuals is a process, and, as such, it is important to look beyond the plan and ensure that the organization is actually doing the things necessary to create environments that rewards risk taking, career changes, and alternative career paths. Ultimately, focusing on the process helps ensure that, over time, many candidates are looked at and evaluated.



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Incentive Compensation

Hand in hand with succession planning, organizations must retain top talent in a very competitive environment, while ensuring that the goals of the organization are met. The following will focus on the role of incentive compensation in helping boards achieve these goals.

The prevalence of formal incentive programs has continued to rise steadily with 46% of the CEOs in the total sample receiving an incentive in the year 2015 (3% more than in 2014).

Position	2014 Survey		2015 Survey		Average Incentive (\$000s)
	% Receiving Incentive	Incentive as % of Base	% Receiving Incentive	Incentive as % of Base	
Chief Executive Officer	43%	17%	46%	16%	\$59.2
Top Operations Executive/COO	34%	12%	42%	14%	\$34.7
Top Financial Executive/CFO	39%	12%	36%	15%	\$34.6
Operations VP/Director	40%	13%	38%	12%	\$20.8
VP of HUD	35%	12%	19%	26%	\$41.4
Chief Administrative Officer	43%		33%		
Top Marketing Executive	38%	16%	35%	18%	\$28.5
Top Legal Executive	35%	10%	25%	15%	\$41.7
Top Human Resources Executive	36%	11%	36%	11%	\$17.9
Top Facilities/Construction Executive	31%	11%	29%	13%	\$21.6
Top Strategic/Long Range Planning Exec	46%	11%	29%	15%	\$28.0
Top Fund Development Executive	31%	13%	27%	12%	\$16.7
Top MIS Executive	37%	11%	28%	10%	\$16.5
Top Quality Assurance/Healthcare Exec	49%	10%	32%	46%	\$15.4
Top/Chief Compliance Officer	31%	9%	29%	8%	\$10.5
Executive Director-Multiple Facilities	59%	16%	31%	10%	\$16.9
Executive Director-Single Facility	34%	12%	23%	12%	\$17.2
Average	39%	13%	32%	15%	\$28.7

Note: 2014 survey result data sourced to Rodeghero Consulting, the author of the 2014 study.

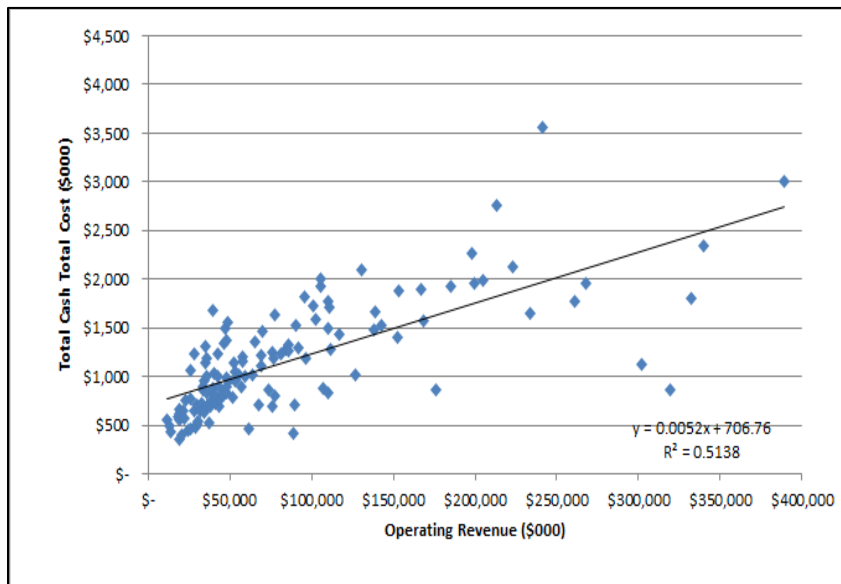
Formal incentive plans continue to emphasize mission with a balance of financial and operating metrics. There continues to be a strong relationship between the use of incentives, organization size, CEO pay, and the organizational results. It is clear that organizations with better performance pay incentives more often and in larger amounts.

