2014

CPA firm mergers and acquisitions : how to buy a firm, how to sell a firm, and how to make the best deal

Joel L. Sinkin

Terrence E. Putney

CPA FIRM MERGERS & ACQUISITIONS

How to **Buy a Firm**, How to **Sell a Firm**, and How to **Make the Best Deal**

AICPA® PCPS

Joel L. Sinkin
Terrence E. Putney, CPA

CPA FIRM MERGERS & ACQUISITIONS

How to **Buy a Firm**, How to **Sell a Firm**, and How to **Make the Best Deal**

14410-349

AICPA® PCPS

Joel L. Sinkin
Terrence E. Putney, CPA

Notice to Readers

CPA Firm Mergers and Acquisitions does not represent an official position of the American Institute of Certified Public Accountants, and it is distributed with the understanding that the author and publisher are not rendering legal, accounting, or other professional services in the publication. This book is intended to be an overview of the topics discussed within, and the author has made every attempt to verify the completeness and accuracy of the information herein. However, neither the author nor publisher can guarantee the applicability of the information found herein. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

1 2 3 4 5 6 7 8 9 0 SP 1 9 8 7 6 5 4

ISBN: 978-1-94023-512-7

Publisher: Linda Prentice Cohen
Acquisitions Editor: Erin Valentine
Developmental Editor: Suzanne Morgen
Project Manager: Amy Sykes

CONTENTS

About the Authors

Joel Sinkin is the President of Transition Advisors, LLC, a firm that exclusively consults on mergers and acquisitions for public accounting firms. Mr. Sinkin, who has been named on *Accounting Today*'s list of the Top 100 Most Influential People in Accounting, is an expert in practice evaluation, succession planning, and transaction structure. He has personally overseen hundreds of transaction closings of accounting firms since 1990 and has worked with firms of all sizes, from sole proprietors to large regional and international firms. He consults on internal and external succession planning and provides complete transaction support, including valuations, alternative deal structures, documentation, due diligence, and transitional issues regarding partners, staff, and clients.

To create a new type of consulting firm that offered a fresh approach to accounting firm succession and growth, Mr. Sinkin joined forces with Terrence E. Putney, CPA, in 2004 to form Transition Advisors LLC. Transition Advisors is dedicated to working exclusively with accounting firms nationwide to develop and execute strategies to expand through mergers and acquisitions, to identify objectives and create unique methods to facilitate retirement and other owner transitions, and to build business plans and owner agreements to facilitate and manage internal succession.

Mr. Sinkin teaches CPE courses and lectures for the AICPA, many state societies of CPAs, national accounting organizations, and many other professional organizations. He is frequently quoted in trade magazines and has authored or been quoted in articles including the *Journal of Accountancy*, *Accounting Today*, *CCH's Practice Management Forum*, *The CPA Journal*, *Insight*, *The Practicing CPA*, the *Practical Accountant*, *Inside Public Accounting*, *CPA Practice Management Forum*, *The New Jersey CPA*, *The Sum News* (Massachusetts Society of CPAs), *The Diplomat*, *Florida*

CPA Today, *The Business Journal*, the *MNCPA Footnote, The Asset, CPA Leadership Forum Report*, *CPA Wealth Provider*, and *Mergers & Acquisitions Best Practices in People Management For a Changing Environment* (a Watson Wyatt publishing product). He coauthored *Buying and Merging CPA Firms*, published by PPC. Mr. Sinkin is an editorial adviser to the AICPA's newsletter *Small Firm Solutions* and a member of *The CPA Journal* Editorial Review Board.

Terrence E. Putney, CPA, brings his unique experience in both the accounting and merger and acquisition disciplines to his role as CEO of Transition Advisors. Mr. Putney, who has been named in *Accounting Today*'s list of the Top 100 Most Influential People in Accounting, has over 35 years of experience as a practicing CPA, as president and CEO of a large CPA firm, as a partner leading mergers and acquisitions for a national accounting firm, as a corporate executive responsible for building and leading professional service strategies, and as a consultant to accounting firms of all sizes.

After leading 5 years of unprecedented growth as President and CEO of Donnelly Meiners Jordan Kline in Kansas City, Mr. Putney negotiated the sale of the firm to form the foundation of HRB Business Services and became the first president of this accounting firm consolidation strategy. The firm expanded to over 1,000 professionals in its first year through the acquisition of large local firms forming regional platforms. He led the transformation of HRB Business Services into RSM McGladrey after its acquisition of the nonattest assets of McGladrey & Pullen in 1999.

As Senior Managing Director-Mergers and Integrations of RSM, he participated in managing the growth of the firm through acquisition to its position as the fifth largest accounting firm in the United States before its sale back to McGladrey & Pullen in 2011. He then successfully launched a pilot program to offer accounting and tax services under an alternative branding strategy as vice president of the small business resources division of a *Fortune* 500 professional services firm in 2002.

He fulfilled a personal goal to return to his first passion, consulting, and bring the knowledge and personal experience he gained firsthand back to the accounting profession when he joined with Joel Sinkin to form Transition Advisors in 2004.

An accounting graduate of Kansas University, Terry is a licensed CPA and a member of the AICPA and the University of Kansas Accounting and Information Systems Advisory Council. He is a frequent speaker at conferences and is regularly published in accounting profession magazines. He has been published in the *Journal of Accountancy, CCH Practice Management Forum*, and *The CPA Journal.*

ACKNOWLEDGMENTS

We want to thank the AICPA Private Companies Practice Section (PCPS) for asking us to write this book. Succession issues are at the top of the challenges facing practitioners and owners of CPA firms. PCPS and the AICPA are making a tremendous effort to create resources that will help CPAs address their individual succession needs. We are honored that PCPS looked to us to provide some of those resources.

We also want to thank the staff of PCPS and the AICPA for their support of this project. We want to especially thank Erin Valentine, Content Development Manager—Practice Management, of the AICPA for her involvement and oversight of this project.

Particular thanks goes to Natasha Schamberger, Senior Technical Manager, PCPS/Firm Services; Mark Koziel, Vice President, Firm Services and Global Alliances; and the PCPS Executive Committee for their input and for ensuring that this project moved forward. Members of the PCPS Executive Committee include the following individuals:

Cheryl Burke, DiCicco, Gulman & Company LLP

Jason Deshayes, Butler and Company, Certified Public Accountants

Loretta Doon, California Society of Certified Public Accountants

Joseph Falbo, Tronconi Segarra & Associates LLP

Chris Farmand, Chris Farmand + Company

Charles Frederick, FredrickZink & Associates, CPAs

Robert Goldfarb, Janover LLC

Carter Heim, HeimLantz

Karen Kerber, KerberRose SC

Anthony King, King, King and Associates, PA

David McIntee, McIntee Fusaro Del Corral LLC

Joel Olbricht, Olbricht Storniolo Group LLC

Melody Schneider, Schneider & Shilling CPAs LLC

Jacquelyn Tracy, Mandel & Tracy LLC

James Walker, Walker Chaney CPAs

George Willie, Bert Smith & Co.

Finally, and certainly not least, we want to thank Anita Dennis, who put in countless hours assisting us with the editing of this book. Anita, your patience and creativity were sorely needed and we could not have gotten through this without you.

INTRODUCTION

We have worked on CPA firm mergers and acquisitions for more than two decades and have been involved in hundreds of successful deal closings. In that time we have almost never seen a firm default on a transaction with which we were involved. We have a strong belief that when the parties to a merger or acquisition of CPA firms use the right process, there is a high likelihood of success. When two businesses come together to begin initial discussions about a possible deal, each one tells a story about their company and its many advantages. The next step, due diligence, is when you usually get a more realistic view of each business. The amazing thing about CPA firms, however, is that due diligence usually reveals that their practice is exactly as the owners described it in the early meetings. There may be problems that prevent the deal from being finalized, but false promises, inaccurate disclosures, or defaults are not normally among them. It's clearly a profession built on honesty and integrity at every level, and on a genuine concern for clients. In addition, both buyers and sellers usually have the same base objective for the transaction: maintaining the relationships the acquired firm has with its clients, employees, and other critical constituents. A deal that is structured in a way that recognizes this shared objective is normally one that will be successful in the long run.

When two parties come to the table in good faith, they deserve to take part in a process that runs smoothly and that has the best possible chances of achieving their goals. This book was written to help ensure that will happen. We are in the midst of a dynamic mergers and acquisitions market in the CPA profession, spurred by the retirement of the baby boom generation and numerous other factors. Given the level of activity in this market, CPA firm leaders need a comprehensive understanding of the many issues to consider when they become a buyer or a seller.

Each merger or acquisition is the result of a multifaceted process. Too often, we see people becoming fixated on one aspect of a deal, such as the multiple, down payment, or tax ramifications. This book identifies the many elements that are involved in a successful transaction so that CPA firm owners are armed with the information they need as they chart their own paths to transition. Each deal is unique, with its own structure and key considerations. If every transaction involves 50 critical elements, the smartest person in the room would likely only anticipate 35 of them. Our goal with this book is to ensure that you are fully prepared to meet the challenges that arise in any deal. If this book can prepare you to address 45 of the 50 possible critical elements in your deal, we know that common sense will take care of the remaining concerns, and leave you able to execute a transaction that meets all of your objectives.

We wish you the best of luck on your own road to transition!

Joel L. Sinkin

Terrence E. Putney, CPA

CHAPTER 1
The Marketplace

A funny thing happened when the AICPA Private Companies Practice Section conducted its 2013 PCPS CPA Firm Top Issues Survey.[1] It found that succession planning, which had been ignored by all but the largest firms in previous surveys—and even then was not at the top of their lists of chief challenges—had become a significant concern for most firms. Notably, firms with between 2 and 10 professionals considered it among their top 2 issues, and all but sole practitioners listed it as among their top 4.

That is a significant step forward for practitioners, but simply acknowledging the issue is not enough. Many firms are not as far along in the process as they should be. According to the 2012 PCPS Succession Survey,[2] only 46 percent of multiowner firms had written, approved succession plans. That is up from 35 percent when the survey was taken in 2008, but less than half still cannot be seen as a victory. Among those who had a plan, only 51 percent could say that it had been implemented and was periodically updated. Another 30 percent said some progress had been made toward implementation and 19 percent said relatively little had been done. It is clearly time for firms that have not already done so to begin giving serious thought to succession.

---

[1] www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/StrategyPlanning/FirmStrategyandPlanning/Pages/PCPS%20Top%20Issues%20Survey.aspx.

[2] www.aicpa.org/interestareas/privatecompaniespracticesection/strategyplanning/center/pages/default.aspx.

In this chapter, we will explore the critical factors affecting the marketplace, including domestic and international economic considerations and technology, gender, and diversity trends. We will take a look at the current state of succession planning and at the all-important question: Is it a buyer's or a seller's market?

It is important to point out that this book will provide valuable information for both buyers and sellers. It is important for both parties to gain a full understanding of their potential partner in a deal, which means that they can benefit from knowing each other's motivations and preparations for the transaction. For that reason, in all of our recommendations, both sides will find insights into the key characteristics they should be seeking in a merger or acquisition partner. Our discussions of firm value, alternative deal structures, roadblocks, due diligence, and transitions will all be equally valid for both parties to the deal. We are advocates for both sides, because our philosophy is that the best deal is one in which both parties come away feeling as if they have achieved their goals.

What Are the Marketplace Trends?

Before we consider the state of CPA firm succession today, let's step back and examine how firms are being affected by developments in the domestic and global marketplace and by trends within firms themselves.

The Overall Economy and CPA Firms

The ups and downs of the last decade have had a profound impact on CPA firms and the CPA firm marketplace. The legislative and regulatory environment following the collapse of Enron and Arthur Andersen and the Bernard Madoff scandal created an unprecedented surge in demand in the mid-2000s because it required many organizations to hire multiple professional firms to perform the services traditionally done by one firm. In addition, due to changed compliance standards, larger firms began shedding their less strategic clients and creating new business opportunities for a successor CPA firm. (Remember, one firm's floor is another firm's ceiling.) These simultaneous market conditions created additional opportunities across all sizes of CPA firms. In the absence of recent major legislation or regulations, there was nothing to counteract the economic forces that have kept the profession from growing.

Keep in Mind

Visionary CPA firms that are planning and staffing for succession are excellently positioned to scoop up clients from firms that have failed to plan.

Growth definitely slowed in the midst of the economic downturn, but it appears that the tide is turning once again. Based on the findings of the PCPS CPA Firm Top Issues Survey, back in 2009, right after the financial meltdown, client retention was top of mind for firms of all sizes. By 2011, many firms continued to wrestle not only with client retention but also with fee pressure and pricing and client collections. However, many were also focusing on bringing in new business; a sign that renewed growth seemed a reasonable possibility. The latest survey, taken in 2013, showed that finding not only new clients, but also qualified staff had become critical concerns for firms, although a few were still worried about client retention or competition.

That means, among other things, that visionary CPA firms that are planning and staffing for succession are excellently positioned to scoop up clients from firms that have failed to plan. Although retaining quality trained and experienced staff will remain a critical success factor throughout the next decade, we see an available stream of new clients for the taking for years to come as the turnover in firm ownership accelerates. However, profitability and success will become more dependent on a firm's ability to determine and commit to a target-client profile. Systems and compensation must be set up to motivate partners to find clients that are in line with the firm's strategic plan. This also means that once you have culled your client base to match your client profile, it becomes imperative to create a culture that

- develops and maintains client loyalty, especially to the firm's brand.
- ensures client needs are being satisfied (rather than just selling them the services you offer).
- builds a wall of services around their clients, which for smaller firms may mean reassuring clients that the firm will be around for the long haul and will be able to serve ever-changing needs with a dynamic basket of services.
- only hires and trains people to provide the capacity to profitably take on new clients.

International Trends

The globalization of the American economy is rampant. Not too long ago, only firms located near the U.S. borders felt pressure to offer specialized services to clients with international needs. Now, even small businesses located in the middle of the country are engaging in international trade. As a result, CPA firms that have not found a way to serve these international service needs are at risk of losing their best clients!

Be aware that this problem can actually be exacerbated by succession issues. Firms with aging partners tend to recoil from making big changes and investing in their firms. Partners nearing retirement have a tendency to avoid upsetting the apple cart because they have little time left to recoup investments and overcome mistakes. However, in today's fast changing business environment, as these partners seek to protect their investment by taking the conservative route, they may actually be doing more harm to their firm and its equity value.

Trends in CPA Firm Demographics

Exhibit 1-1 shows what the 2012 PCPS Succession Survey revealed about the timing of succession challenges at firms and exhibit 1-2 reveals retirement plans over the next few years.

Exhibit 1-1: Timing of Succession Planning Challenges

	2012 %	2008 %	2004 %
We will have succession planning challenges in 6 to 10 years.	32%	17%	32%
We will have succession planning challenges in 3 to 5 years.	28%	30%	18%
We have current succession planning challenges.	22%	20%	1%
We will have succession planning challenges in the next 1 to 2 years.	12%	13%	15%
Our succession planning challenges are over 10 years away.	5%	3%	11%
Succession issues will arise, but we have ways of dealing with them.	NA	16%	13%
Total	100%	100%	100%

Source: 2012 PCPS Succession Survey.

Exhibit 1-2: Expected Retirements at Firms

	% with retirements this year	Average # of retirements	Age of most senior retiree	% of equity ownership to be distributed
1–2 Full-Time Equivalents				
Retiring in 2012	14%	2	59	98%
Retiring in 2013	0%			
Retiring in 2014	0%			
Retiring in 2015	0%			
Retiring in 2016	29%	1	61	75%
3–7 FTEs				
Retiring in 2012	8%	1	69	45%
Retiring in 2013	6%	1	69	45%
Retiring in 2014	13%	1	67	30%
Retiring in 2015	10%	1	68	55%
Retiring in 2016	16%	1	69	60%
8–15 FTEs				
Retiring in 2012	7%	1	64	29%
Retiring in 2013	11%	1.06	66	48%
Retiring in 2014	9%	1	66	40%
Retiring in 2015	13%	1.05	65	51%
Retiring in 2016	26%	1.1	64	49%
16–25 FTEs				
Retiring in 2012	5%	1.25	67	24%
Retiring in 2013	14%	1.08	67	34%
Retiring in 2014	12%	1.1	69	28%
Retiring in 2015	16%	1	66	29%
Retiring in 2016	24%	1.1	64	36%
26–50 FTEs				
Retiring in 2012	18%	1.07	65	21%
Retiring in 2013	14%	1.08	65	19%
Retiring in 2014	17%	1.07	65	20%
Retiring in 2015	18%	1.07	63	26%
Retiring in 2016	37%	1.26	65	26%

(continued)

51–100 FTEs				
Retiring in 2012	20%	1.2	66	17%
Retiring in 2013	24%	1.09	64	13%
Retiring in 2014	25%	1.31	65	23%
Retiring in 2015	31%	1.13	64	21%
Retiring in 2016	31%	1.38	65	19%
101–200 FTEs				
Retiring in 2012	27%	1	63	7%
Retiring in 2013	59%	1.31	65	12%
Retiring in 2014	36%	1.63	63	13%
Retiring in 2015	41%	1.22	63	13%
Retiring in 2016	45%	2	63	13%
201–350 FTEs				
Retiring in 2012	44%	1.5	62	5%
Retiring in 2013	67%	1.33	64	4%
Retiring in 2014	44%	2	64	7%
Retiring in 2015	78%	1.86	63	7%
Retiring in 2016	44%	1.5	64	4%
351+ FTEs				
Retiring in 2012	89%	3	65	5%
Retiring in 2013	78%	3.86	64	6%
Retiring in 2014	89%	2.63	65	4%
Retiring in 2015	67%	3.5	64	7%
Retiring in 2016	89%	3.25	66	17%

Source: 2012 PCPS Succession Survey.

The 2008 Succession Survey found some sobering information about the age ranges of sole proprietors.

Age	%
44 and under	5
45-54	31
55-64	52
65 and up	13

A total of 65 percent of sole proprietors were 55 or older at that time, with a large group following just behind them. Even though many practitioners are working longer before retiring, 65 still tends to be the most popular age for retirement. We can conclude, then, that possibly as many as 50 percent or more of sole proprietors are likely to seek to reduce their time commitment to their firm by 2018.

Although the survey did not track the same statistics for multipartner firms, this data was obtained from the respondents:

Partner Demographic	Average Age	Average Ownership Percentage	Percentage of Group 60 or Older	Average Percentage Owned by 60 or Older	Percentage of Group 65 or Older	Average Percentage Owned by 65 or Older
Most Senior Partner	60	35%	52%	29%	20%	25%
Second Most Senior Partner	55	25%	25%	19%	5%	10%
Third Most Senior Partner	51	17%	14%	13%	2%	10%

The median number of employees of the multipartner firms responding was 20, making the median number of partners around 4. Clearly, the aging of partners and the imminent retirement of a significant portion of partners is also an issue in most multipartner firms.

Technology Trends

Another factor affecting the work environment in CPA firms is the explosion of technology, something we will talk about in much greater detail later in this chapter. Young professionals are better able to leverage technology than older ones, which can lead to greater productivity. When this increased productivity leads to higher revenues per hour, it is possible to improve work life integration without any loss of income. However, many firms have not captured productivity gains in the form of increased billing rates or fees per hour. As a result, many older partners still hold on to what seems to younger generations to be an obsolete view of what it means to have a suitable work ethic.

This difference in perspective on the meaning of a good work ethic is important. Because there are so many of them, baby boomers have long felt that they must scrap for every opportunity. During their younger, most impressionable years, they were competing against many other baby boomers for every job opening. The next generations after the baby boomers grew up in an ever-expanding labor shortage. For those that entered the profession before the economic downturn of 2009, competition for each job opening had been minimal to nonexistent. Many younger people have had the luxury of demanding more work flexibility and privileges than the baby boomer generation enjoyed when of a similar age. Firms that have embraced this generational difference in perspectives have a greater tendency to thrive, but those that hold onto the notion that younger people should perform in a more traditional manner are often frustrated by their inability to attract and retain the best younger people.

Gender Trends

Many firms continue to subscribe to the "pipeline myth," which holds that women will naturally take over more leadership positions as more of them come into the pipeline. However, although there have been approximately equal numbers of men and women in the profession for a quarter-century, only 19 percent of all public accounting firm owners are women, according to the AICPA's 2013 Trends in the Supply of Accounting Graduates and the Demand for Public Accounting Recruits.[3]

Keep in Mind

Although there have been approximately equal numbers of men and women in the profession for a quarter-century, only 19 percent of all public accounting firm owners are women.

Do not overlook women's initiatives as part of your succession planning. If you have lost or failed to recruit top female professionals over the years, then you are missing out on half of the available pool of potential firm leaders. As staffing becomes more challenging in the coming years, that will make it more difficult to build a workable succession model and maintain a thriving practice. It will also make it challenging to vie for business from companies with women leaders and decision makers who may question your firm's lack of diversity.

Many promising female professionals leave firms because it is too difficult to integrate their work and personal lives, but that does not have to happen. Technology makes it possible for any firm member to work full time from a remote location. Flexible work schedules are much easier to manage when performance measurement and compensation are tied to output instead of input; in other words, by relying heavily on timesheets. Keep in mind that flexibility is no longer just a "women's issue;" many younger men leave accounting firms because they also wish to spend more time with family.

[3] www.journalofaccountancy.com/News/20138181.htm.

At the same time, do not assume that addressing flexibility concerns alone will ensure improved retention of women professionals. Role models who demonstrate a variety of leadership styles as well as offer tools for career navigation can also help enhance women's chances for advancement in a firm.

Where Do Firms Stand on Succession?

With all of those trends in mind, let's take a look at where CPA firms typically stand in their succession planning. Although CPAs often work with clients on their planning for new leadership, they remain woefully behind in charting their own transitions. Looking more closely at the 2012 PCPS Succession Survey, we see that there are succession plans with only

- 15 percent of firms with 1 to 2 professionals.
- 25 percent of firms with 3 to 7 professionals.
- one-third of firms with 8 to 15 professionals.
- 50 percent or less of firms with 16 to 25 professionals.

Some 79 percent of all firms participating in the survey think succession will be a significant issue over the next decade.

In our own experience, sole practitioners in particular are lagging behind. Although many say they expect to wind down within the next five years, most still have not put together a succession plan. The main reasons they give are a reluctance to yield control over the firm and the impact on their compensation.

Many multipartner firms have fared only slightly better. They may generally be more aware of the succession issues in their firm, but they may not be realistically managing them. Some expect current staff members to become future partners, but they have not given these professionals the responsibilities and experiences that would allow them to prove themselves and take on a leadership role. Others are unrealistic about the firm's capacity to replace partners in the near future. Others continue to think they will suddenly find the diamond(s) in the rough: young talent who can be nursed along as part of internal succession plans. The majority of multipartner firms we speak with are always seeking young talent—especially those with a book of business—to bring into their firm to help build their internal succession teams. But the reality is that so few are successful in accomplishing this worthwhile goal that it makes it challenging to feel confident that this strategy will be successful as a total succession solution.

It is safe to say that lack of internal succession readiness and failure to prepare for a smooth transition usually lead firms to sell externally. If a large percentage of firms sell externally, that will have a significant impact on the market.

So, Is It a Buyer's or a Seller's Market?

That question is always on the minds of the firms we work with, but the answers depend on numerous factors. Generally speaking, we have already seen firm values drop over the past several years, both in internal valuations (partners buying out partners) and external sales. We can expect this trend to definitely continue due to demographic trends. Another ongoing trend will be less money put down on sales and a stronger emphasis on retention periods for smaller firms with partner-loyal client bases. However, there are many factors at work that will have different impacts on different firms.

Keep in Mind

Generally speaking, we have already seen firm values drop over the past several years, both in internal valuations and external sales. We can expect this trend to definitely continue due to demographic trends.

The marketplace trends we have discussed and the demographics of the aging of the baby boomers are clearly changing the accounting marketplace. For decades, the marketplace has always been very seller friendly. This makes sense based on the economic opportunity that acquiring a firm presents. When a firm or practitioner sells, hundreds of thousands or millions in revenue is ready for transfer to a buyer. There have always been a substantial number of buyers who recognize that accounting firms have a limited number of growth options. Growing one client at a time is feasible in a good economy, but acquired growth gives a firm an immediate boost in revenue and client base. In a poor economy, organic growth may not even be strong enough to offset attrition. Therefore, sellers willing to part with a substantial number of clients have always been attractive, especially in markets with several potential buyers. That is why much of the United States has historically been viewed as a seller's market. Given the demographics and cultural attitudes we have been discussing, will the seller firm remain a hot commodity?

Sizing Up the Seller

Factors that always have a strong impact are firm size and location. Supply and demand is a hard and fast rule of economics, and it is certainly valid in this discussion. Small firms in densely populated areas can likely count on strong seller's markets because

- acquiring up to $1 million in clients in one step is an appealing prospect for many firms in your market.
- there are likely many firms that can absorb your practice into their infrastructure with nominal incremental increases in overhead, so the economics of the transaction are very compelling.

The market for smaller firms morphed somewhat during the economic downturn. The effects have included decreasing valuations, terms that require less upfront cash investment by the buying firm, and restricted criteria for the types of practices many buyers will consider. This has been due to

- a significant increase in the supply of sellers.
- tight credit markets.
- reduced profitability and cash flow at many buyers firms in a tough economy.

But no matter what is happening in the economy, overall market demand will remain strong enough that small firms in good sized metro areas should be able to find a successor. As an illustration, there are 3,000 accounting firms in Nassau County in New York. When a CPA goes to sell a $1 million practice, there is such a big market for that practice that the economy is less of a factor.

For small firms in areas that include very few other local accounting firms, supply and demand will more likely create some problems because they may find little if any demand for the practice. In some very remote areas, we have heard practitioners say that "when John and Jane Doe retire, we have no need to acquire their clients, because most have no one else but me to go to anyway!" These firms will find it even more critical than others to build an internal succession team when possible.

Shifts in the Mid-Size Firm Market

Although location is a critical concern for the smallest firms, supply and demand is having a great impact on slightly larger practices. That's why the most significant change in the marketplace that we have seen has occurred in the small- to mid-sized regional firms, with 5 to 25 partners. To a small firm, it may seem improbable that a firm with 25 partners could have difficulty executing internal succession. However, a surprising number of firms this size have a glut of older partners and a significant shortage of younger partners who can be internal successors. At the same time, in most large markets, there are as many as 40 firms generating $3 million to $10 million in revenues annually. They generally have between 3 and 15 partners. Most other firms cannot absorb practices that size without substantial incremental increases in overhead, which makes the economics of the merger or acquisition less attractive. In addition, many of these markets may only have a handful of firms large enough to absorb these mid-sized firms. As a result, not only will values for this size firm likely decrease, but the criteria used by the acquiring firm for choosing which firms to absorb will tighten.

Keep in Mind

The most significant change in the marketplace that we have seen has occurred in the small- to mid-sized regional firms, with 5 to 25 partners.

Consider an example that illustrates why advance succession planning is so important for these firms. In a large metro area like Boston, there are dozens and dozens of firms generating between $3 million and $8 million in revenue. Many begin by thinking that they will have an internal succession in which one or more promising staff members take over. Over time they invariably decide, for a variety of reasons including failure to plan properly, that this will not work. As a result, many of these firms will be seeking to merge up, and probably within the same time range given the baby boom demographics. In most cases, they would seek larger regional firms (those $20 million and higher) to be their merger partner. Because of the volume of smaller firms that likely will not achieve an internal succession, the larger firms will be in a position of strength, and it will become a buyer's market as many smaller regional firms chase mergers with the handful of firms large enough to be their successor.

Get Ahead of the Trend

As a result, firms that wait as the demographics worsen due to baby boomer retirements may face real problems finding a successor. Getting ahead of the trend and seeking a solution now may be imperative. What are the options for mid-sized firms that are not able to find a firm that can provide a suitable succession solution in the future?

- Building an internal succession team is the only choice if the firm is to maintain its current size. Merging in and developing young talent is critical for all firms so that they are not left standing when the music stops and all the chairs are taken. But the task of adding young talent with revenues is daunting for many reasons, including the fact that they are the most sought after commodity in accounting today.

- For some firms, contraction will be necessary if they cannot find replacement partners to maintain the current volume of work. This can be accomplished in a controlled and even profitable manner by culling out a portion of the practice by selling off an office, a segment of clients, or a specialty division. (See more on this option in chapter 6.)

Exceptions to the Rule

Obviously there are always exceptions to the trends we have discussed. Examples of factors that can overcome the market trends are firms with excellent niches or a very strong, growing client base. Although operating metrics will remain critical, other issues will take on greater importance:

- Are your clients brand-loyal or partner-loyal? In later chapters we will discuss this concept further and explain why brand loyalty is easier and takes less time to transition.
- Are there talented young professionals who can be groomed for a larger role in the future?
- Do you have service or industry niches or special expertise that can be cross-sold to a broader client base?

Remember that although some niches may be selling points, that is not the case for service or industry niches that were once hot but are now heading into decline. We call this the “Blockbuster” effect, after the once-highly successful video rental chain whose fortunes have reversed in recent years. What are the examples in the accounting arena? Sarbanes-Oxley compliance work, which drove tremendous demand for CPA firm services, is not dead but it is no longer as strong as it was. Many companies that were outsourcing it to CPA firms have brought it in house and the fees for any work performed are lower because the expertise is more readily available. Here is another one that is a blast from the past: Y2K consulting, which was popular in 1998 and 1999 and that led to other information technology consulting work, died out when the year 2000 arrived. In addition, the move to outsource tax compliance to Asia is reversing. Firms are setting up service bureaus in the United States instead of working with overseas suppliers.

Keep in Mind

One commodity that will remain in great demand going forward will be young partners, especially young partners with a book of business or niche.

One commodity that will remain in great demand going forward will be young partners. Young professionals who have proven the ability to develop and retain clients, manage a practice, and thrive will be coveted by many firms to help build their internal succession team. If you have talent on board, retaining them should be a top priority for your firm.

Let's Talk Technology

Technology has also had a far-reaching impact in the mergers and acquisitions marketplace. Let's begin by taking a look at how it affects a firm's appeal. One of our clients was recently considering two acquisition candidates. One firm had great metrics and good staff, but it was not paperless, had no portal, and was not involved in cloud technology. The second did not have good metrics and its realization was poor, but it had a very strong foundation in technology. Our client favored the latter firm. As he told us, "I have enough confidence in our firm's skill set that I believe we can bring another firm up to our quality standards, but it will cost me $7,500–$10,000 per person to get them on the same technology platform." That includes not only the cost of hardware, software, and training, but the sometimes painful, time consuming, and costly job of changing an acquired firm's culture to embrace technology.

Technology enables overhead reduction and cross-selling, even with satellite offices, all of which can make deals more appealing. In recent years there has been a significant increase in mergers by the Major Firms Group and smaller regional firms in new geographic areas in which they were not already established. Technology advances, such as cloud applications, have made operating in multiple offices much less costly and much easier to implement. This trend has helped some firms seeking succession in areas of the country where there is a limited pool of buyers to find mergers to create succession solutions. A satellite office was once an expensive proposition, but those costs have been significantly mitigated by technology. We have one client from the Washington, D.C. area that bought a practice in Fort Lauderdale, Florida. The practice's phone rings in D.C. as necessary and the D.C. office handles all of the billings, collection, and administration. The computers are all on the same server, and although some of the overhead is still redundant, technology has greatly lowered the costs.

Finding Alignment

In the end, the marketplace is driven by the differing goals of the businesses and people involved in it.

What do buyers want? A new business opportunity that will help them expand and make more money.

What do sellers want? A fair payment for the practice they have built and for their years of sweat equity, and perhaps the chance for continuing professional opportunities in a reduced role.

What do partners want in an internal succession? A reasonable deal that will enable the retiring partners to be paid out and the remaining partners to make more, which leaves them with a practice that is poised for continuing success and potential growth.

When those goals align, the result is a deal that meets the needs of everyone involved. Getting there can be complicated, however, and this book will examine those complications and offer comprehensive practical details on how to address them.

CHAPTER 2
Succession: Getting the Timing Right

What is the best time to tackle succession planning? The simple answer is that you should begin the day you form your firm. There should be specific and detailed language within your partnership agreement covering when and how the transition will occur and setting forth some guidelines on financing, structure, and transition. If you have not started already, or if you would like to update and refine your plan, this chapter will help you understand the many considerations involved in timing your exit, including dealing with leases, planned retirements, and the all-important client transition. For buyers, this chapter will provide a review of the issues that a well-run practice should be taking to position itself for an orderly transition, and will help them in their evaluation of potential merger or acquisition partners.

LET ME COUNT THE DAYS

If you expect to sell your practice one day, either to a younger staff member or an outside buyer, there are interim steps that you can take to maximize the value of your firm. The key to any firm acquisition is client retention, so it is important to begin by reviewing how much longer the owners will have client contact before they reduce their time commitment to the firm. In a perfect world, we should affiliate with our ultimate successors well enough in advance to give the clients an opportunity to gain a comfort level with them. (Remember that for an internal successor, affiliation means to not only employ the person who is the intended successor but also that he or she begins to take on a visible leadership role that includes client contact.)

When we first started consulting with CPA firms in 1990, most owners and partners met regularly in person with their clients. Today, that is no longer the case. Although there is a myriad of new ways to communicate with clients, the amount of face time we have with them has dropped significantly. Many clients are now being visited by staff, emailing information back and forth, and working through portals and the cloud. As time becomes more precious for all and the cloud gains more power within the profession, it is reasonable to assume face time will drop further. We have heard that 87 percent of accounting firm clients are only seen once a year by the owner or partner in person, although the volume of phone calls, emails, texts, portals, and other forms of communication has risen exponentially.

So if you are thinking you may want to reduce your time commitment to your firm in the next five years, what may sound like an eternity translates into only five visits for the lion's share of your clients. That is important because most clients really are not equipped to judge whether we are great, adequate, or inept at what we do for them. They choose a firm because they like and trust the CPA they work with. Of course, fees, location, service procedures, and other elements all are critical as well. However, if the client is not comfortable with you, in most cases he or she will likely choose another alternative. Given the trust clients place in you, you should use your remaining face-to-face visits wisely to prepare for the best possible transition. From experience, we know that a proper transition of a client relationship requires the personal involvement of the transitioning partner in introducing and supporting a successor. For the best clients, relying on e-mail or a letter alone won't cut it.

We purposely used the phrase "reduce your time commitment to your firm in the next five years." This is a critical factor because many practitioners focus on when they want to retire but, in reality, most owners don't go from full time to retirement in one step. Instead, they slowly decrease their time commitment to the practice. Thus, you need to focus not on when you plan to retire but when you plan to slow down!

Keep in Mind

You need to focus not on when you plan to retire but when you plan to slow down!

There are ways to affiliate that enable the retirement-minded members of a firm to maintain control and income while gradually acclimating their clients and successor to each other. One way to actively participate in the transition is to remain involved as needed after your ownership interest has been transferred. Another technique is what we refer to as a two-stage deal, which allows the seller to maintain his or her current level of income, independence, and control over his or her practice and still start the process of acclimating clients to a successor. Look for more on this technique in chapter 6.

WHERE DO CLIENT LOYALTIES LIE?

One variable that is crucial in determining how to pace a role reduction is whether your clients are partner-loyal or brand-loyal. (*Note to buyers*: partner- versus brand-loyalty, which we will discuss in detail in later chapters, is an important factor to consider when evaluating a potential partner in a deal.) A key element in any transition is the transfer of succession and loyalty by the client to the new partner. The longer and more actively you participate in the transfer of trust, the more likely the transition will be successful. That will translate into strong client retention, elevate the value of your firm, and allow for a more satisfying transition of client relationships.

If your clients are partner-loyal, it is highly likely it will take longer to transition them and create a successful succession plan. In general, the smaller your firm, the more likely your clients are partner-loyal. Smaller firms frequently find it more than challenging to inspire brand loyalty in their clients because, in many cases, the client may have been developed and managed by one partner since he or she joined the firm. Getting clients acclimated and comfortable with other team members can help mitigate this issue but rarely make it disappear.

Keep in Mind

Be aware that when it comes to transitioning individual partners, one succession approach does not fit all.

If your firm is among the top 20 in the country, it is very likely that the overwhelming majority of your clients are loyal to the brand (the firm) and not to an individual partner. Brand-loyal clients typically take less time to transition than partner-loyal clients. However, many firms, including firms in the top 100, assume all of their clients are brand-loyal, but many actually may be more loyal to an individual than to the firm. Thus, when making a succession plan in a multipartner firm, certain partners may require a longer and more involved succession plan than others. Be aware that when it comes to transitioning individual partners, one succession approach does not fit all.

See exhibit 2-1 for help in distinguishing between brand and partner loyalty.

Exhibit 2-1: Partner Versus Brand Loyalty

How can you decide whether clients are partner- or brand-loyal? In most cases, the answer may be obvious, but here are some questions to ask:

- How many firm members does the client or his or her staff speak with? If clients know and are used to working with your successor, you can count on a smoother transition.
- Do junior staff members have any contact with junior client employees? Any contacts outside of the main partner will help reinforce brand loyalty.
- If contact is mainly with one person, how long has the client worked with that person? If the client's most significant contacts over a number of years have been with just one partner, his or her commitment to the firm will likely not be very strong once that person leaves without a strong transition plan.
- Do any clients speak with more than one partner? This is typical in clients who are more brand-loyal than partner-loyal.
- What will bind the client to your firm once his or her main contact leaves? If it is hard to say, then that client is partner-loyal and retention may be an issue once a transition takes place.

