

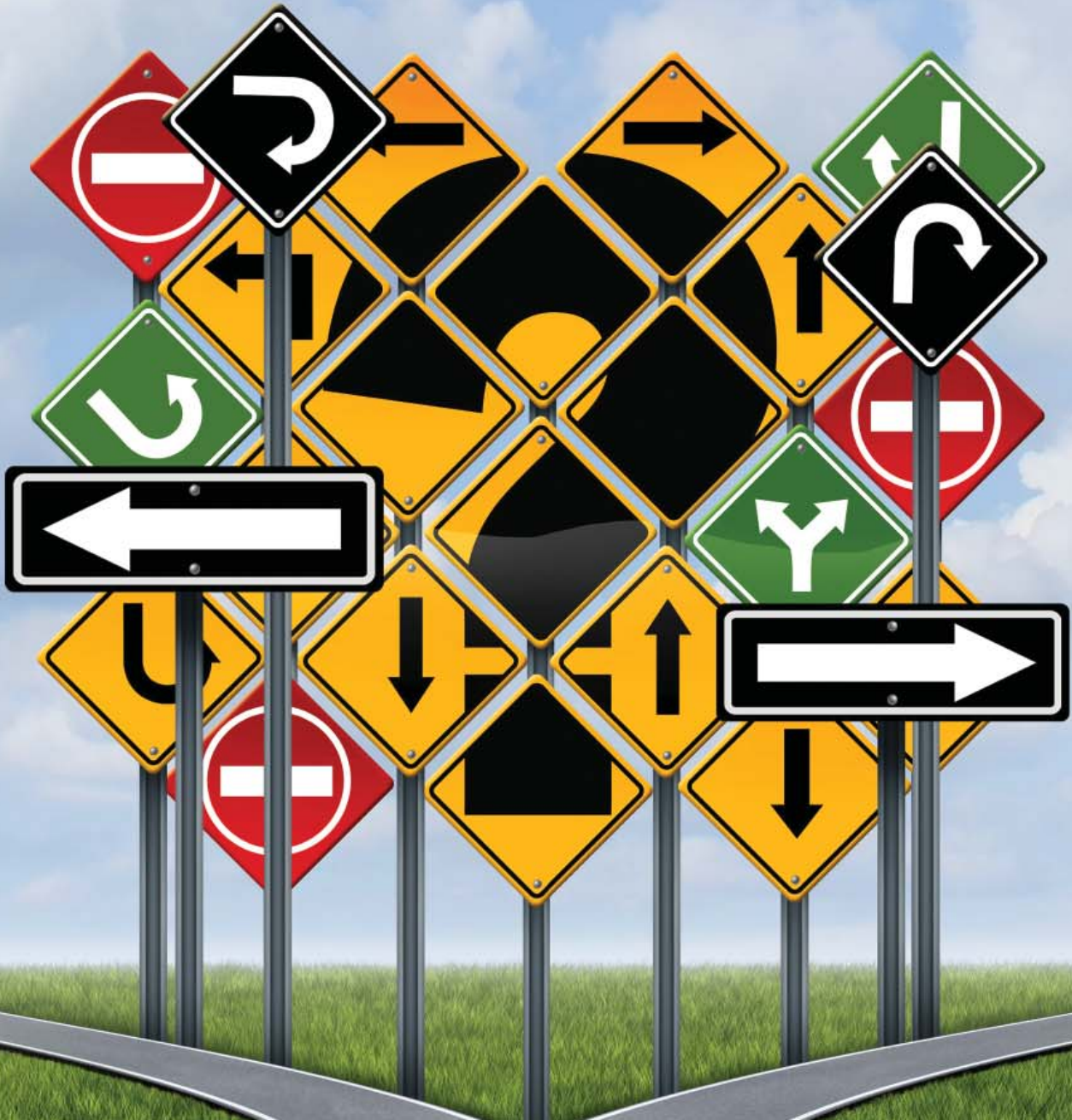
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## Exit Strategies for Owners of CPA Firms

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**If you are an owner of a small- to medium-sized CPA firm, the demographics say you are going to reach normal retirement age within the next 10 years. If you don't personally fall into that group, and you have partners, there is a good chance at least one of them will be retiring at some point over the next decade. The AIC-PA estimates that about 70 percent of CPA firm owners in the United States are, or will become, 65 years old by 2025.**

So, what are your options when you decide to finally hang it up? This article explores the pros and cons of various exit strategies you may consider. There are four general categories of how to relinquish ownership of your firm:

- Turn out the lights
- Selling
- Merging upstream
- Internal succession

**Turn Out the Lights** – With this option, your practice's existence is tied directly to you. It means either working your practice until your health won't allow it any longer or until the practice withers away to nothing through attrition. Some practitioners can never justify going through the changes required of a sale or merger, so they don't. Surveys indicate about 18 percent of all practitioners intend to go out in this fashion.

