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The Key to Successful Succession Planning

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As tax professionals, we provide the guidance our clients need to plan for retirement. As in the old story "The Elves and the Shoemaker," it is amazing how often we neglect ourselves and fail to plan appropriately for our largest intangible asset, our practice. You may be shocked to learn that most professionals fail to plan until they are on the cusp of retiring. Because of this lack of planning, many in the industry fail to cash in on the full value of their practice.

Accountants and tax practitioners are generally oblivious to the very profitable alternatives to a pure retirement or a pure sale. There is no canon of ethic that reduces your options to either be running a practice full-time or selling. You augment your power to hold the clients for your successor when you create an environment where you gradually reduce your role and integrate your successor into the client fabric. By doing so, you maintain your current income with a reduced exertion, while simultaneously perpetuating your annuity.

We'll explore the criteria and variables that you should take into consideration when creating a transition of your practice.

Starting the Process

Clients can select from among hundreds, if not thousands, of accountants and tax preparers. Why did they choose us in the first place? Rarely do clients possess enough knowledge to truly evaluate their practitioner's technical skill level. Instead, they select and stay with the person with whom they feel the highest level of comfort and trust.

Knowing that client retention is based on comfort and trust, and knowing that a seller gets a much higher price with a retention clause, has got to make you ask, "How can I maximize retention when I sell?" First, it takes time for clients to become comfortable with your successor.

Therefore, you should start the transition process before you plan to exit. Divide the process into Stage I and Stage II. During Stage I, introduce your successor and create a basis on which your clients can develop trust and comfort. If you work it right, you will benefit by having more free time and earning more profit for yourself, while continuing to own the practice. During Stage II (the actual sale period), you will reap the rewards of Stage I, and maximize your income from the sale.

Before you consider reducing your role or retiring from your practice, first ask yourself the following questions:

1) How many more tax seasons do I want to work full-time? If you were to set a date to retire or reduce your workload, three years would seem like a long time to you. But in your profession, three years represents only three visits for most of your clients. You need sufficient time to establish comfort and trust in your successor among your clients. Ideally, your clients should see you working side by side with your successor. If you have a practice where your clients see you on a monthly basis, a shorter incubation period would suffice. The critical factor is not the frequency with which you serve your clients, but how often they have personal contact with you.

2) What cash investments will my practice require in the next few years? Nowadays, practices swallow cash like a horror show monster, and there is nothing you can do to avoid it. These investments can take the form of expensive technology that requires periodic updating, changing accommodations (moving or remodeling), and staff replacement and additions that have no cost-justification in the short run. If you are two years from retiring or reducing your role, you want to postpone these expenditures or shift them to your successor, who will pay the costs and be around to reap the benefits.

3) What lease commitments should I lock myself into? If you commit to an extended lease, you may be excluding potential buyers who will not accept your location and lease.

4) What are my current staffing needs and what will they be in the future? Staffing can be a major issue. Finding and retaining good staff is always difficult. If you become too dependent on a critical staff member, lose a valued employee, or foresee someone's eventual departure, now is the time to act. By affiliating with your successor, you'll keep the same profits during Stage I and be set when the time for succession is right. You'll avoid the cost of advertising, interviewing, hiring, and training staff members who may leave for a better job once they are trained. Often, your best choice of a successor is a firm or practitioner who has the excess capacity to replace a lost staff member. This can be a win/win situation if your successor and staff become acclimated to each other, while you continue to cover the workload.

Planning for Succession. While health, lifestyle, financial status, and age are some of the criteria you may consider before selling your practice or reducing your role, the main rule of thumb is to start well before you are seeking the phase-out.

Most professionals enjoy great loyalty from the bulk of their clients. Many practitioners we have met have told us they are on the second and third generation with many clients. They have watched their clients grow, mature, and are friends with many of them. Clients frequently spend considerable amounts of time with their service provider, catching up on their social lives as much as their professional ones.

Loyalty is a wonderful thing. You shouldn't fear this loyalty, but use it in an ethical way to help your clients deal with the transition. They know you and trust your decisions. You need to reassure your clients that you would never sell your practice to someone who is not going to take care of them. Time is the critical factor, and this is why we recommend starting the process sooner as opposed to later.

