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SUCCESSION PLANNING/M&As

Two-Stage Deals

A sequenced transition can smooth a firm's ownership transfer.

by Joel Sinkin and Terrence Putney

EXECUTIVE SUMMARY

■ **Although it's not the only way to go about** succession planning, a two-stage deal offers a transitioning CPA an opportunity to imbed a practice into a successor firm's infrastructure while maintaining a considerable amount of autonomy for an agreed-on period of time.

■ **Both firms negotiate the eventual transaction** contract just as in an immediate sale. The firms agree to the latest date when the sellers will reduce their time commitment to the firm and final payments will commence, usually within one to five years.

■ **Clients are served under the buyer's brand,** and the buyer hires any new employees. The transition looks just like a traditional merger to outside constituents. The buyer's payments are mostly or completely deferred until the contractual back-end date or a triggering event occurs.

■ **Transitioning owners earn similar income** as before if they dedicate comparable time and effort to the practice and fees remain steady. They also can avoid costly late-stage reinvestment in infrastructure.

■ **Most accounting practice sales** have contract contingencies that adjust the purchase price based on client retention. It is in both parties' interests to give clients and the successor an opportunity to get acclimated to each other before a trusted partner

■ **Two-stage deals bring successor** firms the benefits of both a straight acquisition and a traditional merger. Buyers delay investment in the acquisition until they assume complete control.

Joel Sinkin *has been involved in succession planning for accounting firms for more than 15 years.* ***Terrence Putney,*** *CPA, has been involved in many acquisitions of accounting and consulting firms as national M&A director with RSM McGladrey. Sinkin and Putney are the senior partners of Accounting Transition Advisors LLC and together have handled in excess of 700 mergers and acquisitions of accounting firms. Their e-mail addresses are jsinkin@transitionadvisors. com and tputney@transitionadvisors. com, respectively.*

How can you have your cake and eat it too? You aren't quite ready to retire, but you know you need to find a successor for your practice. You wonder how much accountability an owner firm will impose if you decide to merge. You worry about a change in culture, loss of identity and what your role in the new firm will be prior to your eventual exit. You want this settled. Consider a two-stage deal—primarily designed for the small accounting practice of one to three partners who want to reduce their time commitment over a one- to five-year period. It creates a flexible way to affiliate with a successor firm when internal succession is not an option. Retiring partners get to start the process, achieve some long-term goals and maintain some independence until they retire, while the successor firm benefits more than from a straight purchase or standard merger. Retiring partners get to start the process, achieve some long-term goals and maintain a measure of independence until they retire, while the successor firm benefits more than from a straight purchase or standard merger.

Step Out in Style

A "two-stage deal" handles succession in increments rather than all at once. Stage one is a contractual period during which a seller continues to work at the firm, retaining income and a level of autonomy. Stage two, which is activated by an agreed-on date or by a triggering event, is the buyout.

HOW DOES IT WORK?

Flexibility is the key to this type of transition strategy, and the parties to a two-stage deal can customize it to fit their goals. The idea is to imbed a transitioning firm's practice into the successor firm but allow exiting owners considerable autonomy for an agreed-on time period.

In stage one, a seller typically relocates into the buyer's office—the seller's practice becomes an infrastructure within the buyer's. The seller continues running his or her practice with no change in income or schedule. However, during this time clients gradually get to meet the new owner. That helps stabilize client retention and gives the buyer potential cross-selling opportunities while the seller reduces his or her role. Payments are deferred during stage one even though equity is transferred on the effective date of the deal. Stage two is the buyout—when the payments commence.

The sequence of a typical two-stage deal is as follows:

■ The firms work out all the terms in advance, just as in an immediate sale. Both parties put everything in writing and have a clear understanding of the purchase terms and the business plan.

■ The firms agree to the latest date (the back-end date) when the seller(s) will reduce their time commitment to the firm and buyout payments will commence. This is normally in the range of one to five years. Typically an agreement lets a seller accelerate the retirement date through triggers such as working fewer hours than a certain quota, giving notice, permanent disability or death, which triggers buyout payments to heirs.

■ The firms consummate their affiliation at the beginning of stage one. To outside constituents the transition looks just like a traditional merger. Clients are served under the buyer's brand, and the buyer hires new employees.

■ During stage one, selling owners manage their book of business much as they did before. Their income stays substantially the same if they put comparable time and effort into the practice and fees remain steady.

■ The buyer defers making most or all purchase payments for the equity until stage two, which is the earlier of a trigger or the contractual back-end date.

