



CPA FIRM SUCCESSION:
SOLIDIFYING THE FUTURE

Mergers Emerge as Dominant Trend

First in a series: New demographic and economic realities are reshaping succession strategies.

by Joel Sinkin and Terrence Putney, CPA

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 or practice-continuation plan in place.

These realities are rewriting the rules for U.S. accounting firms and CPA firm owners. Gone are the halcyon days of whipping together a succession strategy, transitioning the clients to the next generation of CPAs, and riding off into a retirement funded by the new partners at the firm. Firms today must contend with unprecedented financial, cultural, and marketplace changes.

To help CPAs deal with these changes, the *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This installment examines the importance of understanding the mergers-and-acquisitions (M&A) market when preparing a succession plan.

THE M&A FACTOR

M&A has emerged as a dominant trend among U.S. accounting firms. Dozens of major mergers have been announced over the past three years, and scores more have taken place under the radar. How prevalent is the merger mania? Nearly half of all U.S. accounting firms either were in merger talks or expected to be within two years, according to the *2012 PCPS Succession Survey*.

Demographics and other succession

issues are the main factors fueling the consolidation craze. The gap between the number of firms dealing with partner retirements and the number of firms with successors, or even succession plans, in place has created a need to find alternative ways to continue the practice and fund partner retirements. Increasingly,

firms are looking to the merger markets for an exit. This trend is affecting the balance between a "buyer's market" and a "seller's market" and having an impact on firm valuations as well.

Despite all the turmoil, a firm's size and location continue to be the main factors in determining its appeal, and value, to potential buyers. For instance, small firms in densely populated areas are operating in a seller's market. A plethora of firms with the capacity to buy smaller competitors gives selling firms a number of options when seeking a suitor.

The market also favors the selling firm

because many midsize firms can absorb small firms with little to no incremental increases in overhead, especially if the selling firm isn't locked into long-term, expensive leases. That makes an acquisition a cost-effective means of growth. Buying firms, thus, are willing to pay higher prices to acquire smaller operations because it's still cheaper and easier than growing by adding one client at a time or adding a service niche to create cross-selling opportunities and attract new clients.

In contrast, small firms in remote areas remain stuck, and are likely always to be

Firms with excellent niches, strong young talent, or a strong and growing client base can separate themselves from the competition, driving up their value.

stuck, in a buyer's market. The limited supply of potential buyers means that it's difficult for a selling firm to find a suitor. In some areas, accounting firms don't feel pressure to acquire a retiring competitor's clients because most of those clients "have no one else to go to anyway."

Where the most significant change in the buyer-seller balance has occurred is among small-to-midsize regional firms. Consider the following: In a large metro area such as Boston, there are dozens of firms generating between \$3 million and \$8 million in annual revenue and a handful of larger regional firms—those with

EXECUTIVE SUMMARY

■ **Mergers and acquisitions (M&As) are becoming increasingly popular as an exit strategy for retiring CPA firm partners.**

New demographic and economic realities are making it more difficult for firms to complete internal succession, leaving a sale to an outside firm as the best option.

■ **Increased M&A activity**

among accounting firms is affecting, in some areas, the balance between a "seller's market" and a "buyer's market." The biggest change is being seen among small-to-midsize regional firms.

■ **The rising number of CPA firms up for sale is exerting downward pricing pressure on**

firm values. This means that time is of the essence for CPAs to figure out how they are going to pay for their retirement and whether an external sale will be necessary.

■ **Buyers are requiring longer partner-retention periods in accounting firm acquisitions** and are putting down less money upfront.

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To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

\$20 million or more in annual revenue. The smaller firms represent good acquisition targets for the bigger firms, for the reasons already discussed, but until re-

in the near future) that they don't have the cash flow or young talent to execute an internal succession plan. The firms then have little choice but to seek an exit

A firm's size and location continue to be the main factors in determining its appeal, and value, to potential buyers.

cently relatively few of the smaller firms have come on the market because their business has been solid and they've executed internal succession to pay for partner retirements. That pattern, however, is changing.

DOWNWARD PRESSURE AND OTHER TRENDS

An increasing number of smaller regional firms are discovering (or will discover

via merger or acquisition. This trend is producing a larger supply of smaller regional firms, shifting the power in the marketplace to the buyers and creating downward pressure on firm valuations.

The authors have already seen values of firms drop over the past few years for both internal valuations (partners buying out partners) and external sales. Also, buying firms are putting less money down on acquisitions and are placing a

stronger emphasis on retention periods for partners with the smaller firms, which tend to have partner-loyal client bases. All of these trends will continue, with some exceptions. Firms with excellent niches, strong young talent, or a strong and growing client base can separate themselves from the competition, driving up their value.

What does this all mean for firms that have yet to complete their succession plan? When should a firm have a plan in place? Those questions will be addressed in next month's installment of this series. ❖

The Succession Situation

Succession is a major issue not being dealt with on an adequate level within the CPA profession. Consider the following findings from the *2012 PCPS Succession Survey*, a joint project of the AICPA Private Companies Practice Section (PCPS) and Succession Institute LLC:

- Nearly 80% of the CPA firm owners surveyed expected succession to become a major issue for their firms in the next 10 years.
- Fewer than half of all multi-owner accounting firms had a written and signed succession plan. The percentages dropped dramatically for smaller firms: 33% for firms with eight to 15 professionals, 25% for firms with three to seven professionals, and 14% for firms with one or two professionals.
- Only 6% of sole proprietorships had practice continuation agreements (PCAs), the first step in succession planning.

For more, see the *JofA* article "Succession Planning: The Challenge of What's Next" (Jan. 2013, page 44).

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JofA articles

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- E.D.G.E.—Sharpening the Next Generation of CPAs, Aug. 7–9, Austin, Texas
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The Long Goodbye

Second in a series: Partners need to factor in the frequency of their client visits, among other things, as they transition into retirement.

by Joel Sinkin and Terrence Putney, CPA

The best time for an accounting firm to start work on a succession plan is the day the firm is formed. Of course, most firms don't do that. The question in many cases has become: "How quickly can I put together a succession plan and head in to retirement?" The answer depends on a number of factors.

Partners plotting a path to retirement need to compare the frequency that they meet in person with their clients to how many more years they desire to work fulltime before slowing down.

Note the phrase "work full time before slowing down." Many practitioners focus on when they want to retire, but most owners don't go from fulltime to retirement in one step. Instead, they gradually reduce their time commitment to the firm. Thus, the focus when determining the timing of a succession plan should not be on when the partner plans to retire but on when the partner plans to slow down.

This is a crucial point when combined with the need to understand how often partners meet in person with their clients. Face-to-face meetings used to take place multiple times per year, but not any more. More than 85% of accounting firm clients meet in person only once a year with the owner or partner. Communication still occurs on a regular basis, but it's in the form of phone calls, email, and, in the case of some firms, via video conference technologies including Skype. The increasing popularity of portals and internet-based accounting systems allows firms to access clients around the world, tearing down

geographical barriers but making it harder to meet in person. As a result, look for the frequency of face-to-face meetings to decrease further.

Face-to-face meetings are the best way to work through the transition of clients to the successor partner or firm.

This is important because face-to-face meetings are the best way, in the authors' opinion, to work through the transition of clients to the successor partner or firm that a departing CPA would like to handle those clients' accounts in the future. Consider what that means for partners who want to reduce their time commitment to the firm in the next five years. Half a decade might seem like an eternity, but for most partners, it's only five visits with each client. A two-year window allows for only two visits.

BRAND LOYAL OR PARTNER LOYAL?

The next factor in calculating the time to retirement is honestly determining whether clients are brand loyal or partner loyal. Generally speaking, the smaller the firm, the better the chance that clients are partner loyal.

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These realities are rewriting the rules for U.S. accounting firms and CPA firmowners. Firms must contend with unprecedented financial, cultural, and market place changes. The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month's installment, the second in the series, looks at how much time accounting firms need to develop, implement, and execute a succession plan.

If clients are partner loyal, it likely will take longer to transition them and execute a successful succession.

Most large firms assume all their clients

are brand loyal, but in almost all cases, at least some clients are more attached to an individual than to the firm. Firms need to factor this in when designing succession and transition plans. Avoid treating all partners the same under the plan. Client loyalty can vary by partner.

Smaller firms frequently find it more challenging to make their clients brand loyal, because in many cases a single partner has developed and managed the clients during their entire relationship with the firm. Getting clients acclimated and comfortable with other team members can help mitigate this issue, but it rarely disappears.

There are always other factors that influence the timing behind commencing a succession plan. Foreexample, if a partner in a firm has a very specific skill set, it will likely

EXECUTIVE SUMMARY

■ **Partners assessing how quickly they can retire need to factor in how frequently they visit with clients.** More than 85% of accounting firm clients meet face to face with their CPA only once a year.

■ **Most CPA firm owners don't go from full time to retirement in just one step.** Consequently, partners should think in terms of how much time they have left be-

fore they want to reduce their time commitment to the firm, as opposed to when they want to retire.

■ **Firms need to assess whether clients are partner loyal or brand loyal.** Clients who are more loyal to a partner than to the firm take longer to transition to other professionals in the firm. It usually takes at least two years to transition a client from

one partner to another.

■ **Firms should avoid locking themselves into long-term leases,** which can hurt the possibilities of making an external sale to fund retirement for a partner or partners. Outside buyers that already have an office in the market where the selling firm is located will not want to assume a large, long-term lease. Having one on the books can scuttle a deal or

lead to a lower purchase price.

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All told, it usually takes a minimum of two years to transition a client from one partner/owner to the next.

take longer to identify and potentially train a successor. All told, it usually takes a minimum of two years to transition a client from one partner/owner to the next.

LEASE CONSIDERATIONS

A key issue that too few firms consider in the succession planning process is leases. Consider this real-world example: A four-partner firm with \$4 million in annual revenue wants to merge with a larger firm that can facilitate long-term growth for two partners but near-term succession for the other two. The two partners staying on have the desire

but not the capacity to replace the two senior partners. The firm recently signed a 10-year lease extension and enjoys a well-appointed space, great location, parking, and rent at below market value.

What's the problem? The firm is targeting suitors ranging from as small as \$8 million in revenue to top 100 status. Firms that size already have offices. Firms considering a merger or sale should avoid tying potential successor firms to a lease. By signing the 10-year lease, the firm in this example eliminated from its list of potential buyers all the firms that don't want a satellite office,

especially if a potential buyer already has an office in the same area. Potential buyers are likely to reduce their purchase offer to account for the costs of carrying the additional overhead of the lease.

