Succession Planning for Smaller Accounting Firms

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You have worked hard for many years and it is closing in on your time to reduce your commitment to your practice or retire. When do you start creating a succession plan and the transitioning of your practice? What is your practice worth? This article puts you on the right path if you are seeking to establish a succession plan.

When do I start the process?

As many professionals, accountants can be the case of the shoemaker's shoes. While we are constantly reminding our clients to plan for their retirement in advance, we frequently delay making our own succession plans. There are several key items that will dictate when to start the transition process:

- *Frequency of Client Meetings.* The frequency one meets with their clients tied into how many more years the practitioner desires to work full time is the most important aspect of knowing how far in advance to create a succession plan. When one reflects on most practices under $1 million dollars in annual revenues, there is typically a significant percentage of clients, both business and personal, that the principal of the firm only meets with once a year. Therefore, if someone is 4 years from reducing their time commitment to their practice, for most annual clients and many business clients who either mail in the work during the year or possibly work with the staff but only deal with the owner during the tax season, it is really only 4 visits. Clients have great loyalty to their accountants and it takes time to perform a proper transition. Thus it is critical that well before a practitioner cuts down on his time dedication to his practice, he is getting his clients, staff and ultimate successor acclimated to each other. A basic rule we use is 5 years. An initial affiliation can be created wherein the partner who is ultimately going to retire can maintain control and income while gradually commencing a transition.

- *Staff Losses.* Some smaller firms may lose a critical staff member simultaneously as they were closing in on retirement. Instead of searching for and then training new staff, perhaps now is the time to affiliate with a firm or practitioner who has the excess capacity to replace that staff member and at the same time commence a transition.

- *Leases and Significant Expenses.* If you are about to obtain a new lease for your office and are close to retirement, you must be wary. If you commit to a long-term lease, you may be forcing your ultimate successor to accept your location. This will limit your audience to firms that either would accept a satellite office or are not married to a lease themselves. There are also times you need to reflect prior to making a large investment of assets or the like for the practice to confirm you will have time to get a return. For many firms facing signing new leases or acquiring a significant asset, the answer may be to affiliate now with your ultimate successor who simultaneously can address your needs while effecting a gradual transition.

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What is my practice worth?

Ask 50 accountants how they value a practice and you may receive 50 different responses. Most, however, will try and tie the price of a practice to a multiple. While each deal is unique and will have additional items that need to be considered, the following are our 5 main variables we review when starting the valuation process of an accounting firm:

1. *Cash Up Front***.** Most deals have from zero to one third of the anticipated purchase price paid at closing. This can be affected by the time of year one closes, tied into the anticipated cash flow of the practice, treatment of accounts receivable and work in process of the seller. A practice that generates the lion's share of its revenues during tax season may get a larger down payment in December then a buyer may be willing to provide in June. In many deals, balloon payments can help bridge a gap between the two party's desires and form a compromise point. It is happening more frequently but still rare that an accounting practice is sold with all payments at the closing!

2. *Length of Guarantee Period.* The overwhelming majority of practices sold include a guarantee or retention period that adjusts the balance due the seller based on actual retention of the clients and collections of fees from them. These periods can be as short as one tax season or run the entire duration of the payout period. Again, in rare circumstances, there are no retention periods.

3. *The Profitability of the Deal for the Buyer.* The seller's net profit is only a starting point. A buyer should base the value of the acquisition on the profitability he expects to receive. If a buyer can take over a practice and bring it into his current infrastructure without any incremental increases in overhead, it is an amazingly profitable acquisition. However, if in order to absorb a practice an additional location, staff and other expenses need to be realized, the benefit of the acquisition becomes more marginal. Profitability may also include many other factors including tax ramifications of the payments between the buyer and seller and potential cross selling opportunities. If a buyer has a niche the seller did not, yet the seller's former clients lend themselves to this niche, the potential value of the practice may increase. Sometimes the talent and specializations of key staff members can add value, just as demanding the successor retain poor staff members unneeded in the successor firm can hurt the profitability of the deal.

