

Leaders' Edge

*The newsletter of The Michigan Association of
Certified Public Accountants*

March/April 2007

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Practice Management

Unique Approaches to Succession Planning for Accounting Practices

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As an accounting and tax professional, you advise your clients to plan years before they retire or sell their businesses. Yet, many accountants fail to take their own advice and wait too long to start the process of succession planning.

When do you start? The plan many practitioners have for their practice is to work full time until they don't or can't work any more and then sell it. It's black and white. Work or sell. However, by using alternative approaches to succession, practitioners can address long term succession now, continue to work full time and even create a better quality of life while not losing independence and control.

The first step in succession planning is to think about how many more years, or tax seasons, you desire to work full time.

Most practices have a significant amount of personal and business clients dealt with on a once-per-year basis. Some clients may have contact with the office or staff throughout the year, but are truly only seen in person once per year by a partner. This is important because if you are five years from cutting back your time in the practice, in reality, that is only five more visits for many clients. Two more years is only two more personal visits.

The key to a successful transition of your client base is to be personally involved as much as possible in the transition process. Why?

Your client base is built upon the fact that your clients like and trust you. Fees, location, manner of providing services, and other factors are important to the decision clients have made to hire and retain you. However, for most of your clients, their level of comfort with you, personally, is the most important factor.

The key to the success of any deal to transition your practice is client retention. Providing enough time for you to personally be involved with clients in the process of transferring the trust they place in you to your successor is vital to client retention. Sending a letter to your clients announcing your recent sale of the practice places much more stress on the relationship than a letter that announces your new firm affiliation, coupled with at least a couple of tax seasons, during which you personally introduce clients to your eventual successor.

Other factors to consider regarding when to start a succession plan are:

- The need for a major investment in technology,
- Expiring leases or the need to move,
- Staffing shortages or required replacements, and
- Other major operational issues.

Ideally you will find an affiliation with a firm or individual that will relieve you of the need to make a significant investment your practice, especially if you are only a few years away from cutting back. That firm should also be in a position to be your long-term successor.

How can you structure a deal whereby you retain income and control and create a succession plan at the same time? There are several ways to affiliate with your ultimate successor without becoming a junior partner in your own firm. One popular approach for a retirement-minded practitioner is to become a firm within your successor's firm. This is most effective when the two firms share space as well, although that is not mandatory.

For example, assume you have a firm generating \$500,000 in annual revenues before owner compensation of \$200,000. Further, assume you want to reduce your role over the next five years. The following is an approach that could meet all of your objectives:

- You create an affiliation with your successor firm that appears to the outside world to be a merger.
- You share space with the successor, accomplished through both firms moving into your existing space, the other firm's space or even new space.

Because you are able to continue the practice using the same amount of staff time (therefore, resulting in no increases in staff costs for your successor while you continue to work full time), you should be able to continue to earn the same level of compensation without the other firm suffering a loss. You should still be able to come and go as you please, remain "master of your domain," yet have back up, support, and gradually acquaint your clients and successor with each other. That is the most effective way to transition your client relationships.

This approach also acts as an insurance policy. If you have a short-term health problem, the successor is there to cover you. If you have a more serious health issue or worse, the succession and buyout can be accelerated and your estate and clients are protected.

Generally, overhead reductions become available to the successor firm due to eliminated cost redundancies such as rent, labor, software and other overhead items. There may be niches one or both firms have that the other did not, thus creating new income potential through cross selling additional services. These circumstances create an incentive for the other firm to accommodate you and maintain your level of income.

In the future, if you elect to reduce your time commitment to the practice, you generally would experience a pro rata reduction in your income.

Finally, when you reduce your time below a certain predetermined level (say 50 percent of full time) or at an agreed upon back date, the buyout payments commence.