Determining whether a client is partner- or brand-loyal will generally be subjective and depend on the details of each situation, but these questions can help you make a realistic assessment of where your firm stands.

Unique Skills

Other factors also influence the timing of a succession plan. For example, if a partner in a firm has a very specific skill set, it will likely take longer to identify and potentially train a successor. There are certain niches in which licenses or credentials are involved, such as an ABV in business valuation or a registered investment adviser in wealth management. Many of these are well known, but you may be surprised at the more obscure ones that may have to be considered in a transition. For example, if you do municipal accounting in the state of New Jersey, you must be a registered municipal accountant. If you are retiring or selling your firm, you must find a successor who is an RMA.

Technical skills or experience are not the only issues to consider. We have seen difficulties in replacing partners who spoke a language other than English or had a specific ethnic or cultural heritage shared by much of the client base. If you are in a market with limited access to talent, finding and training new leadership will be another challenge. Keep in mind it traditionally requires a minimum of two years to transition a client from one partner or owner to the next, and when special skills or other issues are involved it can take longer.

What Are Your Commitments?

Internal changes or investments should also be considered in relation to succession timing. If you are about to relocate, make a major investment in technology, add staff, or institute another significant change, this may be the time to review your succession plan to see if these steps make sense given your expected timeline. If you need additional staff capacity or technology to enhance your practice but you are thinking of reducing your role in the next five years or so, an affiliation now with another firm that has that technology or excess capacity can possibly achieve all of your goals. Before you act, consider whether there is another firm or practitioner with whom you can affiliate that will participate in the investment, or perhaps the affiliation itself may satisfy your need because of the other firm's resources.

Lease terminations also can play a significant role in the timing of your succession plan. If you are fewer than five years from reducing your time commitment to your firm, then now is not the time to enter into a long lease for your space. If you have a lease, you will limit your potential audience of successor firms to ones that can support another location. Firms that take on leases at this stage likely will reduce the size of the offers they receive by this additional cost factor. Making it easy for a successor firm to move your practice into its infrastructure makes a more profitable deal for the successor firm, which means they can afford to pay you more for your firm and still make more.

Leases are an often overlooked consideration for firms in succession planning. The following is not an atypical example: A four-partner firm generating $4 million in revenues called us for help in merging with a larger firm. Two partners were looking for long-term expansion of their business, and two others were seeking to reduce their roles in the near term. The firm had just signed a 10-year lease extension and had well-appointed space, great location, parking, and a below-market-value rent. After discussing other goals and firm metrics, we asked what size firm they wanted to target as a merger partner. It turned out they had firms in mind that were as small as $8 million in revenues right up to a top 100. However, because any of these potential merger partners would already have an office, the firm was spending a lot of money on a new space that might actually weaken their merger negotiating position.

Keep in Mind

When you are considering a merger or sale, you are marrying your successor firm to any lease commitment you make.

Many firms forget that when you are considering a merger or sale, you are marrying your successor firm to any lease commitment you make. By taking on a lease obligation, the firm has eliminated a large portion of the potential successor firms out there that may have considered the opportunity but did not want a satellite office (let alone one in the same area). Even worse, firms will reduce the offer they ultimately make on the practice by the costs of carrying this additional overhead. Remember to a lesser degree this includes all types of leases you may be considering, not just office space. Although leases on servers, copiers, or postage meters may not seem to be very significant items, you should determine in advance whether your buyer will be willing to take them on or if you will have to cover the remaining costs yourself.

PERSONAL AND PROFESSIONAL ROADBLOCKS

Some succession hurdles are put in place by the CPAs themselves. Let's say you work in a relatively small firm, one where there are many partner-loyal clients. At the same time, your practice has evolved to a point where you do not see clients more than once or twice a year. In this situation, a gradual turnover is particularly important, but many practitioners continue to put it off. Why? After consulting over the past 20 years with thousands of accounting firms, here are the main reasons many practitioners have shared with us:

- *Accountability*. Most owners and partners like the autonomy of running their own ship. The idea of losing some control is so distasteful they prefer to ignore their succession concerns rather than affiliating with a successor firm and experiencing any change.

- *Loss of income*. In the minds of many practitioners, transitioning their firm or book of business means selling. Selling means at least partial loss of current income. A practitioner who is three years away from slowing down often cannot justify giving up current income to accomplish what feels like a long-term goal. Unfortunately, they are failing to recognize that in most such succession plans, there is no need to reduce your income unless your revenues or time commitment shrink as well.

Both of these are understandable reservations, but they can obstruct a smooth transition. If you believe these kinds of concerns are causing you to postpone succession planning, consider what your greatest fear about the transition may be:

- Loss of control? If so, could you fashion a merger arrangement that offers you a new consulting role as you transition your clients to new partners?
- Loss of income? The best way to ensure a good deal is to have a well-run firm that can be easily transitioned to maximize client retention. By resisting change, you may be harming your own future income opportunities.

Case Study: The Cost of Procrastination

Let's consider how self-imposed roadblocks might work against a CPA in practice. Jim, a sole practitioner, puts off finding a successor until the last minute. While he is procrastinating, he experiences several setbacks:

- A key employee resigns
- A large client that is growing steadily is at risk because it needs services the firm cannot offer
- The aging information technology (IT) system requires a substantial upgrade

These are not random misfortunes we are using for illustration. In fact, it makes perfect sense that a talented staff member might begin looking for better prospects if there is no clear future career path at the firm. It is also reasonable to expect that a key client might outgrow a firm that is not focused on the future, and that its IT system would be behind the times. All of these setbacks have left Jim desperately seeking a successor and ready to take any offer that comes along instead of managing the process in an orderly fashion. This case study truly demonstrates that succession is not an event; it is a process, and one that must be initiated early and approached in a strategic manner.

One final roadblock is the failure to keep an open mind. Many practitioners have certain expectations about how a deal will work, how much they will receive now or over time, how involved they will be in the firm, or many other considerations. But if you are approached by a viable merger or acquisition candidate, do not allow these expectations to become roadblocks. Instead, be flexible and listen to what they have to offer. You may be pleasantly surprised by what you hear. It is important that you differentiate between absolute must-haves and preferred items. In later chapters, we will discuss in detail the importance of issues, such as being flexible about the size or existence of down payments and about the many options for a practitioner's continued involvement in a firm.

Committing to Retirement or Sale of Ownership

We do not believe that a number on your driver's license should necessarily be the sole determining factor of when you must give up your business. At the same time, as we have noted, it may be difficult to retain talented young professionals if they see no path to a future leadership role. There may also be internal friction if a founding partner begins to scale back his or her output but maintains the same income level.

According to the 2012 PCPS Succession Survey, only 47 percent of firms have mandatory retirement guidelines. This is actually a hot topic at many firms because the founding partners and many senior owners want to extend their careers beyond an agreed-to retirement date. This was especially true in the aftermath of the financial meltdown in 2008, when many baby boomers saw their 401ks turn into 201ks, real estate values tank, and retirement savings in general become less reliable. Even though the economy has stabilized, many partners may still fear ending up on a much tighter retirement budget than they expected several years ago. As a result, they are trying to extend their income earning years.

Partnership agreements that address this issue usually set 65 as the mandatory age, but we have seen many partners pushing for later dates. We have seen ages as early as 55 and as late as 72.

There has been more attention to this issue because the absence of any discussion about retirement can prevent the firm from planning for partner transition. With a set date, firms believe they have time to develop their bench of successors to coincide with expected retirements.

Firms without mandatory retirement dates feel they are operating in the dark, just waiting for the inevitable but having no idea of when it might happen.

In the end, it comes down to setting priorities. Even in well-run firms, we have found partners postpone dealing with their retirement timetable. It always becomes personal. Partners tend to think, "If I am going to hold my partners to a strict timetable for their retirement, I am boxing myself in as well." The partner group has to decide that what is best for the firm as a whole overrides what is desirable for the individual partners.

At a recent firm retreat with a group of partners who ranged from 40 to 63, each person was asked when they planned to retire. The earliest date was within 5 years and the latest was 15 years out. With 10 partners, the average term to retirement was 9 years, with the median being 10. This was a shock to partners because they expected the youngest partners to plan on working at least another 25 years or more. Instead, the partners furthest away from retirement did not plan to work that much longer than the ones closest to it. This may be due to generational differences or it may be that most people naturally are unable to commit to a timeframe for when a life changing event like retirement will occur. We have worked with dozens of firms over the years that, when asked when a specific partner intends to retire, say "about 10 years." Five years later, when asked the same question, we have received the same answer: 10 years. We have concluded from this that 10 years really means, "I haven't really thought about it and I am not ready to think about it now." Many firms believe that a mandatory retirement date takes the emotion out of this decision.

JUMP START CHANGE

If you need further incentive to establish your succession plans, keep in mind that merging may be the perfect tactic to introduce significant enhancements in the way your firm operates. These enhancements can include the following:

- *Cultural*. Some firms face steep challenges in getting team members to buy into changes that are philosophically or economically different from current practice. Key people may agree that change is needed, but they cannot decide what approach to take or are unwilling to make the investment. Merging with another firm can jump start beneficial improvements.

- *Financial*. Members of your firm who are seeking short- to mid-term succession may be hesitant to invest in infrastructure because they will not be around for the return on investment. These individuals may be right because, as we have noted, certain changes may not make sense if your goal is a near-term merger. For example, you might change your tax preparation software today to become more efficient or you may be thinking of moving to a paperless office, multiple screens, or portals. However, you may find a merger candidate that already uses the same software or has the ability to help you make the changes you were contemplating. You can avoid the investment in training and data migration by waiting and letting the successor firm do the work.
- *Procedural*. To avoid reinventing the wheel, the successor firm may be able to institute necessary changes using existing systems and procedures in less time and with less money.
- *Additional services for cross-selling.* If your firm concentrates on traditional services, a merger with a firm that offers estate planning, business valuation, wealth management, or any services that you do not can open up new business opportunities that will enhance the merged firm's overall success.
- *Talent*. Often the biggest benefit of merging is the access to talent necessary for the firm to carry on. Either a successor firm will have the necessary replacement talent in place or, as is more often the case, the systems and resources necessary to find and develop that talent.

Other changes are best taken now because they can make your practice more attractive to a potential suitor. Examples include but are far from limited to the following:

- Attempting to make your clients more brand-loyal and less partner-loyal by diversifying the contact points in your firm for client service. Next time you meet with any key client, bring along a partner who provides a different service they may need or include a promising younger colleague.
- Getting your records up to date. Whether you are valuing your firm or looking for consolidation opportunities in a transition, well organized records are always beneficial.
- Cleaning up your accounts receivable and work in process. Acquiring firms are often leery of old receivables because they tend to taint the quality of the client base as a whole.
- Making your firm easier to absorb by removing problem staff and eliminating commitments that the successor firm would have to assume. We have talked about lease obligations that the

buyer may not want to take on, but staff members who are not pulling their weight are draining your resources and diminishing the firm's value.

Sooner Rather Than Later

Your practice value is greatest when the firm is running at top efficiency. By creating your transition succession plan in advance when the practice is peaking, you can structure the most lucrative deal. That will involve preparing clients for a smooth transition, making some realistic decisions about when partners will actually slow down, assessing skills that will need to be replaced when they do, and taking some care in making investments and commitments on the firm's behalf. It will also involve being honest with yourself about the reasons you may be putting off succession plans and determining how the right deal can help you address your concerns.

Keep in Mind

Your practice value is greatest when the firm is running at top efficiency. By creating your transition succession plan in advance when the practice is peaking, you can structure the most lucrative deal.

Which would you pay more for, a business that is stable or growing or one that is in decline? Even if your firm's revenues have started to decline, now is a better time to address your succession. This is especially true because demographics and the growing number of retiring partners over the next few years are lowering market values. Securing a deal sooner can help you lock in higher valuations.

Action Agenda

It will take time to transition the relationships you spend years establishing and nurturing. The questions in this action agenda can help you begin the process. Given the answers, what steps should be taken to make the firm more attractive to a prospective buyer?

Questions	Answers
1. *Take stock*. Is there language in your partnership agreement regarding succession? If so, how will it affect your options? If not, what guidelines might you want to add now?	
2. *Look ahead*. Decide how many years you have until retirement or a reduction of hours and compare that to the amount of face time that will actually take place during those years. Is there enough time for your successor to build a strong relationship with clients?	
3. *Assess loyalty*. Using the questions in this chapter, determine the percentage of your clients that are brand-loyal versus partner-loyal. If a large percentage is partner-loyal, begin now to introduce them to other firm members and nurture relationships with them. This can include a firm administrator or office manager if you expect him or her to transition to a new owner.	
4. *Consider your skills*. Do you have special skill sets or niches that should be considered in the transition? If so, do you have current staff who can learn or provide these skills or service these niches? If not, would it be best to seek a successor that can do so or should you be prepared to sell off some of the practice before a transition?	
5. *Review commitments*. What kind of lease or other commitments may complicate the transition?	
6. *Examine your exit strategy options*. If you expect to sell your firm, assess the following: • Is your current staffing sufficient? • Will you need more staff in the near future? • Is your technology adequate as is? Will it need to be updated soon? • Will you need to relocate or renew your lease in the near future? If not, how long is your current lease? When does it expire? • Do you have many potential successor firms for your type or size firm in our geographic area or just a few?	

CHAPTER 3
How to Choose a Successor You and Your Clients Will Love

For most practitioners, choosing your successor is the last and most important decision you will make relating to your firm. There are many aspects to consider in your choice, including the person's background, experience, and areas of expertise; your personal reaction to them; and the economics of the deal. Even if you make a great choice, handling the client transition properly is crucial.

In this chapter, we will focus on issues other than economics that will influence the success of a transition, beginning with one basic concept: When you consider a successor, remember that you are replacing the role, not the body. Whether you are a sole proprietor or are involved in a multipartner firm, start by taking a holistic view of the role in the firm that must be replaced, not just the person in it. What are the responsibilities? Does the current employee have a particular technical skill and or license? Beyond technical skills, does he or she perform a great deal of client handholding, rainmaking, and administrative duties? Is this person a dynamo who functions as the face of the firm? Does he or she have great managerial skills that have kept the office running at a high level of efficiency?

Your succession plan should be designed to do more than simply replace one body with another. Think about quantitative issues, such as hours worked and areas covered, and qualitative issues, such as a leadership role within the firm or being prominent or influential in the community. The plan should identify a professional or professionals who can take on the entire role the retiring partner was performing as thoroughly as possible. Too often we have seen firms decide that Jane in the tax department has been a great technician, team player, and rainmaker, so she will replace the next retiring partner, whoever that may be. But if that next partner is the audit partner, quality control partner, or something else, there will be many challenges in the transition and key leadership and technical roles may be lost along the way. In this chapter, we will address all of the issues practitioners should consider and we will use illustrative case studies to clarify our points. Although the recommendations are directed toward the seller, buyers should also be aware of the many elements that contribute to a successful transition.

Think About the Four Cs

It is fairly easy to recognize skill sets and experience that must be replaced, but we also place a lot of emphasis on what we call the four Cs: chemistry, capacity, culture, and continuity. Both buyers and sellers should be aware of their potential impact on any deal.

Chemistry

If you do not want to eat lunch with the person or people with whom you are considering affiliating, do not affiliate with them. This is the single most critical advice we give anyone. It is particularly important in an external succession, but even in an internal succession the incoming and outgoing people should like each other.

Keep in Mind

If you do not want to eat lunch with someone, do not affiliate with them.

Think about it. Why do most of your clients stay with you? There are dozens if not hundreds of practitioners in your area for them to choose from. Most clients have no yardstick to determine the quality of their

CPA's technical skills. They stay with you mostly because they like and trust you. If you do not like and trust the person you are merging with or turning over your clients to, why would your clients and staff?

Many of us spend more time with our co-workers than with our families. Your work environment must be conducive to success. If you are comfortable at work, that will enhance your productivity and happiness. These good feelings are passed down to staff and clients, and the opposite is true as well.

Chemistry is especially important if the successor is external for many reasons, including:

- *Partner-loyal clients.* As we mentioned in chapter 2, many firms, especially smaller ones, have clients that are loyal to a specific partner. The proceeds of most sales of accounting firms are at least partially, if not fully, dependent on how much of the client base is retained by the acquiring firm. For this reason, the fit between the acquiring firm and your practice can actually have more impact on the value the seller receives than the terms of the deal will have.
- *Staff.* Your clients can always choose another accounting firm, and so can your staff members, especially the stronger ones. In many firms, key staff people also have significant client contact. That means, once again, that there is a danger that your staff may leave if they are no more comfortable with your successor than you are, and they may take clients with them.
- *Working relationship.* A good transition can take many years to accomplish, so you may be working with your chosen successor for quite some time, both before retirement from full-time involvement and after, if you choose to stay on in an "of counsel" part-time role with the firm. A good working relationship is critical if you are transitioning using a two-stage deal (see chapter 6). Do you want to work that closely for many years with someone you don't really like?

Keep in Mind

If the deal includes a retention period, the fit between the acquiring firm and your practice can actually have more impact on the value the seller receives than the terms of the deal will have.

Capacity

If you and other partners or even staff will be slowing down in the near future, does the successor firm have the capacity to take on the work load of the professional slowing down as well as the expertise to replace his or her role? If they do not have the full capacity in place, do they have a credible plan and a commitment to acquire it? For instance, if someone in your firm who must be replaced is a major producer of billable hours, the acquiring firm would have to be overstaffed (not a good indication of a well-run firm) to replace those hours without hiring anyone. Does the firm appear to have the systems in place to hire people when needed? Who will be taking over managing your clients? The acquiring firm should at least have a plan for that important role and a commitment you can rely on to execute it. The plan could involve promoting a manager to partner to create more partner-level capacity or, if special expertise is required, hiring someone from the outside.

Capacity is one of the issues that can force firms to shift their focus from an internal to an external succession solution. We have done many retreats for firms in which as many as a third of the partners are five years or less from reducing their time commitment to the firm. Until we remind them about the capacity issue, they are confident they have an internal solution. But when they start to focus on the hours, the skill sets, and the many responsibilities they will need to replace, it can be an eye opener. Can that time be leveraged or eliminated or does it need to be transitioned to another owner or partner only? The answer will have a significant impact on your selection of a successor.

Culture

A firm's culture is central to how it defines itself, but there are many ways to do that. The term generally refers to the firm's environment and philosophy. When some firms think about culture, they are thinking about how clients are serviced, billed, or communicated with. In other cases, it is about what might be called client ownership, and whether the firm has an "eat what you kill" or book-of-business mentality as compared to a one-firm philosophy. In other cases, it means having either an open or closed compensation program for partners. Some firms define themselves by their work life integration policies or their use of cutting edge technologies. No matter what definitions are used, it can be tough to merge two conflicting cultures or ones that have little in common and little interest in change. If that cannot be achieved, once again the practice is risking client or staff losses.

Continuity

Change is challenging for anyone going through a merger or acquisition. Partners, staff, and clients traditionally seek to avoid it. Keep in mind that if your clients have stuck with you, they apparently like the way you are servicing them or they would have complained and gone elsewhere. If your successor requires wholesale changes that will be visible to or have an impact on clients, there may be immediate client defections.

Keep in Mind

If your successor requires wholesale changes that will be visible to or have an impact on clients, there may be immediate client defections.

Not all change is bad. In fact, there are two types of change: change behind the door and change in front of the door. Change behind the door happens, for example, when work that was done by a partner in your firm will be done by a manager or senior in the new firm—but the client is unaware of this shift. It may also include changes in software made by the successor firm or a new policy that allows staff to work remotely. The change has no direct impact on clients and they know nothing about it. Some of these changes may be very positive because they offer improvements to clients and staff who stick with the successor without inconveniencing or alienating them in any way.

An example of change in front of the door, on the other hand, is when a client who was accustomed to being seen in person by a partner every quarter is now told to mail in the work and is visited annually by a junior. If a firm needs to make significant in front of the door changes, it may not be your best choice for successor because clients may become dissatisfied and switch firms. Sudden changes in fees, service methodologies, and many other factors that will have an impact on client service can also result in client losses.

Staff can be heavily affected by change as well. It can be daunting for employees who have worked in a firm that is not very technology driven to be dropped overnight into a new practice that is paperless or a multiscreen environment where client information is exchanged through portals. We are certainly not suggesting that firms that are not up-to-date on technology should find a firm that is equally behind. Our point is rather that if staff retention is key, be aware that an additional investment of time and training will be necessary and must be included in the transition plan. A firm that will not tolerate that investment may not be as good a fit as it might initially appear.

What Is the Worst That Could Happen?

Let's consider the consequences that can occur when a firm makes a hasty or poorly thought out successor choice.

Case Study: Impatient Transition Goes Bad

Jane is a sole proprietor with firm revenues of $200,000 a year. She employs a clerical assistant but otherwise does almost all of the client work herself. She has not given much thought to succession, but she will be turning 65 this year and has realized that she would relish a break from the long hours and regular challenges involved in running a solo practice.

Through her local state CPA society chapter she meets a partner in a small local firm that has been growing aggressively and that is seeking to buy another practice in the area. They make a deal and within a few months Jane finds herself heading into retirement. To her dismay, she quickly hears that many of her long-standing clients have left the firm and found another CPA. The rate of defections is so great that it threatens her payout, which was based on client retentions over set time frames.

What went wrong? Let's look at a couple of the mistakes that were made.

Blasting through the transition. Like Jane, many of her clients were older people who have lived in the community for a long time. In some cases, she was also serving their adult children and other family members, building strong relationships across the generations. She offered to remain with the new firm in an advisory role during the transition, but the buyers were anxious to introduce the clients to their firm and to switch their allegiances to new CPAs too quickly.

Why that was a mistake. Jane's clients had a great deal of partner loyalty, but the buyers moved quickly to remove Jane from the picture. The clients had no loyalty at all to the new firm, so they had no qualms about jumping ship. Involving Jane in the transition—and working to transfer loyalty to the new firm and the people in it—could have prevented those client losses.

Forgetting the personal. We have talked about the importance of liking your merger partner enough that you would be willing to go to lunch with them. Jane went to lunch with her buyers because she was a good businesswoman and admired their drive, but she noticed right away that she did not have a lot in common with them. They did not have the same deep roots in the community that Jane did or do the kind of handholding her clients were accustomed to. The buyers seemed very passionate about growing their firm, but they were not deeply invested in local community groups or charities, as Jane was.

Why that was a mistake. Your clients like and trust you because they believe you understand them. They may not think about it in so many words, but that means in part that they believe you have a similar outlook and values. If that were not the case, they would not feel as comfortable following your advice. Your buyers do not have to be just like you, but clients have to believe that they are well enough in sync with their values and aspirations that they will give them the right advice. Otherwise, they will go elsewhere.

Jane's transition was too abrupt and she did not take into consideration crucial issues such as culture and continuity. Jane was a tremendous resource where client retention was concerned, and the successor firm should have made the most of her contributions in the transition, asking her to introduce clients to new contacts and sitting in on meetings with her as needed. Jane should have also done a bit more research on the culture and practices of her successor firm, including their approach to personalized client service (or the lack thereof) and their billing rates.

Smart Ways to Smooth the Transition

Now let's look at two successful transitions, one good and the second one even better.

Case Study: Good Transition

This time, we will consider the transition from the client's point of view. Doug owns a small construction business and has been working with a four-partner CPA firm for about a decade. About a year ago the partner Doug had worked with, Steve, contacted him and told Doug that he and his partners were merging their practice into a seven-partner firm in the next town. Steve assured Doug that he and his partners would be partners in the new firm and still available to him, although Steve's partner, Lisa, was going to be retiring in about a year.

Almost immediately, Doug became concerned. When he read about mergers of businesses in the paper and heard about them on television, it seemed they only resulted in layoffs and had few advantages that he could see. He wondered how this merger of his accounting firm—and trusted adviser Steve—was going to work out for him. In addition, Lisa was going to retire. What would happen to Mike, a staff accountant at

(continued)

Steve's firm that Doug worked with as well and liked a lot? For years, Steve or Mike had stopped by Doug's office to pick up the data and documents they needed and to catch up on where his business stands. When Steve offered advice or suggested some added services he could provide, Doug almost always agreed because he felt that Steve had good first-hand knowledge of his business due to all those visits.

Sure enough, the first time following the merger that Doug called to ask a question, Steve wasn't there. Doug thought this was not going to work out.

Then Doug got a call from Steve. He wanted to come by Doug's office and introduce him to one of his new partners, Beth. They stopped by the next day. Turns out Beth specialized in construction companies and worked on about 20 other regional firms in that industry. She was the treasurer for the local chapter of the Construction Financial Management Association. Steve assured Doug that he would still be working with him and that Doug could call him whenever he needed anything. Beth was going to be a big help with her added expertise and, in fact, she had worked on several bidding models for construction companies in the past. Doug had recently mentioned to Steve in passing that he could use a tool to do a better job with his bids. Steve, lacking any experience with that kind of need, had let the comment slip by. However, now Steve enthusiastically brought the subject up and suggested Beth would be able to help.

Still Doug was a little skeptical. His brother's accounting firm had merged into a larger practice and the first communication he got following the merger announcement was a notice that his fees were being increased by 50 percent and that a whole new team, part of which was not even located in his city, was being assigned to his account. But along with Doug's first invoice from his new firm, he received notice that his fees for the next 12 months were being held at the same level as the previous year for the same services he had been provided. These steps taken together calmed all of Doug's fears. He remains a loyal client of the combined firm.

What could have been handled better? In the end, Steve's relationship with Doug was salvaged because he heard all of the things he needed to hear eventually. However, human nature tends to fill in the blanks with the worst case scenario when there is a lack of information. Steve's initial communication with Doug and all the rest of his clients should have anticipated what they needed to hear to make them comfortable with the change from the outset. We will spell out many of clients' most common questions in our next case study.

Case Study: Better Transition

John was one of two owners in a practice that merged into a firm that was about three times larger. John had a lot of initial concerns about how successful the merger would be. He considered many of his clients to be personal friends. He attended the weddings of their children and many had attended his children's weddings. His clients confided in him about everything in their lives, including personal matters that had nothing to do with their finances. Some of his clients had been with John for over 30 years. Some had even told him, "Don't ever retire because you are the only accountant I ever want to work with." How was John ever going to tell them that he would soon be retiring and someone else would be taking his place? How could he count on the successor firm keeping his clients after he no longer was there?

Fortunately, John kept an open mind and listened to the advice he received from us regarding the transition plan, and so did his successor firm.

The first step was to break John's clients into groups based on their importance to the firm. Level of annual fees was a critical characteristic but not the only one. Stature in the community was considered, as was long-term potential for additional fees and the types of services rendered. For instance, individual tax clients with no business ties were separated from business accounts.

Next, an internal successor was assigned to each client. Many of those were partners in the new firm, but not all. Then a means of communicating the change John and his firm were going through was chosen for each client. This was done, of course, in groups. For instance, most of the individual-tax-only clients fell into the same category. The choices of communication style available were (1) a letter, (2) a phone call, and (3) a personal visit. The most important clients got a personal visit not only from John but also his internal successor. This was critical because by including the successor, it prevented clients from saying, "This is all well and good, but I want you to keep doing my work."

John and the firm developed a script that explained what was going to change and, just as important, what wasn't. It was used as a guide to conduct the meetings and calls and it provided the content for the letters. John and the successor firm also developed a plan for how John's involvement with his clients would change over the two years John planned to stay on in a mostly full-time role. John was to remain totally accessible to clients and very visible in the combined firm so the clients would not feel abandoned. However, at the same time the goal was to

(continued)

gradually move John to the background while he constantly supported his successors in the firm as their new go-to people. The overall objective was to introduce as little change as possible for the clients in the early stages so they could easily support the transition. The internal theme for the transition was, "Let's not make this about what the client is losing, but about what they are gaining from the newly combined firm!"

John was pleasantly surprised to find that there was a common theme to the responses he received from his clients. They tended to ask five questions almost every time:

- Is the new firm going to be able to serve me the way I have been accustomed to being served?
- Will the cost of my services increase?
- Are you moving your offices and, if so, will it be convenient for me to go there when necessary?
- I have been working with Sally and Evan for quite a few years. Are they still going to be working on my account?
- John, I have known for some time that this was inevitable. You are no spring chicken anymore. Is this a good thing for you personally?

John and the successor firm received almost universal support for the transition. The attrition the successor firm did experience was essentially limited to clients John would have lost anyway due to businesses being sold and clients passing away or moving.

Why this transition was so successful. John's communication with his clients was much more proactive and customized to the needs of each client than Steve's was. His clients heard what they needed to hear to realize the ship was sailing in the same direction as it always had, even though John would be leaving the firm soon.

Worth the Effort

Choosing the right successor is clearly a multifaceted effort, but it is well worth doing because it sends a message to clients and staff that the transition is not going to be about abrupt change and the loss of a key person. Instead, making the right match can be perceived as an opportunity to be served by or become part of a new team with the promise of many potential benefits.

ACTION AGENDA

Follow these steps when evaluating potential successor options:

1. *Consider what's being replaced*. What does the outgoing person contribute to the firm? Will a potential successor be able to cover attributes? Keep in mind:

   a. Hours worked.____________________________

   b. Services or industries served.____________________

   c. Specialized skills, credentials, training, or experience._______

   d. Responsibilities within the firm.____________________

   e. Involvement in the community.____________________

2. *Put it in perspective*. Are other partners or staff members also leaving in the near future?

   Yes____ No____

   If so, how does that change any conclusions on what the successor will have to replace? For example, does the successor have the capacity to take on the work performed, not just by the partner who is reducing hours now but also by any partners or staff who plan to slow down in the next five years?

   ____

3. *Remember the 4 Cs*. Although capacity is generally covered in step 1, also remember the importance of chemistry, culture, and continuity.

   a. Chemistry: Is the successor the kind of person who will be liked by clients and staff?

   ____

   b. Culture: How would you define your firm's culture? What sets it apart from other firms? What kind of clients or staff are attracted to the firm? Does your potential successor have the same culture? If not, could it stand in the way of the merged firm's success?

   ____

   ____

c. Continuity: What differences will the clients become aware of once the planned transition takes place? Will they likely feel comfortable with them or not? What will it be like to work for the firm after the transition? Will key staff members likely want to continue to work there?

4. What kind of communication will clients receive about the change? Personal visit? Phone call? Letter? If different kinds of communications will be used, which clients should receive each kind? How will the outgoing partner be involved in communicating with clients about the transition? How will the successor be involved?

Client	Type of Communication	Outgoing Partner Involvement	Successor Firm Involvement

Chapter 4

Our Managers Will Buy Us Out, Right? Speed Bumps to Avoid on the Road to Internal Succession

Is your succession plan based on the belief that one or more younger professionals in the firm will step up to buy you out when you are ready to retire? If so, it is not too soon to begin putting together your plan B. As we have mentioned in earlier chapters, many firms have a strong conviction that they can rely on an internal succession solution, and a large percentage of them face unpleasant surprises once it is time for that succession to take place. This chapter will help you take the surprises out of your own internal succession considerations. It will explain why setting the right terms in a partnership agreement can strengthen the chances of achieving a successful internal succession. It will also examine some critical issues that must be addressed if an internal succession plan is to succeed. Given those considerations, we will offer some practical advice on how to avoid roadblocks or work past them when they occur.

The Road to Succession

1. Create an effective partnership agreement.
2. Obtain the right talent.
3. Develop that talent into internal successors.
4. Make sure you have appropriate financial arrangements in place.
5. Create a strong transition plan.
6. Develop a detailed financial plan.

What Is on Your Partners' Minds?

An internal succession plan must cover not only the legal agreements between the owners and the firm, but also the firm's business plan for effecting the transition of owners. As part of that business plan, the firm must be able to replace the resources lost when an owner leaves and be prepared to transition client relationships. At the same time, the plan must address the validity of some of the assumptions the partners have made. When we consult with firms, we often ask for confidential information from each partner on the following:

- Their personal financial and professional goals.
- Their plans for their career, especially how long they expect to work full time before reducing their time commitment to the firm. Remember, most partners do not go straight to retirement but phase out instead.
- An assessment of the firm's advantages and challenges in handling owner transition.
- The issues they would like to see better addressed in new partnership agreements.
- Aspects of the existing agreements that they believe should be retained.
- The quality of their bench of near-partner talent, which represents their pool of internal successors.

Practitioners are often surprised by how wrong they are about their partners' intentions and opinions. For example, when we went through this exercise with a $6 million firm with six equity owners and one nonequity principal, we found that

- several partners were dissatisfied with the approach to profit distribution.
- one partner was currently reducing his time commitment to the firm as he neared retirement and the others believed he should accept pro rata reductions in his compensation as a result, but he wasn't.
- a younger partner who was expected to be part of the long-term succession team was actually planning to pursue an alternative career in several years.
- their agreement did not cover internal promotions to partnership. All previous partners were either founders or had been admitted through merger.

These are a few examples of things that can come from such a dialogue. A successful plan starts with knowledge of your partners' intentions for their succession. The more time your firm has to plan for what will be required to transition client relationships, replace critical responsibilities, and find the necessary talent, the better the transition will go. There should be frequent discussions among the partners about their plans, at least annually (for example, at a firm retreat).

Strengthening the Partnership Agreement

With that in mind, let's step back a moment to talk about the partnership agreement, which is the foundation upon which successful internal succession plans are built. (Data from the 2012 PCPS/TSCPA National Management of an Accounting Practice Survey[1] in appendix A provides some background details on succession and partnership agreements.) As we have noted, succession planning should be addressed in the partnership agreement when the firm is first formed. Among other things, the partnership agreement should require a minimum of two years' notice of intent to leave to minimize risk for the firm, which usually allows enough time to plan and execute an orderly transition of duties and key relationships. Keep in mind, in particular, that it will take more time for partner-loyal clients than brand-loyal ones and that transitioning partner-loyal clients will require the active involvement of the retiring partner.

Unfortunately, many agreements allow an owner to retire from the firm without any restriction on age with full benefits or to leave at any time as long as notice is given. We have seen many agreements that require as little as 90 days' notice of intent to leave and even no notice. With little to no restriction on a partner's ability to reduce his or her time

[1] www.aicpa.org/interestareas/privatecompaniespracticesection/financialadminoperations/nationalmapsurvey/pages/default.aspx.

commitment to the firm, planning for succession can be a best guess and the firm may have very little time to execute a transition of the terminating partner's duties and relationships. The effect on client retention and firm management can be devastating in the worst case scenario.

Keep in Mind

The partnership agreement should require a minimum of two years' notice of intent to leave to minimize risk of a poor transition for the firm.

Protect Against Risk

We usually recommend that the agreement cover every kind of termination of a partner's role in the firm, including retirement, death, disability, involuntary termination, and voluntary termination other than retirement. Each one carries different types of transition risks for the firm and they should all be considered in the buyout terms. For instance, it is impossible to plan for the death of a partner. Insurance that protects the firm's and the partner's loss of value can mitigate the risk associated with a sudden need for transition. Key person insurance, which protects a business against losses due to the death or extended disability of a critical employee, is one example. However, without insurance, such an event can be very similar to a partner terminating without any notice and the risk this poses for the firm should be reflected in the owner agreement.

Let's assume adequate notice is not given for whatever reason. We have found that the most effective approach is to adjust the buyout payments for the firm's loss of business during the two years after the owner's exit, under the assumption that any revenue declines will be due to the lack of adequate time to transition the retiring partner's duties and relationships. This ensures that the retiring partner will have a vested interest in helping with the transition and, more important, providing the notice.

How would that work in practice? Let's say a partner leaves the firm without giving the notice the partnership agreement requires. During the subsequent 2 years, the firm loses 10 percent of its business, so there is a 10 percent reduction in his or her buyout payments. The terms of the partnership agreement might call for measuring the lost business on a firm wide basis or restrict it to the book of business the departing partner was responsible for managing.

Let's return to the $6 million firm with 6 equity owners and 1 nonequity principal, in which many were surprised by their own partners' plans and attitudes. In our work with them, we found that their agreement required only 90 days' notice, upon which the firm was obligated to fixed buyout payments for the next 10 years. This left virtually no time to plan and implement a transition of a retiring partner's duties, including client relationships. There was a significant risk that the transition would not only fail to succeed but also be financially disastrous. We recommended a 2-year notice period, which was accepted. With 2 years' notice, the firm has the ability to consider all of its options. Ideally, this gives them 2 years to execute an orderly transition. However, if that is not possible either due to a lack of adequate internal succession resources or the unique characteristics of the departing partner's duties and relationships, the firm can also develop and execute plan B. Plan B could be an extraordinary acquisition of talent, a cull out of the partner's book of business to sell to a firm in a better position to assume it, or even an upstream merger of the entire firm. For discussions of cull out sales and other alternative options, see chapters 5 and 6.

