Case Study Number 11: A sole practitioner establishes a Practice Continuation Agreement (PCA)

What is a PCA?

A Practice Continuation Agreement is a business plan for one accounting firm (Successor Firm) to take over for another firm (usually a sole practitioner-SP) in the event an unplanned event results in the SP's inability to continue to manage the practice or provide client service. Those events are typically temporary or permanent disability or death. The PCA usually lays out the terms for the Successor Firm to operate the practice until the SP can return or in the case of a permanent loss of the SP, to buy the practice.

The Sole Practitioner

We were approached by a SP with 3 staff generating $750,000 in annual revenues to assist with setting up a PCA. This firm offers primarily accounting and tax services. The SP works mostly with small closely held business clients and some stand-alone individual tax clients. At the time we provided this service the SP was 10 plus years from slowing down. He was not interested in merging into another firm and because he was that far out from a transition he was not a candidate for a Two Stage Deal as is described in Case Study One. A Two Stage deal is a much stronger method of protecting your firm if you are 5 years or less from slowing down. We advised this practitioner that his best option was to execute the PCA now as insurance against a sudden catastrophic event. He should later consider a permanent solution to his succession needs when he as about 5 years away from slowing down using a Two Stage Deal. A Two Stage Deal could be executed with the firm he was considering for the PCA or another firm that might be a better fit at that time. Even though this SP had professional staff, none were considered capable of becoming his successor.

The Consultative Process

Our client hired Transition Advisors to help make recommendations on the type of candidate to target as a partner in the PCA and to develop terms for the agreement.

Choosing a PCA partner:

A solution some SP's choose is a "Cross-PCA" wherein two firms agree to step in if the other firm is in need of someone to take over. The apparent advantage to this is matching cultures. We have SP's say "The best person to step into my shoes is a practitioner just like me. He or she understands the type of clients I serve and those clients will relate well to them." The reality is the only time we have seen a Cross-PCA work is when four or five SPs enter into that type of arrangement with each other. Why?

The biggest problem with choosing a PCA partner similar in size to you is c*apacity*: Your PCA partner has to have the capacity to replace you on a part time or full time basis ideally with an owner level person. If your clients are accustomed to dealing with you, the owner, they cannot suddenly be expected to be happy dealing with a junior staff person. Plus chances are you produce a lot of the work in your practice with your own time. That might be 40% to 80% of the productive capacity of the firm. Can a firm similar in size find the resources with little or no notice to produce the work you have been producing? The successful Cross-PCAs we have seen involved enough similar size firms that the capacity could be spread so as not to tax one firm too much. Rather than use a Cross-PCA it is normally better to find a PCA partner large enough to have the capacity to take over immediately without taxing their own resources too much or a small firm just starting out who has a tremendous amount of capacity.

The other characteristics you need to consider in a PCA partner are:

Technical strength: Your PCA partner needs to have the ability to handle the type of services you provide. This will be an issue if you provide any specialty work or are required to have special licenses or credentials.

Continuity-Clients and staff are likely to give your PCA partner the benefit of the doubt to an extent and for a while when it comes to how they are served and expected to work. However, the more aligned your operating environment is with your PCA partner, the better. One important operating system that you should consider looking for alignment on is tax and other software. That will be important for managing staff efficiently. Otherwise, think about how your clients are served by you and look for a firm that serves its clients in a similar way. Make sure your PCA partner will be able to keep client fees about the same. Your clients won't react well to an increase in fees. If location is an issue for your clients, try to find a PCA partner that can either continue to operate your firm from your location or whose location is convenient for your clients.

Chemistry: If you are not comfortable with the culture of your PCA partner, why would your clients and staff be? Your PCA partner should be used to serving clients like your clients with a style similar to your style. Personality is important. If you can't imagine spending a lot of time with owners of your PCA partner firm, you might not be considering the right firm.

The PCA Partner

Our client SP chose a local 4 partner firm who understood the handholding nature of his service style, had the capacity to take on the work, and used a similar fee structure. He had known the managing partner of the firm for a long time because they worked together in their early days of their careers.

Terms of the Agreement:

In the event of a temporary need, the Successor Firm agreed to manage the existing staff of the SP and use that staff to do as much of the work as possible. To the extent necessary the Successor Firm would provide additional staff and partner time to fill in the shortfall in productive capacity. Essentially, the SP firm would continue to operate as always and the Successor Firm would provide contracted labor as necessary. However, due to professional ethics, the Successor Firm will issue the reports under its firm name. The Successor Firm agreed to provide all of the necessary staff time needed and retain from the client billings 67% of standard rates and partner time at 80% of standard rates. Fees would continue to be billed to clients at historical levels used by the SP firm.

The terms included a definition for temporary disability versus permanent disability. In this case, temporary disability was limited to six months. This was to avoid an open ended arrangement.

In the event of the death or permanent disability of the SP, the terms essentially became a practice purchase agreement. The terms were based on 15% of collections from the clients for 5 years. The Successor Firm agreed to help out with the liquidation of the other practice assets, especially the collection of accounts receivable. The liquidation proceeds were to be retained by the SP or his estate.

Where Are the Parties Now?

Thankfully the PCA has not been activated. Every year, at our recommendation, the Successor Firm and the SP get together so the SP can familiarize the Successor Firm with the client files, technical information, passwords to systems and make sure both parties are ready in the event the need arises.

Why a PCA is Not a Succession Plan

There are some SPs that believe once they have a PCA in place they have also dealt with their long term succession. A PCA is poor way to deal with the managed and planned succession of your practice. The only situation where a PCA should also be considered an exit strategy is if you intend to work in the practice until you are physically unable to do so any longer. That type of exit strategy is referred to as "Turn Out the Lights". As the owner of a small business, it is your right to determine when and how you wind things up in your practice. A little less than 20% of SPs end up Turning Out the Lights. That can happen because, at an advanced age, you suddenly (normally due to health issues) are unable to continue on. Or as you become older your practice contracts because your clients and staff become aware that eventually you won't be around but they don't know when you'll retire. So little by little they find a new home. So in the event you must stop working or die while there is still a practice remaining, your estate will be able to better able to capture the value of what's left compared to desperately finding a buyer.

If you desire to i) capture good value for your practice, and ii) have a managed and effective transition, you are much better off looking for an upstream merger or a Two Stage Deal. A Two Stage Deal is best used when you are 5 or fewer years from slowing down substantially or retiring altogether, If you are looking for a long term succession solution and are more than 5 years from slowing down, an upstream merger is a better option.

A PCA has several disadvantages compared to a merger or Two Stage Deal:

- The circumstances that are anticipated in a PCA are the result of a sudden loss of <u>you</u> in the practice. As a result there is normally more risk that clients will not have enough time to transition to a successor firm. The value of the practice may not be as high as it would if a transition plan was in place that was designed to maximize client retention.
- When a SP is suddenly lost from the practice, especially due to death, experience has shown us that clients will quickly start leaving. A PCA will likely result in a better outcome than if you don't have one. But it pales in comparison to creating a planned transition of your practice in a way that will maximize client retention.
- A PCA should really be viewed as an insurance policy. Relying on a PCA for the transition of your practice is a little like relying on fire insurance as a means to sell your home.

Certain facts and descriptions have been altered to protect the confidentiality of the parties involved in the above case study.