CONCLUSION

The time for succession planning is now. Firms that don't have a plan in place are in danger of seeing opportunity and firm value melt away as the number of firms seeking buyers rises over the next few years. CPA firm partners need to understand the realities of the succession landscape and plot an appropriate course for a gradual transition into retirement. Failure to plan properly could prove costly for firms and partners alike.

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How to Select a Successor

Third in a series: Numerous factors demand consideration when a CPA firm is looking to replace a departing partner.

by Joel Sinkin and Terrence Putney, CPA

Selecting the successor for a retiring partner in an accounting firm can take on many forms. The decision can be made by an individual CPA or by the firm leadership. It can involve the transfer of clients, ownership, and/or responsibilities internally or the sale of ownership to an outside entity. Regardless of the scenario, a number of factors should be considered in evaluating potential successors for a retiring partner.

This article looks at several areas CPAs can assess in weighing whether an individual or a firm would be a good fit to take over a partner's ownership stake and book of business. Later articles in this series will delve into the details of calculating whether internal succession is possible financially and which deal structures make the most sense for external sales. Regardless of whether the retiring CPA or the firm has the final say on who the successor will be, the following advice can be applied.

When assessing internal candidates, do the following:

- Look at their track records. How have they performed when promoted in the past? Have they picked up things quickly? What does the track record show about their attendance and work ethic? Have they shown an ability to develop and retain clients? Everyone makes a big deal about rainmakers, but if the firm doesn't have partners who can keep clients happy enough to stick around, the firm has a turnstile, not a client base.
- Put them in a position to prove themselves. Whenever possible, it's wise to see if a person can do a job before promot-

A good rule of thumb when choosing a successor is to not pick anyone whom the partners would not want to eat lunch with regularly.

ing him or her permanently. In the case of partner positions, a good option is to create a nonequity partner level or a similar type of position that can be used as a steppingstone. It's a setup that can benefit both sides, neither of which is locked into an ownership arrangement. Firms can say to potential full partners, "We're going to give you more business, and you need to manage a larger book." Then the firm sets up criteria that will provide an accurate assessment of whether they would be successful as a partner. For example, a firm might tell a non-equity partner that it needs her to develop \$100,000 in new clients over the next year or two. The benefits to this are that the firm can see whether their CPAs can make the grade and the CPAs get a chance to prove themselves.

Many firms make the mistake of promoting a CPA to partner because he has been there for a long time, and it's "his time" to

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These realities are rewriting the rules for U.S. accounting firms and CPA firm owners. Firms must contend with unprecedented financial, cultural, and marketplace changes. The JofA is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month's installment, the third in the series, looks at factors accounting firms should consider when selecting a successor to a retiring CPA.

make partner. Tenure is not a reason to make someone a partner. Not everyone is cut out for that role. Some people are better suited for staff positions, and that's fine. The factors that should take precedence are the candidate's skill set, track record, and desire. A staff member who isn't asking about how he or she can get ahead in the firm may not be aggressive enough for a partner position.

REPLACE THE ROLE, NOT BODY

Another mistake firms make when selecting a successor is failing to understand who would replace the roles being lost with the departing partner. For example, if a three-partner firm has two partners focused on tax and one on audit, and the audit partner leaves, it can't just replace her with a tax partner. The firm needs someone to take on the audit book of business and fill the roles the retiring partner handles. This person also must be able to manage his or her current work-load to create

EXECUTIVE SUMMARY

■ **Firms assessing internal candidates for succession should look at how they have performed in the past and also put them in a position to prove themselves.** It's preferable to see whether a person can do a job before promoting him or her permanently.

■ **Don't promote a CPA to partner just because he or she**

has been with the firm for a long time. Tenure is not a reason to make someone partner. Some people are better suited for staff positions, and that's not a bad thing.

■ **Firms should replace the role, not the body, when replacing a departing partner.** If a tax partner is leaving, for example, promoting an audit expert to

partner may not be the best move.

■ **Consider the four C's—chemistry, capacity, culture, and continuity**—when selecting a successor for a departing partner. How a successor—whether an individual from inside the firm or an external firm in a merger—fits with the departing partner's firm is crucial to success or failure.

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the capacity to take on new work.

That's why it's so important, regardless of whether a firm is a sole proprietorship or a multipartner firm, to take a holistic view of what needs to be replaced in a succession situation. Look beyond the departing partner's name. What role(s) does she perform? Does he have a particular technical skill or license? Does she perform a lot of client hand-holding, rain-making, and administrative duties? Firms need to create a plan that doesn't simply replace a body with a body. Firms must choose a professional or professionals who can fill, as closely as possible, the roles that the retiring partner was handling.

THE FOUR C'S

While choosing someone with the "right" skill set is tremendously important, other factors tend to demand more of the authors' time when helping clients with this issue, especially in external sales situations. These are the four C's.

Chemistry. A good rule of thumb when choosing a successor is to not pick anyone whom the partners would not want to eat lunch with regularly. This is especially true if the successor is external, for three main reasons:

■ **Partner-loyal clients.** As discussed in the August article ("The Long Goodbye," page 36), many firms, especially smaller ones, have clients who are loyal to a specific partner. In addition, most clients have no true yardstick to ascertain the skill set of professional(s) to whom the firm wants to transfer their account. Clients choose a firm more often than not because of a personal comfort level they have with a partner. If the current partners are uncom-

fortable with a potential successor candidate, why would clients be comfortable with him or her?

- **Staff.** Just as clients have choices when selecting their accounting firm, many staff members, especially the stronger ones, also have choices as to which firm they will work for. In many firms, key staff people also have significant client contact. Thus, once again, if the current partners are uncomfortable with a potential successor, why would the staff be comfortable with him or her? Client retention likely will affect the value of the partners' retirement package, and the loss of staff often leads to the loss of clients.
- **Working relationship.** A good transition plan requires years to take hold in many cases. Therefore partners/owners choosing their successors may be working with them for many years, both before they retire from full-time work and if they elect to stay on in a part-time role with the firm after retirement. With external sales, a good working relationship is critical if a transition occurs as part of a two-stage deal, a type of merger in which the selling partners retain income and control for a

invests required to be re-placed by partner-level professionals, or can some of that time be delegated to lower-level staff?

The authors have done many retreats for firms that have as many as a third of their partners five years or less away from reducing their time commitment to the firm. Until reminded about the capacity issue, these firms were confident they had an internal solution. Smaller firms need to consider hand-holding time an owner/partner may spend with clients. Can that time be assigned to staff or eliminated, or does it need to be transitioned to another owner/partner only?

Culture. This term is used a lot but remains a vague concept for many. Think of culture in three ways: (1) What's it like to work here?; (2) What's it like to be a client here?; and (3) What's it like to be a partner here? The partners must consider whether this successor or merger candidate can cut the mustard in all three areas.

Continuity. Most accounting firms have their client base because their clients are comfortable with their people and approach to service. Clients tend to focus on fees, how services are provided, the level of hand-holding, and specialties, to name a few. In a merger,

Firms must choose a professional or professionals who can fill, as closely as possible, the roles that the retiring partner was handling.

period of time, usually two or three years, before shares are exchanged. The next installment of this series will cover the two-stage deal in detail.

Capacity. How many chargeable and non-chargeable hours does the retiring partner/owner devote to the firm? Is all the time she

the successor firm must avoid the clients' viewing this as a loss of the old firm and instead promote the gain of the new firm. If the successor firm intends to make wholesale changes upfront that will directly impact client experience, this can be a red flag for potential client retention issues.

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A Two-Stage Solution to Succession Procrastination

Fourth in a series: Deal structure provides a path to retirement for CPAs who fear a loss of control or income.

by Joel Sinkin and Terrence Putney, CPA

The 2012 PCPS Succession Survey, a joint project of the AICPA Private Companies Practice Section (PCPS) and Succession Institute LLC, found nearly 80% of CPA firm owners expect succession to become a major issue for their firms in the next 10 years (see “Succession Planning: The Challenge of What’s Next,” *JofA*, Jan. 2013, page 44).

The same study revealed, however, that more than half of all accounting firms—and more than two-thirds of those with 15 or fewer professionals—do not have a signed succession agreement in place. The percentage of firms with signed succession plans is on the rise, but it is behind where it should be with large numbers of Baby Boomer CPAs eyeing retirement over the next several years.

The trend is not surprising. In more than 20 years of consulting with thousands of accounting firms, the authors have found that CPAs often put off planning for retirement and succession. Two main reasons for this are:

- **Loss of income.** Transitioning a firm or book of business means selling in the minds of many practitioners. Selling means at least partial loss of current income. A practitioner who is three years away from slowing down often can’t justify giving up current income to accomplish what feels like a long-term goal.
- **Loss of control.** Most owners and partners believe they are the master of their domain. The idea of losing some control is so dis-

tasteful they prefer to ignore their succession concerns rather than affiliating with a successor firm and experiencing any change.

To overcome these concerns, practitioners need an option that allows them to commence the transition of relationships with clients and staff—the basis for the value of an accounting firm—in a manner that enhances the retention of those relationships without giving up control and income before they are ready. This is where a two-stage deal comes into play.

A two-stage deal allows the selling practitioner to retain control of the practice and to maintain his or her income level during the transition.

A two-stage deal is designed for practitioners who are six years or less from reducing their time commitment to the practice. In essence, the two-stage deal involves affiliating now with a successor firm, starting the transition while the practitioner is still in control of his or her practice, and postponing the adjustment in income until he or she slows

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The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month’s installment, the fourth in the series, looks at the two-stage deal—a form of CPA firm sale well-suited to succession situations.

down. At that point, the retiring/selling partner would start receiving payments for the sale of the practice.

The first stage of a two-stage deal lasts a maximum of six years and is particularly important for practices with partner-loyal clients. It usually takes two to five years to properly transition partner-loyal clients from the departing CPA to the successor, whereas brand-loyal clients typically take less time to transition.

Example. A sole proprietor was generating \$500,000 in annual revenues with one full time senior professional, a fulltime paraprofessional, and a clerical person while netting 40%, including perks and benefits. This owner wanted to work three more years full time and several more years in a part-time role thereafter. The buyer was a three-partner firm gener-

EXECUTIVE SUMMARY

■ **CPAs often put off planning for retirement and succession.**

The main reasons are concern that such plans will result in a loss of income, a loss of control, or both.