Structuring the Deal

Immediate Sale vs. Merger to Buy-out. You can structure your deal in a way that suits you and your goals. There is no "right" way to set up a sale and transition. In each case, the factors are the same: 1) Decide how long and in what capacity you desire to work (full-time, part-time, or not at all); and 2) determine how you can maximize client retention and price.

Immediate Sale. This is the obvious and most basic method, requiring only one step. You simply sell the practice immediately in a document. This doesn't mean you will not be available for a proper transition or are unwilling to remain on.

With this type of arrangement, you and the buyer need to create a plan detailing what your post-closing role will be. We'll discuss this later in the article when we address transitioning.

Merger to Buy-out. If you seek to remain working in a significant role, you may want to use this two-stage process, which has many variations. Arrange a merger to buy-out when you seek a short-term continuing role in a "merger period" and a long-term succession with the buyer. During the merger period, you and the buyer will operate as one firm. You'll continue to service your original clients. After introducing the buyer to them, your job is to build up confidence in the new owner. The clients, in turn, learn to respect your successor, and become habituated to the name, style, location, and procedures of the new firm. The affiliation may be so perfect that you'll become involved in the buyer's client base. Most of these successful arrangements have the following elements:

- The seller's income remains generally preserved, so long as the client base remains steady and the seller devotes similar time to the practice as had been devoted in the past.
- The seller has the right to gradually reduce his or her time commitment and accept pro rata reductions in income.
- The seller remains the "managing partner" in regard to his or her original clients.
- A pre-determined buy-out formula is put in place at the time the affiliation is negotiated. The purchase payments are deferred until the seller either retires or dramatically reduces his or her time commitment to the practice.

Variables to Keep in Mind. Some key variables in this two stage affiliation are listed below:

- During Stage I: Does the seller participate in new revenues generated from the combined firm or does the "interim merger" instead safely insulate the seller's revenues from the ups and downs of the rest of the firm? If the seller is safely insulated from fluctuations, does the seller still reap the benefits of overhead reductions, cross selling of services, and new business development?
- During Stage I: If the seller decides to be a full participant, how is equity determined for each partner of the combined firm? In 95 cases out of a 100, mergers allocate equity based on the dollar volume of the repetitive volume of the clients brought into the merged firm. That volume is computed using last year's collections or a post-merger look-back period for collections. In 5% of the cases, the partners agree on the net of their respective practices and use the net to determine equity.
- Stage I and Stage II can be mixed. In such cases, the roles of the selling partner can vary from: 1) an active participant in the servicing of clients with distributions split between a payout for

the equity in the practice and a direct service fee, which is compensation for his or her work; and 2) a transitional role player who supports new client relationships, but does no billable work.

Mechanics of the Deal

The Buy-in to Buy-out. This is a two-stage succession plan with cash exchanged on day one. This kind of arrangement is very similar to the merger to buy-out. The significant difference is that the buyer, in addition to merging, acquires additional equity from the seller. An example of this type of affiliation follows:

- The long-term seller has a \$400,000 practice.
- The buyer has a \$100,000 practice.
- The firms merge together and now have a \$500,000 practice.
- In order to be an equal partner, the buyer needs to acquire \$250,000 in equity, but since the practice contributed only \$100,000, the buyer needs to acquire an additional \$150,000 of the seller's practice to create an equal relationship. This acquisition is typically done with a payout over time.

Frequently, buy-ins are scheduled in several stages. An example is where the buyer acquires a one-third interest in the practice on day one, another one-third in the future, and an ultimate buy-out sometime after that. The three stages accomplish three things: 1) a delay in cash payments for the buyer; 2) the gradual reduction of equity for the seller; and 3) a gradual transition for the clients.

As in other forms of a merger to buy-out, each situation can be drafted to give flexibility to roles, income, decision-making authority, economic cooperation, etc.