Cover All the Angles

Retirement notice is just one of many succession-related issues that should be covered in a partnership agreement. We provided this firm's partner group a written assessment of their current agreement and recommendations for a new one, including the following:

- A valuation and payment formula that covered death, disability, and normal retirement.
- A methodology for handling the partner termination other than through normal retirement.
- A look-back financial analysis of the valuation formula that demonstrated the plan was self-funding.
- Provisions covering a deferral in the payment of the retirement liability in the event of a severe short-term cash flow crunch or the loss of one very large client. This involves instituting a cap subjecting the payouts to former partners to a predetermined percentage of the gross revenues. Any obligations in excess of this limit would be deferred to the subsequent year. Keep in mind that the basic principal for your agreement should be protecting the firm first. If the firm does not survive, no one wins.
- A recommendation that the agreement preclude 2 partners from retiring within 12 months of each other.
- Recommendations for handling pay out of capital accounts.

- Tax treatment of all payments. In this case, we recommended the payments be structured to be deductible as paid, which also means that they would be ordinary income for the recipient. There are many ways to approach this issue. However, the wider the gap between the timing of payments and the timing of the deduction, the more pressure it puts on the firm's ability to pay, which should be reflected in the valuation. Tax treatment resulting in nondeductible payments (such as for treasury stock) often places an unreasonable burden on the firm's cash flow.
- Restrictive covenants for terminated shareholders that ensured that while the firm was paying the buyout payments, the terminated partners would be precluded from diminishing the value of the firm by diverting the client relationships that are the basis for much of the value.

We also structured a financial methodology within the agreement for admitting new partners. An assessment of the firm's transition needs showed that it would be necessary to admit 2 new partners either internally from the bench or by acquiring experienced near-partner talent within the next two years. A revised partner compensation system addressed this need (and some current partners' compensation concerns). The new method included an allocation based on equity, base salaries generally tied to 60 percent of historical compensation and significant administrative duties, a new business bonus system for partners, and allocations of the remaining profits based on objective and subjective performance criteria, such as productivity, profitability of managed books of business, and subjective performance attributes. The new plan also addressed how to pay partners who were already in a transitioning, part-time role.

A poorly designed compensation system can actually hinder succession prospects. Transition is always more difficult in a firm that allows partners to hoard clients and manage growing books of business in individual silos that have little to do with the rest of the firm. But the compensation arrangements at many firms support this behavior. They also reward these partners in buyouts by tying equity to book size. Basing the buyout to compensation can have a similar effect if the compensation is tied too directly to a managed book of business. We will talk more about financial roadblocks to succession in chapter 5.

Be Sure It Is a Workable Plan

A robust effort to create an effective succession plan can solve a multitude of problems. In this firm's case, the level of compensation dissatisfaction among the partners was potentially disastrous. Tackling it head on left the firm with a stronger and more motivated partner team. The firm already knew it had not adequately addressed long-term partner development. The younger partner's intention to transition earlier than expected revealed the need for additional talent in the long-term succession team. The firm was able to develop a specific plan to promote its two strong internal team members to partner. We also helped the partner team look beyond the existing team for partner development and consider the alternatives. The firm now has a follow-up plan that includes acquiring additional talent through external merger and recruiting experienced talent.

This firm had a succession plan, but a careful examination and frank discussion showed that it probably would not have worked as intended and would have left a weakened firm as owners transitioned out. By identifying and addressing issues in the firm's business plan and partnership agreement, the new plan created a strong foundation to manage transition. All partners are now on the same page and there is a business plan for both short- and long-term goals. A new agreement was drafted and now dictates the firm's transition plan.

Keep in Mind

This firm had a succession plan, but a careful examination and frank discussion showed that it probably would not have worked as intended and would have left a weakened firm as owners transitioned out.

Who Should Lead?

An effective partnership agreement is crucial to a smooth transition, but the most critical element is the new leadership who will run the firm in the future.

It is often unclear, however, who will take over for retiring partners if an internal succession is planned. In the 2012 PCPS survey, 42 percent of those responding from multipartner firms felt that younger members of their practice were not ready to step into leadership roles. This number is even more alarming when you realize that it is up slightly from 38 percent in the 2008 survey, indicating that firms might actually be getting slightly worse at grooming future leaders.

Training Future Leaders

Whether you are building long term for a transition well into the future or seeking an experienced person who can step into a leadership role fairly quickly, a sound internal succession plan depends on getting the right people in place. In many cases, that means training the people you have to replace the roles of those who will be winding down their involvement. There are three forms of training that need to be a part of every professional's development. This applies to everyone in the firm but is especially important for future owner candidates.

Generic Competency Training

By this we mean continuing professional education, including the courses taken to maintain a CPA license, often in classroom settings. It takes the form of technical training, personal development (in areas such as writing, time management, and information technology), and leadership training. Leadership training is often directed at future owner candidates and includes project management, supervision, and practice development training. To develop future owners properly, it may be necessary to increase the budget for their generic competency training and consider including specialized training to develop the skills that are unique to owners of CPA firms.

The AICPA Emerging Partner Training Forums[2] are one option for leadership training, and there are also several consulting firms that offer partner development programs, as do most accounting associations. The PCPS Human Capital Center's section on owner development also contains valuable resources.[3]

Firm Culture-Specific Training

Although this may often be called on-the-job training, we use this term to emphasize that the point is not just to know how to do something, but to know how the firm does it and what it takes to be successful in the firm. As a candidate approaches the point when he or she might be ready to be admitted as an owner, it would ideally be a foregone conclusion that he or she will be able to handle his or her new responsibilities. The best way to confirm that he or she is ready is to observe the candidate managing those tasks beforehand. For example, a key responsibility for an owner in a CPA firm is managing all aspects of client relationships, for the benefit of both the client and the firm. An example of firm culture-specific training would be assigning full client management responsibility to managers, including handling all aspects of a billing run (with appropriate oversight). Let the managers learn how to balance the needs of the client, maintain quality control, manage firm resources, and achieve the firm's goals for profitability. The key to a strong firm culture-specific training program is often to stretch your expectations beyond what you know staff can do to include what you would like them to learn how to do.

---

[2] www.aicpaconferencematerials.com/emergingpartner/.

[3] www.aicpa.org/INTERESTAREAS/PRIVATECOMPANIESPRACTICESECTION/HUMANCAPITAL/Pages/default.aspx.

Mentoring

One of the reasons mentoring is so important is that, if done properly, it is two-way communication. Not only can the mentor tailor advice to the specific needs of the mentee, but the mentee also can identify his or her goals. Here is a typical scenario in our experience: We ask firm management about the potential for a specific candidate to become a future owner and we find that no one even knows if that person wants the job. Mentoring provides insights into candidates' true long-term goals and allows firm leaders to explain the opportunity the firm offers candidates. It is an important chance to build on the insights candidates gain from their daily observations of how the owners in the firm operate and manage their careers. The very best candidates will find a way to succeed on their own. Mentoring gives you the opportunity to make sure (1) those candidates end up succeeding in your firm instead of somewhere else and (2) that the candidates who need some extra help receive it.

Nonequity Partners

Many firms are now using nonequity partner status (also known as an income or contract partner) to provide the final polishing needed for future owners. Often the financial commitment to a nonequity partner is not nearly as significant as to an equity owner. There may be a much lower obligation for retirement or buyout, if there is one at all. The nonequity partner normally does not sign onto the firm's ownership agreement. Compensation is often managed completely separately from equity owners. Of course, a nonequity owner is usually not a party to the proceeds of a sale or merger and it is usually easier to terminate or demote a nonequity partner.

The advantage is that this professional is usually given many of the same day-to-day responsibilities and influence with clients and staff as an equity owner, making it possible to observe how he or she handles those duties without first committing to giving him or her the perks and benefits of equity owner status.

Does your internal succession team have the training and experience they need to take over? Use the worksheet in exhibit 4-1 to help you decide.

Exhibit 4-1: Characteristics of a Partner

A good successor must have all the attributes of any successful CPA firm partner. Use this worksheet to evaluate candidates in your own firm and identify gaps in performance and skills that must be addressed.

Candidate Name	Characteristic	Assessment (Does the candidate have this characteristic? Why not?)	Action Needed?
	Leadership: Provides guidance and is a role model for other partners and staff to achieve the firm's goals.		
	Client management: Can manage an expected level of client relationships profitably and effectively; has a loyal following of clients who see him or her as their trusted adviser.		
	Personal productivity: Meets expectations in producing services.		
	Growth: Is able to develop new client relationships and expand services to existing clients at a level that enables the firm to grow.		
	Firm management: Participates in the overall management of the firm, especially in		

Candidate Name	Characteristic	Assessment (Does the candidate have this characteristic? Why not?)	Action Needed?
	administrative areas assigned; is a good businessperson who understands and executes the firm's business plan.		
	Technical skills: Has developed the technical skills necessary to provide exemplary service to clients; ideally is known as an expert in an area of service important both within the firm and to the outside community.		
	Teamwork: Puts the firm's interests ahead of his or her own; promotes a team attitude among the partner group and staff.		
	Staff development: Assists in recruiting new talent for the firm and in developing staff to become valuable members of the firm; is a trusted mentor to staff.		
	Community involvement: Is the face of the firm in the community; is involved in		

(continued)

Candidate Name	Characteristic	Assessment (Does the candidate have this characteristic? Why not?)	Action Needed?
	activities that promote the interests of the firm and personal development.		
	Professional involvement: Takes part in professional activities that promote the interests of the firm and for the betterment of the profession as a whole.		
	Passionate: Has unwavering loyalty to the firm and a passion for making the firm as successful as possible; does not see his or her role as just a job.		
	Communication skills: Excels in both written and spoken communication.		
	Personal investment: Is on a constant journey to improve and sees every day as an opportunity to learn; is willing to invest the time necessary to advance his or her skills and is open to input from others on his or her need for improvement.		

USING MERGERS FOR LEADERSHIP DEVELOPMENT

Mergers can play a role in leadership development as well. Many smaller firms find themselves with the right people at the wrong time. The firm is not growing fast enough to provide an opportunity for advancement to owner status when the perfect successor's maturation is complete. Existing owners may be reluctant to dilute their profits and value by splitting the same-sized pie into more pieces. An acquisition can accelerate the development of young near-partner talent and help the firm create an opportunity for someone to take over for the older practitioners acquired in the merger as they transition out of the firm.

Here is an example of how it works: Assume the firm has 3 partners who manage on average $1 million in business each. They have a talented young professional, Sally, who should be considered for owner status as soon as possible. Sally has brought in about $100,000 of new business over the past several years. Sally's clients would naturally be a good start to her managed book of business. However, the owners are reluctant to promote Sally with only $100,000 in clients to manage. They are also reluctant to carve out much of their existing books of business to seed Sally's book. They have located a practitioner with a $500,000 practice who wants to retire in 3 years. Using a two-stage deal (see chapter 6), they merge in the practitioner. Sally is promoted to partner, possibly nonequity partner, and over the next 3 years most of the practitioner's clients are transitioned to Sally. At the end of the 3-year process, Sally is managing a $600,000 book of business and the firm's succession team is 1 person stronger. Completion of that transition might also be the trigger for Sally's promotion to equity partner status.

Using a merger to address succession issues when there are no viable internal succession candidates will be covered in chapter 5.

DO NOT OVERLOOK THESE KEYS TO MAKING A DEAL WORK

In addition to identifying and training the best people, there are other critical issues to consider in crafting an effective internal succession plan.

The Buyout Formula Must Be Attractive

Imagine that a client asks you to value a business and you report, "You should buy this company. My due diligence has determined you will lose money for the next five years. It is a great deal!" You would never say this to a client and you cannot expect to say it to your partners or potential successors. That is why your partnership agreement—and the buyout formula it contains—can be important elements in attracting talent and building an internal succession team.

Succession plans should 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. We believe internal succession should be based on a properly structured plan for buying out transitioning owners that will do the following:

- Ensure that retiring partners are well paid for their years of commitment to the firm
- Create adequate margin to acquire replacement resources
- Allow for residual profit so that the remaining partners will benefit from increased earnings, which motivates them to accept the risk this type of change creates

We will talk more about this issue in chapter 5.

Lifestyle Issues Have Become More Important to Younger Potential Successors

One firm we worked with created a flexible workspace using remote access technology that gave partners and staff access to systems, files, and records, allowing them to work from home occasionally. The result was higher productivity and happier people. The firm attracted high-quality team members with excellent attitudes who were integral parts of the succession team.

Leadership Is a Critical Attribute for Successors

Although not every partner has to demonstrate great rainmaking skills (though certainly some should), most partners need to be good leaders. Leaders set good examples for work ethic, quality, and integrity.

Training a leader involves the following:

1. Generic competency development
   a. Classroom training
   b. Online resources, books, videos
   c. College and specialty development courses

2. Firm-specific development
   a. On-the-job training
   b. Increasing responsibilities
   c. Income partner status

Ideally before becoming a partner, a candidate should have functioned as one.

Keep Succession in Mind With Each New Hire

Assess candidates and current promising talent against the job description for partners. Identify their strengths but also their shortcomings so you can train them to overcome them. Make partner development a part of the ongoing discussion with your best candidates.

Teamwork Is Essential to Success

An environment conducive to internal succession is one that values the contributions of team members and has a team mindset.

Recognize the value built in the firm not only by the retiring partner but also by the rest of the team. The purchase value in most internal sales is usually somewhat discounted in recognition of the contribution that the successors have made that may not be fully captured in the formal determination of equity.

WILL THE TRANSITION WORK?

So, you have identified the best future leaders, you are offering them the training they need to take on new roles, and you have worked out a good buyout formula. The next step is laying the groundwork for a good transition. When it comes to executing a business plan that supports the transition of a retiring owner's role, it is important to keep the ship sailing in the same direction without losing ground. Your goal should be to keep the clients the owner managed and the staff who worked with the owner, as well as maintain the firm's momentum. The best plan for making these things happen will vary based on each firm's and owner's situation. As we have noted, one critical concern is requiring at least two years' notice of an owner's plan to leave if the retirement payments will be fixed at the date of termination, and penalizing the owner if insufficient notice is given.

There is an assumption in this type of plan that given two years, the firm and retiring partner will fully execute a transition plan. Most firms we have worked with are confident both parties will perform as expected. When that confidence cannot be achieved, there are some additional tools that can be used to strengthen an agreement. The following is an example that we used in a recent succession plan:

- The firm committed to submit a written, detailed transition plan to a partner that gave notice within 30 days of receiving such notice. The plan would include an assignment to a named successor for each client the partner was responsible for. This could include a number of successors within the firm. The successor for any other significant duties performed by the partner would also be designated.
- The plan would further lay out the guidelines and timing of the transition steps expected of the transitioning partner for each client and for any other significant duties the partner had.
- If the transitioning partner failed to follow the plan, he or she would be given written notice of such failure and 30 days to correct the failure.
- At the discretion of firm management, and assuming the firm had given adequate notice and time to cure, the partner's buyout could be subjected to adjustment in the same fashion as if the partner had failed to provide adequate notice.

A more drastic approach to manage the financial risk of a transition is to tie the retirement payments to the retention of clients following the retirement. Fewer firms are taking this approach as more move away from the "eat what you kill" structure. We tend to see this approach used more often in smaller practices where the partners exclusively manage a book of business and no other partners are involved with other partners' clients. We believe the disadvantage of tying retirement payments strictly to retained books of business is that it fails to create an incentive for the firm to develop and execute a transition plan before owner retirement. The tendency is to procrastinate because the firm has no risk, which often results in a poor transition. In the worst case scenario, a partner contemplating retirement senses the firm is not addressing the transition of his or her book of business adequately and he or she seeks to affiliate with another firm that will actively plan for his or her transition and provide a more certain outcome.

Assume that your firm has taken the steps necessary to transition the duties of a retiring owner. How can you ensure that transition is effectively executed?

Transitioning Client Relationships

For most firms, the key owner duty to be transitioned is management of client relationships. Most firms depend on owners to be personally involved in the firm's relationship with clients, especially the largest and most important ones. However, it is also logical that the more dependent the firm is on an owner's relationships with clients, the more at risk it is when the owner leaves because of the uncertainty it can create in clients' minds.

That risk is a reality because many clients have backup relationships with other firms through a relative or acquaintance or because another practitioner has been recently soliciting their business. Studies have shown that up to a third of all clients in a typical CPA firm are considering moving to another firm at any one time. The key to a good transition is to make the day an owner leaves the firm into a nonevent for the clients that he or she was involved with. That can be done by completely transitioning the relationships before the owner leaves. To accomplish that, consider the following.

Capacity

Anyone who is qualified to succeed a retiring partner is likely already completely booked with capacity. A well-run firm is not going to have good people waiting for more to do, which is why many succession plans break down. A firm can have the right people in place and the right financial arrangement, but when it comes time to shift duties from a transitioning owner to someone else, no one has the capacity to take on the new duties. As a result, clients begin to receive less attention than they did from the transitioning owner. The transitioning owner senses this and abruptly stops the transition because he or she is afraid to lose clients.

Just as a busy, established partner cannot take on a retiring partner's full responsibilities, a newly promoted and usually inexperienced partner cannot effectively manage the most complex client relationships of a transitioning owner. The best approach is to consider a shift of duties for several of the owners, taking the time to reposition client books for several partners and key managers. Most partners have clients they are overqualified to manage, so they can be shifted to a less experienced partner or even a nonpartner. Other clients might be better served by a different partner with expertise or skills that better suit their needs.

Also keep in mind that the firm must, at a minimum, replace the dollar-value productive capacity of a transitioning owner to maintain your revenues. If an owner is producing 1,200 billable hours at $250 per hour, that is $300,000 in production that must either be absorbed by existing or new personnel. Failure to take that fact into account can lead to a loss of revenue.

Best Use of the Transition Period

Use the two-year notice period to establish the internal successor while the retiring owner can participate in the process. The client has relied on the retiring owner's financial advice for many years, and he or she will also follow his or her advice as the retiring owner leads the client through the transition process. If handled gradually over a couple of years, the client should ultimately accept the internal successor as his or her go-to person. If the designated successor is just not the right person for a specific client, two years also gives you time to find another successor.

Of course, depending on the person retiring, there may be other duties to be transitioned as well. If it is the managing partner, a transition of longer than two years may be necessary. It is not unusual for the successor to be identified far in advance of the expected retirement date and to work alongside the managing partner for several years in that role. Chapter 10 goes into additional detail regarding transitioning clients.

Identify Critical Issues

To enhance their chances for a successful internal succession, firms should engage in an in-depth analysis to identify the planning and implementation steps necessary. Issues to consider include the following:

- Who are the viable prospects for your internal succession team?
- How can you strengthen your bench if necessary?
- How effective are the terms of your owner agreement regarding buyout terms for retiring owners and admission of new ones?
- How well does your owner agreement address
  - death, disability, and other forms of partner termination?
  - covenants restricting competition from terminated partners receiving post-termination benefits?
  - firm governance?
  - owner compensation, both for existing owners and newly admitted ones?
  - cash flow safety nets that help ensure the firm remains solvent in light of owner retirements and is able to meet its obligations to its partners?

- How would alternative approaches to determining equity value help smooth the transition for new partners, such as the unit approach?
- What transition plan for retiring owners will keep the firm on a successful course?

Don't Forget the Safety Net

Even with the proper planning, unforeseen events can cause a financial hardship to the firm if it is funding retirement payments to former partners. As we recommended for the example firm described earlier in this chapter, consider creating a safety net that defers retirement payments if payments to retired partners exceed a predefined level. For instance, if partner retirement payments exceed 8 percent of revenues, the excess might be deferred to a later period when there is no longer an excess, it may be delayed to the end of the period, or it may extend the intended payment period. A less popular approach to manage this risk is to base the threshold on partner compensation. For instance, if historical partner compensation is 35 percent of revenues, the threshold might be set at 30 percent. Retired partner payments would be reduced pro rata for any additional shortfall. Again, 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.

Action Agenda

Take the following steps to enhance your firm's chances of a successful internal succession:

- Determine your partners' plans. Depending on firm size, use a firm retreat, third-party administered survey, or other means to find out how soon owners intend to retire and to measure their satisfaction with compensation and other critical issues.
- Take a realistic view of the firm's internal succession options. Are young professionals prepared to take on the responsibilities of leadership? If not, what changes are necessary? Consider both steps needed to groom current staff and changes needed in the firm's hiring approach.

- Update your partnership agreement. Use partner feedback to make necessary revisions in the partnership agreement. Issues the agreement should cover include
  - the timing of required minimum notice of intent to leave, as well as consequences if sufficient notice is not given.
  - a valuation and payment formula that covers death, disability, and normal retirement.
  - a method for handling the partner termination other than through normal retirement.
  - a financial analysis of whether the plan is self-funding.
  - provisions covering a deferral in the payment of the retirement liability in the event of a severe short-term cash flow crunch or the loss of one very large client.
  - a cap of total payments to retiring partners at any one time.
  - limitations on how many partners can retire within 12 months of each other.
  - guidelines for handling payment of capital accounts and for tax treatment of all payments.
  - restrictive covenants for terminated shareholders.
- Identify the appropriate generic competency development, firm-culture-specific training, and mentoring that future leaders may need.
- Establish a transition plan that is embedded in your partnership agreement.

CHAPTER 5
What Is a Firm Worth?

In the last chapter we discussed internal succession, including the importance of an effective partnership agreement in this process. Many firms set terms in a buy-sell or partnership agreement based on an assumption of what they believe a third party would pay for the practice. However, there are some significant differences between an external and internal transaction. This chapter will address the concept of value in a CPA firm, the factors that may affect it, and the various issues that should be taken into consideration in both an internal and external sale. It is aimed at both buyers and sellers, because each one has a pressing interest in knowing the right value and price of a firm that is the subject of a merger or acquisition. A buyer must understand the variables that impact valuation in order to avoid overpaying or making offers that are below market value.

EXTERNAL VERSUS INTERNAL SALES

How do these two situations differ? An external sale is often the result of a bidding process that may include several potential buyers, and an internal succession involves one potential buyer and no negotiation at closing, if it is governed by a pre-existing agreement. An owner agreement is the same as a put option for stock. The firm is normally contractually obligated to buy out the retiring partner subject to certain conditions. An investor would pay for a put option on a marketable security. A discount in value is a way of paying for this feature in an owner agreement. (See exhibit 5-1 for a rundown of all the differences between external and internal sales.)

Clients and staff retention are critical issues in any sale. In an internal transition, there often is a retention advantage because neither is being asked to change firms. Keep in mind, as we discussed at length in chapter 4, a poor transition plan can create as much of a retention problem in an internal transfer of ownership as in an external one.

Terms for an internal deal are often dramatically different from those for a third-party sale. For instance, it is rare that the terms for a pure external acquisition include

- setting the price at closing.
- a payment period of 10 or more years.

It is more common, though, to see those terms in an internal transaction.

There is usually reluctance on the part of a retiring owner to charge his or her partners the same price for a buyout as he or she would seek to obtain from a stranger. The success of the firm following an owner's buyout has a significant effect on that owner's legacy. This is often less important in an external sale.

What Is the Multiple?

In external sales, CPA firm values are typically set based on a multiple of gross revenues. In the case of a $1 million firm, if the multiple is 1.1, then the anticipated purchase price will be $1.1 million. In an internal sale, the multiple may be set in one of two ways. In the first, it would be a multiple of the owner's equity interest multiplied by the revenues applied against a multiple. For example, a partner who has a 50 percent stake in a $1 million firm would get $500,000 if he or she received a multiple of 1. In the second, the multiple would be based on compensation. In most cases, the compensation figure is set by taking an average of 3 to 5 years' payments, then multiplying it by the multiple. Most larger firms now pay based on compensation rather than equity.

The normal range of multiples is often lower in internal buyouts and retirements than in external sales. In our work with CPA firms, we routinely see pricing for internal purposes of between 50 percent and 100 percent of revenues for equity-based plans and between two and three times annual compensation for plans based on owner compensation. We are seeing a drop in pricing multiples as firms prepare for an unprecedented increase in baby boomer retirements. (This mirrors the same trend in external transactions, in which pricing can vary widely based on the market, firm size, client mix, and other factors.)

Exhibit 5-1: Mapping the Differences

Terms	Internal Sale	External Sale
Bidding and negotiation	Usually one potential buyer (your firm) and no negotiation, if terms have been addressed in the partnership or succession agreement.	Typically involves a process that may include several potential buyers.
Client and staff retention	Generally easier to retain clients and staff because the change is less abrupt.	Clients and staff must be acclimated to the new firm and become comfortable with it.
Deal details	The price may be set at closing and the payment period may last as long as 10 years or more.	Price is usually determined before closing but typically with contingencies and the payment period tends to be shorter than the longest periods in an internal deal.
Price	Probably lower than in an external sale.	Typically higher because the owner is selling to a stranger.
Multiples	May be based on a multiple of owner equity, although the trend among larger firms is to use a multiple of total compensation. The normal range of multiples is usually lower than in external sales.	Usually set based on a multiple of gross revenues that are based on client retention over a negotiable period of time.
Trends in multiples	Dropping due to the expected supply increase because of baby boomer retirements.	Expected to decline due to supply issues, but may also be affected by local market, firm size, client mix, and other factors.

NEGOTIATING AN INTERNAL SALE

If you are a retiring principal, your most likely buyers are your existing partners. Even though the price will generally be lower than in an external sale, the variables that influence an external sale also apply, with a few additional considerations. Many firms have capital accounts, and the structure of the payback of those accounts, along with accounts receivable and work in process (WIP) when the partner leaves, plays a significant role in shaping final terms. The terms of the deal must also be attractive to both buyer (the remaining partners) and seller (the retiring partner).

Issues to consider include the following:

- *Buyout agreements.* In a constantly changing business environment, it is important to review and update the partnership buyout agreement at least once a year. A good buyout deal compensates the retiring partner and allows the successors to enjoy additional earnings for taking on the additional responsibility. Note that every buyout agreement should include disaster contingency language to protect the practice's cash flow and to extend the payout period in case of calamity.
- *Pricing a partner's equity.* Compensation is everything the partner takes from the firm, including all payments for draw, profits, perks, and benefits. From this sum the firm should subtract the costs of replacing the partner. The difference, if everything else remains stable, is the additional cash flow available to the firm upon the partner's retirement. If the remainder is positive after making the retirement payments, the terms will be considered self-funding (we will walk readers through this process later in this chapter). This objective provides a starting point for calculating a price, allowing the parties to agree on what percentage of the additional cash flow will go to each party and over what period. Keeping a self-funded deal as a target allows the retiring partner to be paid fairly for their years of contribution to building value for the firm and should keep the remaining partners motivated to see the obligation through to its conclusion.
- *Formulas.* The most popular approach to allocating value to a partner is to establish a formula-based value for the entire firm, often using a multiple of billings of the firm, which is then multiplied by the retiring person's equity. Let's say Debbie owned 75 percent of the $1 million firm and expected to receive 1 times billings. The equation in that case would be as follows:

  $1 million [billings] × 1 [multiple] × .75 [Debbie's equity stake] = $750,000
- Another method becoming popular, especially in larger firms, bases retirement dollars on recent average annual compensation. For example, a firm would take an average of the retiring partner's last 3 years of income, apply a multiple such as 2 or 3 and pay it over a period of 7 to 10 years, and add that to the partner's capital account. In this case, Frank's income over the

last 3 years has been $200,000, $225,000, and $250,000. The average is as follows:

($200,000 + $225,000 + $250,000) / 3 = $225,000

- The firm applies a multiple of 2 and pays it out over 10 years:

$$\frac{2\text{ [multiple]} \times \$225{,}000\text{ [Frank's average]}}{10\text{ [payout period]}} = \$45{,}000$$

- *Incentives to execute a transition*. Due to the importance of promoting a smooth transition, many partnership agreements include a penalty or adjustment if a partner fails to provide adequate notice of intent to leave. Therefore, retiring partners who are vested, provide ample notice, and assist in the transition get the maximum price; those who do not are penalized with lower prices or longer retention guarantees to protect the firm's survival.
- *Retention period*. It is common for internal sale agreements to specify a short client retention period—or none at all—because the firm expects to go on with minimal change. However, when the retiring partner provides little notice or is the main or only contact for certain clients, keeping those clients is not a given. Requiring a minimum of two years' notice prior to retirement allows ample time for a careful transition, and a retention period in which the payments can be adjusted following retirement may be less critical. This is especially true for firms in which clients are brand-loyal. Partner-loyal clients can be more challenging to transition and retain. Remember, though, that in some situations an orderly retirement transition may take as long as five or more years.
- *Insurance buyouts.* Most firms' partnership agreements include buyout formulas that address partner buyouts due to death or permanent disability. These liabilities are usually funded through insurance. Many firms compensate partners for the costs of personal insurance policies and lower the buyout as an offset, which results in a more favorable tax treatment all around.
- Traditionally, company-paid insurance policies either become the buyout vehicle or are credited toward it. If the latter, which can occur when insurance proceeds paid to an estate do not cover the full buyout liability, additional payments due a former partner's estate may need to be deferred to give the firm time to get back on a strong footing as it recovers from the loss. For example, the remaining payments may commence a year after the insurance proceeds were paid to the estate. Because the estate has already received a large amount of money, the heirs should

not be desperate to receive the balance. Partners should check insurance policy terms yearly to ensure they reflect current equity value. (See appendix B for an annual succession planning checklist.)

A Willing Seller Still Needs a Willing Buyer

Firms may assume they have laid the right foundation for internal succession, then be taken by surprise when it is time for a transition. In chapter 4, we discussed some of the issues that can stand in the way of succession. Let's now look at another critical concern: setting the right financial terms. Consider the case of Robert, who formed a firm with 2 other partners 35 years ago. Along the way, he has bought out those partners as they moved into retirement. Over the next few years he plans to cut back on his hours and have his 3 younger staff members, whom he has groomed to become managers, take over his responsibilities and begin to buy him out. He approaches each manager about being admitted as a partner. To his surprise, 2 of them decline because they are reluctant to pay for Robert's buyout.

What went wrong? The problem may have been the deal was not self-funding, which meant that the terms of the partnership agreement would have required the firm's new partners either to infuse capital into the firm or take a significant reduction in compensation over the next five years to fund Robert's buyout. Both managers thought they could find a better opportunity at another firm. Because the remaining manager would not have been able to fund Robert's retirement entirely on his own, he and Robert had to find another firm to merge into, and Robert's retirement payments were much lower than he had expected.

How could Robert and the firm have avoided this result?

The most important objective in structuring an internal buyout or retirement plan is to make it self-funding. A self-funding plan must replace the retired owner, pay for the buyout or retirement, and produce benefits for the remaining partners that motivate them to do the deal. People do not make investments to lose money, and a self-funded succession plan ensures that will not happen.

Keep in Mind

People do not make investments to lose money, and a self-funded succession plan ensures that will not happen.

In most cases, the primary capital that a firm uses to fund buyouts and retirements is the departing owner's foregone compensation. That compensation will have to cover three things for the plan to be considered self-funding:

- Compensation for someone to replace the retired owner
- The buyout or retirement payment
- Some upside for the remaining owners that motivates them to take on the buyout obligations

That is a tall order, but a failure to meet all three objectives can lead to the following:

1. Loss of business.
2. The need for a capital infusion from external sources, such as borrowed funds or contributed capital.
3. More work for the remaining owners with no additional, or even declining, compensation. The possibility of this outcome can sink the deal if the new owners who would be required to take on the obligation decide their future prospects are not attractive.

One of the top reasons that we see firms choosing to seek third-party sales and mergers is the need to find an alternative to internal buyout obligations because the owner retirement plan does not appear to be viable. Two case studies illustrate the challenges involved and different ways to solve them.

Case Study: Making It Work When It Is Not Self-Funding

Firm A has 5 owners. One owner is retiring in 2 years. She earns $270,000 a year and owns 30 percent of the $3 million firm. Her retirement is based on her ownership percentage multiplied by the firm's annual fees billed for the 12 months preceding her retirement, which would be $900,000 (or 30 percent of $3 million). This total is to be paid over 5 years without interest, a total of $180,000 per year. In addition, she would be paid the full amount of her accrual-basis capital account, which is $175,000 at the date of her retirement. This owner generates 1,400 billable hours per year at an average billing rate of $250 per hour.

The firm's remaining owners believe that they would be able to assume her duties for managing client relationships as well as other key responsibilities. However, to replace her productive capacity ($350,000 of billable time), the firm would have to hire additional people at an annual cost of $140,000, including benefits.

(continued)

With the $270,000 of compensation as the available funds, the firm would have $130,000 of cash flow remaining after the cost of replacement resources. The firm would then have to invest an additional $225,000 (including $175,000 to pay out the capital account) and $50,000 per year for the next 4 years.

If your firm has a partner who is getting ready to reduce hours, see exhibit 5-2 to plot your own situation against Firm A's. Exhibits 5-3 and 5-4 do the math on what these numbers mean.

Because the funds available from the retired owner's foregone compensation do not cover the required payments, the plan is not self-funding and thus may not be viable. If the worksheet and your calculations show that you are in the same position, you might consider some or all of these options:

- Reducing the valuation multiple of trailing revenues from 100 percent to a lower multiple
- Increasing the payout period for the retirement payments to 10 years from 5 years
- Paying the capital account over five years instead of one

The steps shown in exhibits 5-5 and 5-6 are an example of an approach that makes the terms self-funding, and thus more viable.

Exhibit 5-2: 5-Year Payout at 100 Percent; Capital Fully Paid in Year 1

	Firm A Retiring Partner	Your Firm
Annual firm revenues	$3 million	
Retiring partner's earnings	$270,000	
Ownership percentage	30%	
Retirement payout formula	Ownership percentage multiplied by the firm's annual fees billed for the 12 months preceding retirement, to be paid over 5 years without interest. Accrual basis capital account to be paid in first year of retirement.	
Annual retirement payout based on firm formula	$180,000	
Accrual basis capital account at retirement	$175,000	

	Firm A Retiring Partner	Your Firm
Billable hours	1,400	
Average billing rate	$250	
Annual cost to replace retiring partner's productive capacity	$140,000, including benefits	

Exhibit 5-3: 5-Year Payout at 100 Percent; Capital Fully Paid in Year 1

	Year 1	Your Firm
Available funds from retiring partner's compensation	$270,000	
Payout of capital account	($175,000)	
Retirement payments	($180,000)	
Replacement resources	($140,000)	
Annual shortfall	($225,000)	

Exhibit 5-4: 5-Year Payout at 100 Percent; Capital Fully Paid in Years 2–5

	Years 2-5	Your Firm
Available funds from retiring partner's compensation	$270,000	
Payout of capital account	(N/A)	
Retirement payments	($180,000)	
Replacement resources	($140,000)	
Annual shortfall	($50,000)	

Exhibit 5-5: 10-Year Payout at 80 Percent; Capital Paid Over 5 Years

Years 1-5	Firm A	Your Firm
Available funds	$270,000	
Payout of capital account	($35,000)	
Retirement payments	($72,000)	
Replacement resources	($140,000)	
Annual surplus	$23,000	

Exhibit 5-6: 10-Year Payout at 80 Percent; Capital Paid Over 5 Years (Impact in Years 6–10)

Years 6-10	Firm A	Your Firm
Available funds	$270,000	
Payout of capital account	(N/A)	
Retirement payments	($72,000)	
Replacement resources	($140,000)	
Annual surplus	$58,000	

Case Study: A More Viable Approach

Firm B has 6 owners. The firm pays retirement over 10 years based on 2.75 times the average of the past 5 years' compensation, eliminating the low and high of those years. Capital is paid out over 5 years with interest at *The Wall Street Journal* prime rate (as of this writing, 3.25 percent). *Note*: The longer the firm takes to pay back capital, the more terms will tend to include interest on deferred payments of capital. It is rare that interest is paid on deferred payments of intangible value or retirement.

One owner is retiring in 2 years. His average compensation for calculation of retirement is $350,000, and his capital account is $210,000. Based on his productivity, the firm believes it can replace him for about $140,000 per year. His annual payments for the intangible value portion of the buyout would be $96,250 per year for 10 years, and the payout of his capital would be approximately $45,000 per year for 5 years. The cash flow for this plan would be as shown in exhibits 5-7 and 5-8. The plan is self-funding for all the years of the payout because the retiring partner's foregone compensation covers all of the firm's obligations.

Exhibit 5-7: 10-Year Payout; Capital Paid Over 5 Years at Prime Rate

Years 1–5	Firm A	Your Firm
Available funds	$350,000	
Payout of capital account	($45,000)	
Retirement payments	($96,250)	
Replacement resources	($140,000)	
Annual surplus	$68,750	

Exhibit 5-8: 10-Year Payout; Capital Paid Over 5 Years at Prime Rate, Impact in Years 6–10

Years 6–10	Firm A	Your Firm
Available funds	$350,000	
Payout of capital account	N/A	
Retirement payments	($96,250)	
Replacement resources	($140,000	
Annual surplus	$113,750	

Unbalanced ownership can also be a significant issue in internal sales. When a retiring owner has a disproportionate stake in the firm, his or her ownership level may not reflect the value that has been created by the remaining owners responsible for the buyout. For example, Jennifer owns 60 percent of the equity in her 4-partner firm because she is the longest-serving partner, and equity for retired partners has always been redistributed pro rata to existing equity holdings. But she manages less than 25 percent of the firm's business, and her compensation is less than 25 percent of overall partner compensation. It may not be realistic to expect the other partners to pay her for her equity based on 60 percent of the firm's overall value.

Another key element that helps make an agreement financially viable is a cap on the amount of payments that can be made to all retiring owners at one time. The cap is often expressed as a percentage of revenues, although profit before owner compensation is also used. In large firms, this number can be as low as 3 percent of revenues; in smaller firms, it can grow to as high as 20 percent. Typically, the larger the firm, the lower the cap number.

