



Planning for Internal Succession of Partners in an Accounting Firm

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Leading CPAs through Transition with Succession and M & A Strategies

A solid and complete buy-sell agreement is a vital component of a succession plan. However, the business plan for how the firm will transition client relationships and roles leading up to and after the succession of a partner, are equally important. This report identifies key issues that should be addressed in an internal succession plan.

1. Make Sure You Have a Win-Win Economic Proposition

Many internal succession plans have failed because the partners that are obligated to fund the buy-out feel they can't afford to do so. In the worst case scenarios, this fear breaks up a partnership or causes defections. Conversely, partners that would prefer to retire don't because the payments they will receive aren't enough to motivate them to do so. They hang on beyond when they are valuable contributors.

Succession plans can normally be structured so that there is an economic incentive for both the retiring and remaining partners to carry out the agreement with an appropriate amount of risk for both parties. Prepare an economic analysis and be realistic in the terms.

You wouldn't recommend to your clients to acquire a business knowing they were likely to lose money. Your partners should not be expected to take a substantial reduction in their income to become a partner or to buyout senior partners.

Your firm has a market value in an external sale or merger. Most practitioners have a notion of what that value is. The terms of your internal succession probably should be different than an external sale. Usually the "price" used in an internal buy out is somewhat less. However, if the value that the retiring partner will receive dramatically differs from a third party transaction, it can be a symptom that the

underlying economics of the succession plan won't work.

A great way to determine what internal funds are available to pay retiring partners is to start with their total current compensation package, including perks and benefits. From that sum, subtract the cost of replacing the labor needed when the partner retires. The balance is money available to the firm for retirement payments plus incremental profits for the remaining partners, assuming the practice remains steady. This is what we call our "Working Backwards" method of valuation. The allocation of this pool should give the retiring partner a fair value for their interest in the firm and leave a fair amount for the remaining partners who will now be responsible. It is of particular benefit to do this calculation for the benefit of newer partners because they often don't have the same understanding of the dynamics of firm profitability.

2. Require Appropriate Notification

Sufficient notification in advance of retirement will provide the remaining members of the firm a reasonable opportunity to conduct a transition and retain the clients. Most firm partners have certain clients they are the primary contact for. It is critical that BEFORE a partner retires, these relationships are transferred so that the practice can remain whole. Some agreements require as much as two years' notice.

Failure to provide adequate notice of retirement puts the firm at risk that it won't make the necessary transition of roles which can lead to a diminishment in its value or even its overall viability. Penalties including reduced values and making the valuation subject to adjustment for client retention post retirement are mechanisms that can be used to protect the firm when adequate notice is not given.



3. Consider All of the Retiring Partner's Roles

Managing client relationships is a competency normally many persons in the firm have, especially other partners. Although replacing responsibility for managing specific client relationships is critical, don't forget about the other roles the retiring partner plays. Some of these may use unique skills that will not be easy to replace.

The lists of other roles you need to find replacements for include:

- Production-consider the hours and dollars the retiring partner has produced
- Rainmaking-practitioners late in their career are often at their peak performance in practice development
- Leadership and administration-consider the transition of these roles early in the process
- Special expertise and licensing-failure to find a successor for these areas can lead to loss of entire service offerings

Sometimes a retiring partner who handled all the administration, quality control and performed the function of a critical "inside" person is replaced by a new partner that has different competencies such as practice development. The body is replaced, but who is now going to make sure the work is getting done correctly, timely, and that the firm is run properly? You may need to consider an external replacement if the skills are specialized or if no one in the firm has the right experience or abilities.

4. Not All Succession Needs Are Due to Retirement

Succession needs also result from death, temporary and permanent disability, resignations, and involuntary terminations. Your succession plan and agreements need to define how the firm will handle all types of terminations.

Typically the buy-out liability for death can be covered through insurance. Disability insurance is available in both traditional long-term payout form and lump sum form which is specifically designed to fund buy-sell agreements. It can be costly and determining whether certain situations qualify as disability can be difficult. You may want to consider self-insuring the early stages of disability since the eventual outcome is often not clear up-front. You will need to consider whether the partner and their estate is the beneficiary or the firm and this has to be coordinated with buy-sell agreement.

An innovative approach to death and disability is to use insurance for part of the liability and to self-insure a portion as if the death or disability was a termination without adequate notice. This might reflect the underlying economics of the situation and save on insurance costs.

Remember to review the amount of insurance required as often as annually. Many plans require the firm to make up the difference if a shortfall between the death benefit and actual value occurs. The timing of the payment for a shortfall also needs to be addressed. Assuming the payment is substantially insured you should consider deferring the balance owed for a year or more. The short term needs of the estate can be met with the insurance and the firm can use the additional capital to invest into staff and other resources needed to replace the lost partner.

Many agreements handle resignations without notice or at an early date, based on tenure or age, in such a way that it discourages this type of decision. This can be accomplished by reducing the valuation dramatically and/or by extending the payout period. Another means of handling resignations without adequate notice is to tie the valuation to post termination client retention.

If the terms regarding involuntary terminations are too punitive, this can be a disincentive for the firm to make this type of decision when the circumstances seem to call this action. Post termination competition restrictions might be relaxed in these cases, for instance. It is common for



involuntary termination with cause (due to felony convictions or acts detrimental to the firm, for instance) to be handled differently in the agreements than terminations “without” cause (such as due to general performance issues).