The biggest advantage to turning out the lights is you stay in total control of how much, for whom, and how you work to the end. Some practitioners have told us, "If I just work three more years, I can make the same money a six-year payout will generate if I sell." They are right, based strictly on the math. The key difference is that when you sell you are paid for not working. Of course, if you never want to stop working you won't be motivated by post-work payments.

There are several significant disadvantages to turning out the lights. One is that you are letting an asset with significant value, your practice, fade away. You will also inevitably bur-

den your family with what to do with your practice once you can no longer manage it. Even with a practice continuation agreement, which is highly recommended if you are going this route, the end will be messy and your spouse may have no idea what to do. Finally, you might conclude that your clients deserve a better transition than receiving a letter from someone they don't know that you are suddenly not able to practice any longer.

**Selling** – For many practitioners, when they think of selling they imagine an abrupt change in control. Yes, if you wait until you are ready to hang it up to seek a sale that is what will happen. You'll inform your clients of what firm is your successor, and you'll familiarize the firm with your client list and employees. You might keep working part-time at a vastly reduced level of compensation, or no compensation, in addition to the sales proceeds. But it doesn't have to be so abrupt, and it shouldn't be.

The value of your practice is based on client retention, so an abrupt change in your clients' trusted advisor can be risky. We have found that in some cases immediate sales can create an ineffective transition because the clients are asked to make a decision about the new firm with no warning. Clients that already have your replacement in mind may not give your successor a chance. Some surveys have found as much as 35 percent of clients know where they will go when their CPA is no longer practicing.

Don't let the fear of giving up control, losing compensation, or the additional accountability you assume will be the result of selling dictate the potentially negative consequences of an abrupt sale. There is a more effective way to transition your client base. A buyer's expectation of the fees they can retain after you are no longer involved drive the value of a sale. If you are lucky enough, you might find a buyer who has an estimate of what portion of your clients they will retain and fix the price at closing. However, other firms are likely to make the deal contingent on actual retention. This technique, a two-stage deal, often works better for both the seller and the buyer.

The key to this tactic is allowing at least a year during which the seller remains involved in the practice on a mostly full-time basis. This allows the seller to gradually acclimate clients to the successor firm with the seller's support and participation. This leads to much higher retention and, therefore, maximum practice value. The longer a seller can stay involved the better. A two- or three-year transition stage is ideal.

As an example, stage one of a two-stage deal might last three years. The seller might move into the buyer's offices, although that is not always the case. The buyer will take over responsibility for all overhead, including hiring the seller's employees. The seller's practice will be operated under the buyer's brand, and the clients become the buyer's clients. The key, though, is to keep the seller as the go-to person for the clients and to minimize or gradually introduce changes to the way clients are served. This arrangement is held out as a merger. The seller then gradually weans the clients and introduces them to a successor go-to person. The goal is to make the day the seller really retires or goes into a part-time role a nonevent for clients.

The seller's compensation is kept whole, so long as his or her time commitment remains the same and the revenues remain steady. For instance, compensation might be defined as

a set percent of collections from the sellers' clients, with the requirement that no additional staff resources over what was historically used by the seller is required after the merger. Purchase payments are delayed until stage two because the buyer cannot be expected to keep the seller whole in income and pay for the practice at the same time.

There are several significant advantages to this approach. During stage one, the seller has the backup and support a larger firm can offer, leading to better service for the seller's clients. The arrangement also acts like a practice continuation agreement; in the event the seller can't continue working as planned, stage one is terminated and stage two is accelerated. The seller not only retains reasonable control of the practice, but the buyer also is not burdened with replacing the seller all at once. The result is usually maximum client retention, enhanced value for the seller, and a much better outcome for the buyer.<sup>1</sup>

**Merging Upstream** – An upstream merger into a larger firm is also an effective tool to manage succession. The advantages of an upstream merger are generally the same as a two-stage deal. However, keep these things in mind about upstream mergers:

- This is normally a relevant strategy when the acquired partners are at least five years, and usually longer, from seeking succession. It won't make sense to either side to bring in new equity partners that are short-term.
- The acquiring firm's owner agreement will dictate the value of the acquired partner's ownership interests.
- If some of the partners in the acquired firm are seeking to retire sooner than five years, consider a two-stage deal for their portion of the practice while merging in the long-term partners.

**Internal Succession** – Many firms, even sole proprietors, have a preference for an internal buyout over an external solution. They imagine maintaining total control and creating little change for themselves and their clients while still getting paid for their buyout on their terms and timetable. While some of these are worthwhile objectives, consider these realities. For sole practitioners and many small firms, affording a partner-level person on the payroll who is waiting to buy you out can be daunting. Complicating matters further, the greatest commodity right now in public accounting is young talent with a book of business willing to give up their independence to join a firm and wait for their opportunity to buy. A slightly less challenging solution is young talent without a book of business. Of course, with no book of business, you have to reduce your income to hire them in most situations.

Two things are required for successful internal succession: a strong transition of a retiring owner's responsibilities and clients to an internal successor, and the right financial arrangement.