The Buy-in. A buy-in makes sense when you must plan for the role-reduction or retirement of a partner, but cannot schedule a time for complete succession. The buy-in usually includes all the elements of a practice continuation achieved with a sale, but the partner who is buying in becomes the natural selection for succession.

To conduct a proper transition, ideally the "new partner" will work along side the retiring partner for a period of time. The downside to a buy-in is that control issues frequently arise, since the seller's intention is generally to remain for an extended period of time.

Immediate Sale With a Continuing Employment/ Consulting Agreement. If you plan to remain on for a period of time, you can arrange an immediate sale with a continuing role for yourself. This insulates you from liability, a very attractive feature for many retiring practitioners who desire to maintain income, but avoid the headaches of ownership.

Instant sales with a continuing role for the seller ensure continuity. Sometimes, the clients, the public, and even the staff are not aware that the seller no longer has equity ownership. Often, the seller can still earn a similar wage and even manage the practice as before, all while avoiding the obligations of ownership.

How to Get Paid Twice for the Same Thing, and Still Make Everybody Happy! Finances are often critical to the acceptance of the payout plan. It wouldn't be economically feasible for the buyer to pay you for equity while simultaneously compensating you for working full-time. If such were the case, inevitably you would need to discount either the value of your practice or your value as a worker.

A solution would be for you to defer all or most of the payout until you reduce your hours/role. You will maintain your pre-transaction cash flow, while your successor makes some level of profit. Eventually, the buyer will pay an appropriate purchase price once your compensation is reduced (typically pro rata).

Typically Stage I terminates and Stage II, which is the buy-out, commences when you reduce your role below 50% of your normal capacity.

Cull Out Sales. Suppose you decide to focus your time and attention exclusively on financial planning. You no longer wish to perform the compliance side of the business (performing the accounting and tax services), so you wish to sell that portion of your business to a willing buyer. The buyer will ask you to sign an agreement not to compete in specific fields, while acknowledging that you plan on providing other specific services. Many times the buyer must also sign an agreement not to compete, at least as it relates to the clients purchased. This type of arrangement has become very common in the industry. We have seen professionals elect to exclusively focus on computer consulting, business consulting, litigation support, etc.

By way of illustration, we recently helped a professional sell the accounting and tax portion of a practice while retaining the right to sell financial planning services and products. The buyer agreed not to compete in the financial planning arena. Post closing, these practitioners even elected to share space and held this affiliation out to the public. One firm concentrated on the financial planning, portfolios, retirement income, insurance needs, and the like, while the other firm focused exclusively on the compliance accounting, tax, and business planning. They even established an incentive program for cross referrals to each other.

In this situation, the clients quickly became comfortable with the arrangement, helped, we are certain, by the fact that the service provider they were accustomed to seeing remained on the premises. These clients also felt better serviced.

"Die at My Desk" Professionals. There are also practitioners who are determined never to retire. Even these "die-hards" ought to merge so that they have the backup, support, and long-term succession about which their clients may worry. However, many are just not comfortable in a shared environment. For these professionals, the answer is a practice continuation agreement.

Practice Continuation Agreements. A practice continuation agreement is simply a document between two firms to cover the firm whose principal dies, becomes disabled, or simply chooses at some point in time to step out. Practice continuation works on paper, but you still need a transition agreement. The major problem with these arrangements is the lack of transition. Client retention may suffer because the firms did not affiliate in advance. Most people who enter this type of arrangement do so to protect against death or disability. The reality is, however, that it is impossible to perform a

proper transition with someone who is deceased or unavailable. This method rarely protects anyone – the seller, the estate, or the clients.

A Summary of How to Get Started

Know Your Practice and Goals. Decide how many tax seasons you want to continue working and how hard you want to work. This is a personal, professional, and financial decision. Take a realistic view of your practice and prepare a method for getting a fair price.