If a terminating partner is allowed to take clients under the agreement consider the following:

- Accounts receivable and WIP should follow the clients taken and this may require that these items be bought
- If the firm will have ongoing obligations for overhead, lower revenues due to the loss of clients may result in difficulty covering it- consider requiring a settlement with terminating partner of these obligations. This is, in part, the basis for the requirement in many agreements that a terminating partner buy their book of business from the firm.
- Create penalties, disincentives, or restrictions for taking clients at a level beyond the partner’s equity.

5. Internal Succession Requires a Strong Back-up Team

When creating a proper internal succession plan, nothing is more important than having the “right” people on the team. What are some of the keys to attracting and retaining the best talent in this world of Generations X and Y?

- You cannot get the best of the best with empty offers. We recall a client who asked us to find a successor through a merger with an up-and-coming young practitioner. They wanted a real rainmaker, proven client handling ability, and great people skills. When we inquired what kind of package they were prepared to provide this ideal candidate, the response was far below market value and they justified that offer because they felt the succession opportunity provided tremendous upside potential. The market today demands

that current rewards are competitive in addition to having long term potential.

- Life style issues have become more important to younger potential successors. A recent firm we worked with created flexible workspace using current technology for remote access. Their system allowed partners and staff to work from home occasionally. The result was higher productivity and happier people. The firm attracted high quality team members that had excellent attitudes, and were integral parts of the succession team.
- Leadership is critical attribute for successors. While not every partner of a firm has to demonstrate great rainmaking skills (although certainly some should), most partners need to be good leaders. Leaders set good examples for work ethic, quality, and integrity.
- An environment conducive to internal succession is one that values the opinions of team members and creates the mindset of we, not me. Recognize the value in “sweat equity”. Not only that of the retiring partner but also the rest of the team. Most internal sales use a somewhat discounted value relative to an external sale partially due to the contribution the succeeding partners have made that may not be fully captured in the formal determination of equity.

6. Create a Safety Net For the Firm

Even if your agreement is based on the concept of a win-win economic proposition, unforeseen events can cause a financial hardship to the firm if it is funding retirement payments to former partners. Consider creating a safety net that defers retirement payments if profit before partner compensation and retirement payments falls below a predefined level. For instance, if historical profit before partner compensation is 35% of revenues, partner retirement payments might be reduced on a prorata basis along with partner compensation if partner compensation



falls below 30%. Typically, the reduction is intended to be a temporary event and is repaid later. It is better to ease the burden temporarily than completely risk the receipt of future payments due to an unforeseen financial hardship.

7. What is the Value of the Firm in an Internal Succession?

Just as in open market sales, the range of values for firms is large. There is no rule of thumb that you can use. It eventually comes down to what the parties agree to. However, there are several factors regarding valuation you should consider.

- Most buy-sell agreements use a formula to determine value. Common value metrics are revenues or profits before partner compensation. The regular use of formal valuation processes is uncommon. It is usually preferable for the parties to be easily able to calculate value than to have to rely on a complicated and costly approach every time value has to be determined.
- The use of our Working Backwards strategy when calculating value (described earlier in this report) is a good way to assure that the valuation and the cash flow available for the buyout are aligned at least based on historical results.
- Internal succession plans normally use a “price” that is lower than what could be expected in an external sale. However, keep in mind that because the terms of an external and internal sale usually differ dramatically, it can be difficult to compare the actual value that is being used.
- Enlist the help of an outside expert if the parties are having difficulty arriving at a value. A consultant that has extensive experience with accounting firm sales AND internal succession plans can assist in making a fair comparison to what other firms with similar attributes use for value in these situations.

- The tax treatment of the payments has a major impact on the value of the deal. Historically, most internal agreements treated internal buy outs as ordinary income primarily to avoid creating a tax burden on the firm. With the advent of deductible amortization of intangibles, some agreements are now structured to treat payments as the acquisition of capital assets. The tax laws that govern this area are complicated and not all entity forms will work so be careful before pursuing this avenue.

8. Find Expert and Experienced Help

An internal succession plan should address many items. How will the collection of accounts receivable and work in process, liabilities, long term commitments, and capital accounts be handled? What restrictions will be placed on competition and solicitation of clients after termination of employment? Should you fund the buy-out in advance? How can you stage the buy-out, transition, and adjustment of equity over time? Should you shore up the firm’s financial and business foundation through acquisitions or mergers to brighten its long term prospects? How does the firm’s hard assets and debt service affect the value? These are but a small example of the items that need to be addressed in internal succession planning. This is not only a critical business decision for all the partners, it can get emotional. Having a professional, who has years of experience specific to accounting practice transitions, can be the most important step in building an agreement and business plan that will work for all the parties and will create long term viability for the firm.

Should you have any questions or comments, please feel free to call us directly or e-mail us at one of the addresses below.

If you want to find out more about how internal succession planning can work for you, we will provide a free consultation on this issue. Contact us to find out more about what you need to do to get the process started.



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Since 1990, **Joel L. Sinkin** has exclusively provided merger, acquisition, and succession plan consulting to accountants nationwide. He has personally been involved in closing over 650 such transactions. He is the co-author of Guide to Buying and Merging CPA Firms published by Practitioners Publishing Company. He is a frequent speaker at national accounting conferences and has been an instructor in dozens of CPE courses. He has been published in Sum News (Massachusetts Society of CPAs), The New York State CPA Journal, Insight (Illinois CPA Society), and TAXPRO Quarterly, the AICPA's The Practicing CPA, and he is frequently quoted in local and national mediums. His article, Price Equals Value plus Terms, is featured in the December, 2004 issue of the Journal of Accountancy.

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