■ **A two-stage deal can help move retirement and succession plans forward.** The deal is designed for practitioners who are six years or less from reducing their time commitment to the practice.

■ **Two-stage deals call for departing or selling owners to associate with successor firms** for a period of time before payments commence for the sale of the practice. This allows the transitioning of clients and staff to the new firm to begin while the selling partner still controls his or her practice and maintains his or her income level.

■ **The first phase of a two-stage deal typically lasts for a maximum of six years and acts**

much like a practice-continuation agreement, except with income certainty. The selling partner usually runs his or her practice through the administration and infrastructure of the successor firm.

■ **The second phase of a two-stage deal is the buyout**, which is delayed until the selling owner no longer is receiving full-time compensation. This saves the successor firm from having to pay the partner's compensation

and buy his or her practice at the same time.

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ating \$2.2 million a year working with similar clients, under a similar culture and fee range.

Stage One was set up to be a maximum of three years. At its inception, the two practices were combined. Stage One could end sooner at the discretion of the selling, or transitioning, owner. The successor firm provided the practice with the same amount of labor required in the past through a combination of retaining and replacing staff, as both were deemed necessary by the parties. The successor firm took over most of the administration, and the deal was held out to the public as a merger.

The transitioning owner was able to come and go reasonably as he saw fit, run his practice through the successor firm's infrastructure, and retain significant autonomy and control. Because he historically generated a 40% margin, the successor firm agreed to assume all the operating costs of the practice and pay 40% of gross collections from the transitioning owner's original clients as compensation. Stage One was set to terminate on the first of the following events: (1) the end of three years; (2) the death or disability of the transitioning owner; or (3) the election of the transitioning owner.

Stage Two was the buyout, and it was set up in a traditional fashion. Stage Two kicked in at the end of Stage One. By deferring the buyout until the full-time compensation ceased, the transitioning owner could extend the period for his full-time compensation, and the successor wasn't being asked to pay for the practice and full-time compensation at the same time.

The authors have found buyers and sellers prefer this approach for several reasons:

- Transitioning owners are normally exposed 100% to the loss of any business. The loss of a \$50,000 client means \$50,000 less profit when they are on their own. In a two-stage deal, the successor firm is in a much better position to adjust costs and maintain margins. Under the above compensation formula, the transitioning owner's compensation decreases by only 40% of the \$50,000, instead of all of it.
- If the transitioning owner suddenly needs more labor than he used in the past, he has the resources available. So if he wants to cut back his hours to, say, 80%, he can. His compensation would be adjusted for the use of more labor, but he has much more flexibility.
- The transitioning owner can cut back her overall time due to a much lower adminis-

■ Both parties can focus on crossselling additional services and developing new clients during Stage One, leading to a better outcome for all.

■ The successor firm usually experiences increased profitability even during Stage One due to elimination of redundant costs such as excess labor, rent, software, etc. Plus the successor firm can offer an expanded service mix to more clients.

The authors have used this technique for larger multipartner firms as well. They find many firms with partners in up to three categories of transition: (1) partners seeking to work for many more years and grow professionally and financially; (2) partners seeking to slow down in five years or less; or (3) partners seeking an immediate transition to retirement or part-time work. With the two-stage deal, all three catego-

Both the retiring practitioner and the successor can benefit from retaining clients and developing additional services and new clients during the transition.

trative burden without giving up income, or she can redirect that time to practice development or more client service.

- This structure operates like a practice-continuation agreement but with complete certainty of outcome.
- Most two-stage buyouts include a retention period just as outright sales do. However, because Stage One is where the transition is primarily executed, client retention is maximized, resulting in maximum value for both parties.

ries of partners can complete a merger with one successor firm—a merger that meets everyone's needs, including those of the successor firm.

For partners in the first category, a traditional merger is probably appropriate. They would exchange the equity in their firm for equity in the combined firm. A two-stage deal would accomplish everyone's goals for the second category of partners. The partners looking for a short-term transition would be best served by a traditional buyout using terms negotiated as a part of the merger discussion.

AICPA RESOURCES**JofA articles****CPA Firm Succession series**

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How to Value a CPA Firm for Sale

Fifth in a series: Methods and results differ for external transactions and internal transfers.

by Joel Sinkin and Terrence Putney, CPA

One of the key components of a CPA succession plan is the sale or transfer of the retiring CPA's ownership interest. How is the value of that interest determined? In most circumstances, the value of an owner's interest is different when selling to an external buyer than it is in an internal transaction.

EXTERNAL SALES

The most common question about accounting firm sales the authors are asked when teaching CPE courses is "What is the multiple (of billings)?" The multiple is determined by four main factors:

1. Cash Upfront, If Any

In more than 90% of the 900-plus deals the authors have consulted on in the past 24 years, the down payments have ranged from nothing to 20%. The authors have seen many more deals with no cash down than with 15% to 20%. A typical down payment is 10%. The factors that affect buyers' thinking include:

The time of year. For example, if a selling firm bills 65% of its revenue by May 1 and the closing is May 15, the buyer may have to carry the practice at a net loss or break-even for months, so the amount of the down payment, if any, tends to be less. Obviously, the same practice closing Jan. 1 is likely to get more upfront. As with almost all deals of this type, the buyer's ability to obtain a return on investment quickly usually affects the terms offered.

Treatment of accounts receivable. Most sellers expect to retain their receivables—that is, the money they are owed for work they've already completed, plus work still in progress. This is logical. However, consider that the buyer will have to replace those funds, re-

sulting in negative cash flow upfront from the operations. The situation is exacerbated if the acquired client base is accustomed to paying slowly, meaning that the buyer could have to wait months before seeing revenue come in from the buyer's billings. In those situations, the buyer will have to contribute more capital to meet expenses. This can result in lower down payments. On the other hand, the authors have seen buyers willing to make larger down payments for the practice if the seller is willing to lend the accounts receivable to the buyer for a period of time following the sale. The buyer then repays the seller for those accounts receivable once positive cash flow is established.

Bank financing and other factors. Banks have tightened credit, making it more difficult to finance acquisitions. One result has been a trend toward lower upfront payments. If significant investments are required while transitioning the practice, such as for technology upgrades, the buyer may be unwilling to pay a lot upfront.

2. Retention Period

The majority of external accounting firm deals base payments on collections. That is, the buyer pays a specified percentage of the fees it collects for a specified period after the deal closes. If the buyer loses clients and the

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fees fall during that period, then the seller receives less money. Conversely, if fees increase, the purchase payments do as well. It's an arrangement that seems to fly in the face of most business sales, in which the buyer pays a negotiated price. Many of the accountants the authors have worked with over the years were surprised that accounting firm sale prices were determined by a formula based on collections. These are not "buyer beware" sales; rather, such deals are shared-risk transactions unique to accounting firms because the value of firms lies for the most part in client relationships, not hard assets.

Most external sales have a retention period that adjusts the balance due to the seller based on client retention and fees collected. Some retention periods can be as short as one to two years, but many deals are structured with payments based on a percentage of collections over the entire payout period. Rarely do the authors see one-year retention periods. Instead, the recent economic difficulties have led to longer retention periods, which offer more security to buyers afraid that clients will go out of business or otherwise reduce the fees being paid to the buyer.

3. Profitability

This can be a confusing variable to many because it doesn't refer to the seller's profitabili-

EXECUTIVE SUMMARY

■ **The value of an accounting firm's shares differs for an external sale as opposed to an internal transfer.** However, the methods for determining an accounting firm's value do share a number of factors.

■ **The multiple of billings used to determine the sale price is determined by four main factors:**

(1) amount of cash, if any, paid upfront; (2) length of the retention period; (3) the deal structure's profitability for the buyer; and (4) length of the payment period.

■ **Inside ownership sales usually use a lower multiple than external sales.** Most retiring partners don't expect their partners to pay as much

as a stranger.

■ **CPAs selling their shares should expect potential buyers to need a financial upside from the deal.** Don't look for buyers to be happy with losing money or breaking even for several years.

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ty but the buyer's. Here is an example: A CPA owns a small firm operated from her home, with her spouse as the only labor. Her profit margin could reach or even exceed 85% because she might not count her spouse as a cost. Now, the CPA moves into an office and hires staff, driving her margin to less than 50%. At this point, would her firm be worth more to the buyer?

If a CPA is selling a firm with little overhead, then a buyer can absorb the practice much more profitably than it can a firm that has lease and staff obligations. Why can't the buyer just jettison staff after the sale? One reason is that many deals require the buyer to keep certain staff. The reasons for such terms are varied, but one often is the seller's belief that holding on to certain staff will lead to higher client retention. Remember, the amount being paid to the seller in most deals depends on how successful the buyer is at keeping clients. The trade-off is that any overhead the buyer is forced to take on likely will result in a lower offer to the seller for the practice. As another example, if the buyer has to treat the purchase as goodwill instead of deducting the payments as made, the deal is more costly.

4. Duration of the Payout Period

Most deals use a range of three to 10 years for the payments, and most do not include added interest. Smaller firms usually are paid in four to six years, and acquisitions of larger firms traditionally have longer payout periods.

THE MULTIPLE

The multiple, finally, is produced by the interaction of all of these other terms and factors. Think of the following equation: the less money upfront, the longer the payout and retention periods, and the more profitably structured for

the buyer, the higher the multiple. On the other hand, more money upfront, shorter payout and retention periods, and a less profitable structure for the buyer will result in a lower multiple.

Other factors also affect the sale price. Higher-quality firms—with great clients, higher billing rates and realization, etc.—tend to obtain a higher value. If a CPA is in a marketplace where many accounting firms are looking to buy CPA practices, the demand for the practice is greater and the value is higher. In more remote areas, the supply-and-demand curve is different. The authors have seen small firms sell for as high as 1.25 times billings, even occasionally more in cities such as New York, but have seen firms in more remote areas struggle to get 1 times billings.

Volume also plays a role. Larger firms traditionally receive smaller multiples and longer payout periods. This is predominantly because, in densely populated areas, there may be many firms that can absorb a \$500,000 firm into their firm with little to no overhead increases, but no one can absorb a \$10 million firm, for example, without substantial increases in overhead. Also, smaller firms tend to yield a higher percentage of profit to the bottom line than larger firms.

INTERNAL TRANSFERS

Although all of the variables of external sales also play a role in an inside transfer of ownership interests, there also are distinct differences. Inside valuations traditionally use a lower multiple of billings than external deals. Most retiring partners don't expect their partners, who helped build the business, to pay the same price as a stranger. Plus, the terms of inside transfers often fix the price at the date of retirement, and the firm is obligated to

acquire the ownership interest, both of which justify a lower multiple. Many inside transfers are based on a multiple times billings times ownership interest.