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It is important to note that total cash compensation does not necessarily correlate with higher profit margins.



In the chart above, we have identified those corporate positions that are present in at least one-half (50%) of the corporate/home office survey participant organizations (facility executive directors omitted) and added up each organization’s total cash compensation cost across these positions. These eight are the same positions that were included in the prior years’ analyses and can be considered the core executive group among most CEMO organizations. As noted, it is clear that total cash compensation for this group increases as the size of the organization increases.

The following chart identifies those organizations where total executive cash compensation cost is a higher/lower relative value to the organization. Where labor costs are below the relative average and results exceed the averages, we would consider the organization’s executive labor cost investment a good value. Conversely, if labor costs exceed the relative average but results lag the average, the organization is deriving lower value from its executive compensation investment.



As can be seen, profit margin clearly does not drive the relationship between total cash compensation and what is valued by the boards of the participating organizations. This is not to say that the boards don’t value the profit margin, but, rather, on a year to year basis, other factors are of increased importance. It is beyond the scope of our study to determine whether CEOs whose organizations have experienced multiple years of losses have been retained in light of the

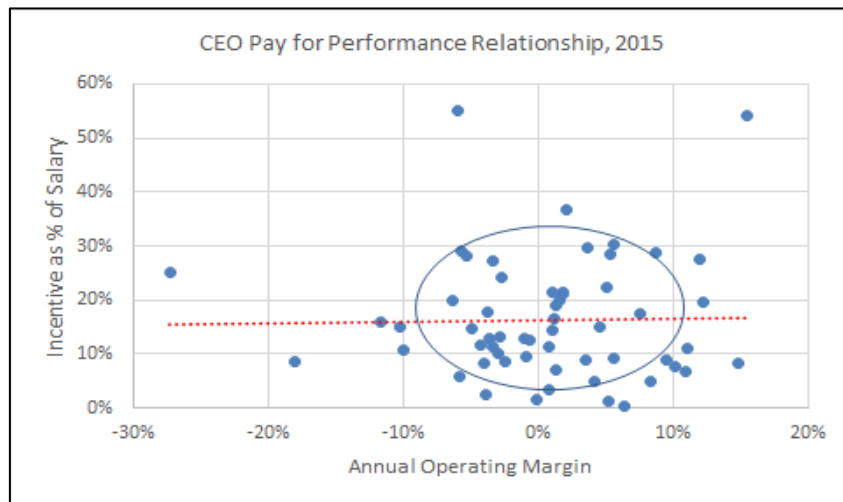
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previous information. That is, incentive compensation may be given out for a variety of factors, but organization tolerance for sustained losses may lead to other courses of action not reflected in the incentive compensation analysis.

As noted below, for those who did receive incentive pay, the results were mixed given that a large number of participants received incentives even though operating margins were below zero percent (negative). As such, we use this to remind the reader that for nonprofits in particular, incentive compensation is tied to more than just profitability, and it would seem that profitability is a lesser component of the overall incentive payment calculus:



Common factors used in establishing incentive compensation goals include:

Incentive Measure	Rank 1	Rank 2	Rank 3	Other Rank or Combination Rank
Mission	65%	10%	26%	
Quality	13%	67%	21%	
Revenue	26%	26%	43%	4%
Operating Margin	47%	19%	33%	
Debt Ratio		33%	33%	33%
Other	24%	24%	47%	6%

As noted above, mission and quality are the most commonly identified non-margin related factors.