This provision ensures that the firm remains a viable debtor in the event of a drop in profits. Usually, any retirement payments prevented by the cap are not relinquished permanently but rather deferred to a later period, when the threshold is not exceeded. This protection is mutually beneficial for the firm and its retired owners. Firms that are burdened with more retirement debt than the current owners can handle might be unable to retain the owners necessary to keep the firm healthy enough to satisfy those debts.

Effect of Tax Treatment and Interest on Deferred Payments in Buyout Terms

Assume the benchmark for a pricing multiple in a firm sale is one times revenues and the payments are tax neutral to the buyer, meaning they can be deducted as paid. If the total obligation is $1 million and the payments are made over 10 years, the firm would pay a retired owner $100,000 per year. However, if the firm is required to pay 6 percent annual interest on the deferred payments, the total obligation increases to $1,332,246 (assuming monthly payments). This is, in effect, a 1.3 times multiple, which is very high for any transaction, especially an internal one. If interest is calculated on deferred payments, it is normally advisable to reduce the multiple of revenues or compensation to take into account the full cost of the buyout.

Retirement payments usually are deductible by the firm as compensation, and they are taxed as ordinary income to the retiring partner. However, there is an increasing trend in the profession to treat at least a portion of buyout payments to retired partners as for the acquisition of goodwill or another asset amortizable for tax purposes under Internal Revenue Code Section 197. This is much easier to do if the entity the firm operates in is taxed as a partnership as opposed to a corporation. This allows the retiring partner to treat the portion of the payment that is attributable to the goodwill buyout as capital gain, taxable at lower rates than ordinary income. But this treatment means the firm cannot deduct that portion of the payments immediately; instead, it must be amortized over 15 years under Section 197. This increases the cost of the buyout to the firm. For this reason, the most common approach remains treating internal buyouts as retirement payments or, for firms that wish to find a more desirable tax treatment for retired owners, stretching the payout period to 10 years or longer so the payments can be treated in a manner that gives the retired owner capital gains treatment without creating an unacceptable cash flow burden to the firm.

Using Mergers and Acquisitions to Build a Succession Team and Preserve Value

When an internal succession does not work, a firm's value is not lost. One option is to use strategic mergers, acquisitions, or even divestitures to build a succession team. The four most popular options include the lateral merger, the upstream merger, the mini merger, and the cull out sale.

In a lateral merger, a firm teams up with another one of a similar size. Keep in mind that these mergers must be approached with care to avoid simply doubling the problem. Consider a five-person firm with several partners seeking to reduce their time commitment over the next few years. The firm merges with another practice that is in the same boat. It is now a bigger firm, but the percentage of partners set to leave remains the same, and there is a good chance that the merged firm will face the same capacity, compensation, and other problems that the two original firms might have had on their own. There would be a better outcome if the original firm merged with a five-partner firm that had excess partner level capacity and that was made up of young partners with young managers and seniors who are on a partner path. Of course, youth and capacity are not enough. The new firm will also have to replace the departing partners' skill sets.

In an upstream merger, a firm merges into a larger firm that has a combination of younger successors and the capacity to take on the work left behind by retiring partners as well as the skill sets needed. This is really not an internal succession solution, but mergers do have a track record of successfully addressing many succession issues for many firms. Allow at least two to three years to find a suitable merger partner so you find the right one.

Keep in Mind

The bottom line is that if your firm is five or fewer years away from partners retiring or significantly slowing down, you may not have the time necessary to develop and implement an internal succession if you have not already done so.

The mini merger is gaining in popularity, especially among smaller firms. To illustrate why, let's consider a stumbling block in many mergers: A manager is promoted to partner and understandably expects to make more money as a result. However, because he or she is not necessarily bringing in any additional revenues, the only way for that manager to make more money is if the other partners make less, at least for a while. This is often a roadblock to promoting someone the firm needs as a successor. A mini merger is an alternative in which one or more practitioners with books of business are merged into the firm. The current owners can retain their current income and the firm has gained someone with demonstrated ability to develop, retain, and manage an accounting firm and clients. They are a proven commodity with new clients and potential cross-selling opportunities. The opportunity to grow financially and professionally and to be the lead in a firm whose senior partners will be leaving soon can be a powerful incentive for younger practitioners. Here is the bad news: There are many, many firms seeking this same talented CPA with a great book of business. Most of these stars do not want to give up their autonomy, name, control, or income to become a smaller fish in a bigger sea. These deals are still worth pursuing, but understand that the field is extremely competitive.

Keep in Mind

Remember, the point of a mini merger is not to make money, but to build the best succession team.

How can you convince a talented young rainmaker to merge into your firm? Consider the following:

- Organize your succession plan to give the new person a chance to buy out some partners or increase their equity within a reasonable timeframe.
- Be reasonable in your valuation. A buyout formula that ensures your successor will make more money during the payout period is an important enticement.
- Be generous. For example, firms can frequently use synergies and economies of scale, including cost savings on software, labor, and rent, to bring in a sole practitioner with no incremental increases in overhead. Passing a significant amount of these savings on to the young professional gives him or her a short-term incentive to give up his or her independence or pick you over another suitor. Remember, the point of this merger is not to make money, but to build a succession team.
- Point out that you can take some responsibilities off his or her shoulders. Most sole practitioners are juggling much or all of the administrative work, as well as many lower-level client service tasks. If a suitor can help the practitioner delegate many of his or her responsibilities and bring in new business, the practitioner and the firm will benefit from this strategy and the young practitioner will be better equipped to take on the retiring partners' roles when necessary.

Finally, the cull out sale is a means of addressing internal succession plans that need a plan B. It refers to a partial contraction of the firm to a point where the remaining partners can manage what is left. Examples of this approach are as follows:

- The retiring partner leaves the firm and finds a different firm that is in a better position to provide succession and can afford to pay the buyout payments.

- The firm identifies a division such as a type of client or service, or a geographic location that it can package and sell to another firm. The sale creates capital to fund a retiring partner's buyout and the firm adjusts to a size the remaining partners can manage.

We will talk more about cull out sales in chapter 6.

Positioning the Firm for Possible Merger

The difference between a merger and an acquisition is primarily in the relationship the acquired firm's partners have with the successor firm following the deal. In mergers, the acquired firm's partners (some if not all) become partners in the successor firm and normally are seeking a long-term relationship. In acquisitions, the acquired firm's partners are primarily being bought out even if they are held out as partners or principals for a time. However, acquiring firms almost universally engage in both mergers and acquisitions to promote their growth and improve their firm's success. They see a merger or an acquisition as a more efficient means of accomplishing strategic goals than opening offices, hiring staff, and developing partners from scratch and acquiring new business one client at a time. Therefore, in order to be an attractive candidate for a successor firm in a merger or acquisition, practitioners must understand how their firm and their deal will accomplish those goals for the successor firm.

Successor firms that use a "superstar" model that depends on one outstanding rainmaker may appreciate the fact that your firm operates that way as well. However, as firms increase in size, they tend to move away from this model to a one-firm concept with emphasis on institutional relationships with the clients and less dependence on individual partner relationships. A superstar model may cause a potential suitor to discount the value of a firm or even avoid a merger altogether.

Firms that want to move away from a superstar model should consider how their current partner compensation system promotes that behavior. If compensation is based on an "eat what you kill" approach, it will be hard to get partners to modify how they manage client relationships without an overhaul to the system.

Remember the many buyers we mentioned that want to be able to buy books of business with skilled people available to manage them? Firms that follow a superstar business model have few trained staff because they are not given opportunities to develop. The superstar partner hoards those opportunities. Therefore, if quality of staff is an important attribute for a potential acquiring firm, it may view one with strong superstar partners and poor staff as a less-than-ideal opportunity. This can be the worst part of the superstar model. Often the superstar is the one that needs succession and will only be around for a short time.

Of course, switching from this model takes time and can lead to short-term reductions in profitability. For small firms, it may not be realistic to go through this metamorphosis. They may be better off looking for a merger or sale that will take them as they are. Usually this will be a successor firm that is primarily interested in the clients and the volume they generate.

For smaller firms and those with an "eat what you kill" approach, a sale can still be accomplished, but there will typically be a longer transition period. The buyer will most likely insist on a deal based on retention, in which the seller is paid based on actual collections and client retention after closing, sometimes for the entire payout period. This makes sense when you consider that the firm's success has depended on a superstar that is riding off into the sunset.

What You Need to Know About External Sales

As we have discussed, in an internal sale, the owner buyout terms are often established in partnership or retirement agreements. In an external sale, on the other hand, there is usually a great deal more uncertainty involved because each buyer is going to look at firms differently and have a different approach to deal terms. Value is always in the eye of the beholder.

When working with firms of any size, one of the most common questions we are asked is, "What is my firm worth?" Even practitioners who are not thinking of selling or buying are interested in the value of their firm. Amid a mergers and acquisitions boom in the marketplace, a very high percentage of U.S. CPA firms will engage in some type of transaction in the next 5 to 10 years in which the value of the firm will come into play because they are buying, selling, buying out an owner, or admitting a new owner. Even those that are not anticipating any of these transactions usually wonder about value because their ownership interest is probably one of their most valuable assets.

Keep in Mind

Amid a mergers and acquisitions boom in the marketplace, a very high percentage of U.S. CPA firms will engage in some type of transaction in the next 5 to 10 years in which the value of the firm will come into play because they are buying, selling, buying out an owner, or admitting a new owner.

The simple answer would be a straightforward multiple of revenues, such as one-time annual fees. Unfortunately, that simple answer would be totally misleading because a realistic response depends on numerous factors, each deserving various weightings that are completely unique to the situation. There is a tremendous amount of misinformation in the marketplace about CPA firm values. If a practitioner said she got 1.2 times fees for her practice, most CPAs would conclude that she sold at a premium and not ask anything more about the deal terms. However, if you knew that the terms were 6 percent of collections for 20 years treated as ordinary income as received and that the seller had to throw in her receivables plus fixed assets as part of the deal, would you still consider that a premium? That is why it is difficult to make a judgment about prevailing terms in the market without knowing all of the details of the deal.

The value of an accounting firm is made up of two major components: net tangible assets and intangible assets.

Net Tangible Assets

Net tangible assets are what appear on the accrual basis balance sheet (without including any intangible assets from prior acquisitions). (See exhibit 5-9 for an example.) The primary assets involved are cash, accounts receivable, unbilled WIP, furniture, equipment, and any miscellaneous operating assets or investments that relate to the operation of the practice. They are netted against the liabilities, including trade payables, accrued expenses, bank loans, liabilities to retired partners, and any other liabilities associated with the operation of the practice. Normally the bank loans and the liabilities to retired partners are carved out and dealt with separately to focus on the unencumbered tangible net worth.

Net tangible assets are not normally hard to determine. Possible issues might include determining the realization of the receivables and the market value of the fixed assets. In acquisitions of smaller firms, it is common for the seller to retain the receivables and for the fixed assets to be ascribed no value under the assumption that they have very little market value if sold on a standalone basis. If the practice owns real estate, it is often carved out of the deal and the buyer enters into a fair market lease with the seller if it is going to be retained.

One key point: The net tangible value of most practices is about 15 to 25 percent of the overall value of the firm. The substantial majority of the firm's value is its intangible value.

Exhibit 5-9: Accrual Basis Balance Sheet for a $1.5 Million CPA Firm Showing Net Tangible Value

Cash	$50,000
Accounts receivable	$250,000
Work in process	$75,000
Allowance for uncollectible	($25,000)
Furniture and equipment, net of depreciation	$75,000
Other assets	$10,000
Total assets	$435,000
Accounts payable	$25,000
Accrued expenses	$20,000
Note payable-bank line of credit	$75,000
Total liabilities	$120,000
Net tangible equity	$315,000

The Intangible Value

When people talk about multiples in describing value, such as one-time fees, they are talking about intangible value. It is what is normally considered goodwill or blue sky. For tax reporting purposes, it is common for the intangible value to be paid to the seller in a form other than as an asset purchase, such as consulting or retirement payments (in the case of an internal sale). We will discuss tax treatment for varying deal structures later in this chapter.

Keep in Mind

The net tangible value of most practices is about 15 to 25 percent of the overall value of the firm. The substantial majority of the firm's value is its intangible value.

In most sales of CPA firms, the total value of the practice is the sum of the tangible assets and the intangible assets. In many instances, especially acquisitions of smaller firms, the buyer will not buy the tangible assets and will pay only for the intangible assets. In those cases, the seller is usually allowed to retain the tangible assets (typically other than fixed assets) so the seller does not lose the value ascribed to him or her. The larger the deal, the more likely there will be a payment, or at least an allocation of purchase price, for fixed assets. Buyers of smaller firms often see the fixed assets of the acquired firm as a temporary convenience and therefore assign little value to them. Most of the computers and servers of the acquired firm will likely be replaced in a year or two anyway, and if the offices are being combined in the near future, then the furniture and other equipment may be expendable after a short time as well.

Technically, the intangible value represents a number of underlying assets, including the client list, workforce in place, restrictive covenants signed by the sellers (and possibly the seller's employees), name of the firm, its processes, location, and so on. Even though all of those assets are normally important to the ongoing value of the firm, most deals focus primarily on the client list and the buyer's ability to retain and the seller's ability to transition the client relationships. Even when acquiring firms say they are primarily interested in the people in the merging firm, they often end up tying the deal to some extent to client retention. In smaller firms, retention of the seller's clients may be the buyer's sole interest.

The Structure of an Acquisition

To understand the structure of accounting firm acquisitions, it is important to recognize the nature of the client list's intangible value. Accounting firm clients are generally "sticky," which means they tend to remain loyal to their firms over many years. That is not true with certain one-time consulting clients, of course. The rule of thumb is that firms lose about 6 percent of their business annually due to client attrition. The expectation that clients will stay with the firm for a long time can create a significant amount of value.

Furthermore, public accounting is extremely profitable. Accounting firms on average are expected to generate about 33 percent of their revenues in profits for the owners, and many smaller firms are even more profitable.

Keep in Mind

The expectation that clients will stay with the firm for a long time can create a significant amount of value.

Finally, sellers routinely sign restrictive noncompete covenants and, in many firms, the employees also sign restrictive covenants to prevent them from leaving and taking clients with them. Incidentally, this is the reason why law firms are generally not sold like accounting firms. Lawyers cannot ethically sign a noncompete and therefore cannot create the same value for a buyer that accounting firms can. Keep that in mind as you review the restrictive covenants contained in the agreements you are asked to sign as a part of a merger or acquisition. Another reason is many law firms are 100 percent special project-oriented, and a significant portion of accounting firm business is repetitive.

Though a restrictive covenant provides an important reason the buyer can expect to retain clients, holding on to clients is very difficult to do without a proper transition. As we have noted in previous chapters, there are critical steps in the transition process that are necessary to ensure client relationships transfer to the buyer and are retained by the successor firm.

The key point is the buyer's investment can be easily justified if there is a perception that the seller's clients will be retained. However, it is easy to derail this outcome if the client transition is not properly executed.

One of the ironies we deal with when we consult with firms that contemplate selling is that many practitioners feel they cannot be replaced. They have an intimate relationship with their clients and it has been developed over many years. Surely no one can step into their shoes, so they tell us they cannot accept a deal that has a retention clause because they do not see how the buyer can replace them. Here is the irony. If the seller does not believe the buyer can replace him or her successfully and retain the clients, why should the buyer reach a different conclusion? If the clients therefore cannot be retained, why would the practice have any intangible value? Our goal in these conversations is to help the seller change his or her mindset so he or she will start working on how to help the buyer replace the seller and accept his or her role in promoting client retention. One of the best ways to demonstrate confidence that this can happen is to accept a reasonable retention clause in the deal terms.

Buyers tie purchase payments to client retention not just because the clients may not be retained, but even more important, because it motivates the seller to engage in a proper transition. The seller is the one who controls and influences the client relationships until the client makes a conscious decision to stay with the buyer firm.

There is a common assumption that what is good for the seller is bad for the buyer. In reality, the goal should be to find a win-win outcome. This can be accomplished by recognizing that the seller firm and the buyer should have exactly the same objective for the transaction: client retention. If the seller and buyer work together to assure a high retention rate, the value of the client list, and therefore the deal, can be maximized. This assumes, of course, that the seller has chosen the right successor (as outlined in chapter 3).

Price Equals Value Plus Terms

The price paid for an accounting firm (which is most often expressed as a multiple of fees) should be the result of the overall terms of the deal. Most accounting firms are sold externally on a multiple of gross billings. The four major terms that affect the price (the multiple) are as follows:

1. The amount of cash the buyer must invest up front
2. The length of the term for remaining payments
3. The extent the payments are affected by client retention
4. The profit the buyer can be expected to generate from the investment

Let's assume the buyer

- does not make a large upfront payment in the form of a down payment or through the replacement of working capital.
- can make the deferred payments over a reasonable timeframe (say 5–10 years) without paying interest on them.
- can base the payments on actual retention of clients following the acquisition.
- can expect to generate good cash flow because the practice is profitable, the buyer does not have to assume a lot of the seller's financial and operating obligations, and the deal is structured to allow favorable tax treatment for the buyer.

In this case, the buyer would be expected to pay a very good multiple (price), possibly even a premium.

Conversely, consider a deal that requires the following:

- A large upfront investment of cash for working capital

- Few or no deferred payments (at an extreme a deal fully payable at closing)
- The buyer to accept all of the risk related to client retention

This buyer could reasonably be expected to offer a lower multiple, possibly even a significant discount from what the seller might otherwise expect. Factors that might lower profitability for the buyer include

- a practice with a low profit margin either due to high costs or low fees.
- the need to assume seemingly unnecessary financial or operating obligations, such as high-priced staff or redundant infrastructure.
- prospects for poor tax treatment, such as assets that must be amortized over 15 years or that are not deductible (for instance, a deal to acquire common stock).

Factors That Affect Value

Because price differs from value, what a business is worth to a willing buyer once the negotiation process gets under way can be affected dramatically by the transaction terms. The following sections include important points to consider for smaller and larger firms.

A Practice of Under $1 Million

First, let's note that there is good news for smaller firms in terms of overall demand. The market has seen a drop in valuations due to staffing shortages and the aging of the baby boomers (supply and demand), which has brought a larger number of sellers into the marketplace. Although the value of medium and large firms has fallen significantly, small firms have experienced a smaller decline.

The first step for any CPA who wants to sell a practice is to look at the sale from the buyer's viewpoint. Negotiating the price of a practice with less than $1 million in annual revenues for an external sale often comes down to the five critical variables previously described. Not one of them dictates the final amount, but their interrelationship ultimately will help determine the price. The terms of the deal for practices under $1 million are central to value because often these practices have one or two owners looking for succession in a few years, so the buyout terms become the focus of the negotiations. Following is a more in-depth discussion of the five variables and their effect on value.

Down Payment at Closing

The first variable is the size of the down payment, if any. The upfront payment can range from 0 to 100 percent of the anticipated purchase price, but at the effective date in the overwhelming majority of deals we have been involved with the down payment usually is around of 10 percent of volume. Many deals have no down payment. This is especially the case with two-stage deals (which are discussed in chapter 6). In these deals, the purchase payments are delayed until after the seller has completed the first phase, in which he or she continues to work in the practice full time and receives what has been the historical level of full-time compensation. When there is a down payment, the seller is financing only part of the transaction and therefore assumes less risk, making a lower price more appealing. The amount of down payment can be affected by many factors.

The time of year may have a significant impact. Clearly a buyer acquiring a practice that generates 75 percent or more of its net income in the first four months of the year will want to put less cash down if the closing occurs in May than it would in December.

Treatment of the accounts receivable and WIP is also an issue. If the practice has a significant amount of receivables and WIP and the seller wants to retain those funds, the buyer is investing significant capital to pay the overhead and operate the practice for months before participating in cash flow. The buyer therefore may want to offset that investment with a lower or no down payment. In many transactions, the parties work out payout periods on the receivables and WIP, allowing for a larger down payment. Another example of an upfront investment is upgrading the acquired firm's technology platform, which may have become obsolete.

Many purchases are structured as a collection or earn-out deal in which the down payment is treated as an advance against future payments based on collections. For example, a buyer may offer a seller a $50,000 advance at closing but request that it be credited against the first dollars due the seller that are based on collections, for instance, $25,000 credited back each year over the first two years.

Other factors may include assets and liabilities associated with the deal.

Case Study: A Typically Structured Deal

In one collection or earn-out sale of a $500,000 accounting and tax-oriented practice, the buyer paid the seller $50,000 at closing. The balance due was based on 20 percent of collections received by the buyer from the seller's original client base for the following 6 years, less the

(continued)

first $25,000 the seller would have been entitled to in each of years one and two. In addition, the deal was structured to provide the successor firm a current deduction, and it included furniture, fixtures, and equipment the practice used and reasonable transition assistance from the seller (a personal introduction to the clients, realistic phone availability to the buyer and former clients, and an orientation on the files). Note, the seller received a 1.2 multiple (20 percent times 6 years), which would usually be considered a premium. This may have been the result of a willingness to accept a reasonable down payment, a collection-based deal, and favorable tax treatment for the buyer.

Most sellers covet large down payments. They perceive that getting their money quicker somehow makes for a better deal. However, they may not realize that a buyer that is not forced to come up with a lot of cash upfront is usually more willing to pay a premium multiple. So which deal is better: one with a 25 percent down payment and a multiple of 1 or a deal with a 10 percent down payment and a multiple of 1.2? Sure, in the first deal the seller receives some of his or her money sooner, but in the second deal the seller receives 20 percent more total compensation.

The Length of the Payout Period on the Balance Due

This is a basic cash-flow variable. If a buyer has more time to pay off the purchase, the annual payments will be lower, thus enhancing the buyer's cash flow. Some sellers allow payout periods as long as 15 years, but others insist on being paid in full at the time of closing. Most deals under $1 million have 3- to 7-year payout periods. The majority of deals for this size firm still contain 5-year payout periods. Larger firms typically seek longer payout periods, more in the range of 8 to 15 years, with 10 being the average. Keep in mind that in larger deals, the buyout terms often apply only to those partners who in the selling firm will be retiring soon, and that is usually not all of the partners of the acquired firm.

The Profitability of the Deal

We believe it is not a seller's profitability that is important in pricing a practice, but the successor's profitability in the deal. Take the following example: The owner of a $200,000 CPA firm operates from home, handles all of the work personally, and nets 80 percent of revenues. A year later he moves into an office, hires staff, and nets 40 percent. At which time was the practice worth more to a buyer?

The answer lies in the profitability of the deal for the buyer, not the seller. If a buyer is able to acquire a practice with little to no incremental increase in overhead, he or she can afford to pay a premium for the practice and still make a profit. If, however, the acquisition requires retaining an additional location and extra staff, the business will be less profitable and the buyer will be inclined to pay less.

Other factors may affect profitability. A key concern is the tax treatment of the payments from buyer to seller. If the seller wants 100 percent goodwill in a deal and a payout period of 5 years, the after tax cash flow goes down considerably for the buyer, who must deduct those payments over 15 years.

Conversely, if the seller accepts all or some of the purchase price in a form that provides the buyer a current deduction, the cash flow of the deal increases for the buyer—and so should the purchase price. In our experience, there is often a 20 percent or more differential in multiple between a deal treated as an asset sale versus one that allows a current deduction for the buyer. Billing rates, how clients are serviced, by which level staff, whether work is mailed in, or if clients are visited are among the other factors that affect profitability.

The Duration of the Postclosing Retention Period and Adjustments for Lost Clients

This variable deals with the timeframe during which the purchase payments are adjusted to reflect clients who leave the firm after it is sold. The overwhelming majority of practices sold include a guarantee or retention period that adjusts the balance due to the seller based on actual client retention and collection of fees after closing. Retention periods (or guarantee periods) typically range from 1 year to the entire duration of the payout, though some deals have no retention period. If a deal is based on collections or an earn-out arrangement, the retention period typically is the payout period. However, it is not uncommon to see retention periods cut off after 5 or 6 years when the payout period is going to be substantially longer, say 10 years.

Several factors determine the length of the retention period. If a practice has predominantly annual clients, a one-year retention period may be risky for the acquirer because it allows for only one CPA visit to each client, barely enough to build a solid relationship. A two-year retention period enables buyers to become confident they have kept the clients.

Another option is a "stepped" retention period, with an additional timeframe that permits purchase-price adjustments for clients lost, not to another local accountant but because the client no longer needs a CPA. This protects buyers from paying for clients who die, close or sell their businesses, or relocate.

Both parties must be clear on what a retention clause guarantees. Some retention periods are based simply on clients staying with the firm. However, most retention terms guarantee the actual amounts to be collected from clients over a specific timeframe. In some deals, a seller participates in fee increases, at least for a continuation of services that were provided in the past. The parties must specify how fee increases will be calculated during the retention period. This is reassuring for sellers who make collections deals because it is unfair to expect them to participate only in losses and never in gains. Some deals cap a seller's participation in fee increases.

Another approach is to allow sellers to replace clients lost during the retention period with new client referrals generated solely due to the seller's efforts. This technique is usually more prevalent when the retention period is longer, say five years. The seller is normally not allowed to grow the practice volume for purposes of the purchase payments with new client referrals, only to maintain its historical volume.

Remember that a good deal is a fair deal. Finding the happy compromise in which the seller receives an appropriate reward for his or her years of work and the buyer makes a profit is the key to establishing a win-win deal. As chapter 3 established, maximizing the value in your firm also strongly depends on choosing the right successor. The deal in which the buyer retains your clients is, in most cases, the one who will be the most profitable for the seller. Once the right buyer is found, creating a transition plan that retains clients—and staff—is equally as critical.

Keep in Mind

Remember that a good deal is a fair deal. Finding the happy compromise in which the seller receives an appropriate reward for his or her years of work and the buyer makes a profit is the key to establishing a win-win deal.

The duration of the retention period is something that gives some sellers pause. That said, most sellers will find that if the buyer has a longer retention period, the buyer will reward them with a higher valuation and be more patient with clients to promote retention. Remember, if the seller does receive a higher multiple as the result of a longer retention period, the total payments received may still be a lot larger even though this approach exposes the seller to the risk of lost clients for a longer period of time. The upside of the larger multiple often overwhelms the downside potential of the longer retention period.

Price and Revenue Multiple

There is no single correct multiple because it is always a product of the rest of the variables. In the simplest of terms, the longer the payout and retention periods, the more profitable the deal is for the buyer, and the less cash investment up front, the higher the multiple. Obviously the opposite is true as well.

However, when asked what they think their accounting practices are worth, most CPAs typically expect to sell for a price based on a multiple of the gross billings without giving any thought to the rest of the deal terms. For example, for a practice that generates $500,000 in billings, a seller may want a multiple of 1.25 or $625,000, and that might be all the seller has considered. Achieving a specific multiple should not be the only consideration because it is the effect of the first four variables discussed here.

Here is an example of a sale based on the following assumptions:

- The practice generates only $200,000 in revenues.
- The acquirer can absorb this practice into a current infrastructure without any additional costs in labor, rent, staffing, or other overhead.
- The seller participates in increases in fees during the retention period.

Given those elements, if you were to ask for 15 percent of collections from original clients for 10 years, with no cash down, structured in a manner that provides the buyer a current deduction, most buyers would enthusiastically accept the deal despite the fact that the multiple is 1.5. Present value has little to do with the potential price if the seller will participate in fee increases (which may be more profitable than any interest factor).

Alternatively, say the seller wants a $40,000 down payment at closing, the balance in 5 years, a locked purchase price after the second year following the closing, payments structured as 50 percent capital gains, and 50 percent in a form that provides the buyer a current deduction. In that case, the purchase-price multiple could drop to between 1 and 1.25. It might result in a multiple of less than 1 in many markets. When a seller insists on all cash at closing, all capital gains and, obviously, no retention or payout period, very few buyers would even consider the deal at a multiple of .5.

These examples are not exact, because an actual transaction would involve additional information about the specifics of each situation. They do demonstrate how the most attractive deal price may not be an absolute multiple, but rather a package that makes sense for buyer and seller based on the interaction of the variables. Other factors—such as types of clients, billing rates, firm assets and liabilities, and qualities unique to your practice—have a bearing too. For example, clients who offer cross-selling opportunities, who grow and provide fertile referral sources, or who have young ownership will add value, as opposed to aging clients who themselves are headed toward succession. Slow-paying clients billed at discounts will hurt value, as will liability issues such as exposure to malpractice claims. Given the renewed demand, good quality staff can actually make a practice more attractive. Although a remote location can work against you, location can be an asset when a potential buyer wants to expand into another marketplace.

Negotiating a Deal for a Larger Firm

To determine an external sale price for firms with more than $1 million in annual revenues, all variables we have discussed play a role, as do others described in the following sections.

Types of Clients and Services

Although the types of clients and services may be important at smaller firms, most large CPA firms today focus on adding consulting to traditional services, and some clients are better prospects for cross-selling additional services. In their due diligence, potential successors often investigate cross-selling opportunities for the merged firms. A seller's niche services that are either new to a successor firm or strengthen an existing niche and that can be cross-sold to that firm's clients can increase the value of a seller firm.

Staff

Many larger firms seek to acquire other practices to increase their talent base. This will likely continue to be the case as the market for staff heats up.

New Marketplaces

Some larger firms seek acquisitions to help them branch into new geographic areas. Acquiring a practice is often the most cost effective way of creating another office in a new location. We have found this to be such a compelling strategic objective for some large firms that in order to establish a presence in a new market they will acquire a firm they would not consider if they were already in that market.

Capacity

The very size of a firm can have an impact on its value. It is a common misconception that small firms are worth lower multiples than large firms. However, for a $6 million practice the most likely buyer will be an even larger firm. Not only are there going to be fewer potential suitors for that size firm (bringing the law of supply and demand into play), but few firms can absorb an entity of such size without incurring significant incremental increases in overhead (space, rent, labor, insurance). Also, many larger firms operate very successfully with lower profit margins than smaller firms. They can do that because their revenue per partner is a lot higher. A large firm netting 30 percent will not be willing to give up 25 percent of collections for many years if that is what is required to do the deal. Larger practices typically sell for lower multiples with payouts over longer periods than small firms do, although there are always exceptions.

Because larger firms tend to manage themselves with an emphasis on maintaining high revenue per partner, they are often attracted to clients that need audits and other more complex services because the fee per client is high. This does not mean that audits and general business work are worth more than tax work. This also does not hold true for all acquisitions that large firms seek. If a merger with or sale to a larger firm is an option it would be wise to keep that factor in mind. Large firms that offer financial services view individual tax clients that are prospects for cross-selling those services as a fertile market for niche services and covet them just like audit clients.

Steps to Increase Value Before You Sell

With a small firm, acquirers are often primarily interested in acquiring your clients in a quick one-step transaction. The quality of current operations is less important because the buyer will be absorbing clients and other parts of the practice into his or her operations. However, as the size of a firm increases, the quality of operations becomes more important because the acquiring firm may be relying on those operations to become theirs, especially if they are creating a new location with the acquired firm.

With that in mind, it may be smart for sellers to do some re-engineering in advance to make their firms better mergers and acquisitions candidates. Exhibit 5-10 reviews the issues for sellers to address and for buyers to consider when they approach a deal. We also recommend turning to the AICPA PCPS/TSCPA National Management of an Accounting Practice Survey[1] to benchmark your own financial results and operating procedures against those of similar firms.

Exhibit 5-10: Assess Your Metrics

Which metrics should be considered in preparation for a deal? To assess how well a deal will appear to a buyer, review the metrics that are defined here.

Leverage Metrics	
Partner headcount	Number of owners
Full-time equivalents (FTEs)	The total number of full-time people in your firm: partners, directors, managers, seniors, staff, and administration. For part-timers, add their time together. For example, two half-time people would be one FTE.
Leverage	Number of FTEs divided by owners.
Utilization Metrics	
Total hours worked	Total of chargeable and nonchargeable time by person, staff level, department, or other insightful grouping of staff and partners.
Total chargeable hours	Chargeable hours by person, staff level, department, or other insightful grouping of staff and partners.
Total nonchargeable hours	Nonchargeable hours by person, staff level, department, or other insightful grouping of staff and partners.
Utilization	Number of chargeable hours per FTE.
Billing Metrics	
Gross production	Amount of total charges generated in the firm (chargeable hours times hourly billing rates) by person, staff level, department, or other insightful grouping of staff and partners.
Average billing rate	Gross production divided by total chargeable hours.

[1] www.aicpa.org/interestareas/privatecompaniespracticesection/financialadminoperations/nationalmapsurvey/pages/default.aspx.

Realization Metrics	
Net revenues	Your billings. Amount actually billed after adjustments for write-ups and write-downs by person, staff level, department, or other insightful grouping of staff and partners.
Realization percentage	This is net revenues divided by gross production. It should be calculated by person, staff level, department, or other insightful grouping of staff and partners.
Net revenues per FTE	This is the simple calculation of net revenues divided by FTEs.
Net revenues per owner or average book size	Net revenues divided by the number of owners (often called owner book or owner run).
Growth in net revenues	This should be calculated both in absolute dollars and as a percentage of the prior period net revenues.
Days of revenues in work in process (WIP)	WIP/(net revenues/365).
Days of revenues in receivables	Accounts receivable/(net revenues/365).
Margin Metrics	
Net payroll and revenues	Payroll (excluding owners' pay) divided by net revenues.
Net profits	Net profits are net revenues, less all expenses, excluding owner compensation. The only owner compensation that would typically be included as an expense would be money paid to nonequity owners.
Net profit percentage	Net profits as a percentage of net revenues.
Staff turnover	For professional staff, the gross number of departures from the firm for any year divided by the average FTEs for the year.
Marketing and revenues	Marketing costs (all marketing and sales materials, advertising programs, time for consultants, and staff who solely support the marketing function)/net revenues.
Technology and revenues	Technology costs (all expenditures for software, hardware, upgrades, repairs and maintenance, training conversion costs, and staff who solely support technology)/net revenues.
Training (CPE) and revenues	CPE costs (all out-of-pocket costs associated with continuing professional education for the firm and staff solely supporting the training function)/net revenues.
Owner Profitability Metrics	
Average owner compensation	Net profits divided by the number of owners.

Source: PCPS Succession Planning Resource Center.

Why are these metrics important? Although average owner compensation is not the only indication of a well-run firm, it is hard to conclude that a firm with low average owner compensation over a sustained period is well run. The metrics shown here can be used in the following formula to manage average owner compensation.

$$\text{Leverage}\left(\frac{\text{total FTEs}}{\text{owners}}\right) \times \text{Utilization}\left(\frac{\text{total chargeable hours}}{\text{FTEs}}\right) \times$$

$$\text{Average billing rate}\left(\frac{\text{gross production}}{\text{total chargeable hours}}\right) \times$$

$$\text{Realization percentage}\left(\frac{\text{net revenues}}{\text{gross production}}\right) \times$$

$$\text{Net profit percentage}\left(\frac{\text{net profits}}{\text{net revenues}}\right) = \text{Average owner compensation}$$

Using these metrics to understand how your firm's performance is achieved, you gain a better understanding of how to improve profitability. Here is an example of how the formula works.

> If the number of FTEs (including the owners) in the firm is 24, and there are 4 owners, the leverage ratio is 6 to 1.
>
> If the total amount of chargeable hours for all personnel is 30,000 hours, the utilization is 1,250 hours (the average chargeable hours per FTE).
>
> If gross production is $3,900,000, the average billing rate is $130.
>
> If net revenues are $3,705,000, the realization percentage is 95 percent.
>
> If net profit is $1,300,000, the net profit percentage is 35 percent.
>
> Therefore, the average owner compensation is
>
> 6 × 1,250 × $130 × 95% × 35% = $325,000.

This end result is not hard to determine on its own because it is the same as net profits divided by four. However, the exercise is important because it offers insights into how you can effect a change in profitability (defined as average owner compensation) through certain changes in your operations. It also gives you a means to compare to benchmarks at other firms.

For instance, if your productivity on average is 1,000 hours per person, that would be considered low in comparison to most other firms. There are various ways to address this:

- You can try to generate more work for your staff.
- You may conclude that you have too many people.
- You could work on increasing productivity expectations.

In the preceding example, if you are able to raise the average productivity of the workforce by 100 hours per person, assuming no other changes in the metrics, you would increase average owner compensation by $26,000.

Be careful when using benchmarks from surveys and other sources as yardsticks to measure your metrics relative to your peers. They may not be really accurate representations if, for example, firms from many geographic locations are included in the survey. There can also be problems in trying to compare firms of disparate size.

Case Study: Using Performance Metrics in Mergers

Which of these two firms is better run?

Firm A:	
Leverage (FTE/owners)	4 to 1
Utilization	1,600 hours per FTE
Average billing rate	$135 per hour
Realization percentage	85 percent
Profit margin	45 percent
Firm B:	
Leverage	7 to 1
Utilization	1,100 hours per FTE
Average billing rate	$145 per hour
Realization percentage	97 percent
Profit Margin	30 percent

There is plenty to like and dislike about both firms. Firm A could be considered a well-run firm because it has high productivity and a high profit margin. Firm B looks like a well-run firm because it has a higher realized billing rate of $140 (compared with Firm B's $115) and because it has a high realization percentage. On the other hand, you could argue that Firm A is poorly run because its realization percentage is lower and Firm B is poorly run because it has a lower-than-average profit margin and less-than-ideal utilization.