The most popular multiple is still 1 times billings, but less than half of agreements now use that multiple. Very few use more than 1 times, and more than half use less than 1 times. In some cases, the multiple is applied to the book of business the partner managed rather than overall firm billings. Larger firms tend to use a multiple of compensation as opposed to equity. Most of these firms use a formula that looks at the average compensation of a partner over a period of time, multiplied by between two to three times, in most cases, and paid over eight to 10 years (plus capital).

For example, if a retiring partner made an average of \$100,000 over the past four or so years, the deal could be structured to pay him or her \$300,000 over 10 years. That's in addition to the capital payment. Usually, the capital refers to the retiring partner's share (say 20%) of the accounts receivable and work-in-progress. Most retirement packages are paid in a manner that provides the firm a current deduction such as guaranteed payments to a partner on a Form K-1 or deferred compensation.

So what multiple should be used, whether it is based on equity, a book of business, or compensation? It's good to start with the following premise. The firm has likely helped dozens of clients value a business they were considering buying. In these situations, a CPA would rarely, if ever, tell a client, "If you buy this business, you will lose money, maybe break even for the next seven years. It's a great deal!" The CPA firm's partners should also have financial upside from buying a retiring CPA's interest instead of losing or running in place for seven to 10 years. How can

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the firm attract young partners if it makes less money after the CPA retires? The following "work backward" formula can test whether the buyout works.

The formula starts with the amount of com-

pensation the retiring partner is making, then subtracts the cost of replacing this partner's labor. That may be as simple as calculating the cost of a high-level staff person to replace the billable time. That leaves the firm with the an-

nual net cash flow it needs to pay the buyout and leave behind reasonable upside. So long as the multiple and other terms the firm chooses enable the remaining partners to have some upside, it is at least a workable start.

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Seven Steps to Closing a Succession Sale

Sixth in a series: Upfront work plays key role in bringing a deal to a successful conclusion.

by Joel Sinkin and Terrence Putney, CPA

Key to a successful merger or acquisition is keeping the process moving. For firm leaders, there is rarely any item of greater importance than a merger they are pursuing. The adage “time kills all deals” is absolutely true with mergers, and this is why:

- Adversarial positions: Naturally, both parties to the deal are looking for the best possible terms. For example, the seller wants to receive the highest compensation possible, and the buyer wants to pay the least. Successful deals depend on the parties working together for a common positive outcome. However, the longer negotiations last, the more likely the talks will develop an adversarial tone.
 - When a successor firm is slow to move the process along, many firms seeking an acquisition wonder two things:
 - If this is not a priority for the successor, am I talking to the right firm?
 - Does the successor firm have the capacity to take on this venture? (Neither of these perspectives, which are inevitable with delays, leads to a good outcome.)
 - Every time someone reads a contract, it has new meaning, and, all of a sudden, issues that were previously resolved become new problems. That leads to more delays and more conflict.
- Some things can't be kept under wraps forever. Many times word gets out that a firm is “in play.” This can lead to competitors and constituents acting on incomplete and false information.

THE SEVEN STEPS

Following are seven steps for deal management designed to keep the process moving. This is not to suggest that one should rush to

Successful deals depend on parties working together for a common positive outcome. Longer negotiations are more likely to become adversarial.

get a deal done, throwing caution to the wind. Rather, the parties need to focus and commit to the process until they realize they have a viable deal or they don't. This improves the probability of closing a deal that should be done and avoids wasting time and resources on one that wasn't meant to be.

Step one. The firm seeking to merge up or

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sell should prepare a generic practice information sheet. Generic, in this case, means that the document should not disclose client names and other confidential information. The sheet should include strategic goals for the affiliation and the operating characteristics of the selling firm, including fee volume, services rendered, types of clients, billing rates, headcount for staff and owners, profit margin, and other information necessary for a potential purchaser to determine initial interest.

Strategic goals should include near-term transition plans for partners, if applicable, and possibly growth, expansion, and other upside opportunities that can be accomplished through a merger. For example, a four-partner firm might have one partner seeking immediate succession, another who is looking to slow down in five years, and two younger

EXECUTIVE SUMMARY

■ **Among the biggest threats to accounting firm merger deals are delays.** It's imperative to keep the process moving because the passage of time increases the likelihood of events occurring that could scuttle the deal, including an adversarial tone developing, late changes to contracts provoking a dispute, questions being raised about the importance of the deal to the other party, and word leaking of the deal discussions.

■ **Firms seeking to sell or**

merge into another firm should prepare a generic practice information sheet. The sheet should cover strategic goals for the merger as well as information about the firm's fee volume, services, types of clients, billing rates, headcount, and profit margin, among other items. The sheet should not include confidential information.

■ **Selling firms also should identify "must-haves" upfront** and have a profile in mind for the ideal successor to any partners who will be cashing out. These

items should be covered in initial merger meetings.

■ **Firms should discuss deal terms early in the merger talks before extensive due diligence takes place.** Firms often complete due diligence first and then discover deal breakers when terms are discussed. Firms that create a foundation for a deal upfront can still pull out if something material is discovered in due diligence.

■ **The last of the seven steps in an accounting firm merger is**

closing the deal. This is the time to bring in the lawyers.

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partners who are seeking long-term growth but lack the capacity to replace the partners with near-term transition plans. The objective of this summary information is to share what the selling firm has and what it believes a successful merger would look like. This allows the other firm to determine whether there is a foundation to move forward.

Step two. The parties should identify "must-haves" and be ready to discuss them. Often there are certain items that would be deal breakers if they are not handled in a way that meets the selling firm's needs. The authors recommend those items be discussed upfront with the other party so they don't come up late in the process, after extensive negotiations, to kill the deal. Examples of must-haves include unexpired leases, location requirements, status of merging partners, compensation, other deal terms, staff retention, and other operating requirements.

This requires keeping in mind three things:

1. The more must-haves a firm presents, the fewer firms are likely to be interested in a deal. Some of these must-haves can affect a firm's value.
2. There are sometimes ways that haven't been thought of yet to overcome an issue considered a must-have, but the firm must be open to finding alternative win-win outcomes.
3. The firm needs to categorize "must-haves" into (a) what it really must have, (b) what it strongly prefers, and (c) what it would like to have.

The name of the successor firm is some-

times listed as a "must-have" for firms seeking an upstream merger or sale. There may be valid reasons for that to be on the list, but the authors have found very few instances where changing a firm's name because of a merger has had any discernible impact on the deal's success. Keeping a name does not replace the need for a comprehensive transition plan whereas a proper transition and communication strategy almost always overcomes any issues associated with a name change.

Must-haves that are easy to explain (such as unexpired leases) are best included in the summary information, while more complicated ones are best discussed in the initial meeting.

Step three. The firm should define what its merger partner/successor should look like. This involves using the four Cs, as described in detail in the third article of this series,

"How to Select a Successor," *JofA*, Sept. 2013, page 40. Here is a brief recap of the four Cs:

- **Chemistry:** If you don't want to eat lunch with someone regularly, don't merge with that person. In other words, if the partners don't personally like the people they are talking to, why would their staff and clients like them?
- **Capacity:** Understanding the goals for a deal leads to knowing the capacity issues

required of the other firm. For example, if one partner is slowing down soon, the successor firm must have the capacity and skill set to replace that partner.

- **Continuity:** Most accounting firms have their client base because their clients are comfortable with their people and approach to service. Clients tend to focus on fees, how services are provided, the level of hand-holding, and specialties, to name a few. A successor firm must be able to avoid the clients' viewing the merger as a loss of a prior firm and instead promote the gain of the combined firm.
- **Culture:** This term is used a lot but remains a vague concept for many. Culture can be thought of in three ways: (1) What's it like to work here?; (2) What's it like to be a client here?; and (3) What's it like to be a partner here? A selling firm needs to

The firms should share what they believe success looks like and find out what their strategic goals are for the merger.

consider if a merger candidate or buyer can cut the mustard in all three areas.

Step four. Before any meetings occur, information and goals should be shared with, and preliminary information obtained from, the other firm. This qualifies both firms for each other. Now attention can be turned to the four Cs and the must-haves in initial meetings. The firms should share what they believe success looks like and find out what

their strategic goals are for the merger. What do they intend to accomplish? What is their business plan for this merger?

Step five. The potential deal terms should be addressed as soon as possible. If several firms are courting the selling firm, the field should be narrowed to ones the selling firm likes and those that like the selling firm. The selling firm should obtain a nonbinding offer from the firm(s) it likes of how the firms would come together. It is not unusual for this to happen as early as after one initial meeting and certainly after no more than two.

Many firms think they need to perform due diligence before making an offer. However, it should be kept in mind that every step described above is part of due diligence. In step one, the selling firm has already told the other firm what it has and what it wants. Other critical issues can be addressed in the form of additional inquiries. It is appropriate to assume the information and responses are accurate. The nonbinding offer should describe what a deal would look like philosophically and financially, subject to verification in due diligence.

Too many times the authors have seen firms go through extensive field due diligence that confirmed all the information shared originally was 100% accurate, only to make

an offer that was not acceptable. This is an inglorious waste of time. Creating a foundation for an agreement with which both firms are comfortable justifies field due diligence. In the unlikely event a surprise emerges in due diligence, the offer can be adjusted or withdrawn since it was nonbinding to begin with.

The terms should be complete as to must-haves, deal structure, and terms.

Step six. Now is the time to perform field due diligence. Each firm should share what information and data it is seeking from the other, and appropriate nondisclosure agreements should be signed (if not done previously).

The authors suggest breaking due diligence into three parts to keep the process moving. First, information that is easily available should be shared. Frequently, this can be done through email. Second, the parties should exchange information that needs more effort but that is still only data. Third, the parties should conduct field due diligence in each other's offices. This is not to imply all three steps can't be done at once. What's important is to not let the process stall, waiting for the last piece of information to become available.

In a subsequent installment of this series, the authors will share in great detail sug-

gested items that should be covered in due diligence. PCPS members can also obtain guidance in Chapter 10 of the Succession Planning Resource Center available at tinyurl.com/cx2nauz (PCPS member login required). This material includes detailed guidance on due diligence and also on the entire M&A process.