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Conclusion and Recommendations – Incentive Pay

- The fundamental basis for any incentive compensation program is simple: *It should equitably and consistently recognize and compensate employees for superior performance.*
- Incentive-based compensation is becoming much more common because of the increased emphasis on performance and competition for talent.
- Government is using pay-for-performance to redirect reimbursement under health care reform, making it more popular and acceptable within health care and continuing care.
- Setting up an incentive-based compensation program requires the same research into the industry as the base pay program. It may work best when it serves as a component of a board approved/managed compensation plan.
- An individual incentive program motivates staff to exert more effort because extra compensation is paid only to those who perform above the established metrics.
 - A well crafted incentive compensation program must direct individual behavior toward achieving established organizational goals.
 - An effective incentive program should be designed to affect favorable change within your organization.
 - A thoughtfully designed incentive program should allow a substantial portion of compensation to be a variable cost. Ideally, the plan should reward results rather than actions.
 - To be fair and equitable, an incentive plan should cover all members of a group, i.e. senior leadership.
 - Plans that cover the CEO only may be designed by the board. Under the assumption that the CEO develops the annual

operational plan and directs the use of resources, human and financial, the goals are generally operational but may also be strategic.

- *The IRS has provided some guidance to nonprofits in the ruling known as Intermediate Sanctions. Discretionary bonuses are generally not acceptable as they are not objective nor results based. The incentive compensation should be based on performance results and truly at risk.*

The study is available for purchase at the link below with tiered pricing based on the buyer's affiliation with LeadingAge and the Chief Executives of Multisite Organizations (CEMO).

Purchase Link:

<http://www.claconnect.com/LeadingAgeCEMO/>

For additional information or assistance, please feel free to contact Mario Mckenzie at:

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Appendix A – Incentive Compensation

Advantages:

- One aspect of an incentive program that may be overlooked is the opportunity to develop employees who underperform.
- An individual incentive program motivates staff to exert more effort in key areas that may bring the greatest advantage to the organization.
- Successful incentive compensation programs can improve employee motivation and morale.
- Enhanced employee motivation
- Increased employee productivity and job performance
- Increased retention of high performers
- Increased ability of the organization to achieve its objectives
- Potentially lower costs

Risks:

- Incentive plans are common, but satisfaction with them is not. Surveys of human resource executives consistently show that incentive plans often do not live up to expectations.
- There is a risk for poorly designed incentive plans to backfire.
- Goals and targets should be clearly defined and clearly communicated. In many cases the failures are because the plans are not clearly defined, people do not understand them, or the logic is flawed.
- Incentive compensation plans reward employees for business related performance that is usually based on results rather than traditional cost of living, seniority, or hours worked.

- Incentive compensation plans can redirect focus away from other important areas of operations. Care should be taken to assure that the incented goals are not achieved at the peril of other areas of operations.
- While most are, not all executives are motivated by money.

General guidelines:

- Incentive compensation may work best when part of a board approved and managed executive compensation plan. Discretionary bonuses should be avoided.
- Goals must be clear, measureable, and based on easily understood metrics.
- Goals may be related to mission, quality, operating revenue, operating margin, debt service ratio or related debt covenants, and other organizational goals.
- Plans generally cover a single year. Longer-term plans are generally related to long-term strategic or performance improvement plans and are inherently more difficult to administer.
- Incentive compensation is generally at risk and is not paid if goals are not achieved.
- Organizations implementing incentive plans for the first time are encouraged to start small and learn from their experiences. While CEMO indicates the average CEO incentive plan represents 17% of base compensation, a graduated approach is recommended. For example, if 15% is the target for incentive compensation as a percentage of base compensation, a three year plan of 5%, 10%, and 15% will provide the needed experience to effectively administer the plan and reduce the risk of failure.