To make this type of arrangement successful, several considerations are important. For instance, because clients normally choose their accounting firm based on their comfort level with key members, personalities are important. Don't do a deal with someone you don't enjoy having lunch with. Location and fees are important, too, so choose a firm that will maintain a comparable experience for your clients. Agree on the roles of the individuals and the brand names that will be used—never agree to agree later.

BENEFITS FOR THE TRANSITIONING PRACTITIONER

The two-stage deal allows a CPA to find a successor and start the exit process before it becomes a necessity. The specific benefits of this approach for retiring owner(s) are

■ They can maintain their income level as long as their time commitments to the practice and the revenues from their clients remain steady.

■ It creates a safety net in the event of death, disability or the loss of key staff.

■ All details of the future transition are resolved for clients and staff.

■ Sellers can avoid costly late-stage reinvestment in infrastructure.

■ They can focus on client service instead of day-to-day firm management.

■ They can reduce the time spent working in the practice at a more flexible pace without jeopardizing the value of their business.

■ Because sellers now have back-up resources and can devote less time to administrative duties, they can focus on increasing the value of the practice.

■ Client retention is enhanced because the seller is still actively involved during the transition—and higher retention equals higher value.

BENEFITS FOR THE SUCCESSOR FIRM

Successor firms using two-stage deals get the benefit of both a straight acquisition and a traditional merger—that is

■ They do not make an investment in the acquisition until they assume complete control of the client list and the seller's compensation has been significantly reduced or eliminated.

■ The transition of client relationships to the buyer's care is enhanced by the seller's active involvement over an extended period, which provides a proper, supportive transition.

■ They get new revenue opportunities and additional profits from reduced overhead—one office suite, one technology infrastructure and one malpractice policy, for instance.

■ They don't have to replace the selling practitioner's production capacity immediately, which can be the acquired practice's largest resource.

■ They can begin to tap the seller's referral network, which often is extensive and therefore ripe with opportunity at this mature stage.

■ They gain the opportunity to cross-sell services to the seller's client list.

■ The date for the transition of control of the practice is already established.

MASTER OF YOUR DOMAIN: A POTENTIAL CLASH IN CULTURES

Fear of loss of autonomy and income are the primary reasons retirement-minded practitioners in small firms often procrastinate until they are ready to retire for good. Although they know they need to address succession issues soon—and that clients and employees would benefit from their active involvement in the process—they are reluctant to give up being master of their domain. They are set in their approach to managing, accustomed to working on their own schedule, and unwilling to embrace a dramatically different role. In a typical merger, they would be right—the successor firm would expect all partners to adhere to its policies. That's exactly why a two-stage deal can work better.

Another area of concern for transitioning practitioners is that a traditional acquisition—structured to create a return on investment for the buyer—can result in reduced income even if the hours worked remain the same. But a two-stage deal enables the successor firm to defer most or all of its investment in the acquisition, so it doesn't have to demand an immediate return.

THE CASE FOR NOW RATHER THAN LATER

Retiring practitioners also recognize the need to properly transition the client base. Most clients don't have a yardstick by which to measure their accountant's level of competency or skill. They remain loyal out of affection and trust. That trust must be transferred from the seller to the buyer, and the seller plays a critical role in making that happen. Trust is earned through a track record of experience, and transferring it is a process that can take months or even years.

Small firms meet personally with clients remarkably infrequently. Business clients may mail in or drop off work and sit down with the partners only at tax season—that once-a-year meeting is not uncommon. So when partners are five years from retiring from the firm or reducing their time commitment, that may turn out to be only five visits with some clients. A two-stage deal takes full advantage of those five encounters.

Most accounting practice sales have contract contingencies that adjust the purchase price based on client retention after closing. It is clearly in both parties' interests to give clients and the successor the opportunity to become acclimated to each other before a trusted partner retires. That way the seller is still available to assist in completing the transition.

The risks and challenges of accounting practice combinations are unique, so consider hiring a professional who has experience with acquisitions and mergers.

TWO-STAGE EXAMPLES

ABC, a two-partner firm generating $1.2 million in annual fees, recently sought assistance in developing a succession plan. The partners were each three years from retirement and were devoting 2,200 hours per year to the practice. One was about 70% chargeable, and the other was 55% chargeable, owing to a greater practice management role. Including all perks, benefits, salary and profit distribution, the partners were netting 36% of their gross.

They were introduced to several potential buyers. ABC narrowed the choice based on the chemistry between it and firm XYZ's similarities in fee structure, service approach and location.