Step seven. Now that it is time to close the deal, the parties can bring in lawyers. The selling firm's partners probably have enough experience to negotiate financial terms and business plan issues on their own, or they might be using a consultant to assist. Often the best use of legal advice is to make sure the deal that is negotiated is properly memorialized in a contract and the legal i's are dotted and t's crossed.

It is best to avoid renegotiating deal terms on which agreements have already been reached, and contract drafts should not be used as a tool for further negotiations of financial terms and business plan issues. If something new, other than a legal issue, needs to be addressed, it should be brought up orally. Few things irritate the other side more than a new item suddenly popping up in a contract draft.

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Alternative Deal Structures for Succession

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

by Joel Sinkin and Terrence Putney, CPA

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 parttime 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.

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

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The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month's installment, the sixth in the series, looks at the seven steps to complete a merger or sale for succession.

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).

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 buy-out,** 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 buy-out is similar to the buy-in leading to a buyout,** but without the upfront acquisitions. This is most commonly used by multi-

partner 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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To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

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.

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 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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How to Manage Internal Succession

Eighth in a series: The identification and development of young talent is essential.

by Joel Sinkin and Terrence Putney, CPA

The success of most accounting firm succession plans rests on the firm's ability to develop young talent into owners capable of buying out retiring partners and carrying the firm into the future. Unfortunately, many firms have little or no talent ready to assume this role, and many of the firms that do have talented staff on board don't know how to convert them into owners.

This inability to find or recognize young talent who can take the place of retiring owners is the main reason so many firms have to sell to an outsider to finance partner retirements. Some firms, however, can manage an internal succession. How can a firm assess and create its internal succession readiness? This article examines the process.

PERFORM SUCCESSION TRIAGE ON YOUR FIRM

A successful internal succession plan is usually determined by the firm's ability to at least maintain its level of business following the transition of an owner. There are three key things to focus on when assessing the risk associated with transition. The first two, timing and client loyalty, were discussed in detail in the second article of this series (see "The Long Goodbye," Aug. 2013, page 36).

The third issue is replacement of retiring partners. How do firms replace a retiring partner's role? Sometimes they can allocate the retiring partner's duties to other partners in the firm. As an example, a partner in a five-partner firm is managing a \$750,000 general book of business. The remaining partners believe they can allocate the clients

among the existing partner team because they all have the capacity to take on extra work. The billable hours for the retiring partner will need to be replaced. However, that can be done across all levels of the firm by hiring two more staff members. A new partner does not need to be added to the team to replace the retiring partner. This is called role reallocation.

In contrast, firms may lack the necessary capacity in their partner group and need to bring on a new partner to take over the responsibilities of a retiring partner. This may be due to a lack of the necessary capacity at the partner level to assume all the responsibilities left behind. Or the retiring partner may have special technical skills or firm management responsibilities that are significant. This is called role succession, which means the firm needs to create succession for this partner's role.

The tool in Exhibit 1 can help in determining the timing and extent to which partners will have to be replaced.

Based on Exhibit 1, one could conclude the following for this example firm:

- The first partner who will be retiring does not appear to pose a significant succession threat. The firm believes it has the

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capacity within its current partner group and other resources and does not need to replace this person.

- The second set of retirements is potentially a critical situation. This firm needs to make sure it has new partners in place in time to properly transition these retiring partners' roles. Admitting new partners may be necessary as early as two to four years from now.

Remember that when the firm is replacing a partner in role succession, it should be replacing the role, not just the body.

DO YOU HAVE WHAT IT WILL TAKE?

There are four major phases to executing internal succession:

- Obtain the necessary talent to develop internal successors.
- Develop the talent so it is ready to step into the role.
- Have a proper financial arrangement—both for admitting new partners and buying out retiring partners.
- Develop and execute a transition plan for a retiring partner's duties.

What constitutes the proper financial arrangement and how to develop and execute

Exhibit 1 Partner Succession Projection

Partner	1-3 years	4-7 years	>8 years
A	RR		
B		RS	
C		RS	
D			RR
E			RS

RR=Role Reallocation

RS=Role Succession

Source: Joel Sinkin and Terrence Putney.

an effective transition plan will be addressed in the next two articles of this series.

Obtaining and Evaluating Talent

A significant number of firms have not developed a process to evaluate both the talent they already have on board and what additional talent they need to recruit. It is common to find a four-partner firm where two partners think Sally is ready for promotion, but the other two partners think she never will be ready. So the partners delay doing something about Sally indefinitely, and that stops the firm from looking for someone the partners can agree has what it takes.

It's critical that firms be able to assess partner candidates objectively so they (1) know what they should be looking for in the recruiting process, (2) can decide what gaps a candidate has in his or her skill set, (3) can institute a development plan to overcome shortcomings, and (4) can form agree-

ment among management that a candidate is ready.

Clearly identifying in writing what it takes to be a successful partner can be a useful tool (see the sidebar, "Attributes of a Partner"). If the partners can't find anyone in the firm who meets those standards, they should keep the following in mind as they search outside the firm for potential partners:

- Be prepared to make a lucrative compensation offer to entice them.
- Paying what it takes can result in a temporary slip in profits, but experience shows that true talent will soon create enough additional value to overcome the investment.
- Make a solid plan and commitment for promotion to partner, including a timetable and benchmarks that need to be achieved, and then communicate the plan to the candidate.
- Understand that an experienced hire with

near-partner talent may bring a different culture.

Developing Talent

Development of partner candidates should come in three categories. Remember to direct the development plan toward the areas where critical shortcomings have been identified.

- **Generic competency development.** This is also called continuing professional education, or CPE. Locate relevant classroom and third-party training in non-technical skills such as practice development, supervision, and public speaking.
- **Firm culture-specific development.** This is also known as on-the-job training. Tailor increasingly challenging assignments to candidates to accelerate and test their progress.
- **Mentoring.** Constant communication and guidance are required to keep the momentum and focus on the development plan.

Many firms are now using nonequity partner or income-partner status as a final proving ground before making the final decision on whether to admit a candidate as an equity partner. Firms that decide to go this route should have in mind how long the candidate will have that status and what he or she needs to accomplish before the final promotion. If the candidate is truly capable of being a full partner in the firm, a two- or three-year period as an income partner may be adequate.

EXECUTIVE SUMMARY

■ **Firms need to think of role replacement when planning for a partner retirement.** This means they need to replace the roles the partner handles, not just the position. In some cases, the remaining partners have the capacity to take on the departing partner's roles. In other situations, a new partner is needed.

■ **There are four major phases to internal succession:** obtaining future partner talent, developing that talent, setting up a finan-

cial arrangement for admitting new partners and buying out retiring ones, and doing a transition plan for retiring partners' duties.

■ **Firms should have a process to objectively assess partner candidates.** This is crucial for firms to know what they are looking for in future partners and to address gaps in those skill sets among potential partners. Such a process also lays the groundwork for partner agreement about who is ready for promotion to

partner.

■ **When searching outside the firm for potential partners,** firms should make lucrative compensation offers to lure candidates, craft a promotion plan with a timetable and benchmarks for advancement, and understand that hiring near-partner talent could change the firm's culture.

■ **Development of partner candidates should come in three areas:** generic competency development (or CPE), culture-specific

development, and mentoring.

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Attributes of a Partner

- **Leadership:** Provides guidance and is a role model for other partners and staff to achieve the firm's goals.
- **Client management:** Can manage an adequate number of client relationships profitably and effectively, and clients see the person as their trusted adviser.
- **Personal productivity:** Is personally productive in supplying services to clients and has a strong work ethic.
- **Growth:** Is able to develop new client relationships and expand services to existing clients.
- **Firm management:** Participates in the overall management of the firm and is a good businessperson.
- **Technical skills:** Has developed the technical skills necessary to provide exemplary service to clients and is known as an expert in a valuable service area.
- **Teamwork:** Puts the firm's interests ahead of his or her own and promotes a team attitude.
- **Staff development:** Assists in recruiting new talent and developing staff and is seen as a mentor to others in the firm.
- **Community involvement:** Is the face of the firm in the community.
- **Professional involvement:** Is involved in the profession outside the firm.
- **Passionate:** Has unwavering loyalty to the firm and has a passion for making the firm successful.
- **Communication skills:** Excels in written and spoken communication.
- **Personal investment:** Is on a constant journey to improve and sees every day as an opportunity to learn.

Plan B

If firms don't have the time to develop talent internally and can't find the right person with near-partner talent to hire, they

should consider using a merger or acquisition as a quick fix. As has been noted extensively in this series, many merger opportunities in today's market come with the need to solve another firm's succession problem.

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Managing Owner Transition Through an Owners' Agreement

This pact can play a key role in establishing a framework for a successful succession deal.

by Joel Sinkin and Terrence Putney, CPA

For accounting firms dealing with partner succession, the owners' agreement can be one of the most important tools for (1) managing the transition of ownership and (2) establishing a culture for owner performance. Managing the transition of ownership is usually the reason a firm drafts an agreement in the first place. Often, establishing a culture for owner performance is an accidental outcome of how the agreement was structured, and unintended consequences can result if care isn't taken to understand this.

VALUATION METHODOLOGY

The 2012 PCPS Succession Survey, a joint project of the AICPA Private Companies Practice Section (PCPS) and Succession Institute LLC, identified three primary methods for determining the value of an owner's interest in a firm: (1) a multiple of revenue for an owner's managed book of business; (2) a multiple of revenue for the firm as a whole allocated based on ownership; or (3) a multiple of historical compensation. The survey found that of the responding firms that have an agreement to retire owners' interests, 75% use one of those methods.

Experience shows that as accounting firms grow, they tend to migrate from the book-of-business method to the equity-ownership method. The largest firms have the greatest tendency to use the compensation method, although smaller firms are increasingly considering this approach as well. All three methods affect a firm's culture.

Whereas the book-of-business method can be a fantastic motivator to building up a client base in a newly formed firm, it tends

to create a silo mentality, which is the antithesis of the "one firm" concept. Over time, emphasizing books of business as the only true measure of value creation can get in the way of a firm's realizing its potential.

The equity method has the advantage of being more team-oriented and encouraging growth of the firm as a whole. It can be a good transition from the book-of-business method. However, it sometimes leads to hoarding equity to the point that equity no longer reflects an owner's true contribution to value creation. Imbalanced equity can cause the breakup of a firm or the need for an upstream merger as the other owners resist the cost of buying out a supermajority owner.

One of the ironies of equity in mergers is the parties occasionally place an inordinate amount of emphasis on the allocation of ownership when, for instance, due to the combined firm's use of compensation as a means for determining retirement value and a one-person, one-vote approach to governance, equity should mean very little to an owner. Many larger firms have leveled out

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the equity allocated to owners to achieve close to complete equality.