It turns out that both firms are generating $325,000 of profit per partner. It could easily be argued that both firms are doing equally well.

Running the performance metrics is a great idea because it can help you understand the cultures of firms with which you are considering mergers. In order to do that, it helps to understand the operational basis for a candidate firm's performance metrics. Does low leverage mean partners are doing a lot of the work themselves and do not have strong lower-level staff? Will they be able to assimilate to a culture where partners are delegating a lot of the work and using staff more? Does a firm with low productivity have a shorter-than-average required work day? Will a firm that has high productivity blend well with one that does not? The low productivity firm might see the other one as a sweat shop, and the one with high productivity practice might believe the more laidback firm has a poor work ethic. Does a firm with higher profit margins manage costs well or is it not investing in its future? You should ask these kinds of questions about your own firm because a potential merger partner will certainly be asking them. Addressing these questions in advance can help better position you for the best deal.

ACTION AGENDA

- Determine beforehand if an internal succession is realistic:
  - Establish in advance partners' expectations to reduce their time commitment to the firm. Discuss the issue in the firm retreats or similar meetings.
  - Make a realistic assessment of whether the firm has the bench talent, skill sets, and capacity to execute an internal succession plan and can replace all retiring partners.
  - If you cannot perform the preceding points, consider the merits of merging up, adding talent, or a cull out sale.
- When selling to partners
  - make sure the terms are self-funding.
- When selling externally
  - view the deal as a package. Do not expect to negotiate one variable at a time. Instead, take a more holistic approach.
- The value of a firm in an external sale is based on the combination of how much is required to fund the deal and the down payment (if any), the length of the payout and retention periods, and the deal's profitability for the successor firm. With that in mind, determine if you have a realistic sense of your firm's value.

Chapter 6
Alternative Deal Structures

Thus far, we have talked about preparing for succession, choosing the right successor, considering internal succession options, and understanding the best way to value a firm. All of the advice given in the first chapters should give practitioners the right foundation for developing or executing an attractive deal as part of a succession plan. It will also help buyers fully understand the many considerations involved in crafting a successful deal and transition and the motivations involved on each side. However, although some basic principles apply to every deal, no one type of deal will work in every situation. In this chapter, we will look at some of the various alternatives available to buyers and sellers. Let's begin by talking about a straightforward immediate buyout.

Immediate Buyout

In an immediate sale, the selling owners usually want to cut back to at least part-time or quit working altogether and are not seeking equity in the successor firm but a sale of their practice. Often the sellers remain involved, performing part-time chargeable work, and they are almost always actively involved in transitioning client relationships to the buyer.

Case Study: Win-Win Immediate Sale

Here are the particulars of an immediate sale that could be described as a win-win deal.

Seller. The seller, located in a densely populated area, is a 2-partner firm with 3 staff and 1 clerical person that generates approximately $1 million in annual revenues. The practice is predominantly accounting and tax. The partners are netting a combined 55 percent of revenues including salary, perks, and most of their benefits. Although the staff members are well qualified, none are ready to take over the firm. The partners want to immediately reduce their role and time commitment but remain available for a proper transition.

Buyer. The buyer is a multipartner firm generating over $5 million in annual revenues. It is a diversified firm that also provides various types of business and financial consulting. It has both physical space available and the ability to take on more work without adding new partners. Its ideal acquisition candidate is a practice with junior- and senior-level staff so it can avoid having to hire a lot of people at one time.

Deal terms. The buyers agree to pay the sellers a 1.20 multiple of fees as follows:

- The payments will be made over 6 years structured 20 percent as a sale of intangible and tangible assets and 80 percent consulting (allowing the buyer a current deduction).
- The sellers receive $50,000 at closing as a down payment.
- The sellers receive 20 percent of gross collections from the clients acquired for the 6 years.
- The first $25,000 that the sellers are entitled to in years one and two is credited against the down payment.

These payments include the furniture and equipment used in the practice and assume there will be one to two personal introductions by the sellers to the buyers for each business client, the sellers' participation in approval of an announcement letter, an orientation to the files, and reasonable communication between the sellers and buyers as well as the sellers and their former clients. The sellers retain their accounts receivable, work in process, cash, and other nonoperating assets. If the sellers are asked for extraordinary transition services involving direct client service, they will receive additional compensation in the form of a guaranteed minimum hourly rate or one third of what the services are billed, whichever was higher. The sellers also get a new business incentive program rewarding them for referrals of new clients they developed and introduced to the buyer after closing.

Benefits to both parties. This is a win-win because the timing and the fit are right. The successor firm increases its client pool, revenues, and depth of talent because the seller's three quality staff members are taken on as part of the deal. The successor firm also gets a larger client base and will be able to pay for the practice out of the current cash flow it will create. The firm's partners should enjoy increased compensation immediately.

The sellers are able to find a quality home for their clients and staff and receive premium compensation for their years of sweat equity and a reliable buyout from a solid successor firm. The sellers also can benefit from the buyout compensation from the potential and expected growth of their practice in the successor firm, and can increase their earnings if they refer new business to the firm even after they have left active practice.

This kind of immediate buyout works when both parties are prepared and ready to effect a transition. They made a lucky match because many firms may not find the perfect solution to their succession needs precisely when they need it, demonstrating that planning ahead is the best way to ensure a workable transition.

THE TWO-STAGE DEAL

An immediate buyout may sound ideal, but it does not work for all practices. Many practitioners who are five or fewer years from reducing their time commitment to the firm are reluctant even to begin considering an external succession plan for many reasons:

- They do not want to give up income or control.
- They do not want the limitations or accountability of working with new partners.
- They are not being realistic about their time frame. Many practitioners may think they want to work another 10 or more years, but when they give the matter serious thought they recognize that they are not expecting to work full-time during all of those years.
- Change is daunting for most of us and entering into a merger is clearly a big change.
- Few firm owners have a realistic view of the time it takes to perform a proper transition.

Keep in Mind

A two-stage deal is primarily designed for small accounting practices of one to three partners who want to reduce their time commitment over one to five years.

One solution for smaller firm owners who are uncomfortable entering into a merger for these reasons is a two-stage deal. A two-stage deal handles succession in increments rather than all at once. Stage one is a contractual period during which a seller continues to manage his or her own client base, retaining income, and a reasonable level of autonomy. Stage two, which is activated upon an agreed-on date or triggering event, is the buyout. A two-stage deal creates an affiliation that looks like a merger to the outside world but allows the purchased firm to operate almost like a division within the successor's infrastructure. It is primarily designed for small accounting practices of one to three partners who want to reduce their time commitment over one to five years. The parties customize the deal to fit their goals. The idea is to embed a transitioning firm's practice into the successor firm but allow exiting owners considerable autonomy and retention of their income for an agreed-on time period.

Case Study: Two-Stage Deal

The following case study illustrates a typical two-stage deal.

One step at a time. Peter is a sole practitioner who employs 1 CPA, 1 non-CPA professional, and a part-time clerical staff person. He generates about $450,000 in annual revenues. As was the case with the first firm we discussed in this chapter, the CPA is talented, but not equipped to take over the firm from him. At this point, Peter would like to work 2 to 3 more years full-time, then 2 years part-time, but he does not want to reduce his income or relinquish control of the practice immediately. He is interested in slowly reducing his time commitment but remaining the go-to partner and the face of the firm for his clients. The practice provides mostly accounting and tax services, and Peter is netting 40 percent of his revenues including salary, perks, and benefits. He works about 2,200 hours annually, of which 60 percent is billable. He works 6 days a week during tax season, 4 days per week during the summer, and 5 days per week over the balance of the year and enjoys 4 weeks of annual vacation.

Peter's potential buyer is a two-partner firm generating $1.5 million in annual revenues. Like the buyer in the first example, it is a diversified firm that also provides various types of business and financial consulting, and it has available space and staff capacity. The partners want to put this capacity to better use and encourage future growth that will allow them to promote one or two current staff members to partner down the road without having to reduce their own earnings.

As part of the negotiation process, the 2 firms exchange due diligence lists, perform field reviews, draft contracts, and prepare a transition plan. From introduction of the 2 firms to closing takes 11 weeks. (See more on this process in chapter 9.)

Peter moves into the available space in the buyer's office. The buyer assumes all of the overhead and much of the administration. The deal is structured as a two-stage deal. The buyer retains all of the professional staff except the clerical staff. Peter retains control over client service matters, his day-to-day activities, and his earnings until stage two.

Stage One. In a two-stage deal, stage one covers the onset of the affiliation until the seller substantially reduces his or her role. Peter continues to run his practice as he ran his firm, coming and going as he sees fit. He bills his clients under the buyer's name and continues to receive the same 40 percent of gross revenues as his compensation as long as he does not need any additional labor support above staffing base resources. Peter elected to have this compensation paid to his old entity as consulting fees so he can manage certain expenses and perks (such as car leases, insurance, and retirement plans) on his own terms. If Peter wants to reduce his time commitment to the practice or for any other reason needs additional staff support, he would accept pro rata reductions in his income. Under the deal, stage one ends and stage two begins at the first of the following events:

- Peter's death or permanent disability
- The date when Peter reduces his time commitment to the practice below 60 percent of his past efforts
- The end of the third year

Peter retains his accounts receivable and work in process as of the onset of stage one. However, in this case, Peter loaned 60 percent of the collections to the buyer firm for the first 12 months and he was paid that in a lump sum.

Stage Two. This is when the purchase payments commence. In this case, the purchase price is 100 percent deferred during stage one. Peter is paid a multiple of 1.10 based on 22 percent of gross collections for the subsequent 5 years paid monthly, including fee increases, special projects, and the like. He receives a $50,000 advance at the start of stage two, which is credited back to the buyers at a rate of $2,000 per month for the first 25 months. He remains on in a reduced role for additional

(continued)

compensation based on 33 percent of what he was billed out for on each mutually agreed upon task. He also receives a new business incentive program that rewards him 20 percent for 2 years on any new business he personally develops and brings to the buyer. The price paid is structured to provide the buyer a current tax deduction as transitional consulting fees.

Benefits to both parties. During stage one, Peter is able to maintain control of his practice, set his own hours, and gradually introduce his clients to the successor firm. He also, in effect, receives a built-in practice continuation agreement that protects his family and clients in the event of his death or disability during stage one, which would initiate an acceleration of stage two. He has the chance to maximize the value of his practice yet greatly reduce his liability and exposure. In stage two, he receives healthy compensation for the value of his practice and continues to spend some time on client service and new business development skills. Because he executed an orderly and slow transition, it is highly likely that the client base will be retained and the value of his practice maximized.

The buyer receives short- and long-term value. In the short run, because the firm had the space to absorb the practice and excess capacity on a clerical level and was able to eliminate other redundant costs, the partners immediately create an additional $75,000 per year in overhead reductions by eliminating the seller’s rent and labor costs on clerical, software, and other expenses. The successor firm is also guaranteed by the end of the third year to be in a position to take over a practice that has already been transitioned to it.

Early results. This case study is based on an actual deal. By the third year, using the detailed transition plan we worked out before closing, virtually every client had been retained other than those who sold their business, relocated, or died. The revenues increased as the retained clients grew. The buyer was able to provide some niche consulting services to the seller’s clients, which produced additional revenues benefiting both parties. Given the smooth transition and the level of client satisfaction, in the second year following tax season, Peter elected to reduce his role by 20 percent. During the third year he reduced his time another 20 percent in tax season and by 25 percent the rest of the year. Because the buyer was doing most of the administrative work for Peter, he was able to invest more time in new client development as well as billable work, which also helped boost revenues. Peter is now working only in a part-time, of-counsel role.

There were a number of other steps that helped this deal work, including decisions about the following:

- Liability issues
- Firm name
- Client and staff transition
- Treatment of accounts receivable
- Work in process
- Due diligence
- Proper documentation

In many merger and sale transactions, the buyer firm actually is interested in allowing the seller to stay on in a part-time role indefinitely. Many practitioners find this gives them the flexibility to define what they want the last phase of their career to be like and receive ongoing compensation while still getting maximum value for their practice, which is sold at its peak, not at residual value. Not only will buyers often pay you for the time you are willing to continue to work, but they also will often reward you for referrals of new business you bring them.

Two-stage deals make it possible to have your cake and eat it too. You are not quite ready to retire, but you know you need to find a successor for your practice. You worry about how much accountability a successor firm will impose if you decide to merge and about a change in culture, loss of identity, and your role in the new firm. A two-stage deal is a flexible way to affiliate with a successor firm when internal succession is not an option. Retiring partners achieve their long-term goals and maintain some independence until they retire, and the successor firm gains more benefits than it would in a straight purchase or standard merger.

THE CULL OUT SALE

The two-stage deal demonstrates that practitioners have options other than simply retiring or working full-time. Now let's talk in more detail about another way that a practitioner can reduce his or her time commitment while maintaining independence, income, and control, one we introduced in chapter 5: the cull out sale. If a firm lacks the capacity to replace all of its soon-to-be-retired owners but firm owners do not want to retire immediately, a cull out sale can also help. In a best case scenario, it can make it possible, for example, to cut back to 50 percent or less of full-time by selling off, for example, 75 percent of the practice (at full value) and retaining only selected clients or engagements, thereby minimizing the headaches and overhead associated with a time commitment. Another alternative would be to sell a division such as a service area, a group of clients, or a stand-alone office to reduce the workload for the partners that will remain after the retirement.

It is a truism that in many firms, the clients that pay the lowest 20 percent of fees take up 50 percent or more of the CPAs' time. But, as we have said, one firm's ceiling is another firm's floor. Culling out these "basement" clients and selling instead of firing them offers several benefits. Some of the least profitable clients are often the ones that have been with the firm the longest and it is hard to fire them. However, low-paying clients at larger firms often fit well within the fee rates of some smaller firms. Instead of firing the client, a cull out sale puts them in the hands of a competent CPA who really wants them. You can tell the clients that instead of subjecting them to significant fee increases, you are referring them to a trusted local firm who can offer them quality service within their budget. You remain available and of counsel during the initial transition. Even if you accept a purchase price of 15 percent of collections on these clients for 5 years, you would likely make more money selling them than retaining them.

Let's say Ronald Smith, CPA PC, generates $750,000 in annual fees. Ron would like to reduce his time commitment from the firm but not fully retire. In an ideal situation, he would love to be able to retain about $100,000 worth of clients (mostly chosen based on factors such as the nature of the relationship, the ease of client service, or the fee). In a cull out sale, Ron would sell $650,000 in revenues and retain the $100,000.

In many cull out sales, the seller retains such a small portion of the practice that he or she can work from home with little overhead. Given the resulting high net on the portion he or she retains, plus the proceeds from the sale of the rest of the practice, the seller may remain close to whole in terms of compensation.

In many of these sales, the seller also gives the buyer the first right of refusal to acquire the culled out portion later. It is recommended that the seller add a provision stipulating that if the buyer is late on payments or loses more than X percent of the sold clients, he or she loses that right of first refusal.

Cull out sales have also been used in retaining one niche and selling the balance of a practice. Among the many variations we have seen, practitioners might retain the wealth management portion of their firm, or the litigation support side, and sell the traditional compliance work.

Case Study: Cull Out Sale

This case study demonstrates the use of a cull out sale in a multipartner firm. In this $5 million, 7-partner firm, 6 partners were located in an office and 1 was in a separate location 150 miles away that generated $750,000 in annual fees. That partner wanted to retire in 3 years. None of the remaining partners wanted to move to that market and the firm felt it could not recruit a suitable replacement for the retiring partner in time, so a local firm in that market was found that wanted to operate the practice. A two-stage deal was negotiated for the retiring partner that resembled the internal buyout he would have received from his old firm. The firm walked away from the practice in the remote office in exchange for being relieved of the buyout obligation to its former partner. The same approach could be used in the case of a distinct practice area, like a niche service, or a group of clients with specialized needs such as an industry group.

Mergers Versus Acquisitions

Because we are discussing variations on transition themes, let's consider a merger versus an acquisition and examine the differences between them. In simple terms, an acquisition or sale involves the transfer of a practice from the seller to a buyer in exchange for cash or a future promise that will be realized in cash eventually. The seller normally does not take an equity interest in the buyer's firm. The seller may stay on for a significant period of time following the transaction, working in an employee or consultant's role. The proceeds from the sale may not be realized for a long time. For instance, in a two-stage deal, the seller remains with the buyer firm for one to five years and defers most or all of the proceeds from the sale until he or she leaves full-time employment. To provide the seller's clients a sense of continuity and reduce the fear that they are losing their trusted professionals, the transaction is designed to look like a merger to the outside world, but financially and legally this should be considered a sale.

Keep in Mind

In an acquisition, the seller normally does not take an equity interest in the buyer's firm. In a merger, the transitioning firm combines with the successor firm and the owners of the transitioning firm exchange their equity interest for an equity interest in the combined successor firm.

In a merger, on the other hand, the transitioning firm combines with the successor firm and some, if not all, of the owners of the transitioning firm exchange their equity interest for an equity interest in the combined successor firm. This is important because the value of their equity interest in their firm is determined for the most part by the following:

- The allocation of equity in the successor firm at closing
- The operation of the successor firm
- The transitioning firm owners' participation in the growth of the successor firm
- The successor firm's owner agreement governing the owner buyout

There is one key difference between a merger and a sale: in a sale, the value of the acquired firm is determined by the agreement governing the sale or two-stage deal. Generally, in a merger the value of the merging owners' interests in their old firm (for those owners that become equity owners in the successor firm) is determined by the successor firm's owner agreement. When we are asked by owners of accounting firms that are anticipating an upstream merger what their firm is worth in today's market, we tell them that it depends on the owner agreement of the firm you merge into.

Combination Deals in Mergers

Many transactions use several different deal structures that suit the needs of various partners. The best way to demonstrate the concept of "combination deals" is the following example.

Case Study: Combination Deal for 4-Partner Firm

The transitioning firm is a 4-partner practice. Andy decides he is ready to slow down soon and stay on in a part-time role. Bob is 3 years away from wanting to slow down and wants to work full-time until then. Connor and Diana are younger and are 10 years and 15 years away, respectively, from retirement.

It makes no sense for Andy, and probably not even for Bob, to become equity partners in the acquiring firm. At the same time, it makes no sense for Connor and Diana to sell their interest and become nonowner employees in the acquiring firm. Andy and Bob are more interested in creating as much certainty as possible in their buyouts and compensation for the short time they will remain with the firm. They would appreciate an upside opportunity but not if that means accepting downside risk. By the time they acclimate themselves to being equity partners in the successor firm, they would be ready to leave. Internal buyout arrangements are often designed for partners who will hold that status for the long term. Vesting schedules, valuations, and other factors may not work for a partner who is only around for a few years. It makes a lot more sense to negotiate a separate set of terms to handle the buyout of the short-term partners.

It should be noted that in some cases, partners in a selling firm may not meet the criteria for being a partner in an acquiring firm. For instance, a partner in the selling firm managing a $500,000 book of business might not be considered a good fit as an equity partner in a firm where equity partners are required to manage at least $1 million in business. The acquiring firm might offer this partner a nonequity partner or senior manager position.

In this example, all of the partners in the selling firm meet the criteria of an equity partner in the acquiring firm. If this was not the situation, a resolution of the owner interest these partners had in their previous firm would be required, which normally means that equity partners not admitted as equity partners in the successor firm would need to have their ownership interests addressed. Sometimes the successor firm has a retirement plan for nonequity partners and sometimes a separate agreement must be negotiated. Another option is to set up a buyout program between the partners that become equity owners or sellers in the deal and the partners that do not become equity partners.

As is often the case for the combination of firms with this fact pattern, the deal is structured in three separate transactions. Andy, who wants to reduce his role immediately, is handled in an outright sale of his interest. Bob, who sees himself slowing down in three years, is handled as a two-stage deal. Connor and Diana are admitted as equity partners in the acquiring firm and sign onto its partnership agreement. The approach to valuing each transaction is handled separately.

Andy has a preconceived notion of the value of his equity interest based on the valuation metrics used in his firm's partnership agreement. In a situation like this, ideally the acquiring firm will consider those terms reasonable, making it easy to structure a buyout for a partner like Andy. This could be the case if the partner owns a reasonable amount of the equity relative to his compensation and the valuation and payout terms are reasonable. For instance, Andy owns 25 percent of the equity in his firm, he earns 25 percent of the compensation, the buyout terms in his firm's agreement pay him 1 times his firm's overall fees times his equity interest over 10 years without interest, and his capital account is paid over 5 years. The acquiring firm has some concern about retention of his client base and adds some contingencies to the terms to compensate for that risk. However, overall

(continued)

the acquiring firm finds the rest of the terms acceptable even though they set a slightly higher valuation than they use internally. The firm works out a suitable compensation package for the short time Andy is to be on board and starts the buyout payments soon after the merger.

Bob is not ready to quit working full-time and as a result wants to maintain his compensation level for a few years. The acquiring firm is willing to accommodate that request if Bob's time commitment and the revenues he continues to manage remain steady. In fact, the acquiring firm welcomes that arrangement because Bob's continuing presence at the firm will help transition his client relationships and duties. This is the classic two-stage deal. However, the acquiring firm does not want to pay him full-time compensation at the same time it will be making buyout payments for his equity. In this case, the acquiring firm defers the buyout payments until Bob is no longer working full-time. The same valuation formula and terms are used for Bob's buyout as are used for Andy, again assuming they make sense based on the valuation of Bob's equity and compensation. Although Bob continues working full-time, his compensation is determined on a contractual and formula basis. The goal is to try to replicate his historical compensation contingent on his working to maintain the firm's profitability. His compensation is tied to his managed book of business (even as it is transitioning) and billable hours.

How are Connor and Diana handled? The rule of thumb for making a partner an equity partner in a merger is to consider that partner's timetable. Six or more years from expected transition usually leads to equity status and five years or less often leads to contract or nonequity status with a separately negotiated buyout arrangement (like what was done for Bob). In this example, Connor and Diana are admitted as equity partners and the firm's partnership agreement dictates the valuation of their equity interest. That valuation, of course, only becomes relevant when Connor and Diana retire or otherwise leave. There is a bridge or transition agreement for Connor and Diana that dictates any exceptions to the acquiring firm's partnership agreement. These exceptions are considered temporary and include commitments to minimum compensation levels for two years, exceptions to vesting requirements in the partner retirement plan that recognize past service, and specifications for contributions of capital (which are tied to what is available from their capital in their old firm).

As they plan their own succession, practitioners should be aware that it is possible to allow all the partners to customize their succession and growth methods on their own time frames and still participate in a successful deal. Buyers should also be aware that there are many creative ways to structure a transition in a merger.

Adding It Up

As we will discuss later in the chapter, problems with structuring a merger can come about when the sum of the parts of the acquired firm exceed the value of the whole acquired firm. As an example, assume in the preceding case that Andy's equity interest is 50 percent and that his compensation as a percentage of the total compensation pool is 30 percent. Bob's equity interest is 30 percent and his compensation is 25 percent. Connor and Diana each own 10 percent and earn 22.5 percent of the compensation each. The acquiring firm uses three times annual compensation as the basis for buying out partners. Assume a 33 percent profit margin for the acquired firm.

If we use the same initial approach to the deal structure, the acquiring firm would eventually be paying the following for the firm:

Andy:	1 × 50 percent = 50 percent of volume
Bob:	1 × 30 percent = 30 percent of volume
Connor:	22.5 percent × 33 percent × 3 = 22.5 percent of volume
Diana:	22.5 percent × 33 percent × 3 = 22.5 percent of volume
Total:	125 percent of volume

The acquiring firm often would likely conclude it is paying for more than the value of this firm. The problem occurs due to the change from using the equity method of valuation to a compensation method for Connor and Diana. One of the techniques we have used to overcome this problem is to recognize that Connor and Diana are being enriched solely by signing onto the acquiring firm's partnership agreement. Therefore, the premium Andy and Bob will be paid can be offset with a credit against the eventual liability that will be paid to Connor and Diana when they retire. If the excess buyout that will be paid Andy and Bob totals $250,000, Connor and Diana might carry a permanent credit against their eventual buyout of $125,000 each.

Relative Values of Two Firms in Mergers

As a note, most often the relative value of 2 firms in a merger is not really relevant beyond their respective volume or partner compensation. For instance, in a merger of a firm with $5 million in volume and a merger of a firm with $3 million, the equity allocated to each partner group would often be 5/8 to the larger firm and 3/8 to the smaller firm. This makes sense if the partnership agreement values the firm internally based on volume times equity owned by a partner applied to a valuation multiple. If the successor firm uses a compensation multiple for buyout valuations, the compensation of each partner is all that matters, not the equity. Assuming partner compensation is set logically and considered fair by the partner group, the resulting buyout valuation should also be considered fair. In these cases it really does not matter what one firm's value is when compared to the other firm.

Equity, however, can have meaning in firms as it relates to governance, voting, and profit distribution, so even if it does not affect retirement compensation, it still can be a meaningful concept in certain firms. We have seen many negotiations get stuck on the issue of equity allocation between the two firms. If the successor firm will operate in a one-partner, one-vote governance system, the retirement proceeds will be based on compensation (and so will sale proceeds if that should ever happen), and equity is not a component of compensation, what difference does it make how much equity a partner owns? For this reason, the trend among larger firms is to level out equity among partners.

If relative equity does have a role in allocating value or compensation, using relative revenues to allocate beginning equity in the successor firm can cause trouble when it appears that over the long run the relative value of the two firms might become imbalanced. For example, if one firm has been growing organically at a rapid pace and the other firm has been flat, an allocation of equity solely based on relative volume at a particular point in time may not be considered fair down the road unless equity will be subsequently adjusted. Realization, profitability, brand value, technology, and other infrastructure investments are also factors that can influence equity allocations.

Compensation Gaps

Let's look in more detail at one of the most common—and challenging—potential obstacles in a merger: compensation and benefits for partners and staff. There are usually differences between merging firms on compensation levels and methods and benefits packages. It is crucial for staff and partner retention that the merging firms combine the varying systems into one that seems fair to all. Failure to address these concerns can result in high staff and partner turnover, which can be a mortal blow to a merger.

Pay and perks might not be the most important factors in employee satisfaction, but they cannot be ignored. Employees will leave if they feel they are underpaid and have other employment options. Here are two examples on how to successfully navigate situations where compensation and benefits differences could trip up a merger. In both scenarios, the four Cs of mergers and acquisitions—chemistry, capacity, culture, and continuity—play a key role.

Bridging the Gap

Good & Co., a CPA firm with 6 partners and $5 million in annual billings, is merging with Will & Co., which has 2 partners and annual billings of $1.6 million. Good & Co. is the successor firm and expects to shift all Will & Co. personnel to its policies. Their compensation policies are spelled out in exhibit 6-1.

Exhibit 6-1: The Gap Between Compensation Policies at Good and Will

Policy	Good & Co.	Will & Co.
Salary	Seven senior staff members have 3–6 years' experience and earn between $65,000-85,000. Managers earn an average of $115,000 and usually have at least 7 years' experience.	Two seniors have 10 years' experience and earn $110,000.
Vacation	Employees with more than five years' experience get three weeks paid time off.	The two seniors get four weeks paid time off.
Health insurance	Employees pay half their premiums.	Firm pays 100 percent of premiums.

Will & Co.'s seniors have a compensation package that is comparable to that of Good & Co.'s managers. Good & Co. is not sure Will & Co.'s seniors are as strong as its own managers, but Will's seniors may leave the firm if their compensation is slashed—a potential disaster because they have major client responsibilities.

How should Good & Co.'s leaders handle the situation? Maintaining the Will & Co. employees' compensation package would not harm the combined firm's margin because Will & Co.'s margin already reflects these costs. It would be best if Good & Co. acted to hold on to Will & Co.'s seniors long enough to determine if they can meet Good & Co.'s performance expectations for managers. There are two options that could work.

Option 1

Promote the Will & Co. seniors to manager and maintain their current compensation. Keeping them as seniors at their current pay could cause resentment among Good & Co.'s seniors. If, after 12 months or so, the promoted seniors cannot cut it as managers, Good & Co. could terminate or demote them with far less risk that the changes would lead to client problems or attrition. The most vulnerable time for client retention is before the clients are acclimated to the new firm and its people.

Among the risks Good & Co. might have identified in this approach is a decline in client service if the newly promoted seniors cannot perform at the level required of Good & Co.'s managers, as well as their possible failure to comply with professional standards. This likely would result in lower staff morale, disputes with dissatisfied clients, and extra costs. Good & Co. should establish enhanced supervision for these new managers until the firm is confident in their abilities. This potential problem should also be mitigated to some extent because it is likely the Will & Co. seniors will continue working on most of the same accounts in the same fashion immediately following the merger. If there is in fact a quality problem with their work, it is likely it would show up in due diligence.

Option 2

Keep the Will & Co. seniors at the same level and pay. To avoid resentment among the Good & Co. seniors, firm management can challenge the Will & Co. seniors to strive for manager level to justify their compensation. If these seniors cannot develop their skills to earn promotion to manager, the firm can terminate them or cut their pay.

In either scenario, Good & Co. must address the differences in benefits between the two firms. For example, Good & Co. should eliminate the extra vacation and superior health benefits for the Will & Co. seniors to bring them in line with its own policies. At the same time, it should increase those seniors' cash compensation to make up for the lost week of paid time off and the lower health insurance subsidy. This is a small price to pay to avoid asking Will & Co.'s seniors to take a step back in compensation.

Given the stakes, it is generally better for a successor firm to engage in some flexibility on compensation rather than risk a failed merger, especially for staff that have significant client contact as they can be the glue that cements the relationships through a transition.

Dealing With Conflicting Policies

Case Study: Conflicting Partner Perquisites and Benefits

Redd & Co. is a 3-shareholder firm merging into Rose & Co., a 15-partner firm. The managing shareholder of Redd & Co. is retiring in 3 years. The other 2 shareholders are staying on for at least 10 years. Redd & Co.'s shareholders liberally run expenses for cars, club dues, lavish trips for CPE, full family health insurance premiums, cellphones, home computers, and other items through the firm as a benefit for themselves. The managing shareholder takes off about 12 weeks per year to stay at a vacation home, where he works occasionally.

Rose & Co.'s partners enjoy virtually none of the same benefits or perks and are limited to four weeks of vacation per year. Redd & Co. is a corporation and, therefore, pays its shareholders as employees, and Rose & Co. is a partnership, so its partners have to pay their own self-employment taxes and other benefits.

Clearly, there are major differences in the two firms' cultures, which calls into question whether the two Redd & Co. partners who are planning to stay on long term will be able to adjust to Rose & Co.'s culture and live with its policies. If the answer is "no" or a grudging "yes," the merger may fail.

The first step in the reconciliation process is to determine the effective income of each partner or partner-to-be by adding back to reported income the value of all benefits and perks. Comparing compensation on this apples-to-apples basis is important in assessing the firms' compatibility.

Assuming the net incomes per partner are reasonably similar, or that the differences are manageable, Rose & Co. could guarantee the new partners' compensation for one or two years following the merger, provided they maintain their fee volumes and personal productivity.

The Redd & Co. shareholders have been together a long time, so they have devised their own methods for allocating compensation. Further, it would be challenging for the Rose & Co. partners to assess each of their new partners' worth in the initial stages. Therefore, it would be quite common for Rose & Co. to allocate a block of income to the new partners and let them determine how to divide it among themselves.

The ex-managing shareholder of Redd & Co. might be subject to the same arrangement, but because he is scheduled to cut back and transfer responsibilities to others, his pay is more likely to be set either as a formula based on how well these goals are met or as a fixed amount. Rose & Co. should tolerate his liberal time off during the three years before his retirement, as long as the effect on the combined firm's profitability can be calculated and any negative variance leads to an adjustment in his compensation.

The other two new partners of Rose & Co. would become part of the firm's normal partner compensation system after the guarantee period, or they might opt to do so sooner if it is to their benefit.

Although differences in compensation and benefits may seem to be insurmountable, firms can clear those hurdles through a combination of creativity and collaboration.

Other Postmerger Issues

Besides compensation, several other areas can cause postmerger stress and should be addressed in detail in the merger agreement. (For a thorough discussion of due diligence concerns, see chapter 9.)

Client Transition

In the case study featuring Redd & Co. and Rose & Co., it is assumed that the retiring Redd & Co. managing partner will transition his clients during his three-year tenure with the new firm. But what if he doesn't? Or he does not do so in a reasonable time frame? (We have seen retiring partners wait until the last day to start the process.) Assuming his buyout is not tied directly to client retention, the solution is to include a detailed transition process in the merger agreement. The document should incorporate a client list with the names of the new partner and manager in charge of each account and the date by which the account will be transferred, and details about the transition process such as the types and timing of meetings with clients to introduce the successor partner. The merged firm also should establish compliance incentives for the retiring partner (for example, no pay reduction despite the loss of personal chargeable time) or, if need be, penalties for noncompliance (for example, reduction of retirement pay if clients are lost due to a late transition).

Advising Clients

The merger agreement should state exactly how firm clients will be advised about the transaction. Identify which clients will be informed by letter, which ones will receive a personal phone call, and which ones will require an onsite visit. Also, specify the time frame for completing each task (see chapter 10 on transitioning clients and staff through a merger, acquisition, or succession plan).

What Is Left Hanging

Merger agreements should address incomplete (catch-up) or deficient (fix it) work by the prior firm that the successor firm must handle. If the prior firm has been paid for work that is incomplete at the time of the merger or acquisition (for example, under a retainer or fixed-fee arrangement), the successor firm might do the work at full rates and charge the prior firm either through an adjustment in buyout payments or a reduction in guaranteed compensation. If deficient work by the prior firm comes to light after the merger, to the extent that this is not billable to the client in question (and it seldom is), the successor firm might do the necessary rework and charge the appropriate party based on costs. Both of these approaches should only be used if the problem is material. The worst way to start off a merger is for the successor firm to start nickel-and-diming the merged-in firm. Ideally, this kind of need can be identified in due diligence and a plan that both firms agree to should be set up prior to the merger. For instance, if the merging firm routinely prebills clients for work that has not yet been completed (for instance, retainer billing), the parties should discuss how this will be handled postmerger and what the financial consequences will be.

Perks

Partners usually go into a merger assuming they will enjoy the same perks they did before, but as shown in our second case study, not all firms have the same policies, so it is important to document how they will be handled. Some perks that merging firms should consider, define, and resolve to everyone's satisfaction include the following:

- Payment for CPE (number of hours, travel restrictions, and other details)
- Payment for travel to clients
- Payment for entertainment expenses
- Size and location of personal offices
- Administrative support
- Furniture and furnishings
- Timesheet assistance
- Billing assistance
- Collection assistance
- Staff assignments
- Parking

- Office hours
- Working-late arrangements
- Evening meals in tax season

The Right Deal for You

What is the best value and deal structure for your practice? There are clearly many complicated issues to consider, but there are also numerous ways to assemble a deal that provides good value to both buyer and seller. In the next chapter, we will consider some of the obstacles that can stand in the way of a smooth transition.

Action Agenda

The right actions depend on the timing and particulars of the deal. Consider the following points:

- If you are ready to begin reducing your time commitment now, consider whether your firm is properly positioned for an immediate buyout.
- If you are five or fewer years from transition and want to maintain active management of the practice in the meantime, determine whether a two-stage deal is your best option.
- If the firm cannot replace retiring owners but those owners do not want to scale back completely, investigate the advantages of a cull out sale.

Chapter 7
Managing Merger Minefields

Throughout this book, we have discussed many of the mistakes that can be made on the way to a successful and mutually beneficial merger or succession. The four Cs discussed in chapter 3—chemistry, continuity, capacity, and culture—are certainly important elements. We have also talked elsewhere about the impact that leases, fixed assets, restrictive covenants, and staffing can have on merger prospects. In this chapter, we will review some of the roadblocks to a smooth transition in detail and offer advice on how to avoid them. We will also take another look at the partnership agreement and provide a practical worksheet you can use to ensure your document covers all of the right bases. Finally, we will consider how to make the best of a bad situation, providing tips on how to prepare for and respond to a merger gone wrong.

Reasons Some Mergers Fail

Let's begin by reviewing some of the situations that can trip up a merger before it even begins (and afterwards too). We will focus mainly on ones that have not been discussed in detail in other chapters.

Mergers for the Wrong Reasons

Pure overhead reduction is one bad basis for a merger. A successful merger usually means becoming true partners in a combined firm in which all are subject to the same accountability, governance, and compensation approaches, among other things. If filling excess office space is the only purpose, it might be better to cohabitate—rent or sublet space and share or minimize costs—rather than getting married in a merger. Many of us spend more waking time with our partners than our spouse, so saving overhead alone is not sufficient justification for a merger.

Keep in Mind

In one merger, the managing partner wanted to add a niche and merged in a specialty without really getting his partners' buy-in. As a result, they were unwilling to share access to clients who would have been the best candidates for the niche services.

Poor Deal Structure

A poor foundation can lead to a disappointing merger. In one deal, several partners in Firm A were to be bought out by Firm B over a few years following the merger. In reviewing the buyout terms, we found a situation we have discussed in other chapters: the cost of acquiring those partners' equity plus the cost of replacing them was greater than their compensation. As a result, Firm B would be out of pocket in negative cash flow for many years during the buyout period.