The affiliation can take the form of a merger, a sale with continuing employment, an ongoing consulting agreement, or a practice continuation agreement. In every case, there are several key concepts for picking your successor and deal structure to consider:

- If you do not want to eat lunch with someone, they should not be your ultimate successor. In other words, make sure you enjoy being with your successor. This normally ensures your clients and staff will relate to them as well.
- Never do a deal that leaves the terms open, with intentions to work them out in the future. Agreeing to agree later is a bad plan.
- Use common sense regarding the economics. Buyers do not acquire practices to lose money and you need to be properly compensated for your years of sweat equity. There is no reason everyone cannot win when the deal is structured correctly.

If you have not planned in advance, all is not lost. You can still make a decent transition with little or no advance warning to the clients. However, planning in advance will help maximize the success of the transition and the value of your practice.

Dealing with internal succession plans for multi-partner firms.

Many multi-partner firms do not have a partnership agreement or any other form of succession plan. Some firms have succession plans but they aren't realistic. There are a couple of important items to consider if you are in a multi-partner firm:

Do the partners or managers you hope to promote to become your successor have the excess capacity to replace you? If a partner is working, for example, 2,300 hours and 60 percent is billable, do the professionals you expect to take over have the excess capacity or ability to pass down work so they can ultimately replace the 1,400 billable hours and important other tasks you are responsible for? If not, you have a serious problem and may need to plan to bring in more talent to strengthen your succession team. You may also need to consider an external solution to realistically create an effective succession.

Do you have several partners that are likely to retire or cut back close in time to each other? Can your internal succession team handle that load? A rule of thumb is it takes at least two partners to comfortably replace every partner that is leaving including new partners promoted for that purpose. Most partners already have a full plate. Even in situations where the numbers theoretically work, it can be a problem if the remaining partners can't step up to the added responsibility. Do you have a strategy in place to help clients become comfortable with the designated replacement for a retiring partner?

Valuing partner equity for purposes of an internal buy out is an important item. This is a complicated subject that can't be given full justice in this article. However, there are some basic concepts to consider. In order to have the proper incentive for the remaining partners, internal valuations should result in the remaining partners (who are similar to the "buyers" in an external deal) generating an increase, not a decrease, in their compensation when a senior partner retires. If the remaining partners of the firm determine they will lose money because of the buyout payments, it is difficult to get them to follow through with the plan. This can result in junior partners leaving the firm prior to the retirement or a failure to attract new partners to the firm through recruitment, promotions and mergers.

This is a foundation issue for any internal succession plan. Even if junior partners accept the challenge, an economically unsound plan can result in payment defaults as the remaining partners struggle to overcome the financial burden.

The basic approach to value in an internal succession is to remember it's not the price that matters as much as it is the terms. The five basic terms for any buy out or acquisition are:

1. The down payment,
2. The number of years payments are made,
3. The extent payments are tied to client retention,
4. The tax treatment and other factors affecting profitability for the buyer, and

5. The price, usually expressed as a multiple of revenues.

Start with how much total compensation the retiring partner currently draws from the practice, including perks, benefits and profit sharing. Subtract from that total, the additional cost of labor to replace the retiring partner. The remainder is what is available for buy out payments and upside for the remaining partners.

As an example, a partner receives a total compensation package of \$150,000. When that partner retires, the firm will have to hire someone (not necessarily another partner) to pick up the work being done by the retiring partner or to do the work passed down by junior partners who might be taking over the senior partner's role. Assume the total incremental cost of the replacement is \$70,000 per year. The package of buy out terms can be based on what percent of the \$80,000 remaining should go to the retiring partner for their equity and what should be left for the remaining partners and for how long.

Your practice may be one of your largest assets. Succession planning is difficult and can be a very emotional process. This may be the last and most important decision you make regarding your practice. It is often prudent to seek the assistance of professionals who have significant experience with succession of accounting practices.

The accounting industry is unique due to the importance of long-term client relationships. The most successful deals are structured very differently than sales of other businesses. When done correctly, succession will be a win/win deal for the retiring practitioner and the successor firm or partners.

About the Authors

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