The trend in valuations nationally, regardless of methodology, is decreasing multiples. Whereas 10 to 15 years ago, most firms were using one times revenue or three times historical compensation, PCPS survey respondents indicate that roughly half now use less than one times revenue. Firms that use less than three times historical compensation now slightly outnumber those using three times or more (52% vs. 47%).

AFFORDABILITY OF RETIREMENT TERMS

A common concern for younger members of firms is that they won't be able to pay for senior partners' retirements. In a recent merger negotiation, the younger partners of the smaller firm determined that paying for the retirements of the senior partners in the acquiring firm would require reducing their compensation or borrowing externally during the four-year payout their agreement specified. The deal didn't happen as a result.

Increasingly, firms are looking at a modification in retirement terms to motivate younger partners to carry through with the plan for senior owner transition. Experience shows that developing affordable terms for retirement requires meeting this simple test: A retired partner's compensation less the sum of the annual payment obligation (including the payout of capital) and the cost of replacing that partner has to leave enough upside in cash flow to motivate the remaining partners to want to take on the obligation. If the terms don't meet that requirement, consider restructuring them. Five-year payouts for retirement payments are often hard to accommodate in this type of analysis unless the overall obligation is small. This is why the trend in the profession is to longer payout periods, often between eight and 15 years, with 10 years as a frequent choice.

or up to 20% of profits. Larger firms tend to have a smaller percentage as their cap than smaller firms.

ATTRACTING THE NEXT GENERATION

Owners' agreements can significantly affect a firm's ability to attract and retain young partner candidates. Obviously, the cost for a new owner to buy into the firm can be an impediment. So can the lack of a mandatory retirement age in the agreement. Setting the terms for buying in is usually a compromise among (1) making sure the new owner has "skin in the game"; (2) not giving away value that has been built up by senior owners over many years; and (3) an investment requirement that makes economic sense and creates an upside compensation opportunity

initial investment to as little as a pro rata capital contribution and then control the accumulation of intangible value through a number of approaches. The true accumulation of value for most new owners comes through the additional income they receive after buying out senior partners and moving into ownership themselves. Another tactic, especially in the case of plans that use compensation as the valuation metric, is long-term vesting, which ties value accumulation to the long-term successful transition of owners. The authors are seeing vesting periods for newly admitted owners of at least 10 years and as long as 20 years. Vesting retirement benefits often help ensure that the younger owners stay through the payout of the senior owners' retirement.

The debate about mandatory retirement ages in owners' agreements is raging in the profession. Many Baby Boomers aren't ready to walk away from the lucrative compensation they have recently experienced as senior owners. Plus, the new age 65 seems to be 72 or even older as life spans continue to increase. There is pressure from senior owners to extend mandatory retirement ages or to scrap them altogether. Keep this in mind: The lack of a mandatory retirement age leaves the firm totally in the dark with respect to ensuring an adequate number of successors will be available to take over for retiring owners when they are needed.

With the current severe competition for young CPAs who are viable candidates for

A common concern for younger members of firms is that they won't be able to pay for senior partners' retirements.

The possibility that several owners will retire in a short period of time is also likely in many firms due to the concentration of ownership within the Baby Boomer generation. Establishing a cap on the amount of total retirement payments the firm is required to make helps ensure that the firm maintains a reasonable obligation. These caps are usually set at between 6% and 10% of revenues

for the new owner. The authors have seen few successful arrangements whereby a new owner obtains a 20% ownership stake in a firm and pays a proportionate amount of a valuation based on one times revenue plus a pro rata capital contribution, although those are terms a firm's senior owners might expect in an external sale.

A more effective approach is to limit the

EXECUTIVE SUMMARY

■ **The owners' agreement can play a significant role in two main areas affecting partner succession:** (1) managing the transition of ownership and (2) establishing a culture for partner performance.

■ **The trend in accounting firm valuations,** regardless of the methodology used, is one of decreasing multiples.

■ **More firms are looking to modify retirement terms to make the deals affordable for younger partners.** Among the trends in this space is the lengthening of payout periods from five years to anywhere from eight to 15 years, with 10 years as a common choice. Firms are also establishing annual caps on the total

amount of retirement payments.

■ **The lack of a mandatory retirement age in the owners' agreement** can deter young partner candidates. While many older partners want to work indefinitely to maximize income, potential new owners seek certainty as to when they will be able to buy a partnership position.

Joel Sinkin (jsinkin@transitionadvisors.com) is president, and *Terrence Putney* (tputney@transitionadvisors.com) is CEO, both of Transition Advisors LLC in New York City.

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owner status, don't assume that the best people are going to hang around with no idea of when you'll be ready to give them an opportunity. You may wake up one day having maximized your earning years with no one there to take the reins from you.

THE TRANSITION PLAN

The value of an accounting firm is not innate. It is usually directly related to the firm's ability to transition the key duties from an owner to another person, usually a new owner. Especially in smaller firms, the most important duties of the retiring owner that need to be addressed are client relationships. Therefore, a key component for many owners' agreements should be motivating an effective transition of client relationships.

Many owners' agreements tie retirement payments to post-retirement client retention in a similar fashion to what would be expected in an external deal. Although this approach has the advantage of protecting the firm from a financial obligation that is not supported by ongoing revenues, it can have the opposite effect of what was intended. The fear of losing clients sometimes motivates an owner approaching retirement to hold onto relationships for as long as possible because "no one can replace me." A better approach is to require adequate notice be given for an owner who wants to retire coupled with a clear plan for transition of client management responsibilities. Usually, it takes at least a two-year notice to provide enough time for clients to become familiar—and comfortable — with a successor. If the new relationship doesn't stick, the firm has time to assign a new successor.

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- "Mergers & Acquisitions of CPA Firms," March 2009, page 58, and "Keeping It Together: Plan the Transition to Retain Staff and Clients," April 2009, page 24 (two-part article)

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How to Maximize Client Retention After a Merger

Tenth in a series: Culture, communication, the business plan, and personal involvement are key.

by Joel Sinkin and Terrence Putney, CPA

The retention of clients is essential to a successful merger of accounting firms. Most deals are structured so that the payments from the acquiring firm to the selling firm are based, at least in part, on the percentage of clients that stay with the post-merger firm during a specified retention period. In other words, the departure of clients from the acquiring firm results in lower payments to the selling firm, providing a healthy incentive for selling firms to facilitate a transition that encourages clients to stick with the acquiring firm post-merger.

Acquiring firms, meanwhile, also have a substantial interest in retaining clients—and staff—post-merger. After all, the selling firm's book of business and stable of talent always are a huge reason the acquiring firm invested in the selling firm. The acquiring firm does not want to see those assets depart, even if the deal structure provides some protection in the form of lower purchase payments.

So it is that both parties in an accounting firm merger or sale are highly motivated to minimize client turnover. This article addresses how a proper transition plan can maximize client retention.

The first thing for merging firms to understand is that some client and staff attrition is natural and inevitable. On average, about 15% of staff and 5% of clients leave a firm each year. The goal in a merger is to keep those percentages from rising beyond the norm, especially in the period right after the merger closes, when a spike in client or staff departures could inspire other clients and staff members to leave the firm as well.

A good transition plan establishes a merger process that limits attrition. Transition plans have four key areas of focus:

- Culture;
- Communication;
- Business plan; and
- Personal involvement.

1. Find a Good Culture Fit

It is crucial for a selling firm to choose an acquiring firm that has a similar culture. The goal should be to keep the ship sailing in the same direction with the benefit of added resources to provide even better service to clients. Clients and staff chose the selling firm in the first place at least partially because of their personal comfort with its people and culture. If the selling firm's partners don't feel comfortable with the acquiring firm, why would their clients and staff?

Clients usually can choose among many accounting firms. In some cases, clients are attracted to a firm because of its reputation or special expertise. However, many clients

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 of those 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 10th in the series, examines how to minimize client turnover after a merger.

of small firms make a choice due to the style and personality of the firm's owners. How the firm serves clients is key. Clients accustomed to hands-on and personal communication may not be receptive to service delivery based solely on a technology interface such as email or a portal. Staff members accustomed to having a lot of autonomy and being treated as key members of the service team may not assimilate well into a culture with significant oversight, where they feel like a minor cog.

2. Communicate Clearly

Most clients have the following fears when hearing their firm is merging:

- Will the person I have relied on still be there?
- Is this merger going to cause my fees to increase?
- Will the new firm remain convenient for me to do business with? (This happens especially if the client is used to meeting in the office.)
- Will the combined firm be able to pro-

vide the service I need in the manner I am accustomed to?

Obviously, if the acquiring firm plans to raise fees dramatically or intends to arbitrarily change key people responsible for communicating with clients, the merger is in trouble. Even if the combined firm intends to keep things the same as much as possible for the acquired staff and clients, problems can arise if the firm doesn't clearly communicate its intentions. People affected by a merger often assume things will change dramatically, and for the worse, unless they are specifically told otherwise.

As soon as possible following the merger, the combined firm should make sure clients, staff, and other constituents receive a clear message through meetings, phone calls, and letters describing what this merger means for them. The more important the people are to the firm (for instance, the largest clients in terms of fees), the more they need to have the most personal type of communication, such as a meeting.

It is a good idea for everyone in the firm to have a script of what needs to be communicated to every client. Even if certain clients receive a letter, they will likely also ask questions of staff. An announcement letter or script might state that you merged with Able, Bravo and Co. because the firm has tremendous expertise and resources. In addition, the script could emphasize that the people the client has relied on will remain on board, the fee structure will remain the

Succession Transition Case Study

Here is an example of how to keep the trusted adviser seller personally involved while still supporting the transition to a successor.

John is in the process of transitioning his practice to Jane. John and Jane announce to both client bases they have merged. Almost immediately, John gets a call from a client who is panicking because he received an IRS notice regarding a tax return John prepared. Instead of John just handling the matter as he normally would, he responds, "You know, my new partner, Jane, has tremendous expertise with this kind of problem. Two heads are better than one, so I will speak to her and we'll get back to you right away." Instead of John calling, Jane calls and takes over the matter while reassuring the client that John remains available to assist as necessary. If John had handled the matter as usual, the transition would not have progressed. By encouraging the client to work with Jane, he elevated Jane's presence with the client and moved down the path of transition. Plus, there is no reason for the client to conclude John has abandoned him.

same, the firm will remain geographically convenient, and no changes are expected in how the client receives services. Keep in mind when sending an announcement letter to send it out on the acquiring firm's stationery but in the acquired firm's envelope. If you send it in the acquiring firm's envelope, some clients may not open it because they believe it is a solicitation.