Business Plan Execution

Some other deals are motivated by cross-selling opportunities, which is a good reason for a merger. The problem occurs, however, when the larger firm's partners do not cooperate and those opportunities are lost. In one merger, the managing partner wanted to add a wealth management niche and merged in a specialty in that area without really getting his partners' buy-in. As a result, many of the partners were unwilling to share access to clients who would have been the best candidates for wealth management services. These partners feared introducing a service they did not understand and did not know how to provide themselves. The firm did not realize the expected increased revenue and the merger fell apart.

This outcome could have been avoided by

- communicating with partners about the business plan behind the merger. The partners' objections could have been raised before the union took place and either dealt with or recognized as a reason not to pursue the deal.
- engaging in partner discussions about how the plan will be executed.
- aligning financial incentives (usually compensation) with the plan. The firm could find ways to compensate partners for participating in the cross-selling arrangement and make sure they are aware of them.
- seeking final buy-in and ensuring there is a willingness to execute the plan, if not by all then at least by enough to provide a secure foundation for the deal's success.

Differences in Overhead and Profitability

Larger firms tend to have a much higher investment in technology, including more robust computer networks, paperless client service systems, and more mobile workspace. They also tend to spend more on administrative resources, such as human resource and IT directors, and on managing partners with little billable time, and many have additional layers of quality review. As a result, their profit margins may be lower and their overhead higher.

This can be a problem if the buyer firm's leaders conclude that the seller's practice will not be as profitable for them as it was for the seller. If the seller operated at a 50 percent profit margin, the buyer may determine that the practice will only generate a 30 percent profit margin because that is the buyer's margin. This can lead to a lower valuation and terms that are less attractive than the seller expected, and the seller may understandably decide that it should not be penalized for the decline in profitability due to the buyer's higher-cost infrastructure.

The solution is to concentrate on how the buyer's operating environment can benefit both sides and determine the actual incremental increases in overhead the successor firm will inherit. As we have mentioned, when we speak of deal profitability, we are referring to the buyer's profitability, not the seller's. It is important for sellers to position their firms to maximize value by helping the buyer envision how well the firm fits into its strategic growth or expansion plans. A few well-worded questions during initial meetings can help the buyer understand the value in merging. They include the following:

- "I think my clients will benefit from having access to more services. Do you have any specialty services that would appeal to a client base like mine?"
- "I often see opportunities to go after new clients that I can't handle due to my size. Do you think we would have better success obtaining some of that new business if we were combined?"

Some buyer firms use rules of thumb and broad parameters to assess the profitability of a seller's practice after a merger or acquisition. This can lead to bad assumptions and decisions. Take the example of the buyer firm that concluded that the seller's practice (with a 50 percent margin) would not operate at a higher margin than the rest of its practice did (operating at a 30 percent margin). In this situation, the buyer firm should determine the true incremental margin created from the combination. If there are no increases in overhead (by hiring more staff or acquiring more space or equipment), why wouldn't the seller's margin be maintained if not improved with the synergies achieved in overhead?

At the same time, although the more robust operating environment does carry higher overhead costs, could it also serve to maintain or even increase the seller's margin? For instance, if the buyer firm has much better back office management support, won't that give the seller more time to spend on billable work? Won't the richer technology infrastructure create more efficiency and possibly even lower client service hours required to provide the same output? Will it take less time and effort to complete the work if the successor firm's technology is better?

On another front, smaller firms tend to have much more difficulty assigning the right level of staff to jobs, which can lead to inefficiencies. These firms sometimes use a $175-per-hour professional to do $100-per-hour work because of staff limitations. Assigning the right person to the right job can lead to better profitability, which can also offset a larger firm's higher-cost environment. Leveraging some work may potentially free up partners and managers to perform more chargeable work, cross-sell services, and develop new clients.

Transition

A poor transition can be a tremendous roadblock to a smooth merger. See chapter 10 for detailed information about creating a strong transition strategy to maximize client and staff retention.

Equity

When smaller firms merge with a larger one, the issue of which partners in the smaller firm will be made partners in the combined firm can become a concern. Larger firms generally require more revenue per partner than smaller ones, so bigger firms may look to limit the number of partners they will admit to maintain their benchmark metrics. In one East Coast merger, Firm X, a much larger firm, considered merging in Firm Z, which had $5 million in annual fees and 5 equity partners. In Firm Z, four partners owned 24 percent of the equity each and a fifth partner owned 4 percent. One of the larger firm's management objectives required they maintain revenue per partner of $1.5 million. Although Firm Z did not exactly hit that mark, Firm X felt they were close enough with 4 partners, but not with 5. Without considering any other attributes for the individual partners, the larger firm concluded strictly based on the equity owned that the minority partner must not be one of the key performers and he would initially be offered a senior manager position. There was significant reluctance on the part of the minority partner to go along with this plan and it almost killed the deal. It turns out that although the minority partner held little equity in his firm, he was a clear future star and was already bringing in more new business than most of the senior partners in his firm. The deal was salvaged when the larger firm committed to name the minority partner a nonequity partner in the combined firm with a short-term probation period including clear performance goals which were intended to lead to a promotion to equity status within 2 years.

Ironically, the amount of equity held by any partner means little in most large firms, where compensation depends much more on current performance and retirement is based on compensation. That is why it is especially unfortunate to give a partner a perceived demotion to nonpartner status based purely on equity status in the old firm. To avoid this roadblock, many firms are now using special nonequity partner roles, typically called contract or income partners, as a holding place for equity partner candidates to prove they are worthy of the final promotion. Offering the CPA the title of partner and a clear path to equity may help overcome this roadblock in merger negotiations.

Billing Rates

Too often, we see large firms bypass the chance to merge with a smaller one due to relative billing rates, especially relative partner rates. For instance, a potential buyer might reject a merger candidate only because its partner level billing rate is $275 and the merger candidate bills its partners at $200. Consider the preceding example involving the $175-per-hour professional doing $100-per-hour work. Small firms often reduce the standard billing rates for their more experienced staff so they are appropriate for the tasks they have been assigned. Many firms build service teams based on the maximum level of expertise they will need so they can serve their clients adequately. However, they tend to set billing rates at the lowest level work being done to avoid overcharging. That means that smaller firms may bill out a professional with 3 years' experience at $125 to $150 per hour and partners at $175 to $200 per hour. The differential in rates between those 2 groups does not come close to recognizing the differential in value created by their efforts.

Keep in Mind

Too often, we see large firms bypass the chance to merge with a smaller one due to relative billing rates, especially relative partner rates.

Given the efficiencies of a larger firm environment, after a merger a small firm may easily be able to raise its rates, especially at the partner level, without charging clients more in total for the same services they have been receiving. This is primarily because the right level of staff will be doing the work at the right billing rates. The shift can free up a partner to do partner level work at higher billing rates. The synergy alone should lead to more profitability.

That is why it is a mistake for a large firm to conclude there is a risk of lower profitability due to lower billing rates without investigating the facts further. When these issues come up in negotiation, the parties should work to overcome the math that might lead to a poor valuation or a decision to forgo the deal. They may be able to recapture value with a business plan both parties agree is achievable by leveraging work down to lower staff and using the successor firm's more robust technology and procedures to minimize the time necessary to do the work.

Overall, it is best to think of the value being a basket of terms and to consider possible tradeoffs that will lead to win-win outcomes. There is no right multiple of revenues just as there is no right payment period or down payment. All of the terms have to fit together in a manner that maximizes the value created for both parties to the transaction.

Differences in the Client Experience

It is no surprise that larger firms may have a different operating approach from smaller firms, but the difference can become a problem if it is perceived as a negative impact by clients from the merged-in firm and leads to attrition. For example, smaller firm clients may have come to rely on a level of handholding not available in a larger firm. This is why bigger is not always better. This issue is discussed in greater detail in chapter 3.

Differences in Quality Control Systems

A sole proprietor cannot and should not be expected to install the same robust quality control (QC) system for attest work required of a multi-partner firm. It is true, though, that the need to apply a more involved QC system to a merged practice can lower the buyer's profitability and value, thus potentially turning off a buyer's interest in the firm.

A Failure to Communicate

Clear communication between the parties is paramount. It starts with a business plan with specific expectations before the deal is consummated so everyone knows their roles and what is expected of them after the merger. People should not find out after the deal falls apart that they did not live up to expectations they did not know about. Firms should set up a regular communication schedule that begins before the merger and continues once it has been achieved. It should include some meetings organized around specific topics and others that provide an open forum.

Ego

It is difficult switching from being a major player in a small firm to the accountability of being one of many partners in a larger firm—the proverbial small fish in a big sea. Most partners become comfortable with the new environment of a larger firm because the cost of the diminished autonomy is outweighed by the significant opportunity that it offers professionally and financially. These partners may also find themselves with more leisure time because the larger firm offers more backup and support. However, some partners never become comfortable with their change in status. This may be difficult to anticipate and tough to cure, but it is one of the many contingencies firms should consider when planning a merger.

Timing

Keep in Mind

From the time two firms initially meet and start exchanging information, it should take two to five months to reach a complete agreement.

How long should the process take? From the time two firms initially meet and start exchanging information, it should take two to five months to reach a complete agreement. We have all heard the expression, "Time kills all deals." Here are just a few of the reasons why:

- The buyer and seller have opposing goals. The seller wants to maximize the value in his or her firm and the buyer wants to pay the lowest practical price to increase profits. The longer they negotiate, the deeper they usually dig themselves into their adversarial positions.
- Negotiating one point at a time prolongs the negotiations and increases the likelihood of failure. A discussion of the multiple, for example, inevitably must include negotiations about the down payment, the retention and payout periods, tax treatment of the payments, and so much more. Spending hours driving a hard bargain on every detail often sends one or both parties away from the table.
- It can send the wrong message. For most firms that are selling or merging into a larger practice, the deal is their top priority. It is a decision filled with financial, professional, and personal issues that have tremendous consequences. If they do not feel that the successor firm is giving the negotiation the same importance, the deal may begin to unravel.

  Here is a classic example: In October, a firm generating $6 million in revenues was in a dialogue about a merger with a firm of over $30 million. The smaller firm asked us to get the employee handbook from the larger firm so they could review any differences. We called the large firm's managing partner and were told we could not have the information until late October because he was preparing for October 15 deadlines and a vacation immediately afterwards. We asked this managing partner if his firm had any clients whose fees added up to more than $100,000 annually, and he responded that of course it did. "If that client called you on October 6," we asked, "would it have to wait until late October to receive a document that is easily available on your computer?" We explained that we thought the question was appropriate because, at that moment, the $6 million firm should have been his most important client.

  We explained that if the smaller firm leaders were forced to wait three weeks for a response to such a simple request, they might come to any number of conclusions:

  — This is not a priority of the larger firm.
  — The big firm is so busy now it will not be able to handle another $6 million in revenues.

— If this is how we are treated during the honeymoon, we don't want to find out how the marriage will work!

We asked the managing partner which one the smaller firm should assume. The requested information was e-mailed that day, preventing a probable roadblock.

POTHOLES IN THE PARTNERSHIP AGREEMENT

What is one of the best ways to avoid those potential stumbling blocks and position your firm for a successful deal? We are often approached by firms that want to ensure that they are in a strong position when they sell, buy, or merge with another firm. One of the first things we do is review their partnership agreement to see if they have the kinds of policies in place that will support a smooth transition.

Would your firm pass our litmus test? We discussed some of the smart steps and stumbling blocks associated with partnership agreements in chapter 4. The checklist in exhibit 7-1 highlights some of the issues you should consider in reviewing your own agreement to see if it serves your firm's best interests.

Each firm's partnership agreement should suit its unique needs, so the exhibit does not contain an exhaustive list. However, the items cited all represent significant potential potholes for any firm on the road to transition. Could they have an impact on your practice?

Exhibit 7-1: What Is in Your Partnership Agreement?

Provision	Best Practice		Our Firm's Agreement
Buyout formula for retiring partners	Start with the retiring partner's total compensation, including perks and benefits	$______	Do your retirement payments fairly compensate the retiring partner for his or her years at the firm? Yes___ No___
	Subtract from that total the anticipated cost of replacing his or her labor	– $______	Does the formula self-fund the payments? Yes___ No___
	Subtract from that new sum the annual buyout payments	– $______	Will the retiring partners lose money trying to cover the payments?
	Balance	= $______	Yes___ No___

(continued)

Provision	Best Practice	Our Firm's Agreement
Cap on cumulative payments to retiring partners	We recommend a cap of 5-15% (smaller firms typically have higher caps than large ones) of the firm's gross collections per year on cumulative payments to protect cash flow.	Does your firm have a cap? Yes___ No___
Notice of planned retirement	We recommend a minimum of two years' notice to allow a firm to implement a solid transition. Failure to give notice should allow the firm to reduce the partner's buyout by, say, the percentage of business lost during the two years after the partner's retirement.	Does your firm require notice of planned retirement? Yes___ No___ Are there penalties for partners who fail to give notice? Yes___ No___
Restrictions on timing of partner retirements	We often recommend that agreements limit the number of partners who can retire within any one-year period without the remaining partners' approval so that their roles and responsibilities can be filled satisfactorily.	Does your firm agreement include these restrictions? Yes___ No___
Range of ages when a partner can leave with full benefits	Guidelines on when partners can retire with full benefits ensure stability and make it easier to plan for transition to new leadership as needed.	Does your firm agreement stipulate when partners can retire with full benefits? Yes___ No___
Termination at retirement or due to death, disability, involuntary, and voluntary termination	Because each of these terminations carries different risks and requires different responses, the agreement should set guidelines for handling all of them, especially related to client transition.	What kinds of termination does your agreement cover? ______ ______ ______ Does it address valuation and payment formulas in each case? Yes____ No____

Provision	Best Practice	Our Firm's Agreement
Mandatory retirement	Mandatory retirement ages cut both ways. Most younger partners like them because they establish when they will have an opportunity to step into a larger role. Conversely, for partners who are at or past retirement age, a forced retirement could be a deal killer.	Does your firm have a mandatory retirement age? If so, what is it? ______ Will you allow exceptions made for mergers? Yes___ No___

DO NOT FORGET ACCOUNTS RECEIVABLE AND WORK IN PROCESS

In most mergers, the members of the merged-in firm who are to receive equity in the combined successor firm typically are asked to contribute their accounts receivable (AR) and work in process (WIP) to the successor firm to create their capital account. Some partners of the merged-in firm may not receive equity in the successor firm, typically because they are merging for succession or because their equity ownership in their original firm was too small. These partners may retain their AR and WIP, but we frequently see them loan it to the successor firm and get a short payback period on it.

In most sales, it is very rare for the buyer to acquire the seller's AR and WIP. We recommend that the successor firm collect these funds and pay them to the seller monthly until the AR and WIP have been satisfied. Clients may be given a bad impression if the deal is promoted as a merger and yet each side of the deal is doing its own collections.

Clients who are delinquent payers pose a challenge. If the first dollars coming in after the sale must be paid to the seller, the buyer may be stuck waiting months for positive cash flow because of these clients. The buyer may not work too hard to retain them, lowering the seller's payments that are based on client retention. To resolve this problem, we recommend including the paragraph in exhibit 7-2 in many deal agreements to ensure the successor firm enjoys positive cash flow after a reasonable time and remains motivated to service all clients. In reviewing the paragraph, note that by the time a client is 30 days late to the buyer on current work, they are likely over 120 days late to the seller.

Exhibit 7-2: Addressing Payment Issues in the Deal Agreement

The following sample language is for illustrative purposes only.

Collection of Receivables and Work in Process

(A) The outstanding receivables from the CLIENTS as of the EFFECTIVE DATE will be listed on exhibit A to be provided at that time.

(B) The work in process for the CLIENTS as of the EFFECTIVE DATE will be listed on exhibit B to be provided at that time. This exhibit B is to include both work in process that has not been billed and any work which has been billed but which has not yet been completed (referred to as negative WIP), if any. The FIRM will complete any work in process, invoice, and divide the collections derived from such work pro rata in accordance with the time each Party devoted to each such case.

(C) If the FIRM receives funds in payment of the amounts due from CLIENTS under the 2 preceding SUBPARAGRAPHS for receivables or work in process as of the EFFECTIVE DATE, such funds will be paid to the SELLER within 10 days of receipt. The event the SELLER directly receives such payments the SELLER shall immediately notify the FIRM of said collections and it will be deemed to have been paid by the FIRM to the SELLER.

(D) Should any CLIENT be over 30 days in arrears on current invoices from the FIRM, then 50 percent of collections from said CLIENT(s) shall be retained by the FIRM and applied against the oldest current invoices to the FIRM and the 50 percent balance shall be remitted to SELLER in reduction of the SELLER's debt from that CLIENT, as listed in (A) or (B) of this PARAGRAPH. Such division of collections on a per CLIENT basis shall continue until the account receivable from the CLIENT to the SELLER has been paid in full.

Let's Call the Whole Thing Off

Case Study: A Merger Gone Wrong

Consider the case of a $1 million firm and an $8 million firm that decided to get hitched. Each one believed the merger presented exciting opportunities for growth and cross-selling, overall operational effectiveness, and a better synergy of talent. They each gave up their own offices and relocated to a larger space.

Six months into the merger, things were not going well due to cultural and personality differences that the firms failed to anticipate. The firms decided to de-merge and return to their former arrangements. They had no de-merger agreement, but at first the process went pretty well. They quickly resolved that each firm would take back its original clients (which did, of course, involve breaking this news to the clients). Things became complicated when the larger firm wanted the smaller one to pay for new clients that the smaller firm had developed after the merger took place. Due to its reputation and the backup support it offered, the larger firm felt the smaller one would not have won these clients on its own.

Other problems exacerbated an already contentious situation. The larger firm now held the lease for the new office space but could not afford to pay the overhead. The smaller firm had given up many of its hard assets to make the move and now had nowhere to go. Further complicating matters, a few staff members wanted to switch firms and some clients seemed to want to do so too.

When all else fails, many firms find it is time to undo their union and head straight for a divorce. For that reason, many feel that de-merger agreements are a necessity in any deal. We are not fans of de-merger agreements or clauses because unwinding large mergers is challenging to say the least and it should be possible to avoid this situation with a well-planned transition plan. In addition, in our experience, a de-merger clause actually can make it more likely that a de-merger will take place! We have consulted on more than 850 transactions over the past 20 years. Of those, approximately 150 were pure mergers (not initiated to meet succession needs) and only 5 percent of those had a de-merger clause in their agreement. However, if firms are going to include a de-merger agreement, there are certain factors they should address, which are included in the sample de-merger clause in exhibit 7-3.

Exhibit 7-3: Sample De-merger Clause

De-merger agreements, which reflect the unique aspects of each situation, can range from one to five pages. The following example is an abbreviated version that covers the critical aspects of de-merger language. It is a compilation of several agreements that were written by attorneys. **CPAs should consult an attorney before writing or signing a de-merger agreement and remember that the authors rarely believe having one is advantageous.**

Sample De-merger Agreement

At any time up to XX/XX/XXXX (typically 1 to 2 years), upon 90 days written notice, which may not be delivered between November 1 and March 1, or at any other time that the FIRM and FIRM 2 mutually agree to terminate this AGREEMENT,

(A) Either Party may, by notice (the "NOTICE") delivered to the other Party, exercise their DE-MERGER OPTION, terminate the affiliation, and not be bound by the terms of this AGREEMENT except the provisions of this section.

(B) In the event the DE-MERGER OPTION is properly exercised, the following is true:

a. The clients listed on exhibit A (hereinafter CLIENTS) shall no longer be deemed clients of the FIRM and FIRM 2 may take such CLIENTS with them under no penalties or restrictions.

b. All other FIRM clients shall not be solicited or retained by FIRM 2.

c. In the event a CLIENT indicates a preference to remain with the FIRM, the FIRM shall reimburse FIRM 2 based on the terms _________ (list mutually agreeable terms here).

d. The outstanding accounts receivable and work in process of the CLIENTS shall remain assets of the FIRM.

e. A list of the outstanding accounts receivable for the CLIENTS as of the date of the de-merger (hereinafter DE-MERGER AR) and a list of the work in process for the CLIENTS as of the date of the de-merger (hereinafter DE-MERGER WIP) will be provided to FIRM 2 by the FIRM within 30 days subsequent to the date of the de-merger. Such lists shall include a statement signed by an authorized representative of the FIRM that the list is true, accurate, and complete.

f. FIRM 2 will complete any DE-MERGER WIP, invoice, and divide the collections derived from completion of such DE-MERGER WIP pro rata in accordance with the time each Party devoted to each such case.

g. Any collections received by the FIRM from CLIENTS subsequent to the date of the de-merger shall be considered to be collection of DE-MERGER AR and collection of DE-MERGER WIP for a specific CLIENT until the DE-MERGER AR and DE-MERGER WIP for such CLIENT is satisfied in full. Any collections made by FIRM 2 from the CLIENTS subsequent to the date of the de-merger shall be considered to be payment of DE-MERGER AR and DE-MERGER WIP due to the FIRM for a specific CLIENT as of the date of the de-merger until the DE-MERGER AR and DE-MERGER WIP for such CLIENT is satisfied in full. FIRM 2 shall remit to the FIRM any such collections within 30 days of such collection.

h. The collection of DE-MERGER AR and DE-MERGER WIP shall be considered COLLECTIONS and FIRM 2 shall be paid compensation related to such COLLECTIONS. Such compensation shall be paid to FIRM 2 by the FIRM on the 15th day of the month following the month of collection.

i. FIRM 2 shall have the right to take the specific assets contributed by them in exhibit B of this AGREEMENT.

j. FIRM 2 shall have the right to employ any employees of the FIRM that were employed by FIRM 2 prior to the EFFECTIVE DATE of this AGREEMENT (hereinafter PRIOR EMPLOYEES).

k. In the event an employee of the FIRM that is not a PRIOR EMPLOYEE indicates a preference to leave the FIRM and become employed by FIRM 2 and FIRM 2 elects to employ such employee (hereinafter LEAVING EMPLOYEE), FIRM 2 shall pay FIRM a fee equal to 20 percent of such LEAVING EMPLOYEE's annual base compensation in 12 equal monthly installments commencing on the 15th of the month following the month of NOTICE.

l. FIRM 2 shall have the right to sublet office space from the FIRM for i) a maximum of 6 months, or ii) through April 30 following the date of NOTICE in the event that NOTICE is delivered after June 30 of a calendar year. The office space shall consist of the offices and area used by any FIRM 2 members, PRIOR EMPLOYEES or LEAVING EMPLOYEES at the time of the de-merger. FIRM 2 will pay the FIRM rent based on what the FIRM pays the landlord per square foot for the office space utilized by FIRM 2 plus an additional 25 percent for additional services. Such additional services shall consist of the reasonable use of the software, furniture, fixtures, equipment, internet connectivity, telephone systems, and other such infrastructure necessary for the operation of an accounting office in same manner the FIRM is operating at the time of NOTICE.

(continued)

FIRM 2 shall also reimburse the FIRM for any direct out-of-pocket expenses incurred by the FIRM as a result of FIRM 2 continuing to operate in the offices of the FIRM.

Terms to Address

Each merger is unique and requires special considerations. De-merger agreements define the treatment of very specific issues if the marriage does not work. Among other things, a de-merger agreement or clause should stipulate a deadline on when a de-merger can take place, preferably no longer than two years after the merger and typically at the end of year 1. The longer that de-merger is an option, the harder it is to merge the firms into a cohesive team. Partners and associates of both firms are likely to protect their turf to maintain their viability if something should go wrong.

Protect Client Relationships

A primary objective of a de-merger plan should be to protect the original client relationships of each firm where possible. The first step is to identify each firm's clients and create restrictions that prohibit competition for those clients for an agreed upon time, up to several years. Client relationships can be assigned to each party by attaching lists of existing clients to the merger agreement on the merger date. Of course, sometimes clients are shifted to partners or staff of the other firm due to special expertise, pending partner retirement or capacity, or location considerations. Clients may also simply prefer to remain with the new firm instead of peeling off with their original firm in a de-merger. Rather than attempting to force the client to accept a solution that is not in his or her best interest, it is better for all parties if the firm losing the client sells the client to the firm retaining the relationship.

For example, Firm A, with a $2 million practice, merged with Firm B, which has a $1 million practice. A de-merger is triggered and, after sorting out all the clients that have shifted allegiance, Firm A retained $1.8 million in clients and Firm B retained $1.2 million. Firm B is now required to buy the $200,000 in clients it acquired based on an agreed-upon valuation formula. In this case, Firm B would typically agree to pay a premium, between 1.25 and 2 times, with little to no retention considerations for taking more than it brought into the merger. The premium ensures the firms have no incentive to steal each other's clients.

New Clients

The treatment of new clients developed after a merger is trickier. In a de-merger, it is best to allow clients developed and served by a partner of one firm to remain with that firm if they choose. Two basic approaches are used to assign value and determine compensation for new clients:

1. Assume the firm that retains the relationship has earned the value and, therefore, no compensation is required.
2. Assume new clients are shared pro rata and account for any disproportionate allocation (based on relative equity of the two firms) with an agreed upon valuation formula.

Sometimes a partner or associate in one firm develops a client relationship, but the client is assigned to someone from the other firm who retains the relationship after the de-merger. However, other times a client may elect to stay with the other firm due to its size, location, or other considerations.

Consider the example of Firm C and Firm D. In the merger, Firm C was assigned 60 percent of the equity. While the firms were together, $500,000 of new business was generated. After the de-merger, Firm D retains $300,000 of the new business. Given the $500,000 of new business, Firm D's 40 percent equity would actually qualify it to take $200,000 of that business. Because it is taking an additional $100,000 in new work, an allocation based on relative equity would require Firm D to compensate Firm C for $100,000 of that excess new business. This payment is typically structured based on retention and collections from the new clients going forward at a reasonable multiple (for example, 1 times their equity share).

Staff

Good staff is always at a premium. As a general rule, staff members should return to their original firms in the event of a de-merger, but their wishes should be considered. If one firm retains a disproportionate amount of staff following a de-merger, compensation similar to the fee paid a recruitment firm may be appropriate. The normal range of compensation should be 10 percent to 30 percent of annual salary and should be established in the de-merger agreement. Compensation creates capital for the affected firm to replace lost staff and is also a disincentive to recruit staff to switch firms.

Office Facilities and Infrastructure

When the two firms have not moved in together, each one remains in its space and goes on as before. For firms that are in a combined space, the provisions of a de-merger agreement should serve two purposes:

1. Allow both firms to continue to operate after the de-merger with as little disruption as possible.
2. Protect both firms from the commitment of long-term investments in infrastructure.

If the space that will be left unoccupied after a de-merger is not material to one firm, a three- to six-month transition period to find and equip new space for the smaller firm is normally adequate. If a material amount of space will be left unoccupied, the agreement should allow for subdivision of the space, and each firm then assumes its share of the cost going forward until other arrangements can be made.

Similar arrangements must be made for computer networks, telecommunication systems, and other shared infrastructure. Agreements often allow for a transition period in which the firms continue to share the systems and, in some cases, sharing the cost of a new system for one firm built into the agreement as well.

When a De-merger Clause Is Definitely Not Appropriate

Client relationships usually make up the bulk of an accounting firm's intangible value. When one firm is buying the equity of another, a transfer of client relationships typically takes place. Once the client relationships have been transferred, it is difficult to reverse that step. If it is expected that client relationships will transition soon after the affiliation, it is not advisable to allow one firm to use a de-merger clause to back out of the agreement. The only way for the original seller to mitigate the risk that the acquiring firm would exercise its right to de-merge is to delay the client transition process, but doing so will undermine the merger and defeat its purpose. A de-merger clause in a merger that is essentially a near-term acquisition creates the risk that either firm has the option to make one deal today and pursue a better deal tomorrow. The buyer has made significant investments in new infrastructure, deal costs, and marketing. If the seller finds a better deal and exercises its right to de-merge, the investment will be lost. Conversely, the buyer may threaten to de-merge to negotiate a better deal even after buyout terms have been set in the merger agreement.

Keep in Mind

If it is expected that client relationships will transition soon after the affiliation, it is not advisable to allow one firm to use a de-merger clause to back out of the agreement.

When the risk of irreparable harm from a de-merger is significant for some but not all the partners in one or both firms, a de-merger option that applies to only some partners may be appropriate.

Partial De-mergers

De-merger clauses sometimes allow one partner to leave the combined firm during an agreed upon period even if the rest of the partners will remain. That partner may be allowed to take clients whose volume is equal to the partner's equity interest in the firm. If the volume of clients is less than his or her pro rata share, compensation may be provided for the shortfall. If it exceeds the pro rata share, compensation should be paid, often at a premium, to what is considered market value. This discourages aggressive recruiting of clients by the departing partner.

Another popular approach is to prohibit partners that leave from taking any clients. In these cases, a buyout of their equity is probably appropriate. The downside risk of this solution might be significant enough to some partners to preclude undertaking a merger in the first place.

Merger Costs

In almost every merger, one or both firms incur closing costs that include but are not limited to legal fees, moving expenses, technology investment, consulting and brokerage fees, leasehold improvements, and furniture and equipment. Often, one firm (usually the larger if there is a substantial difference in size) bears most or all of these costs. However, a de-merger clause may require a retroactive allocation of the costs to both firms. This is a fair solution and may discourage one firm from triggering a de-merger without good cause.

Combination Affiliations

Normally in a merger, equity in one of the firms or in a newly formed firm is issued to the partners of one or both of the firms. When one firm purchases another, it might acquire the value of that firm for consideration rather than issuing equity. This happened when Firm A merged with Firm B. Firm B had four partners. In the merger, Firm A bought out two partners of Firm B, with the remaining partners merging into Firm A receiving equity in the firm. In cases involving a combination of a purchase and an issuance of equity, a de-merger clause may be applied when the equity being acquired through purchase is not substantial. If the purpose of the merger includes succession within approximately five or fewer years after the deal, a de-merger clause would not be appropriate.

Action Agenda

- Review the partnership agreement to determine whether its policies and provisions will support a sound transition.
- Before and certainly during merger planning, consider how the following factors could hinder success. Determine how each firm can address the issues to ensure an easier transition:
  - Problems with the four Cs: chemistry, continuity, capacity, and culture
  - Merging for the wrong reasons
  - Poor deal structure
  - Differences in overhead and profitability
  - Equity
  - Billing rates
  - Differences in the client experience
  - Differences in QC systems
  - A failure to communicate
  - Ego
  - Timing
- In a merger or a sale, give thought in advance to how accounts receivable and WIP will be handled.
- If a de-merger is called for, issues to consider include the following:
  - Client relationships, including to whom they are assigned and what kind of compensation will be given for clients who choose to switch firms
  - The determination of value and compensation for new clients
  - Staff, including compensation for those who switch firms
  - Responsibility for office facilities and infrastructure expenses and merger-related costs

Chapter 8
The Power of a Practice Continuation Agreement

We have talked in detail so far about preparing for an expected transition to new owners or new leadership. In this chapter, we will discuss steps that sole practitioners—and partners in some very small firms—can take to address the unexpected so that they ensure a workable transition, and the firm's very survival, in case of illness, disability, death, or any other crisis that prevents the firm's leader from continuing to work. Each one can be devastating for the CPA's clients, family, and employees, but proper preparation using some powerful planning options can mitigate the consequences.

The key tool is a practice continuation agreement (PCA), which is a contract between a practitioner (or firm) and another CPA firm or trusted employee to take over a practice permanently or temporarily depending on the circumstances. Although they can be vital to maintaining value in the event of an emergency, only 6 percent of sole practitioners have them, according to the 2012 PCPS Succession Survey.

This chapter will spell out the many reasons that it makes good sense to have one, and what you need to know to create the most effective PCA for your firm.

PCAs identify the terms and conditions for the takeover. (See the sample agreement in appendix C.) The core elements of a formal PCA include the following:

- A definition of the circumstances that will trigger the activation of assistance, as well as definition of permanent disability, temporary disability, or leave of absence
- The financial terms for the assistance process or the purchase of the practice in the event of the death or permanent disability
- Noncompete and restrictive covenant provisions for the period of coverage and subsequent to the coverage relative to clients and staff
- Details on the specific professional responsibilities that the successor firm will cover and agreement termination terms
- Billing and collection protocols and procedures to be followed during the coverage period
- Record retention and return of record provisions
- Requirements for notification of activation of coverage and transfer back of the practice
- Identification of an approved agent to act on behalf of the CPA requiring coverage
- Staff and client retention obligations

The agreement should identify not only a permanent replacement but also a temporary one. If an owner is expected to miss an extended period, he or she must know that the PCA partner can step in and keep his or her ship sailing. PCAs are not substitutes for disability or life insurance but are considered supplementary to them.

Why PCAs Matter

Let's consider a situation that demonstrates the value of a PCA. Tom, a 48-year-old CPA, has a solo practice with one employee and a part-timer. He is married, and the practice is the couple's largest asset. In June, he is involved in a serious car accident that leaves him in a temporary coma with serious injuries that will require lengthy rehabilitation.

The summer is a relatively quiet time of year for the practice. However, Tom's staff are not accustomed to dealing with clients and do not have the expertise necessary to carry out all client services. The clients are very sympathetic to Tom's plight, but Sarah, his wife, knows that they might start turning elsewhere for help soon. After several days of panic and uncertainty, she reaches out to the local state CPA society chapter for help. Through their contacts, she is able to arrange for a larger CPA firm in the area to take over the practice until Tom can get back to work, nearly a year later. The firm carries on Tom's services, makes temporary consulting agreements with his staff, and passes on some of the fees received to Sarah.

When Tom comes back to work, he is able to slowly rebuild his business, although his revenues never approach their previous level. Some of his clients have moved on, either because they already had another attractive alternative or because they were not completely satisfied with the larger firm. Sarah was under the gun when choosing the successor firm, so she was forced to pick one whose services did not fully match those that Tom offered and whose client service approach was more impersonal. Tom has also lost his trusted long-time employee, who jumped to another small practice because she was unhappy at the larger firm and uncertain when, and if, Tom would come back to work. As a result, he has his hands full just keeping the practice going and does not have much time or energy for practice development.

Keep in Mind

When a practitioner dies, the practice can start losing clients within days. It is not unusual for a practice to lose 25 percent or more of its clients within 30 to 60 days, depending on who is left to continue providing services.

This is actually a relatively positive scenario because the practice does survive and Tom's family does receive some economic benefit from the practice while he is incapacitated. It was also fortunate that the accident took place in June rather than just before or during busy season. However, lack of a plan clearly took a toll on Tom's family and on his practice.

As we have stressed in earlier chapters, the value of a firm, particularly a very small one, is essentially its client list. However, when clients become aware of a disruption in service, and they are uncertain when that service will be resumed, they quickly begin to go elsewhere, taking the value of the firm with them. When a practitioner dies, the practice can start losing clients within days. It is not unusual for a practice to lose 25 percent or more of its clients within 30 to 60 days, depending on who is left to continue providing services. That means that the practitioner's family will quickly lose the fees they have depended on as income and the overall value of a practice that represents their greatest asset. For every sole practitioner and partner in a small firm whose illness or death would disrupt either the firm's services or their family's income, a PCA is a must.

An Exit Strategy

Many smaller practitioners may have a retirement strategy based on either closing their doors, selling to another firm, or passing the practice on to an employee. Think of a PCA as an exit strategy in case you need one before retirement. It is an insurance policy that covers the health of your practice if an abrupt change in leadership is required. We have talked in earlier chapters about the importance of taking the proper amount of time to transition clients and staff before retirement so that you can iron out the many details that go into a proper succession. If transition time is insufficient, the results can be disastrous. The same is true for a PCA, which anticipates a sudden disruption in firm leadership and establishes how it will be addressed. (See exhibit 8-1 for a PCA Implementation Checklist.)

Exhibit 8-1: Practice Continuation Agreement Implementation Checklist

The worst has happened: A CPA has either suffered a short- or long-term disability that will prevent him or her from working or has died. When it is time to put the practice continuation agreement to work, what steps will the successor firm have to take?

1. Access all operating, contact, or other critical information as soon as possible. The successor or the CPA's agent should have keys, passwords, and other access requirements ready.
2. Access the full client list as soon as possible. Identify the most important clients, those for which services are currently in process, and those that have pending engagements.
3. If the practitioner has staff, identify which staff has relationships with which clients. If they appear to be capable of continuing to manage those relationships at least on an interim basis, it may be best to continue to involve them in communicating with the clients and overseeing the engagements. This will go a long way toward maintaining continuity for the clients.
4. If there is no staff or they do not appear capable of managing the relationship, determine who in your organization will be assigned the responsibility for each client that needs immediate attention.
5. Announce to clients and staff that you will be helping out the firm while the owner recovers or, in the event of death or permanent

disability, that you and the firm have a prearranged agreement for you to take over in such an event, and as a result your firm is familiar with the client needs and history and will be assuming the practice and operating under the same fee structure, providing the same services and otherwise carrying on as before. If you can, make sure each client knows who his or her go-to person is now. This can be changed as necessary in the near future. If an announcement letter is coming from your firm, consider mailing it using the former firm's envelopes and your letterhead. If the letter is being sent by the practitioner's family or agent, use the former firm's letterhead.