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Appendix B – Typical Goals for an Incentive Compensation Plan

Typical Opportunities for Performance Improvement: Potential Goals

Measurable improvement in these operational areas;

- Occupancy percentage
 - Payor mix
 - Productivity – revenue per FTE
 - Revenue per occupied bed
 - EBITDA percentages
 - Operational revenue per occupied bed day
 - Bad debt expense as a percentage of operating revenue
 - Debt service coverage
 - Days cash
 - Days in A/R
 - Fundraising percentage increase
 - Employee and resident satisfaction scores
 - Attrition reduction
 - Insurance expense per bed (annually)
 - Interest expense per bed (annualized)
 - Dietary costs per occupied bed and per meal
 - Employee benefits as a percentage of total salaries
 - Costs as a percentage of total expense
 - Administration
 - Support services
 - Nursing care
 - Direct care as a percentage of total costs
 - Direct care cost per resident day (RNs, LPNs, Aides)
 - Direct care cost per resident day (RNs, LPNs, Aides)
 - Ancillary costs and services per resident day
 - Average hourly wages
 - Contract/temporary nursing costs per resident day
- Labor costs (salary and benefits) per resident day
 - Direct care labor cost as a percent of total labor cost
 - Cost/revenue ratios for pharmacy (margin)
 - Cost/revenue ratios for therapies (margin)
 - Others as may be determined by the board to improve, sustain, or grow the organization.

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Appendix B – Typical Goals for an Incentive Compensation Plan

Sample Language: Executive Compensation Plan

Executive Incentive Plan

The executive incentive plan will provide compensation as an incentive to improve organizational and departmental (e.g., nursing home) financial results and achieve the organization's mission objectives. At this time, the plan is designed for the use of the board in evaluating and compensating the CEO. However, the policies and procedures are established to cover any executive staff member who may participate in an incentive compensation program. When approved, the rules established by the board become the policy and standards for all employees. As the plan is tested and better understood, it may, at the discretion of the board of directors, be extended to include other key executives and officers of the corporation, and may be included in the related executive definitions by the IRS.

Target award levels will be earned when pre-defined and approved goals, set by the board of directors, and/or individual goals are fully attained. No incentive compensation award can be paid when performance is below established goals and larger amounts (up to the approved maximum) may be provided when performance exceeds the established goals. No awards will be paid under the executive incentive plan if threshold performance levels are not achieved.

Performance expectations will be articulated in advance with clear, measurable, and written objectives, and performance feedback will be provided throughout the year. These expectations, in the form of measurable goals, will be predetermined annually by the governance committee, in consultation with the CEO, and will be approved by the board.

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Appendix C – Sample Incentive Compensation Plan

Sample Incentive Compensation Plan:

Calculation Example:

Assume Total Incentive Compensation available is \$10,000.

2016 INCENTIVE PLAN GOAL METRICS

GOAL	Threshold	Target	Stretch
FINANCIAL VIABILITY (Weight – 50%) <i>(or \$5,000)</i>	33%	66%	100%
Annual Return on Net Revenue <i>(assume \$1,500 of \$5,000)</i>	Exceeds previous year by 2% <i>(\$500 if completed)</i>	Exceeds previous year by 3% <i>(\$1,000 if completed)</i>	Exceeds previous year by 4% <i>(\$1,500 if completed)</i>
Creates Cash Reserves <i>(assume \$1,500 of \$5,000)</i>	Equal to one month of operating revenue <i>(\$500 if completed)</i>	Equal to two months of operating revenue <i>(\$1,000 if completed)</i>	Equal to three months of operating revenue <i>(\$1,500 if completed)</i>
Develops Marketing Plan Focused on Improving Census <i>(\$2,000 of \$5,000)</i>	Overall census improves by 1% over previous year-end <i>(\$660 if completed)</i>	Overall census improves by 2% over previous year-end <i>(\$1,320 if completed)</i>	Overall census improves by 3% over previous year-end <i>(\$2,000 if completed)</i>

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Appendix C – Sample Incentive Compensation Plan

GOAL	Threshold	Target	Stretch
Human Resources (Weight – 30) (or \$3,000)	33%	66%	100%
Reduces Overall Employee Attrition (assume \$1,500 of \$3,000)	Average of employee turnover in all departments is 2% less than previous year-end total (\$500 if completed)	Average of employee turnover in all departments is 4% less than previous year-end total (\$1,000 if completed)	Average of employee turnover in all departments is 6% less than previous year end total (\$1,500 if completed)
Human Resource – Improvements <ul style="list-style-type: none"> • Presents and board approves alternative staff scheduling options • Presents a formal evaluation of employee benefits, including pension • Presents plan to make (XYZ) a preferred employer (assume \$1,500 of \$3,000)	Completes One of three (\$500 if completed)	Completes Two of three (\$1,000 if completed)	Completes Three of three (\$1,500 if completed)