3. Consider a Business Plan That Minimizes Upfront Changes

You can't avoid making some changes to how an acquired firm operates. However, when building a business plan for the combined operations, group the changes into two categories: "changes behind the door" and "changes in front of the door." An example of a change behind the door is tax

preparation software the firms use. Rarely will a client care or even notice a change from Software A to Software B. The main concern with that change might be making sure staff can continue to efficiently prepare tax returns.

An example of a change in front of the door is a client accustomed to being managed by an owner who is suddenly working with a staff person. That change could dramatically alter the client experience. Increasing fees substantially for the same services is another change in front of the door that can have disastrous consequences.

Changes behind the door can frequently be implemented without much concern for client retention (although these changes can be a huge item for staff retention). Changes in front of the door can have a major im-

EXECUTIVE SUMMARY

■ **Client retention often is key** to determining the short- and long-term value of an accounting firm merger—for acquiring and selling parties. Staff retention is crucial to client retention.

■ **Transition plans have four key areas of focus:** culture, communication, business plan, and personal involvement.

■ **Sellers need to be comfort-**

able with the culture of an acquiring firm.

■ **Both firms in a merger need to communicate the right messages** to the right people in the right format before and after the merger.

■ **Merging firms should strive to develop a business plan** that minimizes upfront changes for clients.

■ **Firms should respect the relationships between clients and the partners or staff they work with.** A transition from a current adviser to a successor takes years and should be gradual, with the successor becoming involved with clients before the departing partner retires.

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pact on clients' comfort level. If substantial changes in front of the door are required, the impact on client retention can sometimes be mitigated by instituting them gradually.

4. Respect Personal Relationships

Firm owners contemplating a sale are frequently concerned that their relationship with clients is so personal and unique that it can't be replicated. They cannot see anyone being able to take over for them. Yet, as counterintuitive as this may sound, the greater the loyalty between an owner and his or her client base, the easier it can be to transition the clients. The highest retention rates are often in the most loyal client bases—if the transition is handled properly. If a seller's clients are not experiencing a lot of change in front of the door, the clients' trusted adviser remains involved, and the successor firm has a larger platform of services to offer (as is frequently the case), why would clients leave for a complete stranger and start all over?

The key is to give the eventual transfer of loyalty enough time, keeping the trusted adviser personally involved while also supporting the transition. In today's hightech world, practitioners tend to see clients in person less often than before. Instead, data and reports are exchanged through the cloud, via portals, by email, over the phone, and through staff picking up and delivering the work. The less face time you have with clients, the longer you should expect the transition to take. The minimum time a typical transition should take is two years. A transition over three to five years usually is more effective. This is one of the key reasons a two-stage deal is such a powerful way to structure the transition of a practice (see "A Two-Stage Solution to Succession Procrastination," *JofA*, Oct. 2013, page 40.)

The retiring partner can play a lead role in introducing the successor to the client. (See the sidebar, "Succession Transition Case Study," for an example of one approach to doing this.) In the end, a transition plan that addresses culture, communication, upfront changes, and client-partner personal relationships has the best chance of minimizing client turnover and maximizing the value of an accounting firm merger.

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The Culture Test

Eleventh in a series: How to assess and manage the most important factor in accounting firm mergers

by Joel Sinkin and Terrence Putney, CPA

As shown throughout this series, there are many types of succession deals and strategies, each with its own advantages and challenges. In the case of a merger or acquisition facilitating succession, the No. 1 key—and threat—to success is easily identified but not so easily defined. The authors have asked hundreds of managing partners over the years what makes a merger successful. “Culture” is by far the most popular answer. Along the same lines, when asked why a merger failed, managing partners usually say something like “the culture of the other firm was not consistent with ours.”

This is important to firm succession for many reasons, the most prominent of which is that accounting firm sale prices most often are determined by a specific percentage of fees the acquiring firm collects during a retention period established by the merger agreement (see “How to Value a CPA Firm for Sale,” *JofA*, Nov. 2013, page 30). Failure to retain clients and maintain fees results in a lower price to the seller. What is one primary result of a poor cultural fit in a merger? The merged firm experiences staff and client turnover, which leads to lost fees and a bad deal for both sides.

Managing partners understand that culture is key, but they struggle to define it. Consequently, when firms consider cultural assessment in due diligence, they usually don’t know what to look for. This article assesses the most important characteristics of culture and also explains how to structure deals to maximize cultural fit and the chances of a successful merger.

Culture is best understood in three categories: organizational, client service, and owner issues. Following are factors firms should consider in each category when assessing the cultural fit of a potential merger partner.

ORGANIZATIONAL ISSUES

■ **Work ethic.** This often can be assessed by reviewing the hours logged by the owners and staff. A firm that expects its owners

to generate 1,700 billable hours per year usually has a much different culture from one that sets the bar at 1,000 hours. How many work hours does the firm expect of its staff during busy season?

- **Mobility.** Does the firm encourage its professionals to work mostly in the field, or are they primarily office-based? How does firm leadership feel about staff working from home?
- **Policies and procedures.** What can you learn about the firm’s value system and management style from reviewing its policy manuals?
- **Organic vs. acquired growth.** Firms with a history of internal growth sometimes can have more difficulty acclimating to the culture of another firm in a merger. On the other hand, firms that have grown primarily through acquisitions may have an exceptionally diverse culture resulting from the combination of many different organizations.
- **Gatekeeper vs. team.** Does the firm encourage management of client relationships through “books of business,” or does the firm embrace the “one-firm concept”? A firm with a strong gatekeeper mentality can have difficulty assimilating into a shared-responsibility environment. Similarly, a firm that creates “partner-loyal” client relationships could have trouble if it is forced into a firm that promotes “firm-loy-

About the Series

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The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month’s installment, the 11th in the series, examines the role culture plays in accounting firm mergers.

al” clients. Neither is wrong or right, but a sudden change can affect client experience and be detrimental to retention.

CLIENT SERVICE ISSUES

- **Billing procedures.** How a firm determines fees and bills for clients is a huge cultural issue. A firm that mostly uses fixed fees might have trouble transitioning clients to a system strictly based on hourly rates. Billing rates, which often are used as a proxy for culture, are discussed in greater detail later in this article.
- **Client demographics.** A firm’s culture has to be consistent with what works for its clients, or they would not remain clients. So reviewing the types of clients—i.e., businesses vs. individuals, size, industries, and services provided—provides an indication of culture.
- **Staff leverage.** A firm that has, on average, 10 nonowner professionals for every owner is likely to operate much differently than a firm with a 2-to-1 ratio. The difference for staff and owners in their everyday client service roles can be substantial.
- **Specialists vs. generalists.** Some firms pride themselves on their professionals’ ability to address a broad range of client and client needs. Other firms are focused on their people having a much narrower range of skills but being experts in an industry or service area. The transition

from one approach to the other can be difficult both for staff and for clients.

OWNER ISSUES

- **Owners' compensation system.** How does the other firm pay its owners? Are there performance evaluations? Does the firm use a formula-driven approach or rely on subjective evaluations for a substantial portion of owner compensation? Evaluation of the owners' compensation system provides a bird's-eye view of what the firm values in its owners' roles. To what extent, if any, is weight given to owner billable hours? Is practice development specifically compensated? Is there any emphasis on activities for the firm outside an owner's managed book of business? Which specific areas of management, such as staff development, are considered in owners' evaluations?
- **Owners' agreement.** In a similar vein to the owners' compensation system, the owners' agreement also gives an important view of a firm's culture. Most agreements contain an owner retirement plan, which is, in essence, how the firm allocates value among the owners. Is this done based on books of business, an equity ownership percentage, or a multiple of compensation? Is there a concentration of ownership in a few people? Does the firm have tight restrictions on the owners' ability to leave and take clients, or is a lot of freedom allowed? Freedom to leave the firm with business in tow might seem to be a positive if you decide you made a mistake in picking a merger partner. However, the lack of a contractual commitment to the firm can lead to instability and a "free-agent" culture within the firm.
- **Compensation level and range.** Two important indications of culture are the

absolute level of average owner compensation and the range from the highest-paid to the lowest-paid owners. It is not necessarily a deal killer if one firm's average owner compensation is \$175,000 and another firm's is \$400,000 if it's clear what is causing the difference and what is likely to happen over time.

Is there a good chance the gap can be narrowed due to the lower-compensated owners' taking advantage of a more profitable operating environment? Will resentment develop if the gap isn't closed? Is there little difference in the compensation range, or, in the extreme, are all the partners compensated equally? Little variance in compensation indicates that the firm values the collegiality of its owner group, although it also can indicate conflict avoidance at the expense of performance. A large range from top to bottom can indicate a culture that values the difference in individual performance—within its owner group. In its extreme form, though, it can indicate that the firm places little value on the owner group's working as a team.

EFFECT OF DEAL STRUCTURE ON CULTURE

The type of deal that is being contemplated should have a significant effect on the relevant cultural issues. If you are considering a sale of your practice with a short-term working arrangement with the successor firm, many of the cultural issues above may not be important. Normally, if you focus on the cultural issues that affect your clients, you can ignore the rest, such as most of the owner issues. Client retention following an acquisition almost always affects the value you are paid for your practice. If it is important to you that your staff be retained, most likely

because of the impact their loss could have on clients, then consider how the integration of your culture and the other firm's culture will affect them, too.

In a sale, the departing owner often will work for three years or less at the acquiring firm and usually under a compensation arrangement that is formula-driven without regard for how the acquiring firm pays its owners. The fact that you, the seller, would not necessarily have chosen to work at this firm for 20 years or more due to its culture should be irrelevant if the firm can achieve your primary goals for the acquisition, especially client retention. The deal provides you with a succession team you don't have now and keeps the practice intact to maintain its value. This can be especially difficult for owners of small firms to understand. They often will never find a firm that fits the culture they built in their firm because that culture was so dependent on them.

MANAGING CULTURAL DIFFERENCES IN A MERGER

Some differences in culture can be overcome by executing a plan to change a cultural difference—for instance, owner-level billing rates. It is not unusual for acquiring firms to conclude strictly based on a difference in owner billing rates that the cultures of the two firms are incompatible and, therefore, walk away from the opportunity before investigating further.

