Succession Planning: Key Questions for CPA Firm Partners to Ask Now

By Joel Sinkin and Mark Basinski

Every practice, large or small, has one common issue. What does the firm look like when the current owners are no longer active in the practice? For most practitioners, it is never too early to think about succession planning. The ultimate goal of the plan is to transition client relationships to an internal successor or outside firm, and monetize the value of the book of business.

One of the key reasons we suggest starting the process of your succession plan in advance is tied to the lack of frequency that we see most of our clients. Most of the annual tax return clients and businesses are only seen in person once a year. Many of the business clients are now mailing in the work, on the cloud, and staff is going to their location, but once again, the majority of the clients are only visited by the owner once a year. Therefore when you are four years from slowing down, remember that during those four years you will visit the majority of your clients only four times. It takes time to transition relationships of this nature so planning in advance is critical.

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Getting Started: Determine Your Goals

So what should you do? It makes sense to step back and look at the practice as if you are doing a consulting engagement for a client. You need to really understand what your personal goals are. If you are a partner in a larger firm, your existing partnership agreement should spell out exactly what happens in the event of death or retirement. If not, update your partnership agreement immediately. It is a fairly common problem for multi-partner firms to have a core group of partners the same age. A good succession plan takes into effect all ramifications of multiple retirements hitting in a short period of time. You shouldn't burden the junior partners with an impossible cash flow position and/or capacity issues. It is unlikely junior partners will have the free time to assume all the retiring partners' responsibilities.

Evaluate Internal Succession Options

For smaller firms there are a couple of things you need to think about. Do you have the staff that can take over the practice? Do they actually desire to take on the responsibility and financial risk? How long do you really want to be active full time; how long part time? For most small practices the answer to the first two of these questions is usually no. If you are the exception and have the opportunity to solve your succession issues internally, make sure that you don't wait too long. It is easy to come up with many excuses to delay the process. It may make sense to give your successors equity or make them feel like a partner several years before the trigger date and not a couple of months before you are ready to retire.

Sales or Upstream Mergers

If you are unable to have an internal succession plan, what's next? A common misconception is that there is some superstar out there just waiting for you to hire them and gradually buy you out. As they say, "if it were that easy everybody would be doing it." So the most likely situation is a sale or upstream merger.

If you decide to consider a sale or merger, how do you choose the right firm with which to affiliate? The most important attribute is cultural fit that offers the greatest continuity to the clients and staff. On the front end of the negotiation, spend a significant amount of time seeing if you like the buyers and vice versa. If you don't trust and enjoy spending time with the principals of a successor firm, why would your clients? The majority of your clients have hired you because they were comfortable with your communication style and personality. They ended up staying with you because of trust and demonstrated competence.

The next thing that you should assess is how the successor firm operates. Are there gaps in client service philosophy? Are the billing rates compatible? Are the systems compatible? If not, what will it take to get them there? What about your employees? Are they going to be attractive to the successor? Please remember that a successor will be objectively looking at the talent and compensation. If there are long-time employees that for one reason or another are underworked or over compensated, this should be disclosed and discussed early. You should not expect a successor to inherit the situation.

In order to help ensure a smooth transition, make sure that adequate due diligence is done by both sides. You should expect that any potential successor will want to have a deep understanding of the services provided, the quality of those services, and the financial attributes of the practice. Both sides should be open and honest if there are some potential negative issues. Eventually, those will surface and it is better to get them out early, so you don't invest a significant amount of time and money only to find out there is a deal breaker towards the end. If the successor firm is going to have to make significant changes the clients will see, such as the level of staff that services them, fees, billing procedures, etc., the risks of poor retention issues increase.

You should also spend time discussing an integration plan. Remember the most important thing for all parties involved is client retention and satisfaction. It is imperative that both parties share in the ownership of making the clients happy. The way you present external or internal successors to your clients will drive success or failure. There should be minimal client attrition with a well thought out integration plan. An ideal situation would be to transition relationships over a period of a couple of years, if possible. For details, read "Two Stage Deals," an article in the March 2006 issue of the Journal of Accountancy at www.journalofaccountancy.com/Issues/2006/Mar/TwoStageDeals. Under a two-stage deal, you work alongside and as a part of your successor firm for a specified period, so clients can become comfortable with the newly combined practice, and the successor can take necessary time to get to know the client base and their expectations while you are still around to help. The secret is to hold this out to clients as the gain of the successor firm, not the loss of the original firm!

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The last thing to address in a transaction is deal structure. Since you are dealing with an intangible asset, both sides would like to mitigate their risk. The extent to which deals are contingent on client retention varies considerably among transactions. When considering this element of a deal we like to see both sides highly motivated to make sure clients are retained and the practice is healthy and growing. Most retirement-motivated transactions will be structured over a number of years. It is also very common in multi-partner firms to limit the total amount that can be paid out in any year for partner retirement benefits. While most buyers and sellers want to focus on the multiple a practice is sold for, we need to remember that multiple is the effect. The causes include how much money is paid upfront, how long the payout and retention period is, and the profitability of the transaction, which includes the tax treatments of the payments. An overly simple, yet realistic approach is: the less money upfront, longer payout and retention periods, higher profitability in the deal structure, higher the multiple, and of course the opposite is true as well.

Internal sales are also based on a multiple. Larger firms normally use a multiple of compensation, typically two to three times the average annual compensation for a partner, paid out over eight to ten years. Smaller firms tend to buy out partners based on a multiple times their equity in the firm, which is typically from .5X to 1X, again paid out over time.

Here is a litmus test to ensure your buyout formula works. Take the retiring partner's compensation and subtract from that the cost of their replacement labor, if any, and the retirement payments. If the sum is a positive number, the purchase price is self funding. If the sum is a negative number, this is likely an unworkable plan, since there isn't an incentive to buy you out if they make less money.

An effective succession plan should allow an owner or retiring partner the opportunity to monetize their asset, make the successor successful and, if applicable, allow for future leaders to develop and perpetuate the cycle.

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