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Appendix C – Sample Incentive Compensation Plan

GOAL	Threshold	Target	Stretch
Resident Life/Participation <i>(Weight – 10) (or \$1,000)</i>	33%	66%	100%
Measuring Resident Satisfaction <i>(assume \$1,000)</i>	Develops and presents measurement system for board approval <i>(\$333 if completed)</i>	Implements resident satisfaction survey <i>(\$666 if completed)</i>	Presents results with plan to improve in areas of low scores <i>(\$1,000 if completed)</i>
GOAL	Threshold	Target	Stretch
Continuum <i>(Weight – 10) (or \$1,000)</i>	33%	66%	100%
Develop Strategy for Clinical Home and Community-based Services <i>(assume \$1,000)</i>	Presents formal plan to the board and board approves <i>(\$333 if completed)</i>	Implements one major plan initiative approved by the board <i>(\$666 if completed)</i>	Implements two major initiatives approved by the board <i>(\$1,000 if completed)</i>

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Appendix C – Sample Incentive Compensation Plan

Incentive Compensation Calculations:

- The sample calculations are provided for illustration purposes only.
- The board establishes the goals and weighting for the CEO incentive compensation based on the mission and strategic and operational goals of most importance to the organization for the coming year. Professional goals may be included at the discretion of the board.
- If applicable, in cooperation with the compensation committee, the CEO establishes the goals and weighting for the senior leadership team.
- A fixed dollar amount (maximum) or a percentage of salary is selected by the compensation committee to represent the maximum potential incentive compensation amount for each eligible participant.
- The weighting determination is used to calculate the percentage of the total amount assigned to each category.
- Subsequent weighting for specific goals may be designed to place greater emphasis and compensation on these goals.
- In the illustration, \$10,000 has been assigned to the plan as the maximum for simplicity of the illustration.
- In each goal category, the maximum amount is assigned based on the board approved percentages.
- The calculation then shows the potential achievement of each goal based on:
 - Threshold at 33%
 - Target at 66%
 - Stretch at 100% (maximum)
- Goal achievement is generally reviewed and determined with incentive compensation awards calculated in the first quarter or 90 days following the close of the fiscal year, allowing for year-end operating results to be determined from the organizational audit or final year-end financial statements.

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Appendix D – References and Definitions

References and Resources:

Leadership Compensation Survey

Incentive Pay Programs

Mike Schraeder – Auburn University

J. Bret Becton – Auburn University, Montgomery

Incentive Compensation

Paul L. Schumann, Ph.D. Professor of Management

Federal Reserve System FDR # OP 1374 – Guidance on
Sound Incentive Compensation Policies

Federal Register: June 25, 2010 (Volume 75, Number
122)

DOCID: fr25jn10-64 FR Doc 2010-15435

IRS – Intermediate Sanctions

Use in Continuing Care: Definitions and Guidelines

Definitions:

- Incentive compensation – a reward system, which may be individual or group based, that motivates staff to exert more effort because extra compensation is paid only to those who perform above the established metrics. It is based on a series of predetermined goals that must be measurable. It is generally considered at risk compensation meaning if not achieved it is not earned.
- At risk compensation – not earned if measurable goals are not met

Other definitions:

- Base compensation (salary) – Guaranteed cash earnings received during one year; salary data does not include the cost/value of benefits.
- Total cash compensation (TCC) – Fixed cash compensation and any additional cash incentives or bonuses received during one year.

- Total compensation and retirement – Fixed cash compensation, additional cash incentives or bonuses, and retirement amount funded during one year. (Does not include the value or cost of health and welfare benefits)

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