Replace the role, not just the body. For instance, if a retiring

partner has special skills or licensing, you need to replace those. If you don't replace the key roles a retiring partner plays, any assumption you make about client retention and the value of that partner's ownership interest is not realistic. One area where firms consistently fall short is practice develop-

ment. Typically, retiring partners are the best at new business development, and in a firm's rush to replace the retiree they ignore the fact that new partners, and often some of

the remaining partners, don't have the same capability. A failure to bring in a steady stream of new business, at least at the rate necessary to offset natural attrition, eventually will lead to failure.

When a partner retires, make sure the firm has the capacity to pick up the workload. Whoever will be stepping into the retiring partner shoes already is working full-time. This seems obvious, but you would be surprised at how often the group agrees that they can replace a retiring partner by spreading the work around, but individually each partner admits that he or she is already at capacity. Be sure to assign a specific successor for every client, and confirm that he or she is ready and able to take on that added responsibility. Also, be sure you replace the retiring partner's overall productive capacity, though it doesn't necessarily have to be partner-level production.

A big fear among young partners is that partner retirement obligations will create too much of a financial hardship. If the obligation to a retired partner is not self-funding, the only two ways it can be satisfied are to borrow or reduce compensation for the remaining partners. There is no reason this should ever be the outcome. Use the following litmus test to make sure a buyout is structured correctly. Start with the retiring partner's compensation. That is the capital you have to fund the buyout. Subtract the cost of replacing the labor. For instance, if they produce \$300,000 per year on their own time, the replacement labor might cost 40 percent of that. Then subtract the an-

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nual buyout payments. Enough should be left over that the remaining partners feel motivated to take on the obligation and the extra responsibilities. If you don't get a satisfactory result, consider lengthening the payment term or reducing the overall obligation.<sup>2</sup>

### Valuation of an Accounting Firm

When we are asked "What are accounting firms going for these days?", invariably the question refers to a multiple of revenues. One-time revenue? More or less than one time? The value of a firm, however, is determined by a whole package of terms. Is there a down payment? Will the seller be paid over time, and will those payments be tied to client retention? How will the payments be treated for tax purposes? The way these terms are worked out in any deal depends on the parties involved, the market the seller operates in, the size of the seller firm, and the nature of the practice. However, keep these three truisms in mind:

- The lower the down payment, the longer the term for paying the seller, the more the price is dependent on retention, and the more favorable the tax treatment is for the buyer, the more likely the multiple will be higher. The opposite is also true.
- The less profitable a practice will be in the hands of a buyer, the lower the multiple will tend to be.
- Because of the economics of supply and demand, the higher the demand for a practice, the higher the value will tend to be.

The second point can be in reference to the seller's historical profit margins. For instance, if the practice has low fees, the seller's profit margin may be low, and most buyers will discount the multiple. It is hard to expect a buyer to pay 20 percent a year for five years for a practice with a 20 percent profit margin. However, low profitability in the hands of the buyer can also be due to costs the buyer is required to assume that will hold down profits. If the buyer is required to assume a long-term lease for an office they don't need, the buyer may factor that cost in by of-


fering a lower multiple. Another factor may be personnel the seller requires to be retained who are paid in excess of market rates and are unnecessary.

As a result of the third point, the smaller the market the seller operates in, the less valuable the practice will tend to be because there will be fewer relevant buyers. For the same reason, the larger the practice, the lower the multiple tends to be. If there are a certain number of firms that are potential buyers for a \$3 million practice, there might be five times as many relevant firms for a \$750,000 practice. The smaller practice may fetch a higher multiple. Highly specialized practices also tend to attract less demand and can go for lower multiples, though this may seem counterintuitive.

### Planning Succession

There are two critical considerations any exit plan should start with. Are your clients brand-loyal or partner-loyal? And how often do you personally interact with your clients? Brand-loyal clients typically take less time to transition than partner-loyal clients. Very large firms tend to have brand-loyal clients. Partners responsible for brand-loyal client relationships may require less time to transition than partners with mostly partner-loyal clients. A rule of thumb is that a partner-loyal client base takes two to three years on average to properly transition. Firm-loyal client bases are not at risk to the same extent.

The key to a proper transition of clients is for the retiring partner to be actively involved in the process. This is best done as a part of the regular client service. Over time, a retiring partner can back away and a successor can ease in with the full support of the retiring partner. If a partner only has one significant personal interaction with a client annually, three years means only three opportunities to personally make the transition happen.

A niche practice or special technical skills can require substantial training and licenses, which may require a longer lead time for a transition. If you are looking for an external solution through a sale or merger, a specialty practice may also require a longer time to locate the right buyer. It may be prudent to start the process as many as five years before the planned retirement date. 

<sup>1</sup> For more on two-stage deals, see "A Two-Stage Solution to Succession Procrastination," *Journal of Accountancy*, October 2013.

<sup>2</sup> For more on internal succession, see "How to Price an Owner's Interest in a CPA Firm," *Journal of Accountancy*, December 2014.

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