Succession planning: The future is now

Here's how to build internal and external succession plans that work

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You have devoted years to building a practice. By creating a realistic business plan, you can maximize the value of this asset and establish a succession plan that works for you, your successor, clients and staff.

A premise with which to start

Why do you have your clients?

Most of your clients really do not have a yardstick to truly measure the skill level of their accounting firm. If they understood enough to measure your technical skills, they might not have to hire you, and instead could handle it themselves. So, since a client accepts on faith the fact that you are competent, why do you have your clients?

The first answer typically is chemistry — a personal and professional comfort level. They are your clients because they trust you. They feel comfortable with how you run the practice philosophically and how you service your clients. They feel comfortable with your staff, your location and, most of all, you as a person.

In many ways, this basic concept is the underlying factor that impacts many aspects of planning your succession. We are not buying and selling people. Therefore, knowing why you have your clients will play a major role in most facets of the succession planning process.

When should you start the process?

As discussed above, most clients remain with their accountants because they are comfortable doing business with them.

In addition, a substantial percentage of most firms' clients (both business and personal) are dealt with in person on only an annual basis by the firms' principals. When someone says they are five years from either retiring or devoting less time to their practice, it sounds like an eternity. In reality, though, that may amount to just five visits with a substantial portion of the client base.

It takes time to get your successor and your clients acclimated to each other. This applies to internal and external succession plans.

Your practice has its greatest value while it is running at top efficiency. By creating your succession plan in advance when the practice is peaking, you can structure the most lucrative deal.

There are other variables that can affect when you start a succession plan. If you are about to make a major investment in technology, relocation, staff and other such items, this may be the time to review your succession plan. Perhaps there is a firm or individual with whom you can affiliate who will either participate in this investment or, by virtue of your affiliation, satisfy your need. For example, if you need additional staff capacity or technology and were thinking of reducing your role in the next five years or so, why not affiliate now with a firm that has that technology or excess capacity and accomplish multiple goals simultaneously?

Whatever you are paid for your practice or interest in your firm, it will normally be based in large part on the acquiring firm's expectation of its ability to retain your clients. It takes time for your successor and clients to become acclimated to each other — and to transition the trust and loyalty your clients have in you. This applies both to internal and external succession plans.

The longer and more actively you are involved in the transfer of trust, the more likely the transition will be successful. This expectation of high retention should elevate the value of your firm, and the successful transition of client relationships will be more satisfying for you.

One way to actively participate in the transition is to remain involved as needed after your ownership interest has been transferred. Another technique is what we refer to as a "two-stage deal." This technique will allow the seller to maintain his or her current level of income, independence and control over the practice and still start the process of acclimating clients to a successor.

The valuation process of an accounting firm in an external sale

Most firms are priced based on an inter-relationship involving the following five variables:

1) Cash upfront.

2) The profitability of the deal for the buyer, which includes items such as billing rates, realization rates and the tax structure of the payout.

3) The duration of a retention period, if any. This refers to whether or not the purchase price is adjusted based on client retention.

4) The length of the payout period.

5) The multiple.

Here is the basic concept: The less cash required at closing, the longer the payout and retention period, the more profitable the deal is structured to the buyer, the higher the multiple.

The opposite is true as well. Would you pay the same for an accounting practice with all cash at closing as you would with an extended payout and retention period?

A premise that will make this case study clearer involves a practice that was able to be absorbed by the buyers with no incremental increases in overhead. Let's say the seller would accept no cash down and a payout based on 17.5 percent of gross collections from the seller's original clients, structured as a consulting agreement. Would you do that deal? Many firms would, even though the multiple is 1.75X. In this deal, the buyer has little or no risk.

But let's say the seller altered the terms and wanted 33 percent cash down, a four-year payout period structured in a manner that created a 15-year deduction for the buyer (a sale of a practice) and a 12-month retention period (thus, if a client is lost after month 13, it would have no impact on the balance

due). In this case, most buyers would lower the value to between 1:00X and 1.25X

If that same seller demands all cash at closing, most firms would be hesitant to offer 1X, let alone .75X.

Obviously, many other factors would be required to perform a full valuation. The above was more to illustrate the formula of how each variable can impact the final price.

Other important factors would include (but not be limited to) assets coming along, staff, general financial health of the clients, accounts receivable, realization rates, services provide, and the seller's transition plan.