4. *Length of the Payout Period.* The simplest of the variables, the longer the payout—traditionally the lower the monthly payment the greater the cash flow. Most payout periods are between 3 and 10 years but there are exceptions to all these rules.

5. *Multiple.* Purposely placed last, the multiple is the result of the first 4 variables. The longer the payout and guarantee periods, the more profitable the deal is for the buyer, and less cash at closing, the higher the multiple. Ask a buyer to pay you more upfront, shorter payout and retention periods, and less profitably structured for the buyer (insisting on retaining a lease, all good will in the allocation…), the lower the multiple.

For example, if you were able to acquire a practice with no incremental increases in your overhead and the seller wanted all cash at closing, would you pay that seller the same multiple you would have if they had provided you a 7-year payout period, 4-year retention period, allocate some of the compensation from the buyer to the seller as consulting, etc… ? Thus the multiple is the effect, the other variables the cause.

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Internal Versus External Sales

While all the variables discussed above become a part of the valuation process for an internal sale, these sales are frequently treated differently. One does not usually have a partner pay the same money a stranger would have been asked due to "sweat equity" and the fact that (hopefully) that partner helped you build the practice.

In many internal succession deals, the sellers do not provide a retention period either under the basic concept that the firm is surviving, therefore the clients will as well. The flaw in that thought process is the assumption is made that there will be a proper transition. Clients need to be weaned from the retiring partners to the successor partners and this can take considerable time. We recommend that if proper notice is provided to partners and the transition has ample time to take place, the lack of retention periods may not be a problem. However, if a partner fails to provide adequate notice, a guarantee should be added into the equation.

There also has been a recent trend among multi-partner firms to use a multiple applied to past earnings instead of revenues of the firm. An example may be taking an average of the prior 2 years income on an accrual basis for a partner, multiplying this by 3 times and paying it over 7 years. Another trend has been utilizing certain aspects of IRC codes 736 to enable the firm to get a current deduction for the firm on the payments made to a retiring partner.

What do I look for in a successor?

The most important aspect of choosing the "right" successor is chemistry between the parties. If you do not want to eat dinner with someone, why would you sell him or her your practice?

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Clients have little to no yardstick to measure the technical skills of their accountant. Therefore they remain with the accountant they trust and like. The critical task of choosing the correct buyer includes finding a personality that you believe will mesh well with your clients and staff.

Other considerations may include certain licenses and specialties. Some practices require foreign language skills and certain other unique intangibles. After "chemistry," the next most critical factor is the excess capacity of the buyer. If a seller is devoting over 2,000 hours to their practice between billable and non- billable time, the successor firm must have the resources to replace that time with appropriate level team members or face serious problems.

Additional critical factors are location, methods of servicing clients and fee structures. Change is a dirty word to all of us. The firm that can offer the greatest continuity to the client base is the firm most likely to retain the clients.

Get Help!

For a deal to be successful, everyone needs to win. Buyers do not acquire a practice to lose money; sellers should be well paid for their years of devotion. The sale of an accounting practice is vastly different than the selling of almost any other business or professional practice. This is mainly due to the fact that you cannot buy and sell people combined with the consideration that most deals have retention elements that share the risk between the buyer and seller. Having someone who has personally handled at least dozens if not hundreds of transactions of this nature, specifically relating to the accounting industry, is a key. The decision to sell your practice may be difficult and emotional. But, the actual process doesn't have to be.

Joel Sinkin is the President of J. Sinkin Consulting, exclusively servicing the accounting industry, providing assistance to accounting firms seeking to merge, acquire, or otherwise affiliate. He has personally been involved with, and consulted on over 600 closings of accounting firms, traveled cross country to teach CPE, and published books and articles nationally. He can be reached at 800.507.6805; joel@jsinkinconsulting.com; or *jsinkinconsulting.com.*