

Bridging Compensation Gaps in a Merger

Achieve success by reconciling firms' different pay and perks.

by Joel Sinkin and Chris Frederiksen, CPA



Accounting-firm mergers must overcome numerous obstacles. One of the most common—and challenging—involves compensation and benefits for partners and staff. Merging firms usually have differences in compensation levels, compensation methods and benefits packages. It's crucial for staff and partner retention that the merging firms combine the varying systems into one without people feeling like they came out losers.

Any merger or acquisition must address two major constituencies: clients and personnel. Generally, failure to retain a high percentage of either clients or personnel (or both) will result in a failed merger.

Firms contemplating a merger must understand the connection between staff and partner retention and client retention. Accounting firms are, for the most part, in a relationship business. The differentiation among firms comes in the relationships clients have with the people at the firm. If you have high staff and partner turnover, you likely will experience unexpected client attrition—a mortal blow to a merger.

To avoid this, merging firms must address potential compensation and benefits problems. Pay and perks might not be the most important factors in employee satisfaction, but they cannot be ignored. You will lose employees if they feel they are underpaid and that they have other employment options.

Here are two examples showing ways to successfully navigate situations where compensation and benefits differences could trip up a merger. In both scenarios, the three C's of M&A—culture, chemistry and communication—play a key role.

CASE STUDY I

Black & Co., a CPA firm with six partners and \$5 million in annual billings, is merging with White & Co., which has two partners and annual billings of \$1.6 million. Black & Co. is the successor firm in the merger and expects to shift all White & Co. personnel to its policies.

The firms must bridge major gaps in compensation and benefits. Black & Co.'s

their compensation package would not squeeze the combined firm's margin because White & Co.'s margin already reflects these costs. Second, Black & Co. should come up with a plan to keep White & Co.'s seniors long enough to determine if they can meet Black & Co.'s performance expectations for managers.

Here are two approaches that could work:

Option 1. Promote the White & Co. seniors to manager and maintain their current compensation. Keeping them as seniors at their current pay could cause resentment with Black & Co.'s seniors. If, after 12 months or so, White & Co.'s seniors can't cut it as managers, Black & Co. could terminate or demote them with far less risk that the changes would lead to client problems or attrition. The most like-

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seven senior staff members have three to six years' experience and earn between \$65,000 and \$85,000 a year. White & Co.'s two senior staff have 10 years' experience and earn \$110,000 a year. Black & Co. allows employees with more than five years' experience three weeks of paid time off; White & Co.'s two seniors are allotted four vacation weeks. Finally, Black & Co. requires all employees to pay half of their health insurance premiums; White & Co. pays 100% of its employees' premiums.

The compensation package that White & Co.'s seniors enjoy is comparable to that of Black & Co.'s managers. Black & Co. isn't sure White & Co.'s seniors are as strong as Black & Co.'s managers. But any plan that would slash the compensation of White & Co.'s seniors could prompt them to leave the merged firm—a potential disaster because the White & Co. seniors have major client responsibilities.

How should Black & Co.'s leaders handle the situation? First, keeping the White & Co. employees whole in

ly time for a client to leave after a merger is before he or she becomes familiar with the new firm and its people.

There is risk with this approach. If the White & Co. seniors can't perform at the level required of Black & Co.'s managers, promoting White & Co.'s seniors could lead to problems such as poor client service and failure to comply with professional standards. This likely would result in lower staff morale, disputes with dissatisfied clients and extra costs. To help avoid this, Black & Co. should establish enhanced supervision for these new managers until the firm is confident in their capabilities.

Option 2. Another option would be to keep the White & Co. seniors at the same level and pay, despite the difference in compensation with the Black & Co. seniors. To avoid resentment among the Black & Co. seniors, firm management would need to inform the White & Co. seniors of the normal pay ranges for seniors and managers in the combined firm and challenge the White & Co. seniors to strive for



manager level to justify their compensation. If these seniors cannot develop their skills in a year or so to earn promotion to manager, the firm would need to terminate

them or cut their pay.

In either scenario, Black & Co. must address the differences in benefits between its employees and those of White

& Co. For example, Black & Co. should eliminate the extra vacation and superior health benefits of the White & Co. seniors to bring them in line with Black &

Other Post-Merger Issues

Besides compensation, several other areas can cause post-merger stress. They should be covered in detail in the merger agreement.

Client transition. In Case Study 2, it is assumed that the retiring managing partner will transition his clients during his three-year tenure with the new firm. But what if he doesn't, or he doesn't do so in a reasonable time frame? (We had one retiring partner wait until the last day!)

The solution is to spell out a detailed transition process in the merger agreement. The document should incorporate a client list with the names of the new partner and manager in charge of each account and the date by which the account will be transferred. The merged firm also should establish compliance incentives for the retiring partner (for example, no pay reduction despite the loss of personal chargeable time) or, if need be, penalties for non-compliance (for example, reduction of retirement pay if clients are lost due to a late transition).

Advising clients. There usually is an assumption that the post-merger firm will advise both firms' clients about the transaction. The merger agreement should state exactly how this will happen. Identify which clients will be informed by letter, which ones will receive a personal phone call, and which ones will require an on-site visit. Also, specify the time frame for completing each task.