Under the negotiated deal, ABC moved into XYZ's offices, but the retiring partners maintained their existing entity, into which their compensation was paid and in which they were the only remaining employees. (In most deals, professional staff is retained at least initially, but keeping clerical/secretarial staff is based on need.) During stage one the two retiring partners were paid 36% of the gross collections received from their original clients. Each retiring partner could reduce the time commitment to the firm and accept a pro rata reduction in income at any time. The death or permanent disability of a partner or a reduction in work hours below 50% of past efforts would trigger the buyout of that partner. If neither occurred, the buyout would take place 36 months from the effective date.

The deal was publicized as a merger, and all client billings moved to the XYZ firm name. Over the next three years each partner introduced his or her clients to the partners who would ultimately assume control of the account.

The retiring practitioners were motivated to make the transition in this form because it let them keep control over their book of business, allowed them to come and go as they saw fit and let them continue to manage their clients. Their practice and estate were protected in the event either partner died or became disabled. Their clients did not lose a CPA but rather gained back-up, support and expertise from the newly combined firm.

The partners kept their income whole while they remained fully committed to the practice. Because payments were made to their preexisting entity, they continued to incur perks and benefits and maintain existing retirement accounts. There was no need to adapt to the successor firm's plans and policies. The deal let them feel they had maximized their firm's value.

The successor firm saw the following advantages: The "merger" eliminated many overhead redundancies, including staff, software and other technology, and rent. ABC, with its different list, provided additional services and generated additional revenues. Its clients were willing to refer business to the larger XYZ firm, and the transitioning partners' contacts referred business the sellers would not have obtained before the merger. The full transition would occur relatively soon—by the end of the third year at the latest. XYZ executed an excellent transitional strategy and retained virtually all the ABC clients.

In the two years since this deal closed, XYZ hasn't lost a single business client to another local firm and has maintained the same retention rate of 1040 clients as the sellers had prior to the transition.

Note: Drawbacks to a deal of this nature are limited, but they do exist. For the selling firm that seeks succession,

■ It can be very difficult to go from an environment in which you have no accountability to one where you do, even if it is far less than in a traditional buyout.

■ In most cases, the seller gives up a brand, location and sometimes even staff. Those changes can make the transition more emotionally and professionally charged.

■ In the unlikely event a deal needs to be unwound, the seller may have significant needs in relocating.

For the successor firm, the possible downside is

Whenever you add additional personalities under one roof, there is always the potential for friction.

- If the successor firm retains staff whose compensation is different from their existing staff in a similar role, conflicts can occur.

- If there are few cross-selling opportunities or savings from trimming overhead redundancies, stage one may not offer much financial reward.

» Practical Tips

Because clients normally choose an accounting firm based on their comfort level with key members, personalities are important. Don't do a deal with someone you don't enjoy having lunch with.

Location and fees are important. Choose a firm that will maintain a comparable experience for your clients.

Work out all the terms in advance and put everything in writing. Agree on the roles of the individuals and the brand names that will be used. Never agree to agree later.

Consider hiring a professional who has experience with acquisitions and mergers. The risks and challenges of accounting practice combinations are unique.

In another case study, sole practitioner John Smith, who had $150,000 in annual fees and wanted to retire in four years, structured a similar two-stage deal. Smith's clients were predominantly monthly and quarterly and required a lot of handholding. For the first year, a member of the successor firm went with Smith on 25% of his client visits. The second year Smith reduced his hours by 20% and accepted pro rata reductions in his income as the new partners became even more involved with his clients. In the third year Smith reduced his time another 20% and the transition picked up steam.

Smith was so comfortable that his clients were well transitioned that he elected to retire after year three. Eight years later the successor firm has retained more than 90% of Smith's clients who still have viable businesses, fees have gone up and those clients have been a fruitful referral base.

Although it's not the only way to go about succession planning, a two-stage deal shows how a compromise between a merger and a straight sale can give selling practitioners more control and input during a retirement transition, and make firms that use acquisitions as a part of an expansion strategy more attractive to sellers. It's win-win for them—and for their clients.

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Dear Mr. Sinkin:

It gives me great pleasure to tell you that your article, Two-Stage Deals, co-written with Terrence Putney, which appeared in the March 2006 issue of the *Journal of Accountancy, was* highly praised *by our* Board *of* Editorial Advisers.

The Board of Editorial Advisers, which evaluates our articles, consists of more than 50 CPAs who represent all segments of the profession. Each month they read and numerically rate every article in the *Journal,* and we tabulate the results.

We thought you would like to know how well your work was received. Thank you for doing such a superb job and I hope you will write for us again.

With all good wishes,

Colleen Katz
PublisherlEditor-in-Chief

cc: Terrence Putney CPA

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