

Replacing Retiring Partners

Succession Planning in Today's Economy

By Terrence Putney and Joel Sinkin

The gap between accounting firm owners' need for successors and the available pool of partner-level talent will continue to widen due to demographic changes as baby boomers age and retire to be replaced by a smaller cohort. This is probably the single most important long-term issue facing small and medium-sized firms. Many of the mergers occurring in today's market are driven by firms' inability to find successors for their partners internally.

Ideally, partner succession should be addressed when a business venture is first formed. A shocking number of firms do not have an adequate shareholders' or partnership agreement that dictates how ownership will transfer due to the retirement or termination of firm owners. Many agreements in place are incomplete. Even firms that have complete agreements often have no processes in place to create new partners who can take over for owners who retire, rendering the agreements moot.

A complete partnership/shareholder agreement should include, at a minimum, the following:

- Value and payment terms for tangible equity/capital (hard assets, receivables, net of liabilities)
- Value and payment terms for intangible equity or retirement benefits
- Tax treatment of payments
- Effect, if any, on payments due to post-retirement client retention
- Mandatory retirement age, if any
- Post-retirement restrictive covenants
- Post-retirement opportunity for owners to continue working
- Adjustment in payments due to contraction of the firm (i.e., cash flow safety net)
- Treatment for death, disability, retirement, and non-retirement-driven voluntary and involuntary terminations

- Pre-funding vehicles such as insurance and qualified or nonqualified plan contributions

Just as important as the financial and legal structure of dealing with partner succession is a firm's ability to replace

personal interaction is a key to the relationship that partner has with the clients and must be respected to maximize client retention following a transition. The less often a partner interacts with clients, the earlier the process should start (which might seem counterin-



retiring partners with new partners who can 1) fill the roles the exiting partners were responsible for in order to maintain client service and growth; and 2) pay the retiring partners off. If a firm has not admitted a new partner internally in the past 10 years, it may be missing the processes and culture necessary to create replacement partners when they are needed.

One important step in determining when to start the transition process for a partner is being aware of how many more tax seasons remain before a partner plans to reduce his role in the firm. The next step is to consider the frequency with which that partner interacts with clients in person. This

tuitive). If a partner traditionally sees clients only once per year in person, three years equates to only three visits. Because a transition of a client relationship is best handled by the existing partner in charge of the relationship, and ideally in person, three years in advance of retirement may be the best time to start the process. Conversely, the more frequent the personal interaction between a partner and her client base, the less calendar time will be required for an effective transition.

Preparing for Succession

The following are the critical factors in determining if a firm can replace partners as they retire or otherwise leave:

The most common reason for mergers

is to deal with partner succession. Choosing the “right” firm to merge into or sell to is critical

Excess capacity. In order to be able to handle the succession of a partner internally, additional capacity must already exist or be created. If a partner is generating 1,200 chargeable hours and another 1,200 hours of administrative and practice development hours, that time must be replaced, or the firm will lose productivity when that partner retires. If existing partners step into the role, the chargeable hours won’t be replaced unless the remaining partners generate more chargeable time, something they are often unwilling to do. Sometimes lower-level staff can be passed down what was partner-level work. If so, productive capacity can be created at a lower level—even at a senior or supervisor level.

Ideally, when a partner retires, a firm has the opportunity to promote a new partner from within the manager ranks. If a firm does not have excess capacity at the partner level and cannot promote a new partner from within, it may limp by, but it signals that the firm “as is” cannot handle partner succession internally. The earlier this is recognized the better, because fixing it takes an enormous commitment on the part of the firm, culturally and financially.

Role of the retiring partner. A retiring partner cannot simply be replaced by anybody—a replacement must be able to fill the same role. If a retiring partner handles a significant amount of administrative duties, for example, he should not be replaced by a rainmaker or partner who focuses on managing a large book of business or generating above-average billable hours. A partner bringing in a lot of new clients or generating significant billable hours is likely better off remaining in that role.

Special expertise. A firm must also consider the niches, special expertise, multilingual capabilities, and licenses a retiring partner has in order to continue serving the same clients. This may seem obvious, but failure to take it into account has caused problems for some firms. For example, several years ago a New Jersey firm had a partner who was an RMA (registered municipality accountant, a credential

that they forgot the special certification needed to be replaced, and the firm’s municipal work was lost.

Succession Options

What options does a firm have for replacing retiring partners?

Developing talent internally. Most successful firms sustain themselves over the long run by developing a deep roster of talented professionals. The following things are required to create successors internally:

- Recognizing and obtaining talent
- Retaining talent by creating an environment that is financially and professionally rewarding
- Development programs that create associates ready to become owners
- Offering the opportunity for staff to become owners not only when a partner leaves, but also when the firm grows—most talent won’t wait forever for partners to leave to have their opportunity.

Admittedly, having all of these processes in place is harder for a small firm than a large one. Hence, many small firms are not well-positioned to promote from within to replace retiring partners.