6. Be prepared to request extensions where possible to provide adequate time to get up to speed.
7. If the firm you are taking over for uses engagement letters, consider whether you need a new engagement letter between your firm and the client for those engagements because your firm will be the one providing the service. Although this creates some extra work, it should help to lock in the client relationships with your firm.
8. Consider operating both software systems if they are different until the crisis is over or, in the event of a death, until a smooth transition to the successor firm has been finalized.
9. Sort out how and where staff from the affected firm will work and what will be done with the firm's office. You may need to obtain employment agreements between the staff and your firm, if you use them. If you are only temporarily taking over for a practitioner, you may be better off contracting with the practitioner's entity for the use of the staff and not hiring them directly.
10. Many successor firms have found it helpful to maintain the phone numbers and the website of the previous practitioner for some time after the transition. Of course, the former firm's clients should be encouraged to call your phone number. If you answer the previous phone number generically as "accounting office," you have the opportunity to explain the change to any callers. If the call is being placed to the former firm, and you answer it with your firm name, you may not have the opportunity to explain why they are not reaching the intended firm. The former firm's website should also include a full explanation of the change and refer the reader to your website.

What Is in a PCA?

Let's take a closer look at some of the core elements of a PCA.

The Triggering Events

The agreement must establish the circumstances in which it will go into effect. Among other things, it should define temporary disability versus permanent disability. Temporary disability usually means the CPA will return to take over the practice once again, and permanent disability generally indicates the CPA will sell the practice to a successor. Temporary disability is usually defined as being unable to work in the practice between 90 days and 1 year. The longer the time period that the PCA allows, the more flexibility the CPA will have to return. This comes at a cost, though. The longer the temporary disability period, the longer that the CPA leaves clients, staff, and the successor firm in limbo. This can lead to client and staff attrition and a loss in value.

The PCA must also define when a temporary disability becomes a permanent disability and how to handle death and permanent disability. Once the owner is deemed permanently disabled or dies, the PCA should indicate the next step. In most situations, there is a buyout made by the PCA partner with the former owner or the deceased owner's estate. This is typically a purchase price predicated on collections (for example, payments based on 20 percent of the gross collections over the subsequent 5 years as billed and collected) because having a fixed price when there is not time for an appropriate transition is the not best approach. Assuming a successor firm would even accept a fixed price at all, it is likely to place such a large discount on the value that the selling owner would probably be much better off having the value determined by the actual subsequent results applied to a full market based multiple. Sometimes a practitioner enters into a PCA with someone who will only cover the practice for a temporary disability and, in the event of death or permanent disability, becomes the agent representing the former owner or the deceased owner's estate and sells the practice.

In the case of multipartner firms, the owner agreement should act as the PCA. However, if the firm does not have an owner agreement, the owners should consider putting a PCA in place to dictate how they will take over for each other in the event of a sudden need. When the owners are not confident they can take over for each other, possibly due to a lack of capacity, or when they have no desire to do so, it may be appropriate to execute a PCA with another firm.

We will offer some cautions about using a PCA as a retirement vehicle later in this chapter, but if retirement will be included as a triggering event, the PCA must address the circumstances and notice required for turning over the practice to the successor. The longer the notice, the better prepared the successor will be to take on the practice. At least one year is recommended and two years' notice is ideal.

Compensation Terms

There is usually no payment to a successor for setting up a PCA, but the sole practitioner must agree to terms that will make it worth the successor's while. If the successor firm is not properly compensated for maintaining or taking on the firm, it may not properly commit to the type of service necessary to retain clients. As we have discussed, compensation to the successor may include pay based on collections received, chargeable hours (frequently at a small discount), or another similar measure.

If the CPA is temporarily disabled, he or she can pay the successor firm to manage the practice, in which case it is conducted under the CPA's name and in his or her entity. It is more likely, though, that the successor firm will want to manage the client relationships as part of its own practice, in which case it pays for the privilege of working with the clients. Either way, the successor firm must earn enough to remain motivated to do a good job. The successor firm should retain anywhere from 67 percent to 90 percent of the billings to the disabled CPA's clients. In some agreements, the successor firm is paid a portion of its standard billing rates and, if there is anything left over, the disabled CPA keeps the excess. A sole practitioner's goal in setting terms for temporary disability is to make sure there is a practice left to return to. CPAs who will need income during that period should consider also obtaining disability insurance.

The terms of the PCA will establish that once the CPA becomes permanently disabled or dies, there will be a sale of the practice. CPAs should expect compensation to generally match what they would normally receive in a sale, with the following additional considerations:

- Because the event is probably going to be unexpected, the successor firm will be obligated to buy the practice from the estate and its costs to execute the plan will be higher than in a normal sale. As a result, the price may be lower than if there had been an orderly search for a buyer. This is somewhat in line with the difference between an external sale, which is the result of a bidding or auction process, and an internal sale, which normally obligates one party to buy out the other party, as is discussed in chapter 5.

- The successor firm will likely be unwilling to pay much up front at closing. Most deals allow the CPA's estate to retain tangible equity (accounts receivable, work in process, and cash), which the buyer will have to replace just as it would in a normal sale.
- It is highly likely the proceeds will be contingent on postsale retention of clients and fees, because the buyer cannot be assured there has been enough time to conduct a proper transition of relationships.

Restrictive Covenants

To enable the successor firm to jump in quickly and easily, you should provide them with a client list at least annually, which means that you are disclosing confidential information to a potential competitor. As a result, the PCA should include a restrictive covenant precluding the successor firm from soliciting those clients.

You should also expect the agreement to include a restrictive covenant that prevents you from taking back any clients if you sell the practice to them.

YOUR PCA PARTNER: A TRUSTED INTERNAL EMPLOYEE

Who should you choose to take over your firm in the case of your death or disability? Some sole owners may believe that one or more trusted employees are the best successors for their practice. They are familiar with the practice's procedures, very likely know the clients, and have taken part in providing services. Neither clients nor staff are forced to work with different professionals, perhaps in another location and with a unfamiliar approach to client service. This can be a particularly expedient choice in the case of temporary disability, when the main goal is to maintain the practice and keep it intact and thriving until the CPA can return.

With any plan that anticipates trusted employees taking over, especially in the case of death or permanent disability, a solo or small multipartner firm might have mixed results with an internal succession. The lack of disruption is certainly an advantage. Offering a leadership role down the road can also help retain a valuable staff member. However, the internal person may be thrust into a role for which he or she is not adequately prepared. The new leader may not have the same level of management or technical experience as the deceased or disabled partner, leading to a rocky and perhaps unsuccessful transition. In a solo practice, this could mean a diminution of value for the

CPA or his or her estate. In a small firm, it could force the remaining partners either to spend a great deal of time bringing the new owner up to speed in a hurry or to seek merger opportunities under duress.

We noted in chapter 3 the importance of preparing staff for eventual leadership roles. If you want to turn the practice over to a trusted employee, it is a good idea to allow him or her to take on a leadership role before he or she becomes your PCA partner as well. This will help prepare the employee for his or her responsibilities or make it clear to you that an external solution is best.

YOUR PCA PARTNER: A SUCCESSOR FIRM

Contracting with a successor firm to be a PCA partner can inspire a measure of confidence because of the likelihood that a firm will offer reliable technical and leadership abilities and some financial stability. In general, a good candidate to buy your firm or for you to merge into will also most likely be a good candidate for a PCA.

Some firms that actively seek acquisitions of sole practitioners as a means of spurring their own growth use PCAs as a preliminary step in establishing a relationship that they hope will eventually lead to a permanent combination of the firms.

Practitioners must conduct proper due diligence of a firm with which they are considering entering into a PCA to ensure that they choose the right successor. Key considerations would normally include the following:

- Technical and professional compatibility
- Billing rates and philosophies
- Capacity to handle the required work and supervise personnel
- Areas of expertise and competency
- Employee turnover
- Client turnover
- Financial commitment
- Partner demographics
- Overall reputation

Let's take a look at a few of these issues.

Capacity

The successor firm's capacity to take on your practice is an important issue. PCAs are rarely established as a reciprocal relationship in which two parties cover the other. A critical criterion for a firm that will be a PCA partner is that it has the excess capacity to take on the workload of the firm that has suffered a catastrophe. Unless both firms are small ones with substantial excess capacity, it is not typical that the two parties entering a PCA will be able to make it reciprocal.

Keep in Mind

PCAs are rarely established as a reciprocal relationship in which two parties cover the other.

Consider a sole proprietor with a $200,000 practice. The practice has one clerical staff person, but the CPA does most of the client work himself. Could that practitioner suddenly take on another sole proprietor's practice of similar size operated in a similar fashion? Probably not, and for that reason, doing a PCA with a similar size firm is often risky. Most well-run firms do not routinely carry the excess capacity necessary to absorb any practice without some additional resources. Key questions to consider include the following:

- Does the firm have the resources to cover your capacity or the ability to acquire them?
- Does the firm have partners who can and will take on the responsibilities for running the practice and managing client relationships?
- How much time is mandatory for the role of partner, and how much responsibility can be passed down in a larger firm with more levels of talent?

Client Service Approach

In previous chapters, we have talked about the importance of making the succession transition seamless for clients, and the same factors must be considered when choosing a successor firm in a PCA. If clients are used to meeting in person at your office or at their location, they likely will not be happy if the successor firm's practice is to mail them the work and offer little or no face time. Client retention is just as important in a PCA transition as it is in retirement succession. If clients go elsewhere because they're unhappy with the successor firm, you or your family will lose the fees and the business value associated with them. This will also be the case if the successor firm does not offer all of the same services that your firm does.

Service Pricing

What will the successor firm charge clients for the services you offer them? The key is not necessarily always comparable billing rates per se, but total fees. Clients will be lost if your business clients pay $2,000 per year for services and the successor firm would normally charge $5,000 for similar services.

Expertise

The successor firm must service the same niches and have the same special expertise or licenses, if any, that your firm has.

Partner Demographics

Because of the baby boom, succession issues are a concern for almost all firms. If the successor firm is facing a looming challenge in servicing clients due to the pending departure of several older partners, it may not be able to effectively service your own clients.

Culture or Chemistry

The importance of good chemistry or culture was discussed in chapter 3, but they are just as critical in a PCA. The following is a review of the high points:

- If you do not enjoy being around the partners in the successor firm, your clients and staff won't either.
- You should be comfortable in the successor firm's offices. If their staff and partners are required to wear suits every day and your culture allows for casual attire, will your staff and clients feel at home with them?
- How large are the books of business the partners manage? A CPA who manages $250,000 of business probably has a very hands-on approach. If the successor firm partners manage on average $1.5 million, clients will likely have a very different experience, with either a less personal approach or nonpartners standing in for you.

- Are the expected work hours of the two firms compatible? If your staff is not expected to work much overtime even during tax season, will they assimilate to a culture where staff must work 80 hours per week?

You cannot realistically expect the cultures of the two firms to match perfectly, so staff and clients will have to tolerate some change. However, the further apart the two firms are, the greater the challenges to staff and client retention. Client attrition usually leads to loss of value and staff attrition often leads to loss of clients.

Do Not Overlook the Small Stuff

PCAs can be very comprehensive and effective. In addition to the core elements we have discussed, success will require other steps that are sometimes forgotten but that will make it easier for the successor to keep the practice running. Important details that should not be overlooked include the following:

- The sole owner or small multipartner firm should have a policy and procedures manual that is updated annually and reviewed by the parties to the PCA. In the absence of a manual, the successor must have access to critical information, such as the practitioner's codes, passwords, and security procedures. If the successor and the CPA's family cannot gain access to the sole owner's laptop because they do not know the password, crucial days and information may be lost.
- The CPA should identify an agent who will transfer the passwords and other key information only as authorized by the agreement. This person must receive any updates to the PCA.
- We also suggest that the CPA and the successor perform an annual review of the client lists (especially large ones), the location of important files and equipment, and other vital information so that, when an emergency does occur, the successor can get up to speed quickly.

Why a PCA Is Not a Good Retirement Vehicle

Unless your planned transition from the practice is imminent, a PCA is a poor substitute for a succession plan. It should be viewed as a worst case insurance policy for the practice that is suitable only in unexpected circumstances. Why? For one thing, the financial and other terms you set today may not be the right terms years from now. Your firm and the successor firm may also change over time, which means a PCA partner that was a great match when you were in your 40s may be a bad fit when you are in your 60s.

Keep in Mind

A PCA should be viewed as a worst case insurance policy for the practice that is suitable only in unexpected circumstances.

In addition, you may be able to do a lot better with a proper sale of the firm. When you are ready to pursue a transition due to your pending retirement, you will likely do best if you consider more than one firm as a possible successor firm. A PCA is normally an agreement with only one firm.

Finally, successor firms that are prepared to take on a new practice are better able to integrate that practice. An acquisition can result in significant growth for the firm and can strain any firm's resources. This may be necessary in an emergency, such as disability or death, but it is not the optimal strategy in a retirement transition. A PCA can help you get the best result out of a bad situation. Negotiating a separate deal with a successor firm for a planned transition of your practice when you are closer to retirement allows both firms to benefit from the agreement.

Plan for the Business of Transition

Keeping clients happy is the key to a successful practice. It should be very reassuring for them to know that their trusted adviser has selected a particular professional or professional organization to take over, but they will make their own decisions about whether the new arrangement is the right fit, based on many elements. Communication and organization of any transition are crucial factors. (See appendix D for sample announcement letters.) That is why it is a good idea to develop a business plan for both a temporary and a permanent takeover when the PCA is drafted. It will help the parties understand all the issues to be addressed and properly plan for them. A key part of the plan is the details for notification to clients and referral sources. The worst time to craft these announcements is during a crisis. Whether the announcement of the implementation of a PCA is done by a letter, a phone call, or in person, the key to its effectiveness is to remember that clients fear change. You do not have the benefit of the practitioner's continuing involvement, so the announcement should mention as many things as possible that will remain the same, such as the fee structure, the staff being retained, the services that will be continue to be offered, and, if you can say so, delivered in the same manner and the office location. If possible, let clients know exactly whom to contact if they have questions, and ideally the communication should be from that person. If some change is necessary, such as a new office location, be clear about that. Make sure the client knows how to contact people at the new firm (phone numbers, website, e-mail addresses).

The best way to first communicate with a client is actually in person or by phone, but timeliness is also critical because this kind of news tends to travel fast. Choose the largest and most important clients first and try to have a personal conversation with them. Go that route with as many clients as possible. Make sure everyone gets some form of communication within a few days if you can. If you have to follow up a letter with a phone call, do so. Share the script for meetings and calls and the announcement letters with the staff so that they are giving the same message as the partners about what the announcement will mean for clients. Staff must also be informed of continuity, their roles under the arrangement, compensation, and any other information necessary to put them at ease. Do not assume the staff will know what to expect. Do not even assume that they will know they will be retained. Tell them clearly what the change means for them. Promote the change as being the result of an unfortunate turn of events that should lead to a future for them that is at least as bright as it was with their old firm.

The business plan should be reviewed at least annually and made a part of the periodic confirmation of the agreement. Other items in the business plan should include, but not be limited to, the following:

- Handling of billings, collections, work processing, and governance
- How staff will be notified, paid, and retained
- Payment of bills
- Details on day-to-day operations

Planning for Leadership Interruption

There is great merit to planning for a leadership interruption in your practice. Once you finalize a PCA, remember that much can happen between the time it is executed and ultimately put into effect, including changes in the overall economy, the local marketplace, and the situations of both parties to the deal. It may be difficult for family members or the CPA's executor or assigned agent to measure issues such as technical competency, client service approaches, or capacity, especially at a stressful and emotional time. For that reason, PCAs often provide for an annual confirmation of the conditions and commitment to minimize any risk at activation. This makes it possible to ensure your plans are up-to-date and will work effectively to protect your practice and your family if the PCA is ever needed.

ACTION AGENDA

Sole practitioners and partners in very small firms can use PCAs to address how clients will be served and how the firm will be managed in case of a practitioner's death or disability:

- If your firm does not have a PCA, consider possible PCA partners.
- If your choice is a staff member, consider the following:
  - Will this person be able to cover your responsibilities and his or hers? If not, are there reliable part-time options available to help?
  - Does the person have the technical skills to cover your responsibilities?
  - Does the person have the management expertise to run the firm?
  - If he or she is not suited to take over the firm on a long-term basis, would he or she be an option in the case of temporary disability?
- If your choice is a successor firm, consider the following:
  - Does the firm have the capacity and expertise needed to service your clients?
  - Does its client service approach match your own?
  - Does it have a similar culture and staffing approach?
  - Are its fees comparable?
- With your chosen successor, perform a semiannual review of client lists and other critical information.
- Develop a business plan for a temporary or permanent takeover and review it at least annually.
- Create a policies and procedures manual that a successor can use in an emergency.
- Appoint an agent to represent you during the transition to a temporary or permanent takeover. Ensure that he or she knows critical access codes and passwords.

CHAPTER 9

The Keys to Due Diligence

The due diligence phase of a deal pulls together much of the advice and observations we have made throughout this book into a formalized process. This chapter will define precisely what this phase entails, offer some insights on the steps involved and what they should encompass, and consider the process from the perspectives of both buyer and seller. It will examine the objectives for each side and how to respond to the findings. Appendix E contains both a summary and a comprehensive due diligence checklist, as well as an abbreviated version that many buyers use for succession deals that are 100 percent based on collections postclosing. The checklists in appendix E also serve as the action agenda for this chapter and are written to be used by the buyer or successor firm in a deal, but sellers or firms that will merge upstream can also use many of their steps as part of their own due diligence efforts and to anticipate the requests they will receive from the other party. Although due diligence is usually expected in a deal between two parties, much of the information discussed here would be valid for an internal successor, as well.

LAYING THE GROUNDWORK

Due diligence should involve a comprehensive effort, which means that it should not be undertaken until both parties are certain that the deal has a reasonable chance of satisfying their goals and succeeding. That means that both firms will

- have a nonbinding offer that was accepted by both parties.
- determine that they are compatible based, among other things, on an assessment of the chemistry, continuity, culture, and capacity involved, as discussed in chapter 3.
- establish a viable business plan for the merger. The business plan covers all of the logistics of the transition and the steps that ensure it will be viable. Those steps will be covered in detail in chapter 10.
- review basic financial and practice information.
- consider partner issues, such as compensation methodologies, career goals, demographics, and partner agreement terms.

The firms should discuss details at this level in no more than three meetings, and often in as few as two to prevent wasting time in discussions or performing due diligence for a deal with poor prospects. In addition, it is best to keep the deal under wraps until both sides have a chance to frame communications about it. The longer the process takes, the more likely people outside the inner circle will find out about it.

WHAT IS DUE DILIGENCE?

Due diligence is an investigation undertaken to assess the business and financial risks associated with a business transaction. In this chapter, we expand that definition to include liability and exposure issues, as well. When it is undertaken during an accounting firm merger or acquisition, due diligence is the discovery of pertinent information, including metrics, to ensure the proposed affiliation has the best chances of realizing the two parties' financial, professional, and other objectives. The evaluation should be tailored to the unique objectives of each transaction and each party to it. At the most basic level, for instance, buyers want to retain clients and staff and maintain or increase fee volume. Sellers want to be sure they are paid fairly for their ownership interest.

Keep in Mind

Due diligence is the discovery of pertinent information to ensure the proposed affiliation has the best chances of realizing the two parties' financial, professional, and other objectives.

The business plan often is a crucial element for buyers and successor firms and too often gets the least attention. It is critical to use the due diligence process to spot pitfalls in the business plan that can stand in the way of success. Success may be measured in many ways, but typically will include items such as client or staff retention, profitability of the book of business acquired, and potential growth spurred by the merger or a stronger, more multifaceted organization.

Building a business plan for a merger or acquisition generally includes gathering data and obtaining assertions from the other party, then making assumptions about the transaction outcome based on that data to develop expectations for a successful outcome. Due diligence involves gathering additional data and verifying assertions (such as the volume of the firm or its profitability) to validate those assumptions. Due diligence generally focuses on five categories:

- Financial issues
- Professional matters
- Business plan assumptions
- Legal concerns
- The final contract controlling the deal

TIMING: WHEN SHOULD THE DUE DILIGENCE REVIEW BEGIN?

Due diligence starts as soon as you identify a potential merger partner or acquisition candidate. Practitioners should immediately begin obtaining information about the clients it serves, its billing rates or fees, its size and locations, and the services it provides (see the Summary Due Diligence Checklist in appendix E). Later, the parties will perform field due diligence, which involves requests for data such as historical financial statements and tax returns, contractual information on leases and employment agreements, professional documents such as workpaper files and peer review reports, and operational data such as time records and employee manuals (see the Comprehensive Due Diligence Checklist in appendix E).

We often see firms attempting to perform field due diligence far too early in the process. Some schedule a robust review of workpaper files and detailed financial information right after the first meeting. There are several reasons why this is a bad idea:

- The process is extremely invasive. The other party may not be willing to undergo an inspection before confirming that the transaction seems workable and worthwhile. Their resistance could lead to a breakdown in the process and an opportunity missed.
- The information disclosed in field due diligence is very sensitive and confidential. Although the two parties will likely have a confidentiality agreement, there is still some risk the information will be inappropriately disclosed. That risk may not be worth taking without a strong commitment to the transaction, which may not yet exist.
- It is hard to do field due diligence quietly. Both parties' professional and administrative staff may become aware of what is going on, which can lead to rumors of a pending transaction long before you would like to release that information. This can easily lead to leaks into the community and may result in the loss of staff and clients. Competitors may use those rumors to discredit the two firms' viability, especially the seller's.
- There is a significant amount of time involved, which will be wasted if the deal never materializes.
- Mergers and acquisitions have a better chance of success if they have a lot of momentum. Slowdowns early in the process can hinder that momentum.

The best time for field due diligence is generally after the parties have at least verbally agreed to the basic general terms and have a lot of enthusiasm for the deal. That enthusiasm is hard to generate early before the parties have identified the upside potential.

Preliminary Versus Field Due Diligence

In an initial basic agreement, the description of the terms of the deal can be covered in a nonbinding memorandum, letter, or term sheet. Because field due diligence has not happened yet, what information should firms have at that point?

Even before a first meeting, each party should review information about the other firm that is available on their website, plus some basic details such as fee volume and number of partners and staff. Normally, a firm that seeks a preliminary meeting will be willing to provide that information. Before or at the first meeting each party should find out the following:

- The number of clients served, broken down into categories such as business versus personal or monthly or quarterly versus annual.
- How clients are served. What percentages are served in the firm office, drop off or mail in information, or are served in clients' offices? This will provide context on the level of service clients expect, the efficiency of current service delivery, and the importance of location to the clients. If a majority of clients are used to dropping by their local CPA's office, shutting down that location may result in client losses.
- Major client concentrations based on industry and annual fees. For instance, do specific clients make up more than 10 percent of their fees? Does the firm focus on certain industries?
- A breakdown of service areas, such as attest, tax, accounting or write-up, and consulting.
- Staffing information, including how many at each level, the range of compensation, and billing rates for each level.
- Information about partners, including range of billing rates and their career intentions. For instance, how many partners want to retire or substantially reduce their time commitment in the next five years? Can they be replaced from within?
- If office locations are likely to be an issue, basic lease information for major offices, including capacity and expiration.
- Profit margin (net income before partner compensation and benefits).

The preliminary meetings should also reveal the type of transaction each party is seeking and why. What are their objectives? If the seller wants an upstream merger, what are their goals? Do they seek more backup and support than they can provide on their own? Do they have partners seeking succession who cannot be replaced internally? Are they seeking to grow by hitching their wagon to a firm that can provide more resources to their clients and prospects? What does success look like?

The seller might consider why the other firm is seeking to merge the firm into their own. Do they want to improve profitability through growth? Do they want to enhance their market positioning? Are they looking to establish a presence in your market, add talent or expertise to their bench, or strengthen their own internal succession team? Are they looking for more clients to cross-sell specialty services?

Firms that are not going to be the successor firm in particular should understand that firm's business plan for the combined operations. How will they deal with transitioning clients to new partners and staff? Will the merged-in firm's office location be maintained and for how long? What kinds of changes in operations, IT, fees, and services can be expected, and how soon will they occur? Will your staff be retained?

Finding out the answer to all of those questions is part of the due diligence process. If both parties have answers, they are well positioned to discuss, create, and evaluate a nonbinding description of deal terms. If those terms are mutually agreeable, the parties can perform the full field due diligence before completing the deal. During field due diligence, they can obtain additional information and verify all of the data they have been provided.

Protecting Proprietary Information

Before undertaking field due diligence, firms should consider executing a mutual nondisclosure or confidentiality agreement (NDA). Sometimes an NDA is signed before any meetings are even held, although postponing this step may make for a more amicable beginning. (See the Sample Confidentiality and Nondisclosure Agreement in appendix E).

Even if the firms sign an NDA early in the process, they might consider signing a new, more comprehensive and robust agreement before undertaking field due diligence. Field due diligence will involve disclosing specific client information, detailed employee and partner data, and extensive financial information. To ensure that the other party does not use what is revealed to compete against you, you might consider two general types of agreements:

- *Confidentiality or nondisclosure*. This agreement protects information about clients, staff, partners, operating procedures, and any other confidential information, including the fact that the firm is even contemplating a transaction.
- *Noncompete*. Many NDAs contain a restriction on using the information disclosed to compete against you. One simple restriction is a general agreement preventing a firm from using what it learns for its own benefit. If the other party finds out the name of your firm's clients, its partners could not approach them to solicit business. A more forceful version would actually restrict the other party from accepting any of your clients or staff for 1 to 2 years. Some will include penalties for violating the restrictive covenant, such as 150 percent to 200 percent of the prior year's fees of the stolen client. Even if a staff person asked the other party for a job, the firm could not hire him or her or may

only do so by paying a penalty, such as 25 percent of the annual salary of the worker. Restrictions this significant are hard to obtain and are much more likely to be acceptable to both parties as a part of a letter of intent that contains the specific contract terms to be included in the final agreements. Remember that a noncompete clause with no duration would not likely be enforceable, so it is important to set a reasonable time frame for this restriction. The practicality of restrictions based on geographic limits may vary based on location. For example, a restriction set on clients within a 30-mile radius of the firm may be impractical in Manhattan, where 3 states are potentially involved, but it may be more workable in a more remote location.

Conducting Field Due Diligence

The process for conducting due diligence will vary based on

- whether you are the buyer or seller in an acquisition.
- whether you are the successor firm or the acquired firm in a merger.
- the terms of the transaction.

For both buyer and seller, the general areas of the firm's operations to review include the following:

- Financial
- Personnel
- Clients and services
- Quality control (QC) and legal
- Infrastructure

In addition, it is important to verify any major assertions made by the other party and the basis for any major assumptions you are making.

The following sections describe specifically how each party should evaluate key considerations in these areas.

Field Due Diligence for Buyers and Successors in Mergers

There are two overall objectives for the acquiring firm. One is the basic objective of due diligence, in other words, to assess the probability of a successful outcome for the transaction. The other is to collect the information necessary to execute a successful postmerger transition. Not all of the information gathered now will affect your decision to execute the deal, but it may put you in a better position to start the transition immediately after the deal closes.

Financial

Ideally, the firm should obtain historical information in the form of balance sheets and income statements for the past three years to gain a snapshot of current conditions and to identify trends. The buyer may also obtain copies of the last three years' tax returns. Surprisingly, many smaller accounting firms do not prepare financial statements for themselves on a timely basis, if at all. In these cases, a tax return might suffice.

We recommend that firms consider obtaining forward-looking financial information as well. What does the other party expect the next few years to look like financially and why? Does the party foresee any material loss of business or does the party forecast a significant increase? Both could affect your plans.

It is also important to get a handle on cash flow. Compare billings to collections by month for the past year. Investigate both the overall collectability of the billings and the seasonality of billings and collections.

Dig deeper on cash flow by looking through accounts receivable and work in process aging. Depending on the deal structure, the buyer or successor firm may inherit the other firm's accounts receivable collection problems. Even more important than the overall collectability is what collection problems say about how the firm manages client relationships. If you run a tight ship and expect clients to pay all invoices within 60 days to avoid service disruptions, the other firm's clients may not assimilate well to your culture if they have routinely been allowed to stretch out payments.

Keep in Mind

If you run a tight ship and expect clients to pay all invoices within 60 days to avoid service disruptions, the other firm's clients may not assimilate well to your culture if they have routinely been allowed to stretch out payments.

If the other firm's profitability is a key component of the deal terms, verify the related assertions. Normally, that will mean calculating normalized net income before partner compensation and benefits to get a true apples-to-apples comparison with your firm. If the deal terms call for you to pay compensation for a period of time on a formula based on historical profitability (for instance, to maintain partner compensation at historical levels for two years), it is critical to verify that compensation.

Check also any firm obligations to retired partners and any other liabilities and commitments, whether or not they are not recorded on the financial statements. It is not unusual for a successor or buyer firm not to assume liabilities. Liabilities to retired partners are often assumed as part of the deal. Even if the buyer or successor is not assuming certain liabilities, it should understand how payment of those liabilities will affect the former owners who may now be partners or key employees in the new firm.

Buyers should also look for opportunities for cost synergies and profitability enhancements. What redundant costs can be eliminated? Where is there excess capacity? Where can productivity be improved? Are any business elements unprofitable (such as an office or a niche division) and are there improvements to be made?

Staff

Depending on the size of the acquired firm, the buyer or successor should obtain a complete employee census for all of the personnel it will be hiring. The firm will need to know all of the information that would normally be required for a new hire, as well as the level of compensation, benefits, titles, roles, and billing rates that person had in the acquired firm. The new firm will likely inherit the other firms' personnel files, so it should not be necessary to recreate the wheel. (A copy of an employee census for partners and for staff can be found in the Comprehensive Due Diligence Checklist in appendix E.)

The buyer should also ask for employment agreements, the acquired firm's employee manual, and details on its benefit plans. Even if the employees of the acquired firm will be signing new agreements with your firm and will be subject to your policies and covered by your benefit plans, you should be aware of how they will be affected by differences between the two firms' policies and plans. We often recommend that acquiring or successor firms strive to keep merged-in employees whole. For instance, if their old firm gave them four weeks' paid time off and the new one only offers three weeks to the same level employee, it may be wise to make up the difference in a compensation adjustment.

Consider how the two firms' cultures differ. For instance, as we mentioned earlier in the book, if the acquired firm's staff was expected to work very little overtime during busy season and your staff works

70 hour weeks in the height of the season, it may be difficult to assimilate the new staff into your culture. Examples of other cultural concerns include the following:

- The level of accountability for performance of staff and partners
- The level of office formality
- Tolerance for unacceptable behavior or performance (especially in the partner group)

Clients and Services

A potential buyer or successor should gather extensive overall information about the other firm's clients and services early in the process. Field due diligence is the time to drill down to more detail, even to specific clients. If the successor intends to keep the acquired firm's ship sailing in the same direction with the same people in charge, it will not be necessary to know as much as would be required if it was taking over management of those clients. That might be the case if one or more partners will be retiring soon after the merger.

If there will be a transition in relationship management soon after the merger, it is important to have a general sense of the tenure of the clients. The longer clients have been with a firm, the more loyal they are to it and the easier they will be to retain. That may seem counterintuitive, but our experience shows us this is true.

It is also advisable to know the following:

- Who manages the client relationship and who does the work?
- Will some clients pose liability issues based on the nature of their business or the services they are provided?
- Do some pose a special financial risk due to the amount of annual fees they are charged?
- Are there services that require special training or licenses? Can you replace the people (especially partners) providing those services if they leave?

Quality Control and Legal

Professional risks should be a key concern in a merger or acquisition. Is the other firm providing services to its clients in a manner that could lead either to liability exposure for your firm or that could make it difficult to assimilate them into your systems? Will there be any independence issues associated with clients of the acquired firm and your firm members?

These questions can be answered by performing a mini-peer review on the firm. Obtain a copy of the firm's quality control document (QCD). Due to the peer review system in effect in most states, most firms have an adequate QCD (unless they are not subject to field peer reviews in their jurisdiction). The key is whether or not they are following the QCD.

Also review the firm's internal QC forms and checklists and representative workpaper files. If possible, interview personnel who manage QC, although be aware this may be difficult to arrange if these people are not partners privy to the merger negotiations. Review the firm's standard engagement letters and its policies on engagement letters. Find out about the firm's client acceptance and retention policies and try to determine if they are followed. Whether you are interviewing QC staff or considering the QCD, engagement letter, or client acceptance policies, the critical question is whether they reflect a practice with sound policies and procedures that would mesh well with your own. As part of this effort, examine a copy of the firm's most recent peer review report. Ask about any current or past litigation and any regulatory citations and investigate any incidents fully. It is also a good idea to broaden your perspective by doing a search on the firm and on individual partners to uncover any negative news or information.

Check the license status of the firm and its partners on their state board of accountancy website to make sure it is active and that there are no outstanding complaints. Do the same for any other licensing bodies with which the firm or its partners are affiliated.

Look into the firm's professional liability insurance carrier to determine its coverage limits and annual premium. Speaking of liabilities, every deal should include extended reporting-period coverage, otherwise known as tail insurance, when possible. Professional liability policies are generally made on a claims-made and reported basis, which means that they only cover work done while the policy is in force. In a merger or acquisition, the insurance policy for the purchased or merged-in firm is typically allowed to lapse and any future claims are covered by the successor firm's policy. However, if Firm A buys Firm B this year and a subsequent claim is made based on work done by Firm B before the acquisition, Firm A's policy will not cover that claim and Firm B's policy will have expired once it was purchased or merged in. Tail insurance covers precisely this type of claim. It is not necessary before a deal is made, but it should be part of every merger or acquisition and the cost of the policy should be part of the deal negotiation. Even if tail insurance is obtained by the seller or merged-in firm, the contract should contain language stipulating that the seller will hold the successor firm harmless and indemnify them for services rendered (or that should have been rendered) before the affiliation, including, but not limited to, compensation for related expenses incurred.

Keep in Mind

Every deal should include extended reporting-period coverage, otherwise known as tail insurance, when possible.

Some firms require all partners or staff to undergo background checks before a merger, with some firms even undertaking personality profiling procedures typically used with a new employee. This procedure remains uncommon and is often met with resistance by acquired firms. Firms that decide it is necessary should be prepared to allow the other firm to conduct the same procedures on their own partners and key employees.

Infrastructure

The two largest areas of concern regarding infrastructure are office space and technology. If the buyer or successor will be operating the other firm's office and assuming its leases, it should obtain a copy of each lease agreement (for office space, copiers, servers, and so on). For real estate, the firm should review basic information about each location, including size, lease term remaining, cost, and expansion options. Also, if the landlord is a client of the firm or a relative of a firm member, consider how that will affect the ongoing relationship. Someone from the firm should visit each location to spot any problems or concerns.

Top technology issues to address include the following:

- How soon will the firm's systems have to be replaced (primarily hardware)?
- Are the firm's systems compatible with your systems? Can they be easily integrated?
- How much will upgrades or replacements cost?
- Will the buyer adopt the seller's systems, migrate them to its own systems, or maintain separate ones?
- Will it be necessary to archive the seller's data or systems for future reference?
- If the systems will be maintained, do they have adequate security?

- Will the successor firm operate both systems for a period of time?
- Are the parties on the same general platform? Are they consistent in their approach to using a paperless office or cloud technology? How compatible is their software and how easily is it to convert programs if not?

Intensive training may be necessary if the members of one firm will be using new operating software, such as time and billing, tax preparation, or paperless audit and accounting. This could affect the transition timing and the return to smooth operations. It may not be prudent, for example, to switch one group's tax preparation software on December 31. That would require training and data migration during the busiest time of the year, and it might be preferable to stick with the current software for one more tax season.

The firm should obtain a list (a depreciation lapse schedule should be adequate) for all the equipment it is buying or inheriting from the other firm. It should be inspected for quality and compatibility to determine necessary replacement costs and establish a transition plan.

Field Due Diligence for Sellers and Firms Merging Upstream

For practitioners who are primarily selling their interest in their firm, there are likely two basic objectives for the due diligence you should perform on the successor firm:

- Maximizing what you are paid for your share of the firm
- Establishing a satisfactory financial and professional relationship with the successor firm while you are still working there

Practitioners who are merging their firm for a longer-term relationship with the successor will likely put more emphasis on their ongoing career with the firm. Their main focus in due diligence will be

- their level of comfort with the firm's culture.
- the successor firm's business plan and how the practitioner fits into it.
- the acceptability of their contract terms.

The advice in this section will help these practitioners get a better sense of the firm with which they may be working for many years, but it is mainly aimed at CPAs who are selling their interest.

Considerations for Sellers

Remember that the proceeds paid in the vast majority of CPA firm external acquisitions are based heavily on client retention, so it should be a critical concern in the seller's due diligence. Another issue is, of course, the firm's ability to pay. Normally, the purchased practice's profits are adequate to fund the buyout, so as long the buyer complies with the contract, they should be able to afford to pay. Credit risk for a seller is often more a function of the successor firm's ongoing viability.

Financial

The seller should obtain a copy of the firm's last three years of financial statements, including balance sheets, and determine the earnings before partner compensation and benefits. Does the firm appear to be stable financially and adequately profitable to maintain itself during your payout period?