Think about how you are going to identify your buyer, prepare a transition, train your buyer, and cash your checks. Start by identifying the attributes you want in your successor. These typically include size, specialty, licensing, location, and billing rates. The three most important things to consider are:

- **Successor's Available Capacity to Service Your Clients.** You must look closely at the time and effort you devoted to manage and perform the workload necessary to handle your practice. Does your successor have the excess capacity to absorb these additional responsibilities?
- **Chemistry, Chemistry, Chemistry.** The most important and basic question in choosing a successor is, do you feel comfortable with him or her? If you do not want to eat lunch with a potential buyer, why would your clients? Most clients have no idea of the competency level of their accountant or tax preparer. If they knew enough to measure the technical skills of their practitioner, they would know enough to do the work themselves. Clients stay with their service providers mostly because they are comfortable with them as people. If you are comfortable with your ultimate successor, it bodes well that your clients will be comfortable as well.
- **Continuity.** Clients have many choices for accountants or tax preparers. They chose to stay with you because of the personal chemistry you established and because they are comfortable with the manner in which you service them. Therefore, you must choose a successor as similar to you and your service policy as possible. Other continuity factors include location, fee structure, and the methods of servicing and billing clients. Specialty factors include language, ethnicity, politics, and gender. These cannot be ignored. We have seen deals turn sour due exclusively to these factors. One example is of a retiree who sold a 1040 tax practice to a large firm. For years, the seller had used the "one-step" process in which he conducted a client interview, completed the return while the client waited, and delivered the return on the spot after collecting his fee. The seller went to Florida and the new owners tried to follow his procedure. They altered it slightly, however, by not delivering the return on the same day, but mailing it out with a bill instead. Client retention suffered greatly.

Plan a Proper Transition. Don't close your deal and say, "Now what?" Plan in advance. Plan the name of the successor firm, write up an announcement letter, and decide how you will advertise the new affiliation. Be delicate while telling your clients that you are making changes to your practice. Be careful not to scare them. Here's what they'll be wondering:

- Will I still be dealing with the people I trust and who know my situation?
- Will my fees increase?
- Will I still be serviced in the same way I'm accustomed to?
- Will the new owner be relocating?

It takes time, care, and planning to achieve a proper transition. For most practices, the perception that the buyer and seller are working together can be one of the most important factors in the success of the transition. It's what will maximize the value and price of the sale or merger.

The key to any successful transition is getting the clients to feel comfortable with the successor. We strongly suggest that practitioners hold the deal out to their clients as a merger. In this way, the affiliation does not raise the clients' fear of losing the service provider they trust, but instead increases their security by adding professionals to help them meet their short-term and long-term needs.

Conclusion

There is an old saying that an attorney who represents himself has a fool for a client. In selling and merging, accountants and tax professionals should rely on professional help. Think about it. The decision to sell or merge your practice is an emotional one. There are no hard and fast rules regarding dollars or structure. Practices commonly sell for high prices, but are sold with a contingency aspect relating to client retention. Contingency payouts are not the norm in business and this predominant aspect of the sale of tax and accounting practices dramatically affects the nature of the deal and the focus of the parties involved.

Professional intermediaries help both parties focus on the right things and keep the process flowing. Time kills all deals, and having a good facilitator can be crucial.

Be sure the help you seek is from a person or firm that has experience specific to this field. As mentioned, the sale of these practices is different than the sale of almost any other type of business. If you have not had adequate personal experience in this area, you will likely forget to consider key aspects that protect both parties.

*Joel Sinkin is a partner in Accounting Transition Advisors, LLC. The firm services the accounting industry exclusively, providing merger and acquisition assistance to firms seeking to merge, acquire, or otherwise affiliate accounting practices and related enterprises. To date, Mr. Sinkin has facilitated over 700 successful closings of accounting affiliations, has published numerous articles in state and national professional publications, co-authored, with Max Krotman, the "bible" of the accounting affiliation field, *Buying and Merging CPA Firms*, published by PPC, and teaches CPE courses across the country. More importantly, his firm is now handling and creating numerous affiliations in the accounting industry in response to the needs of the current marketplace. Call corporate headquarters at 866.279.8550 to receive additional information, a free valuation of your practice, or an update on the current marketplace for buying, selling, and merging practices. You can reach Mr. Sinkin directly by e-mail at jsinkin@transitionadvisors.com or through the website of www.transitionadvisors.com.*

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