A good deal is a fair deal. The seller should be well paid for the years of sweat equity, but the buyer must make a living.

Is your firm prepared for an internal succession?

Many firms find out too late they are not as prepared for partners to leave as they thought. Here are some helpful things to review to ensure your fate is different.

- How much interaction will there be to get the clients and their new contact partner acclimated with each other? Is there adequate time and opportunity to create a smooth transition?
- How many billable and non-billable hours does the outgoing partner devote to the practice?
- Does the firm, especially the partners taking on these responsibilities, have the capacity to take on this workload?
- Does a retirement-minded partner have any specialties or licenses that a firm would lack once the partner leaves?

If the current team members can take on this workload (whether by passing down work or other means of creating time) and have adequate time and skills to make clients comfortable, you may be in a strong position to handle the succession internally. If the time required to replace the professional is not there or a technical skill or license is lacking, you must rethink your plans.

This can be overcome in several ways. The two used most often are bringing in additional talent and merging with a firm that has the capacity to ensure the succession goals.

Though not easily accomplished and filled with its own issues, this step is important in achieving a successful succession. Accomplishing this in advance may be the key to a successful plan.

How do I value the retiring partners' equity in the firm?

All of the five variables mentioned earlier impact the internal valuation of a practice. For the purpose of this article, though, we will give you one basic concept that must be the framework of any valuation plan for an internal sale.

If the buyout for retiring partners (hopefully detailed in your partnership agreement) calls for the remaining partners of the firm to make less money during the buyout of senior partners than they were making immediately before the buyout payments commenced, you have a problem. Over the past 15 years, I have seen many partners leave a firm shortly prior to a senior partner's retirement for this reason. Worse, there might be defaults and other problems related to the buyouts after the partner retires.

The idea of buying something is to make more money, not less. At worst, you'd like to break even. Therefore, let's review a basic method of approaching this growing concern as the baby boomers age.

Start by reviewing the amount of total compensation the retiring partner makes. From such total, subtract the cost of replacing that partner's time.

For example, let's say a retiring partner earns a total compensation package (including salary, benefits, profit distributions, etc.) of $200,000. If the firm needs to hire an additional accountant to help pick up the workload, and that accountant's total cost is $100,000, that will leave a balance of $100,000 in additional cash flow to the firm (assuming everything else is constant). The negotiations can now begin over how much of that goes to the retiring partner and how much remains in the firm, and for how long. In this way, the remaining partners should achieve a financial benefit, yet the retiring partner can also receive compensation for his or her years of sweat equity.

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If it sounds too easy, it is. Remember, this is a starting point. Many other factors have to be placed into the equation to make it work for everyone.

Create an appropriate transition plan

Unlike the sale of hard assets, loyalty and relationships cannot be bought or sold. This is why we emphasize a long-term plan.

The key to any transition includes clients who don't know they are being transitioned. Over the course of years, clients need to get acclimated with additional talent in the firm before their main contact retires. In this way, these clients have already become comfortable and trusting of the "new" partner involved in the account. If a professional retires while still serving as the main contact for clients, a potential retention problem will exist with those clients.

One key to a successful transition is adding someone else, not merely losing the person the client trusted. This is true whether or not your deal is for an internal or external exit strategy.

A useful approach is to utilize the age of specialization. For example, if we were to transition a client who is a high net-worth individual, it may be done as follows: The senior partner brings in a professional who will replace the partner on this account and explains to the client that this new partner is an expert in new tax laws. This "specialist" may also be able to plan new approaches to help potentially reduce the client's tax liability and provide other benefits. That is why the new partner is working side by side with the current partner. Over the course of time, the senior partner can gradually withdraw from the client and create a smooth transition.

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Most announcement letters and transition plans need to emphasize several things. The "seller" is remaining of counsel, the fee structure is remaining intact, the practice is remaining geographically sensitive, and the critical staff is part of the newly combined dedicated team.

Get help!

In a creating an internal or external succession plan, there are numerous things to be worked out — valuing the practice, structuring the deal, treatment of accounts receivables, WIP, liabilities, what to look at in due diligence, names, roles, transition strategies, partner buyout provisions, documentation of the deal and so much more. This is not only a critical business decision, it can get emotional as well.

Having an experienced professional on your side can be the most important step in obtaining a win-win deal for everyone.

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