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# Connecticut CPA

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## Succession Planning:

# What's the **Future** of **Your Firm**?

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# Succession Planning: Key Questions You Should Be Asking Now!

*By Joel Sinkin and Bill Carlino*

For most CPA practitioners, succession planning is something that can never be addressed too early. In too many cases, those without any type of succession strategy are forced into hastily arranged mergers (where client retention suffers) or may even have to shut their doors for good.

## Getting Started: Determine Goals

The ultimate goal of any succession plan is to smoothly transition client relationships to an internal or external successor and, of course, monetize the value of your book of business.

So what's the first step?

We have found that it often makes sense to look at your practice as you would a consulting engagement for a client. That means you first need to understand what your 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, disability, or retirement. If not, your partnership agreement needs to be updated immediately.

It is a fairly common problem for multi-partner firms to have a core group of partners around the same age. A good succession plan takes into account the ramifications of multiple retirements hitting over a short period of time. You shouldn't burden your firm's junior partners with an impossible cash flow position and/or capacity issues. It is highly unlikely that junior partners will have the free time and excess capacity to assume all the retiring partners' responsibilities in such a situation.

## Internal Succession Options

For smaller firms, there are a couple of questions that need to be asked. Do you have the staff that can take over the practice from an expertise or capacity perspective? Do they actually want to take on the responsibility and financial risk?

For many smaller firms, the answer to those two questions is usually "no." If you happen to be the exception and have an opportunity to solve your succession issues via an internal process, make sure that you don't wait too long before proceeding. It may make sense to give your successors equity or acclimate them to the role of partner several years before the actual trigger date and not a couple of months before you are ready to retire. This is especially true if your clients are partner loyal vs. brand loyal. Partner-loyal clients take longer to transition.

All too frequently, CPA firm owners convince themselves that there's a superstar rainmaker out there just waiting to be hired. They envision that person gradually buying their share out. Trust us, if it were that easy, everyone would be doing it.

## Sales or Upstream Mergers

If you are unable to complete an internal succession plan for any number of reasons, what do you do next?

The most likely exit scenario is a sale or an upstream merger. But how do you choose the right firm with which to affiliate? There are many factors to consider, but perhaps most important is the cultural fit, which offers the greatest continuity to both your clients and your staff.

At the outset of the negotiation process, both parties will spend a large amount of time determining if there's chemistry between them. Think about this: if you don't feel comfortable with a potential successor firm, why would your clients? Remember, many of your clients hired you as their ▶

accountant because they were comfortable with you and remain loyal because they feel you are trustworthy and competent.

Here's a good rule of thumb: if you don't want to have lunch with someone, don't do a deal with them!

Next up is assessing how the successor firm operates vs. how you operate. Are there noticeable gaps in client service philosophy? Are the billing rates compatible? What about the IT systems?

Remember, no one goes into a deal to lose money, so any successor firm will be looking at and objectively evaluating your staff and compensation. If there are long-time employees who for one reason or another are underworked or over-compensated, this should be disclosed very early on in the process. You can't realistically expect a successor firm to inherit an unprofitable situation.

Critical to any smooth transition is a thorough due diligence process – by both parties. Both the buyer and the seller need to be open and honest regarding any potential negative issues (debt, liabilities, litigation, etc.). If there are potential negative issues, they need to be brought up early in the process to avoid investing significant time and energy into a deal only to have it fall apart at the 11th hour due to some previously undisclosed situation. This includes any "must-haves" such as leases or similar issues.

It's also critical for both firms to agree on an integration plan. Remember that key components to any successful transition are client retention and satisfaction. Both parties must share in that responsibility. The way you present your external or internal successors to your clients will contribute significantly to the success or failure of the deal. If done correctly, client attrition should be at a minimum.

If the successor firm intends to make significant changes that the clients will see, such as staffing levels, office relocation, or increased billing rates, the chances of poor client retention or, in a worst-case scenario, a mass exodus, increase dramatically.

Ideally, transitioning client relationships is best accomplished over a multi-year period by a successor firm that doesn't need to institute significant changes "in front of the door," where they will be apparent to clients.

## Two-Stage Deals

One of the most common types of external succession strategies we help facilitate is what is known as the "two-stage deal." Under a two-stage deal, you work alongside and as a part of your successor firm for a specified period of time – what we call "stage one." The seller continues managing his or her book of business in his or her usual manner, but the successor firm assumes most, if not all, of the back-office operations and overhead.

This structure has been effective for owners seeking succession because they retain control over their autonomy and income and the successor firm enjoys the synergies. Clients can become accustomed to and, most importantly, comfortable with the newly combined practice. The successor firm can take the time necessary to become familiar with the newly acquired client base while you are still working full-time and remaining visible to your clients.

The seller's compensation is most often based on historic profit margin applied to the collections from his or her client base – as long as the staff and resources necessary to provide services to the clients don't increase. If the need for those resources does increase, an adjustment is made in compensation.

When the transitioning practitioner reaches the agreed-upon date for "stage two," the buyout payments begin. The terms are usually determined in a similar fashion as if the deal had been structured as a sale at the beginning of stage one. But by now, the

clients have grown accustomed to the successor firm once the buyout begins and retention is no longer the concern it once was. The secret to the two-stage deal is how you position it to your client base. You should showcase it as the *gain* of the successor firm, *not* the loss of your firm!

*Remember that key components to any successful transition are client retention and satisfaction.*

## Deal Structure

The last thing – but one of the most critical issues to address in any transaction – is deal structure.

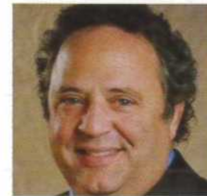
Since you are dealing with an intangible asset, both parties would obviously like to mitigate their risk factors. The three questions we are probably asked the most often, in order, are: what's the multiple, what's the multiple, and what's the multiple?

Larger firms traditionally use a multiple of compensation in deal structures, typically two to three times the average annual compensation for a partner, paid out anywhere from eight to ten years. Smaller practices tend to buy out partners based on a multiple of their equity in the firm – typically from .75 to 1.25, with obvious exceptions, again paid out over time.

However, while most buyers and sellers want to focus exclusively on the multiple a practice is sold for, you need to remember that the multiple is the *effect* not the *cause*. The causes include how much money is paid upfront (if any), length of the payout and retention periods, and the profitability of the transaction, including tax treatments.

Here is a simple litmus test to ensure your buyout formula works: Take the retiring partner's compensation and subtract that figure from the cost of their replacement labor (if any), coupled with the retirement payments. If the difference is a positive number, then the purchase price is self-funding. If it's negative, then it is highly likely that it's an unworkable deal – nobody will have an incentive to buy out a retiring partner only to make less money.

Remember, any effective succession plan (whether internal or external) should allow an owner or retiring partner the opportunity to monetize his or her assets, ensure the success of the consolidated practice going forward, and allow for the development of the firm's future leaders.



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