"Catch-up" and "fix-it." Merger agreements should deal with what happens if one of the prior firms has uncompleted (catch-up) or deficient (fix-it) work that the successor firm must handle. If, at the time of the merger or acquisition, there is uncompleted work for which one of the prior firms was paid—for example, under a retainer or fixed-fee

arrangement—the successor firm would do the work at full rates and charge the prior firm. Subsequent to the merger, it might come to light that work performed by one of the prior firms is deficient and needs to be redone. To the extent that this is not billable to the client in question (and it seldom is), the successor firm would do the necessary re-work and charge the appropriate party.

Perquisites or "perks." Partners usually go into a merger assuming they will enjoy the same perks they did before, but as shown in Case Study 2, this isn't always the case. It's important to document what will happen with perks. Here are a few perks that merging firms should consider, define and resolve to everyone's satisfaction:

- Payment for CPE (how many hours, travel restrictions, etc.)
- Payment for travel to clients
- Payment for entertainment expenses
- Size and location of personal offices
- Secretarial support
- Furniture and furnishings
- Timesheet assistance
- Billing assistance
- Collection assistance
- Staff assignments
- Parking
- Office hours
- Working-late arrangements
- Evening meals in tax season

Note: See how post-merger problems can wreck a merger. Go to this article on journalofaccountancy.com to read an online-only case study. Enter 20114438 in the search box to find the article.

EXECUTIVE SUMMARY

■ **One of the biggest challenges in retaining partners and staff in a merger** is reconciling differences in pay and benefits offered by the merging firms. Partners and staff who feel like the merger is hurting them financially are much more likely to quit the combined firm.

■ **Merging firms must understand that the retention of part-**

ners and staff plays a crucial role in preventing client attrition. The accounting business largely is built on the relationships between firm personnel and their clients.

■ **Firms should deal with potential compensation complications** in the merger agreement. The document should provide details and deadlines for how pay and benefits will be

handled in the new firm.

■ **Culture, chemistry and communication** are essential ingredients in a successful merger. When they combine those with collaboration and creativity, firms usually can reconcile compensation and benefits differences.

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Co.'s policies. At the same time, Black & Co. should increase those seniors' cash compensation to make up for the lost week of paid time off and the lower health insurance subsidy. This is a small price to pay to avoid asking White & Co.'s seniors to take a step back in compensation.

Generally, flexibility on the above issues is a small matter considering the stakes: either not completing a merger that both firms want or completing the merger and having it be less successful than it could have been.

CASE STUDY 2

Green & Co. is a three-shareholder firm merging into Brown & Co., a 15-partner firm. The managing shareholder of Green & Co. is retiring in three years. The other two shareholders are staying on for at least 10 years. Green & Co.'s shareholders liberally run expenses for cars, club dues, lavish trips for CPE, full-family health insurance premiums, cellphones, home computers and other items through the firm as a benefit for themselves. Green & Co.'s managing shareholder takes off about 12 weeks per year to stay at a vacation home, where he works occasionally.

Brown & Co.'s partners enjoy virtually none of the same benefits and are limited by policy to four weeks of vacation per year. Green & Co. is a corporation and, therefore, pays its shareholders as employees, while Brown & Co. is a partnership, so its partners have to pay their own self-employment taxes and other benefits.

Clearly, there are major differences in the two firms' cultures, as evidenced by their approaches to shareholder benefits. This raises a key question: Would the two partners of Green & Co. planning to stay on long term be able to adjust to Brown & Co.'s culture and live with the firm's policies? If the answer is "no" or a grudging "yes," the merger likely would fail. If the answer is a categorical "yes," the odds would favor the firms' reconciling the issues of compensation and benefits to everyone's satisfaction.

■ The first step in the reconciliation process is to determine the effective in-

come of each partner or partner-to-be by adding back to reported income the value of all benefits and perks. Comparing compensation on this apples-to-apples basis is important in assessing the firms' compatibility.

- Assuming the net incomes per partner are reasonably similar, or that the differences are manageable, a successor firm such as Brown & Co. usually would guarantee the new partners' compensation for one or two years following the merger, provided they maintained their fee volumes and personal productivity.
- In this case study, the Green & Co. shareholders have been together a long time, so they would have devised their own methods for allocating compensation. Further, it would be challenging for the Brown & Co. partners to assess each of their new partners' worth in the initial stages. Therefore, it would be quite common for Brown & Co. to allocate a "block" of income to the new partners and let them determine how to divide it among themselves.
- The ex-managing shareholder of Green & Co. might come under the same arrangement, but because the objective for him is to cut back and transfer responsibilities to others, his pay is more likely to be set either as a formula based on how well these goals are met or as a fixed amount. Brown & Co. should tolerate his liberal time off during the three-year period leading up to his retirement, as long as the effect on the combined firm's profitability can be calculated and any negative variance leads to an adjustment in his compensation.
- The other two new partners of Brown & Co. would become part of the firm's normal partner compensation system after the guarantee period, or they might opt to do so sooner if it is to their benefit.
- The Green & Co. shareholders are used to operating under a corporate structure. They might find it advantageous from a tax standpoint to set up individual corporations to become the partners in the merged firm. This would allow them the

option of continuing their various corporate deductions.

As shown in the above examples, differences in compensation and benefits can be major obstacles for mergers, but firms can clear those hurdles through a combination of creativity and collaboration. ❖

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- "Traps for the Unwary in CPA Firm Mergers and Acquisitions," Aug. 2011, page 36
- "Accounting Firm M&As: A Market Update," Nov. 2010, page 30
- "Mergers & Acquisitions of CPA Firms," March 2009, page 58, and "Keeping It Together," April 2009, page 24 (two-part article)

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