Lateral hires of partner-level talent. The short-term answer for some firms is to find a ready-made solution by hiring the talent that can replace a retiring partner. This can be an experienced manager or even a former partner at another firm. Often, professionals looking for a different type of career experience can be attracted to an opportunity to become an owner in a new firm shortly after joining. There are, however, disadvantages to this approach:

- This type of talent can be hard to find.
- Persons with partner-level talent can be expensive; even if the person is capable of being a partner almost immediately, they often won’t have the book of business that normally creates the necessary profit until a partner leaves. This can lead to a one- to two-year period when the firm is required to pay for excess partner-level talent.

■ Some people have an idealistic conception of what it is like to work in a smaller firm. If reality does not meet their expectations, such an individual might leave before the plan is fully consummated.

Merging in a smaller or equal-size firm with excess partner-level talent. These opportunities are hard to find, but they can be a powerful way to solve the problem. They are hard to find because the vast majority of firms seeking an upstream merger are doing so due to their own succession problems. A merger of such firms can exacerbate the succession problem. When the situation makes sense, however, there are distinct advantages:

- The economics are already in place to accommodate the partner-level talent; new persons generally are not needed unless new business justifies it.
- Larger firms have an easier time dealing with reassigning roles and clients.
- Because a lot of administrative tasks require a fixed amount of time and larger firms are better able to support dedicated administrative personnel, partner-level client service time can be created by consolidating administrative tasks

External Succession

What are a firm’s alternatives to an internal succession solution? If a firm is unable to devise an internal solution, there are two obvious options: 1) merge into (or sell) to a firm that can provide the solution, or 2) downsize to handle the business appropriate for the partner-level capacity.

Merging into or selling to a larger successor firm. The most common reason for mergers is to deal with partner succession. Choosing the “right” firm to merge into or sell to is critical. The criteria for this choice include the following:

- Partner capacity—does a successor firm have the partner level capacity to replace retiring partners, or has it shown an ability to create that capacity as needed?
- Skill set—does a successor firm have the requisite expertise needed to replace the resources that will be lost to upcoming partner retirement?
- Culture—are the partners comfortable with each other? If not, why would clients and staff feel comfortable?

■ ■ Continuity—change can be a dirty word to clients and staff. Generally, the greater the amount of change, the greater the risk for attrition. For clients, the important factors will include the firm's new location, fee structure, and approach to service. For staff, compensation, benefit programs, and career opportunities are important. Even if the successor firm can replace retiring partners, if the merger leads to the loss of critical staff and a substantial amount of clients, the result will not be viable for either firm.

Cull-out sale. A very atypical but successful method some firms utilize in the event they cannot replace retiring partners is a cull-out sale. An old rule of thumb is that the low-end clients that generate 20% of fees may be taking up a disproportionate amount of partner time. Losing those clients could free up the capacity needed to replace a retiring partner. Selling those clients in a cull-out sale not only frees up partner-level time but also creates the capital to pay off the retiring partner. What might be considered the low end of one practice could be the sweet spot for another firm. Another solution is to sell off the retiring partner's book of business if the remaining partners are unable to take on the added responsibility of those clients.

No Single Right Solution

The different approaches discussed above are some of the most common ways to ensuring that an accounting firm is able to successfully replace its partners when they retire or otherwise leave the firm. The reality is that every firm is unique and requires a customized succession plan. This plan should be developed well in advance of the need to use it. This can be the most important decision a firm makes to ensure that it survives and creates value for retiring partners. Getting help from an experienced consultant in this matter, or consulting other firms that have effectively dealt with partner succession, is a good way to find solutions. □

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Since 1990, Joel Sinkin has personally been involved with and consulted on over 700 transaction closings of accounting firms from coast to coast. Joel has taught and advised accounting professionals about Mergers & Acquisitions through CPE, professional writing, workshops, web casts and coaching programs on behalf of the American Institute of Certified Public Accountants, national associations, and state societies. He has worked with thousands of firms including start-ups, sole proprietors, local, regional, and national firms.

Joel believes that the needs of the parties in every merger and acquisition are unique and successful execution requires a thorough understanding of each party's objectives. The chemistry between the partners in the two firms is a key component to making the deal work. *"A good deal is a fair deal. I also believe it's beneficial to both parties for retiring practitioners to transition at a pace that meets their clients' needs and is consistent with their personal plans. The best deals are win-win propositions."*

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Terry has over 25 years experience in the CPA profession. For six years, he was Managing Director-Mergers and Acquisitions for RSM McGladrey, the fifth largest accounting firm nationally, and held several executive positions with its corporate parent. He structured and negotiated many transactions resulting in the acquisition of accounting and consulting firms ranging in size from sole proprietors to firms with hundreds of professionals and multi-state operations. Prior to joining McGladrey, Terry was the Managing Partner of Donnelly Meiners Jordan Kline, a 60 associate CPA firm in Kansas City.

Terry thinks it is imperative that practitioners have a clear understanding of their objectives when pursuing a sale of their practice or the merger with or acquisition of another practice. *"I've seen deals not work or not materialize because one of the parties to the succession plan had not thought through what they really wanted to accomplish. Accounting Transition Advisors will make sure the approach to executing your plan will meet your objectives. Because we are consultants and not brokers, we can be much more flexible in helping a firm succeed with its transition plan."*

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