CPA FIRM SUCCESSION:
SOLIDIFYING THE FUTURE

Alternative Deal Structures for Succession

Seventh in a series: There are several ways to facilitate partner retirement and transition of clients.

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For CPAs in public practice, the path to retirement usually follows one of two roads—an internal succession or a sale to an external buyer, with the external route offering additional options.

This series has covered in detail one of those external paths—the two-stage deal, which is structured to enable the selling practitioner to retain a significant amount of autonomy, control, and income while locking in a succession plan (see “A Two-Stage Solution to Succession Procrastination,” Oct. 2013, page 40). This article looks at other options for an external succession plan.

Straight Sale

Selling one day and walking away from the practice the next is certainly possible, though rare. The advantages of a straight sale to the seller are that the purchase payments commence immediately and the seller is not asked to work a substantial amount of time for lower compensation. The buyer can pay the purchase payments out of the profits the seller previously retained as compensation. The big disadvantage is that clients are asked to start the transition immediately without much seller involvement and this can lead to lower retention—something neither side wants. Straight sales usually occur when a seller, either by choice or forced circumstances, waits until the last minute to find a successor firm or has to substantially slow down before finding one.

A better approach to a straight sale is one where the buyer starts the purchase payments immediately and the seller stays involved for a certain amount of time to help manage the transition, often in a part-time role and maybe not for any additional compensation beyond the purchase payments. If the seller is asked to perform chargeable work, he or she traditionally is entitled to additional compensation—for example, one-third of his or her billing rate. The nonchargeable work that is not separately compensated for is usually limited to making introductions to the business clients, providing an orientation to the files and systems, and being reasonably available to respond via phone to the buyer’s inquiries about client issues or to hold former clients’ hands.

About the Series

Powerful forces are transforming the accounting profession in the United States. The Baby Boomers are heading into their retirement years. Baby Boomer CPAs are in charge of most U.S. accounting firms, and most U.S. accounting firms don’t have a signed succession plan or practice-continuation agreement in place.

The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month’s installment, the seventh in the series, examines deal structures for external sales in succession situations.

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Buy-In Leading to a Buyout

This strategy is based on a successor (often a smaller firm or practitioner) buying a partial equity interest in a firm seeking a successor for the purpose of an eventual complete buyout. As an example, Firm A has $800,000 in fees, and Practitioner B, who has a $200,000 firm, is identified as a successor. Firm A's owner is several years away from slowing down.

Initially, the two firms merge. Based on relative volume (a common approach to allocating equity) B becomes a 20% partner in the combined firm. To create parity, B acquires another 30% of the equity upfront (typically with a payout period of years), equating to another $300,000 of the combined revenues, to become a 50% equal owner of the $1 million firm. The terms of that acquisition can use a variety of options, but the payments often are over time. The parties agree upfront on the date that B will acquire the balance of the equity and what the terms will be when that happens.

Another twist is B might keep its existing practice separate from A's practice and work both simultaneously. This could be to limit A's exposure to the financial and other risks of B's practice or for any other number of reasons.

Merger Leading to a Buyout

This is similar to the "Buy-in to a Buyout" but doesn't include any upfront acquisitions. It is the most often used approach when both parties are multipartner firms. Often the larger firm has all or mostly older partners who need succession in the near term, and the smaller firm is made up of younger partners who have the capacity to take on a lot more responsibility.

For example, Firm C is a $3 million, three-partner firm, and all three partners are seeking to slow down within three years. Firm D is a $1 million practice with two young partners. They merge, and 75% of the combined firm is allocated to C and 25% to D. The authors might set up an arrangement for the eventual buyout of the C partners on the first $3 million in volume with a different sharing arrangement on the additional growth so the D partners don't feel as if they are required to buy what they helped build. There may be no requirement that the combined firm buy out the D partners so the C partners don't inadvertently become unwilling successors (although a termination of a D partner still needs to be addressed in the ownership agreement).

Cull-Out Sale

This is a sale of a part of a practice with the seller retaining the rest. It is becoming more popular as a tactic to address certain situations. This may make sense for several reasons. Here are the most common examples of how cull-out sales work:

Niche practices. The selling firm may want to either sell off a niche or sell the traditional practice and retain the niche. Here is a recent example. A one-owner firm generating $1.7 million in traditional tax and accounting fees also operated a separate wealth management practice. The owner had lost his passion for the traditional accounting work and loved the wealth management practice. He had retained the traditional practice because it generated referrals to the wealth management practice.

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He was introduced to a firm that did *not* offer wealth management services. The traditional practice was sold, and the seller agreed to not compete for those services while retaining the right to offer wealth management services to the same clients. The buyer agreed not to offer services to or refer away the wealth management clients. The deal was held out to the world as a merger designed to improve the clients' access to the expertise of both firms. The authors have also seen niche practices sold—for example, an IT consulting division—while the seller retained the core practice.

Capacity issues. A firm may have a succession issue with a partner and not have the capacity to replace him or her. Rather than decide to merge the whole firm, some firms sell off the retiring partner's client

EXECUTIVE SUMMARY

■ **Internal succession and sale to an external buyer are the two main paths** to retirement for CPAs. There are several types of deal structures for external sales.

■ **In a straight sale, the seller divests of the practice and walks away immediately.** This type of transaction is rare in accounting because it offers little to no transition time for the clients.

■ **In a buy-in leading to a buyout,** a buyer purchases a partial stake in a firm seeking a successor. The buyer then completes the transaction when the retiring partner is ready to slow down.

■ **A merger leading to a buyout is similar to the buy-in leading to a buyout,** but without the upfront acquisitions. This is most commonly used by multipartner firms.

■ **In a cull-out sale,** the selling firm divests part of its practice. Sometimes, the part sold is a niche division. Other times, the selling firm keeps the niche business and sells off the traditional accounting practice.

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base and continue to go it alone with the remaining partners. In one case, the partner seeking succession operated a satellite office in another city. The core office could not locate a person to take over running that office. The authors assisted the seller in finding a local firm that had the capacity, and they worked out the buyout of the retiring partner.

Other firms, facing staffing issues, identify a group of clients in a certain industry or of a certain common characteristic and sell off that client base as a means of contracting to a level of activity they feel better managing. Finally, firms that want to exit a certain kind of client, such as stand-alone 1040s or business clients whose fees are unlikely to exceed a targeted minimum, sell off that group rather than just walking away from it. One firm's floor often is another firm's ceiling when it comes to the perceived quality of a practice area.

Post-sale practices. Often a practitioner has a large enough practice that continuing to operate will keep him or her from achieving post-retirement quality of life. But he or she can't imagine not working at all. An example is a sole practitioner who had a $900,000 practice. He identified $100,000 of clients he wanted to keep and service indefinitely, while a buyer was found for the other $800,000 worth of clients. ❖

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- "Succession Planning: The Challenge of What's Next," Jan. 2013, page 44
- "Planning and Paying for Partner Retirements," April 2012, page 28
- "Traps for the Unwary in CPA Firm Mergers and Acquisitions," Aug. 2011, page 36
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