However, when you dive deeper, you may find that this problem is easily overcome. Smaller firms don't have the luxury of assigning tasks to a wide range of experts on staff. As a result, owners can find themselves doing work that a senior staff person could handle. When this happens often enough, it tends to cause the firm to hold down its standard billing rates to avoid frequently mis-

EXECUTIVE SUMMARY

- **Managing partners cite culture as the No. 1 key to success in accounting firm mergers**—and poor cultural fits as the top reason that mergers fail.
- **Accounting firms struggle to define culture.** They know it's important, but they don't know what it is.

- **Three main components to culture** are organizational, client service, and owner issues.
- **Deal structure plays a critical role in determining culture and its effects on a merger.** Firms should focus on how the merger terms will affect staff and client retention.

- **There are many ways to address cultural differences.** One possible approach is to remove contingencies from the terms of the deal.

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pricing its services. Even though an owner might have a standard hourly rate of \$150, when that professional is truly functioning at his or her highest level, he or she could

is for the merging owners to recognize this opportunity and execute a plan to raise their rates.

Another way to address cultural differenc-

Client retention following an acquisition almost always affects the value you are paid for your practice.

easily be worth \$250 per hour or more. After merging into a firm that has a wider range of staff expertise available, an owner might be able to raise his or her standard rate without increasing the price of services to clients, by distributing work to lower-level staff. The key to overcoming that cultural difference

es is through contingent terms. From the acquirer's perspective, if there is a concern the clients and staff may not assimilate well into a different culture, contingent terms for the buyout can lead to (1) more motivation for the seller to execute the integration plan and (2) protection from the risk of lost business

due to a poor integration of cultures.

From the seller's side, the authors have seen deals set up in which a contingency is removed from the deal if the buyer doesn't follow through with a commitment to execute a plan to incorporate a dissimilar culture into its practice. For instance, if the acquiring firm does not offer a service the selling firm offers, the seller might rightly be concerned whether the buyer will retain that portion of the business so the seller can be paid. Assuming the buyer commits to a plan to offer that service (if the buyer doesn't and it's material to the seller's value, it might be best to walk away), the deal could be set up to lock in the price with respect to that portion of the practice if the buyer doesn't live up to that commitment.

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Do's and Don'ts of Due Diligence

Last in a series: The when, what, and how of making sure everything checks out in a merger.

by Joel Sinkin and Terrence Putney, CPA

This article marks the 12th and final installment in a yearlong look at issues affecting succession for CPA firms. The series started in July with an explanation of why mergers have become a dominant trend in accounting firm succession strategies. The series ends this month with a dive into what should be one of the last stages of an accounting firm merger or sale: the due-diligence period.

Due diligence is the assessment of the legal, financial, and business risks associated with a merger or acquisition. It is totally appropriate and recommended for both parties to a transaction to perform due diligence on each other, regardless of the deal's nature and whether you are buying, selling, or merging. This article discusses when you should conduct due diligence, what you should review, and how to interpret and react to the findings.

WHEN SHOULD YOU PERFORM DUE DILIGENCE?

Due diligence starts the first time you meet a potential candidate for a business combination, even when you first review data on the

firm. Every step along the way, you should be assessing whether a combination of your firm and theirs would meet your financial and business goals.

However, there is a specific intensive review that you will undertake referred to as "field due diligence." Too often, firms start field due diligence much too soon in the deal process. A better course is to perform field due diligence only after the following steps have been completed:

- The parties have exchanged enough summary financial and operating information for both sides to make a determination of the deal's appropriate terms, relying on the assumption the information is accurate.

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 of those 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 12th and final part in the series, examines the due-diligence process in accounting firm mergers.

- The parties have discussed and agreed to a nonbinding terms sheet, offering memorandum, or letter of intent, pending the field due diligence that will follow.

Why wait to perform due diligence until you have agreed to deal terms? First, one of the key things you need to review in due diligence is how the terms will affect your objectives for the deal; you can't do that until you know what the terms are. Second, field due diligence is an invasive process, and it can lead to premature disclosure that a transaction is imminent. There is no reason to take that risk until you are fairly certain a deal is viable. Finally, field due diligence requires a lot of time and effort pulling together information, especially on the part of the party being reviewed. It is a colossal waste of time doing that until you know the time investment is worthwhile.

WHAT SHOULD YOU REVIEW?

Obviously, you want to determine in due diligence what financial and legal risks will be associated with a merger or acquisition. Generally, you'll be reviewing historical financial data, details on owners and employees, client categories and specific material clients, service methodologies, benefit plans, policies, procedures, the quality-control sys-

Case Study: Business Plan Issues

A sole proprietor found a firm that appeared to be her perfect successor. The financial terms depended on the successor firm retaining her clients, as is the case with most acquisitions. The seller was confident the successor could do that because the firm operated essentially as she did. Their billing rates were similar. Their offices were close. Their personalities were compatible.

In due diligence, however, she found all of the successor firm's partners were so busy they could hardly keep up with their existing client work. They had no plan for who would take over her client relationships. She realized that while this looked on the surface like the perfect deal, and all the financial and legal due diligence checked out, the other firm appeared incapable of executing the business plan.

Case Study: Client Concentration Risk

A four-partner firm was merging into a somewhat larger firm. Three of the partners in the smaller firm were staying on indefinitely, and one was retiring in three years. The larger firm was initially comfortable that client retention would not be a big issue, so it agreed to fix the retirement obligation for the acquired partners following a 12-month lookback period. However, in due diligence, the larger firm discovered that a group of clients managed by the short-term partner were related and in total made up 20% of the acquired firm's volume. The larger firm modified the merger's terms to change the retirement payments for the short-term partner to be partially based on five years of retention of fees for that client group following his retirement. Financial and legal due diligence checked out, the other firm appeared incapable of executing the business plan.

tem, legal matters such as litigation and licensing, and the condition of assets being acquired.

Many firms don't pay enough attention to the business risks. Every participant in a merger has a business plan in mind. The other side might bring sterling credentials—financially strong, no undisclosed liabilities, a top-notch quality-control system, squeaky clean legally—and still be incapable of meeting the objectives you have for the deal. Consider what assumptions you have made about the other side's ability to deliver on the plan, and then try to confirm if those assumptions are reliable.

The first step as you start formal due diligence is to exchange lists of what each side wants to see. To manage time and priorities, break the review down into three categories:

- Things that are readily available and can easily be delivered, for instance, by email. Examples are financial statements, tax returns, employee handbooks, leases, and employment agreements.
- Things that might require some effort pulling together, such as accounts receivable, breakdowns of client information (fees, industries, tenure), and operating metrics on productivity.

- Information that can be gathered only in the field, such as a review of workpaper files and quality-control processes, inspections of office and equipment, and interviews of key people.

If you stage the requests for data so the easy things can be done earlier, the process is not so daunting. Scheduling office visits can be difficult, and there is no reason to delay the review of historical financial information while trying to arrange the field due diligence.

HOW SHOULD YOU REACT TO WHAT YOU FIND?

Problems surface sometimes in due diligence, and occasionally the matters are serious enough to kill the deal. However, most of the due diligence the authors have been involved with has not turned out this way. This is largely because the parties had quite a bit of information upfront, before field due diligence commenced and before the deal was struck. Accounting firms are inherently complete, accurate, and honest with each other. However, if you do find something troubling in due diligence, how should you handle it?

You can take one of three steps in response to unexpected due-diligence findings: (1) walk away from the deal; (2) modify the deal terms to mitigate the risk you have found; or (3) modify your business plan for the deal.

Case Study: Profitability

A two-partner firm was seeking to be acquired by a much larger firm. On the surface, all the numbers matched, and the small firm was highly profitable. During due diligence, the larger firm found that the smaller firm's partners regularly visited their clients and did much of the work themselves. The firm's staff was not very productive or strong. Because the partners were doing so much of the work, their need for review wasn't considered necessary much of the time. The larger firm realized it could not replicate the profit margins the seller had produced within its quality-control structure and walked away from the deal because the terms could not be modified enough to make it profitable.

EXECUTIVE SUMMARY

■ **Intensive, or "field," due diligence should take place after the parties in merger talks have agreed in principle on terms for the deal.** While some due diligence should be performed from the beginning of the process, the intensive investigation of the other party is an invasive and time-consuming process that requires some knowledge of the deal's terms to adequately

assess how they affect the merger's objectives.

■ **Firms should pay special attention to business plan risks during due diligence.** The other side might have great financials, superior quality control, and a sparkling client base but be unable to meet your objectives in a merger.

■ **Due diligence should be broken into three categories**

of information: (1) things readily available and easily delivered; (2) things that require some effort to pull together; and (3) information that must be gathered in the field.

■ **There are three ways to react to unexpected due-diligence findings:** (1) walk away from the deal; (2) modify the deal terms; or (3) modify your business plan for the deal.

Joel Sinkin (jsinkin@transitionadvisors.com) is president, and Terrence Putney (tputney@transitionadvisors.com) is CEO, both of Transition Advisors LLC in New York City.

To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

KEEP IN MIND THESE TYPICAL BUSINESS ISSUES WHEN CONDUCTING DUE DILIGENCE

- If you are acquiring a practice with a short transition period for the owner, find out how long the clients have been clients. The longer a client's tenure, the more likely the successor will be able to retain the client.
- If you are selling a practice, find out what kind of attrition rate the successor has for its client base. The rate is likely to be the same or worse for your clients after the sale.
- If a firm you are acquiring doesn't have employment agreements with its staff, consider whether the staff will sign your employment agreements and what impact and potential risk there would be on client retention if any refuse to sign.

- If you are merging into a firm to address a succession problem, make sure the successor firm has the capacity and skills to replace your firm's owners who will be leaving soon.
- Review who at the firm really does the work and manages the relationships with the clients and how that might affect retention. Don't assume that just because a client is on a partner's billing run, that partner controls the relationship.

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- Part 10: "How to Maximize Client Retention After a Merger," April 2014, page 42
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Call for Questions

Have questions on accounting firm M&A, succession planning, valuations, deal structure, due diligence, owner agreements, or related topics? Send them to Joel Sinkin and Terrence Putney via jofa_feedback@aicpa.org. If asking about a specific situation, please include as much information as possible. For M&A deals, for example, it is helpful to know gross revenues, number of partners, and location of the parties involved. It also is helpful to have the question categorized as either (1) selling/upstream merging; (2) acquiring; (3) internal succession; or (4) owner agreement. No names will be revealed in any published answers to submitted questions.

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