Consider any liabilities to retired partners and the effect they might have on the successor firm's profitability. As we have discussed, a properly structured partner retirement obligation is self-funding from the retired partner's foregone compensation. Therefore, the fact that a firm has several partners being paid unfunded retirement obligations is not in and of itself a problem. The bigger issue for most firms is replacing the roles of retired partners. For that reason, consider not only the effect that retirements—recent and pending—might have on the firm's financial stability, but also the impact of a pending loss of talent and expertise. Does the firm have a viable plan for replacing those roles? Will the retirement obligations to future retired partners be self-funding using their foregone compensation? If not, the firm may have to borrow funds or ask the remaining partners to accept lower compensation. Neither of these options may be sustainable for the long term. Along the same vein, consider obtaining a credit report on the firm and its partners.

Forward-looking financial information may also provide some valuable insights to a potential seller or merger candidate. What are the successor firm's near-term financial prospects? Is the firm expecting any material loss of business? Is it planning other future mergers and acquisitions? If so, how might they stress the firm's ability to make buyout payments? On the professional side, will the merged-in firm's partners be happy working in a practice that continues to expand?

Staff

What impact will the merger have on staff who will be retained by the successor firm? Their departure could affect client retention or, in extreme cases, even the successor firm's capacity to serve your clients. Review these documents to get a look at the successor firm from your staff's perspective:

- The successor firm's employee manual
- Any standard employment agreement your staff will be asked to sign
- A summary of benefit plans and policies

If there are significant differences between the two firms' plans and systems, find out how the successor firm will address the transition to avoid significant employee attrition, which could lead to client attrition and a drop in buyout payments.

Clients and Services

Practitioners or firms that have not already discussed in detail the successor firm's business plan for serving their clients should take that step in due diligence. Because client retention is a top priority, consider the following:

- What changes in services, relationships, or fees are expected? Find out what the successor firm charges for the services your client receives and ask about billing rates for representative levels of staff and partners. Will the successor firm roll out any fee increases for your clients over time or will they be imposed immediately?
- Does the firm have the capacity to maintain the level of service your clients expect? In some cases the successor firm will know exactly to whom transitioned duties will be assigned, so consider whether those assignments will work for your clients. In other cases, the plan may be less specific. For instance, the successor firm may intend to assign clients to partners and high-level staff. Do those people appear to have the capacity to accept the assignments? If the firm will be taking on more people to serve your clients, ask about the expected hiring process and timing. Does it appear that clients will be handled by qualified people?
- What is the firm's client retention rate? If clients come and go quickly, the firm may not hold on to your clients.
- If the successor firm has done previous mergers or acquisitions, evaluate client and staff retention in those deals. If the results are not consistent with what you expect, how is the firm planning to obtain a better outcome this time?

By the time you are performing field due diligence on the successor firm, you should have a good idea if its culture matches your own. Clues to consider include how people in the successor firm treat each other, their level of formality, and the hours they are expected to keep. Remember, again, that if you are uncomfortable with the environment, your staff and clients may be as well.

Quality Control and Legal

Because the successor firm's QC environment will affect the services your clients receive, you should review its QCD and latest peer review report. Also ask for a sample of workpaper files and review the processes and systems that will be followed on work performed for your clients. Your overall goal is to ensure that the firm's commitment to quality will be satisfactory for your clients.

Larger firms tend to have more robust QC procedures, which can require more time and drive up fees. On the other hand, larger firms also tend to be more efficient due to their use of technology, more specialized engagement personnel, and streamlined engagement scheduling, so a stronger QC process will not necessarily lead to higher fees.

If the seller offers niche services that require special training or licensing, the successor firm should have the requisite personnel and licenses to replace those in your firm who will be leaving soon.

In addition, investigate some of the same issues the successor firm is likely to review with respect to your firm and partners:

- Ask about current or past litigation and any regulatory citations and investigate fully any incidents. Are they an indication of problems or weaknesses that will lead to future issues and drain financial resources?
- Perform a web search on the firm and its individual partners. Are you comfortable with what it reveals?
- Confirm the professional license status for the firm and its partners on the state board of accountancy website and other relevant licensing bodies to make sure licenses are active and there are no outstanding complaints.
- Find out about the firm's professional liability insurance coverage limits and annual premium.
- Consider whether certain areas of the firm's practice (such as work for Securities and Exchange Commission (SEC) regulated clients or in highly regulated industries) or even specific clients might have a negative impact on the successor firm's long-term stability. Although doing SEC work alone is not a problem,

consider whether the firm has the necessary resources and expertise to adequately manage that area of the practice. Does the firm invest in the necessary training to maintain its expertise? Is it registered with the Public Company Accounting Oversight Board?

- Confirm they not only have the capacity to take on the workload from the owners and perhaps staff not coming on board but also the skill sets and licenses needed where appropriate.

Deal Terms and Due Diligence

The terms of the deal should have an effect on the field due diligence conducted. For example, if you are buying a practice, and the deal includes payments based on a percentage of collections from the seller's clients over the payout period, there is not a significant amount of financial risk associated with retention of the seller's clients. The buyer pays only for clients it keeps and the payments likely are lower than the profits being generated.

Reacting to Due Diligence Findings

The point of due diligence is to assess the transaction's chances of success. Problematic findings in due diligence may kill the deal, but those issues can also be addressed in the deal structure. For instance, if the seller finds that the successor firm generally charges its clients substantially more for the same services, there may be a risk that clients will not stick with that firm. However, under the deal the buyer may agree, for example, not to raise fees for the same services by more than a set percentage for two years following closing.

Keep in Mind

Problematic findings in due diligence may kill the deal, but those issues can also be addressed in the deal structure.

Let's say that in another case the seller has a client that is responsible for 20 percent of its fees, and a partner provides a substantial amount of personal service to this client. The buyer worries that retention of this client after the partner's retirement will be challenging. The terms of the deal call for the buyout payments to a partner to lock 2 years following retirement. However, given the concern about this particular client, the deal might be modified so that the buyout payments for that partner with respect to that client do not lock in for 5 years after retirement.

As we mentioned in chapter 7, large gaps between partner billing rates can also be a potential deal breaker, but this can be resolved by, for example, investigating whether many partner tasks could be performed by lower-level staff in the successor firm. Due diligence can help firms avoid deals that may not be right for them, but it can also save a transaction by spotting potential problems that can be addressed in the deal terms.

Action Agenda

Turn to the checklists in appendix E for a comprehensive overview of the actions each side should consider leading up to a deal.

Chapter 10
Getting the Transition Just Right

Just as location is the top priority in real estate, the three most important words in a transition are retention, retention, retention. That applies to clients, of course, but holding on to key staff is also critical. An acquiring firm is essentially buying relationships—and the business that goes with them. In a merger, one of the most critical concerns is also ensuring that important relationships are maintained. Relationships with clients are the backbone of the business, and staff members are the people who help firm leaders maintain them. The true success of a merger or acquisition is ultimately based on client and staff retention.

For those reasons, an orderly and efficient transition is vital, because it can ensure that clients and staff will be more likely to remain with the successor firm. This chapter will discuss the issues to consider in client and staff retention and explain the steps necessary to address them. It will also review the all-important business plan that ensures the deal's viability.

Client Retention

For a client, there are four critical questions:

1. Will the owner or partner I work with remain?
2. Will my fees increase?
3. Will the firm's location still be convenient?
4. Will the staff I am used to working with be part of the new team?

Addressing these concerns is crucial to client retention. A key message to clients should be that, with some variations, the things that clients need and depend on will not disappear. In communications with clients, focus on the continuity they will see.

Some critical issues to consider are included in the following sections.

Timing of the Announcement

Different types of communication may be appropriate for different clients, but all clients should receive a formal announcement before or around the time the news becomes public to reassure them that the firms are thinking of them and are ready to address their concerns. The firms' best clients (usually based on size of annual fees, importance as a referral source, or stature in the community) should be told in person by the seller, who should bring along any new professional who will also be working the client, especially if he or she is ultimately replacing the seller as the client contact. If the firm has a number of annual clients (such as individual tax clients) and the timing is appropriate, consider telling them about the planned deal during their annual visit to the firm. This will offer a personal touch and give them less time to switch to an alternative service provider. With that in mind, some firms that close after tax season do not inform annual clients until they send the organizers out the following year.

The Message

Whether the firm communicates with clients in person, by letter, or by phone, there should be a consistent, positive message about the transaction that presents it as an exciting opportunity. (Appendix F contains five sample letters that firms can adapt to their needs.) Some firms also draft scripts or talking points for staff when talking to clients to reinforce a consistent message.

The main takeaway should be how the deal will benefit the client. The initial announcement, which traditionally comes from the selling firm, might say, "We are merging with ABC & Company to provide our clients with expanded services and resources. I will still be the principal in charge of your account. We are operating under the same fee structure in the same general area with the same staff, but we can now do more for you!" (Be sure to mention any new or specialized services the acquired firm offers.) Wherever possible, the announcement should stress what will not change, especially fee structure and client services. Avoid using the word "purchase" in the announcement because clients do not like to think they have been sold. Even if the firm has been purchased from the estate of a deceased practitioner, call the transaction a merger or an affiliation.

Introducing the Successor

A personal introduction of the successor to the client helps assure an effective transition, but it is not critical if the business combination is undertaken for reasons other than succession. If the partner in charge of an account is phasing out (even over the next few years), the successor can initially be introduced as additional support on the engagement. As we have noted in an earlier chapter, in client discussions, the departing partner should defer to the successor's judgment whenever possible and allow the successor to return client calls. This supports the transition and shows that the successor is taking a sincere interest in the client.

Involvement of Both Firms in the Communication Process

Little things can make a difference. For example, mailing the announcement letter in the predecessor's envelope but writing it on the successor firm's letterhead ensures the letter will be opened and sends a powerful but subtle message about the transition. Letters sent in the new firm's envelope may not be opened, because some clients may think it is a solicitation from a new accounting firm, but everyone opens a letter from their own accountant.

The Seller's Time Commitment to the Transition

Many sellers are surprised to hear that a proper transition may take up to three years. We tell them that the seller's involvement in the transition is critical, but the number of hours that the seller spends working with clients during the handover is less important than the message sent to them. Many practitioners spend no more than 200 to 300 hours per year in front of clients, especially given advances in technology, with the rest of their time spent performing or supervising services for them behind the scenes. As a result, if a CPA simply remains available for consultation via phone and e-mail, the clients may perceive no difference in the relationship. If a buyer insists that a seller must stay involved in person or on site for a lengthy period to perform client work or interact with clients, that buyer may not be a good match. Among other things, they may need the seller to stay because they do not have the capacity or the skill set to replace him or her. Consider whether that is the case and, if so, whether the buyer will ever be in a position to handle your clients properly without you. (The following case study illustrates how two firms can handle a successful, extended transition even after the seller has moved across the country.)

Case Study: A Successful Long-Distance Transition

The problem. Todd, who is 62, planned to sell his practice in 3 years, but his wife's health forced an early move across the country. He worried about how he could sell his $500,000 individual tax-return practice when he could not personally serve his clients.

The solution. Todd merged his practice with Joe's firm, which was very similar in terms of style and expertise. They created a new entity that included both of their names. Todd sent a merger announcement letter to clients and key contacts emphasizing Joe's expertise and discussing how he would brief Joe on each client's needs. The letter mentioned in particular that both CPAs would review their returns and that Joe specialized in helping clients reduce their taxes by finding new approaches during the interview process, so he would be handling the initial meetings this year. Fees would not change, and Todd would remain the lead partner on the account.

Todd called each client from his new home and scheduled their meetings with Joe, who completed the returns and sent them to Todd to review. Todd called each client to discuss their return. When a client called Joe's office with questions for Todd, Joe contacted Todd and he returned the call. In each call, Todd said, "Let me discuss this with Joe and get back to you with our joint opinion. Joe will call you with the answer." If Joe had answered the questions, the transition would not have worked as well.

The result. Clients became used to working with a new accountant, which resulted in nearly 100 percent client retention.

Keep in Mind

The seller's involvement in the transition is critical, but the number of hours that the seller spends working with clients during the handover is less important than the message sent to them.

Staff Retention

Clients are more likely to give the new firm a try if they can preserve a connection with a trusted contact at their old firm or if they get a sense of continuity because long-time staff members are on hand to brief the successor firm on their expectations and ensure that they are fulfilled. The keys to retaining staff are as follows:

- Minimizing change
- Offering a convincing perspective on the benefits of the combination
- Maintaining constant communication

Effective staff-retention strategies address concerns about job security, compensation and benefits, and employee agreements. No single solution can eliminate fears about all of those issues, but concerns can be alleviated with clear and frequent two-way communication in which the successor firm (and any remaining owners from the acquired or merged-in firm) share their vision and ask for (and listen to) staff opinions.

A staff retention plan should involve several steps to address basic concerns.

Inform the Most Senior Staff Members First

It can be problematic to reveal plans too early, but these professionals should hear about the pending business deal prior to other staff. As is the case with clients, letting this group in on plans reinforces their importance to the firm. Generally, key employees should be informed individually and other employees can be addressed in groups. The combination should be introduced to as many employees as possible in a short time frame to avoid misunderstandings and rumors. Try to anticipate how the news will be received and be empathetic. Change can be worrisome, so emphasize the advantages of the combination. Be as complete as possible in explaining the new environment so that firm members do not fill in the blanks with pessimistic assumptions. Conduct an overall orientation to the new firm for all new employees.

Make a Special Announcement

Do not let the staff find out about a merger or acquisition from an announcement meant for clients and the public. Tell them in person.

Send an Upbeat and Positive Message

Reassure staff (as appropriate) that the deal will not involve staff reductions or any loss of status (if that is the case), emphasize the benefits, and articulate all the many things that will not change. The key point should be: You are welcome and wanted and more secure with the combined firm than with the original firm.

Keep in Mind

The key point should be: You are welcome and wanted and more secure with the combined firm than with the original firm.

Tackle Compensation and Benefit Concerns

In addition to job security, staff members will also be worried about the deal's effect on compensation. The merging firms will almost certainly have different compensation approaches. In addition to the other options we have discussed in chapter 7 and elsewhere, consider freezing compensation at existing levels and let natural attrition and time gradually bridge the gap. The same applies to benefit plans and perquisites.

Address Employment Agreements

Merging firms often use employment agreements or contracts as a retention tool, but they also offer other benefits to both staff and employers. For both sides, it is valuable to have a clear definition of the employee's role, compensation, and benefits. In addition, these documents typically include a noncompete or nonsolicitation provision that protects the firm from client poaching. The staff may not always be pleased with restrictive covenants, but the firm can present them as a way to promote internal security and certainty. If that is the case, emphasize the fact that the agreements are standard and signed by all staff. On the plus side, employees under contract can feel a sense of confidence and security in their new positions, inspiring loyalty to the successor firm and making them less likely to look for other opportunities.

Clarify Reporting Relationships

To minimize uncertainty, be clear with each firm member about his or her role and place in the management structure.

Emphasize Career Opportunities

The firm's most motivated staff—the ones who are most concerned about long-term career growth—may assume the transaction will limit their opportunities. Because these are typically the people most worth keeping, make sure that they are aware of the growth possibilities that the merger presents and how they can benefit their careers.

Orient New Employees

If employees of the acquired or merged-in firm will be hired by the combined firm, the best approach is to use the same processes that are used for all new hires. Give them employee handbooks, enroll them in benefit plans, and distribute plan documents to them. New employees should also be trained on all major systems, such as time and billing and tax prep software. To promote a sense of community, consider holding a "get-acquainted" event for the employees of both firms.

Maintain an Open Dialogue

Give staff chances to ask questions and explore what the merger or acquisition means for them after the deal is consummated. Provide opportunities for one-on-one conversations by assigning a go-to person with whom staff can work. Small firms may designate one individual for this role, and larger firms can assign one for each category of employee. Many firms assign a mentor for each new employee who is at peer level and can help them get acclimated and answer questions.

The Transition Plan: Steps to Consider

Of course, an effective transaction encompasses many other areas in addition to client and staff retention. The particulars will vary based on each situation, but this section will review some elements that should typically be considered.

Technology

Align resources

- ☐ Consider what kinds of software, hardware, or other equipment will be required to meet the needs of the combined firm.
- ☐ Reconfigure the computers of the acquired firm as necessary to comply with successor firm systems, including network configurations and desktop software.
- ☐ Review support systems, maintenance contracts, and licensing for major technology and determine the need to continue or replace each element.
- ☐ Identify required updates to the successor website to reflect new firm members, service areas, office locations, or other details. Assign phone numbers and e-mail addresses for new firm members and ensure that they are in the internal directory or online, as appropriate (consider auto-forwarding phone numbers and e-mail addresses that will not be retained).

Make the switch

- ☐ Transition clients and employees of the merged-in firm to the successor firm time and billing system, including inputting client and employee details, billing rates, and open items such as work in process. However, in order to allow clients to become comfortable with the new firm, consider changing work and billing processes gradually.

Create an archive

- ☐ Consider archiving data files for the acquired firm and keeping existing critical systems viable until full transition to new systems is complete. In particular, it may be advisable to keep the acquired firm's time and billing system for at least one year after the merger to maintain access to historical data and to keep the tax software for one season as well if the merger takes place around busy season.

Facilities

Get ready to work

- ☐ Set up offices and workspaces for new employees, which may include relocation of furniture from the acquired firm's offices.
- ☐ Replace signage to reflect the successor or new firm's name.
- ☐ As necessary, obtain occupational licenses or other business registrations for any new locations acquired.
- ☐ Determine the protocol for the hard copy of any files for acquired firm.

- ☐ Notify the post office, vendors, and other nonclient contacts of any change of address.

Marketing

Decide how to deliver the message. In addition to clients, you will also want to decide how to share the news with the public.

- ☐ Consider issuing a press release and working with local media to promote the combination. Both firms should work together to plan this step to ensure that they are comfortable with the message and that it is best suited to the targeted audiences.

Update resources

- ☐ Revise all marketing materials, such as stationery, business cards, brochures, and websites, if the successor firm's name will be changed or if any new entities are formed as a result of the combination.
- ☐ Provide business cards to merged-in employees.

Retain contact information

- ☐ Keep the phone and fax numbers, domain names, and e-mail addresses of the predecessor firm for at least a year.
- ☐ Answer the acquired firm's phone number on a dedicated line with a custom greeting that uses both firms' names or a generic response such as, "Accounting office, may I help you?" This should be done until all clients and business contacts have had a chance to hear about the combination and accustom themselves to it.
- ☐ Modify online listings and other advertising as necessary to reflect any changes in name, location, or other details.

Professional and Legal

Get registrations right

- ☐ Alert the state board of accountancy or other relevant regulatory bodies of any new entities or terminate registration of an acquired firm.
- ☐ Notify all trade organizations, such as firm associations, of the combination.
- ☐ Register and obtain ID numbers for any new entities.

Action Agenda

Firm Integration Plan

As with any marriage, there are many steps involved in merging two firms. In some cases, it will be best to involve at least one person from each firm so he or she can share information about each practice's current approaches and how best to meld them. Use this worksheet to anticipate the areas to consider and assign champions from each firm for them.

Task	Firm ________	Firm ________
Human resources issues, including the following: • New staff orientation • Distribution of employee manual to new staff • Employee agreements • Noncompete or nondisclosure agreements • Payroll • Office access (keys or key cards)		
Migration to the time and billing and any other key software		
Technology logistics, including the following: • Computers, servers, and other hardware • Technical support contracts • Program licenses • Integration of phones and faxes • Phone lines, cell phones, and e-mail addresses for new staff • Updating the backup system for added systems and users		
Technology training		
Other necessary training in firm systems and processes or other areas		
Tax research programs		
Assigning clients to new partners (as appropriate)		
Assigning mentors for newly merged staff		

Task	Firm ________	Firm ________
Acting as go-to person for transition-related staff questions		
Moving coordination (including purchase and rental or sale and sublet of office space, as well as permanent or temporary storage of unneeded items)		
Purchase of new office furniture and equipment		
Stationery, signage, and business cards		
Post office notification of new address for old firm (and newly merged firm, if appropriate)		
Marketing (including the press release and announcements to clients and staff, as well as branding and positioning the newly merged firm)		
Website updates (and redesign if needed)		
Updating insurance (and tail insurance)		
Registration termination		
Get-acquainted gathering		

Chapter 11
The Art of the Deal

In this final chapter, we provide a roadmap not only to a successful deal but also to the many steps that firms must take to position themselves for the best outcome. Each section in this chapter reviews actions that should be taken at different steps on a firm's road to transition. As part of this review, we will also explore the considerations that are unique to various situations.

When the Firm Opens Its Doors

In chapter 2, we discussed the fact that succession planning should ideally begin when the firm is first launched. As part of that effort, practitioners develop a workable partnership agreement that includes guidelines on financing, structure, and transition as soon as they open their doors. If the firm is truly a startup without much business on the books, one critical issue that needs to be addressed is a partner's termination of his or her relationship with the firm, which we have discussed in detail in chapters 4 and 7. Long-term succession is understandably the least of a firm's worries at this stage. However, if a firm is being formed in a more advanced stage (such as the merger of mature books of business), or as a firm becomes more stable, eventual succession should be addressed. At that point, the agreement should contain realistic procedures for admitting new owners and buying out retiring partners based on the circumstances at the time.

If the Firm Is Already Up and Running

For existing firms, there are some steps that should be taken immediately, no matter where they stand in their succession planning. In some cases, those steps are simply good management, but they are important in the succession planning process because they ensure that the firm will be a thriving business and an attractive investment when it is time for a transition, whether that is accomplished through new partners buying in or due to an external transaction. These steps include the following:

- Developing a strategic plan and operating according to it. Setting goals and creating responsibilities and accountabilities that ensure the plan is met is the foundation for a profitable, well-run firm.
- Implementing a corporate governance approach that encompasses clearly defined roles and responsibilities for established powers and limitations for the board, managing partner and CEO, individual partners, and committees and task forces. This one-firm approach will help inspire brand loyalty among clients and allow the firm to operate with greater efficiency. Admittedly this can be difficult in a very small firm, but the silo approach, in which each partner operates in his or her own fiefdom, can hinder accountability and make for a tougher ultimate transition to new leadership or ownership. Nevertheless, the closer the practice comes to a one-firm approach, as opposed to a collection of practitioners sharing space, the better any kind of transition is likely to go. If the most critical outcome of every transition plan is client retention, remember that clients of firms that operate cohesively tend to be more firm loyal and easier to transition and retain.
- Instituting standard operating procedures and holding everyone accountable to them.

Actions you can take now that relate more directly to succession include the following:

- Determining partners' near- and long-term plans to get a realistic sense of the firm's exact succession needs. The firm should have a good idea of the possible retirement date for every partner who may be 10 or fewer years from retirement. A mandatory retirement date in the owner agreement can be a huge advantage in determining this information.
- Identifying how to replace every partner who is 10 or fewer years from transition. Create a succession plan that identifies possible successors for every key role in the firm. This will

involve pinpointing each owner's responsibilities, skills, specialties, credentials, contacts, or relationships and developing a plan to replace them. Consider, "What would we do if Gretchen got hit by a bus on the way home today?" Use your responses to plan for a more orderly transition.

- Keeping the partnership agreement updated and including realistic terms for buyouts and other contingencies. Use it to spell out a transition plan that details what success looks like. Over the years, a firm's circumstances will change, and so should the plan to buy out or otherwise terminate partners. What made sense when there were three professionals who left a large firm to start up from scratch will likely not make sense now that there are eight partners with diverse responsibilities. Evaluate the agreement at least every five years.

If You Are Planning on Internal Succession

Long-term planning and preparation are especially important in an internal succession because it involves

- hiring talented professionals who have leadership potential.
- developing talented professionals into viable successors for current owners. Once again, a one-firm model and clear standard operating procedures (SOPs) will promote this process because it will establish clear procedures and accountabilities. Partners must also be willing to delegate, share responsibility, involve younger colleagues in their work, and provide colleagues with decision-making and leadership opportunities.

If the Firm Is Very Small

No matter the size of the firm, practitioners with good business plans and standard operating procedures will be better positioned to sell to an internal or external successor. In addition, firms with one owner should implement a practice continuation agreement as early as formation of the firm. Follow the recommendations in chapter 8 to craft a document that will protect the firm and the practitioner or his or her heirs in case of death or disability. Update the agreement regularly to ensure that it still serves the firm's needs. As we noted in chapter 8, remember that a practice continuation agreement is not an adequate succession plan. At least three to five years before you plan to reduce your time, be sure to have a succession plan in place.

When You Are Considering a Deal

Whether buying or selling, firms should begin by determining the strategic, financial, and professional goals that they hope to achieve. Common goals for buyers include the following:

- Growth of revenues
- Growth of talent
- Growth from cross-selling a niche
- Growth in a new market (typically involving a satellite office)

Common goals for sellers include

- more robust and reliable retirement benefits in a merger or outright sale than in an internal succession.
- an opportunity for the remaining partners to work with a firm that can offer expanded professional and revenue opportunities.
- the chance to offer clients expanded services in a larger firm or to hold on to clients that are expanding and need more complicated services.
- gaining more clients and additional talent for a niche specialty.
- updating business processes and practices.
- relieving partners of administrative duties and leveraging the management infrastructure of a larger firm.

If you are anticipating selling, consider what is important to you beyond the money you will receive. A seller will be involved with the buyer for perhaps a few years before retiring completely, so determine what matters in that ongoing relationship. Also find out why the buyer is interested in your practice to confirm that you have similar approaches and goals that will ensure a successful outcome.

When You Are Ready to Meet Candidates

Once firm leaders understand their objectives, it is time to identify likely merger or acquisition candidates who can help meet those goals and contact them to discuss the possibilities.

For prospects interested in pursuing discussions

- prepare a nondisclosure agreement for prospective merger candidates to sign.
- provide prospective merger candidates with a high-level summary of practice statistics, such as the performance metrics we covered in the last chapter, and obtain similar information from

them (without divulging client or staff names at this point). Appendix G contains practice summary sheets for both sole proprietors and multipartner firms that can be used in these discussions.

- the successor firm should prepare a nonbinding written offer that outlines logistical and financial details on how the merger or sale would proceed, assuming both parties are interested in going forward.
- if the firms agree on the nonbinding offer, the firms can engage in further discussions that focus on sketching out how the transition and ultimate merger will work. The firms would engage in the summary due diligence discussed in chapter 9.
- if all goes well and there is confidence in ultimate success, the firms would proceed to field due diligence, as outlined in chapter 9.
- the firms would continue discussions up until closing, based on due diligence findings.
- the final agreements represent another opportunity for a review of details. Invariably, transaction terms will arise in agreement drafts that have not already been discussed. These should consist mostly of legal terminology that has no impact on the outcome. There should be no surprises regarding the major financial and business plan issues in the agreement drafts. Final agreements should memorialize what has been agreed to either in written offers or previous discussions; they should not be used as a means to negotiate major terms.
- the firms should maintain confidentiality throughout the process.
- the deal should be announced to employees, clients, and referral sources at the appropriate time, as discussed in chapter 10. Both sides should participate actively in merger integration to ensure client and staff retention. Clients and staff need to hear a common message from the people that they have trusted previously, as well as the people with whom they will form new relationships.

When You Are Thinking About Timing

In a perfect world, deals should be completed with a few months to spare before busy season. This will give firms time to implement changes in the operating environment, conduct training, and generally prepare the practices to operate as cohesively as possible before the major storm for most firms hits. However, because it is likely the last and most important decision that many practitioners will make about their firms, it should be a priority no matter what time of years it occurs. Smaller firms will have clear challenges in completing a merger between February and April, but making the right match is far more important than the timing of the deal.

When the Deal Is Being Finalized

There are a number of ways to document a merger. The most common approach is for the partners of the merged-in firm to sign the successor firm's partnership or shareholder agreement if they will have equity in the successor firm. In most cases, an additional agreement spells out variances and exceptions to the partnership agreement and other stipulations that pertain only to the merger itself or are only effective for a temporary period (such as compensation guarantees, vesting in retirement benefits, and contributed assets).

Whether the deal is a merger or a sale, it is important that everything that will affect the transition from the seller or acquired firm to the successor firm is addressed. Some major issues we have mentioned that almost every contract should address are as follows:

- Treatment of accounts receivable and work in process.
- Whether staff will be offered positions in the successor firm.
- Handling of unexpired leases. The successor firm should obtain representations from the seller or acquired firm that
    - — they know of no malpractice claims or other similar liabilities that are active, undisclosed, or pending.
    - — they will hold the successor firm harmless and indemnify them from acts performed or that should have been performed before the affiliation that can cause a liability for the successor firm.
    - — the acquired firm's partners will sign appropriate restrictive covenants to assure that the successor firm can retain clients and employees without interference from the acquired firm partners after they leave.
    - — the acquired firm's partners will be available for a proper transition if they are planning to reduce their role in the near future (usually in a sale or two-stage deal).
    - — the acquired firm's owners should obtain from the successor firm representations on the manner in which any payment default will be handled. Obviously, the seller can always sue, but other remedies could include locking in the price in contingent deals, accelerating deferred payments, and relinquishing restrictions on taking back clients.

— the successor firm will hold the seller harmless and indemnify them from acts performed or that should have been performed before affiliation, especially in mergers.

— they will not resign from clients without cause and that they will assume leases and honor any other major commitments in the business plan agreed to in the negotiations.

EMBRACE THE OPPORTUNITIES

Matching your outcome to your goals is the ultimate point of any deal. We hope you finish this book with a strong sense of the importance of planning in order to realize your objectives and a clear understanding of the path that will take you to a successful resolution of your succession needs. Our final advice to you is as follows:

- Start now. The earlier you begin enhancing your firm's business model, assessing the prospects for an internal succession or a practice continuation partner, grooming potential leaders, or considering your merger or sale options, the better outcome you are likely to have.
- Stay positive. We have stressed throughout the book the many benefits to a well-thought-out transition and a well-structured deal. We have also noted that mergers and acquisitions is not an adversarial process, but rather one in which both sides can come away satisfied. For those reasons, CPAs should not be reluctant to tackle their succession challenges and embrace the opportunities they present.
- Remember the final deal will be based on many variables. Do not negotiate one variable at a time. Keep in mind the whole package, including not only the financial terms but also the business plan.
- Always keep the four Cs on your radar, especially chemistry! As we said at the outset, you will have a more satisfying, and possibly profitable, deal if you like the other party. Whatever the transaction and whether you are the buyer or seller, keep the deal moving and treat it as a priority.

Appendix A
National Management of an Accounting Practice Survey Data

This data, from the 2012 PCPS/TSCPA National Management of an Accounting Practice Survey, offers some perspective on the state of succession planning and partnership agreements at firms of various sizes and in different parts of the country.

2012 PCPS / TSCPA National Management of an Accounting Practice Survey
National Results

	All Firms	National Firms by Net Client Fees							Region			
		< 200K	200 < 500K	50 < 750K	750K < 1.5M	1.5M < 5M	5M < 10M	10M+	Northeast	South	Midwest	West
Number of Firms	2,362	441	626	323	414	419	82	57	281	857	516	700
Which of the following do you have in place?												
Succession plan	14%	1%	4%	11%	19%	31%	33%	42%	13%	12%	16%	15%
Formal partner in training program	4%	0%	2%	2%	3%	7%	16%	35%	5%	4%	3%	4%
Practice continuation agreement with another firm	5%	7%	7%	5%	6%	1%	1%	0%	4%	6%	4%	6%
Written firm partnership agreement	31%	1%	7%	22%	44%	69%	90%	93%	32%	28%	32%	33%
Partner compensation formula	19%	1%	4%	12%	26%	45%	56%	54%	21%	17%	19%	20%
Malpractice insurance policy	78%	63%	71%	81%	85%	92%	95%	96%	84%	72%	82%	82%
Malpractice insurance coverage limit	1,598,309	720,295	1,049,732	1,081,891	1,765,617	1,901,250	3,756,579	7,006,000	2,071,070	1,647,819	1,417,676	1,491,621
None of these	16%	35%	25%	13%	6%	2%	0%	0%	11%	21%	15%	13%
When was the partnership agreement last updated?												
Before 1995	4%	—	2%	10%	5%	4%	0%	2%	7%	3%	5%	4%
1995–1999	5%	—	4%	4%	7%	4%	5%	0%	4%	3%	8%	4%

2012 PCPS / TSCPA National Management of an Accounting Practice Survey
National Results

	All Firms	National Firms by Net Client Fees							Region			
		< 200K	200 < 500K	50 < 750K	750K < 1.5M	1.5M < 5M	5M < 10M	10M+	Northeast	South	Midwest	West
2000–2002	6%	—	13%	7%	12%	4%	1%	2%	8%	5%	9%	5%
2003–2005	8%	—	4%	10%	13%	8%	4%	2%	4%	7%	12%	9%
2006–2008	17%	—	22%	22%	15%	17%	15%	17%	19%	21%	12%	16%
2009	8%	—	11%	5%	7%	8%	12%	6%	8%	8%	8%	7%
2010	14%	—	15%	19%	12%	14%	7%	20%	9%	12%	14%	17%
2011	26%	—	15%	19%	18%	29	34%	41%	32%	28%	21%	24%
2012	11%	—	13%	4%	11%	11%	22%	11%	9%	11%	9%	14%
Which of the following does the partnership agreement provide for?												
Buyout	88%	—	70%	83%	88%	90%	96%	96%	90%	85%	92%	89%
Conduct	59%	—	46%	47%	52%	63%	68%	81%	61%	59%	58%	59%
Death	92%	—	78%	86%	91%	95%	96%	96%	94%	92%	94%	91%
Disability	83%	—	54%	68%	79%	89%	91%	94%	91%	83%	82%	80%
Early withdraw	61%	—	33%	49%	45%	68%	80%	89%	66%	61%	65%	55%
Mandatory age	31%	—	2%	6%	14%	34%	69%	77%	38%	32%	37%	22%
Noncompetition	69%	—	41%	51%	60%	74%	92%	92%	76%	67%	75%	64%
Retirement	62%	—	26%	40%	49%	68%	92%	89%	69%	59%	64%	60%
Cap on maximum payment to retiring partners	22%	—	7%	1%	7%	23%	57%	60%	23%	22%	25%	19%

(continued)

2012 PCPS / TSCPA National Management of an Accounting Practice Survey
National Results

	All Firms	National Firms by Net Client Fees							Region			
		< 200K	200 < 500K	50 < 750K	750K < 1.5M	1.5M < 5M	5M < 10M	10M+	Northeast	South	Midwest	West
Notification required prior to retirement	41%	—	20%	25%	28%	45%	68%	70%	41%	41%	42%	40%
Managing capital accounts	29%	—	46%	25%	24%	27%	38%	38%	29%	25%	27%	35%
Components included in partner compensation formula (may not total 100%)												
Administrative duties	60%	—	50%	49%	63%	61%	67%	74%	62%	59%	59%	62%
Client billing	68%	—	61%	46%	63%	74%	70%	87%	72%	68%	73%	64%
Compliance with business plan	11%	—	4%	3%	5%	8%	20%	48%	11%	12%	9%	10%
Interest on capital	29%	—	18%	5%	21%	35%	43%	45%	18%	29%	36%	30%
New clients	38%	—	25%	28%	29%	35%	59%	81%	46%	42%	37%	31%
New business from present clients	24%	—	11%	13%	19%	19%	48%	65%	28%	26%	25%	20%
Niche or new service development	11%	—	4%	10%	4%	8%	26%	48%	13%	13%	11%	9%
Timely billing	60%	—	36%	44%	64%	61%	70%	84%	59%	63%	63%	57%
Training and mentoring	15%	—	7%	8%	5%	14%	33%	42%	16%	17%	12%	14%
Years of service	14%	—	4%	8%	11%	12%	37%	26%	15%	17%	9%	14%

2012 PCPS / TSCPA National Management of an Accounting Practice Survey
National Results

	All Firms	National Firms by Net Client Fees							Region			
		< 200K	200 < 500K	50 < 750K	750K < 1.5M	1.5M < 5M	5M < 10M	10M+	Northeast	South	Midwest	West
Personal billable time	54%	—	46%	38%	53%	56%	54%	68%	46%	54%	51%	60%
Postretirement comp formula	5%	—	0%	3%	1%	5%	13%	16%	8%	3%	6%	6%
For Professionals												
Bonus or incentive % of total	5.3%	4.1%	3.6%	5.6%	7.3%	6.1%	6.6%	5.6%	5.1%	6.0%	5%	5%
Average annual base salary % included	5.6%	5.8%	5.9%	6.4%	5.3%	4.9%	5.5%	4.8%	6.1%	5.1%	7%	5%
What is your compensation year basis?												
Fiscal 2011	20%	17%	14%	19%	20%	28%	40%	46%	24%	20%	21%	19%
Calendar 2011	76%	79%	85%	78%	78%	69%	54%	35%	73%	77%	75%	78%
Other	3%	4%	2%	3%	2%	3%	6%	19%	4%	3%	4%	3%

APPENDIX B
Annual Succession Planning Checklist

These are some of the questions firm leaders should consider at least once a year to ensure their succession plans still accurately reflect their current situation and succession needs.

Pending Retirements and Other Changes

Have any partners' career or retirement plans changed since last year? Yes ___ No___

If yes, what impact do the changes have on the firm's succession plans?

Are any partners seeking to reduce their time commitment in less than five years? Yes ___ No____

If so, do we have both the excess capacity and the skill set to replace the partner(s)?

Do we have any critical staff closing in on retirement? If so, do we have both the excess capacity and the skill set to replace them?

Have any new partners been admitted or left the firm? Yes ___ No___

If yes, do the changes require revisions to the firm's succession plans?

Transition

For partners already scheduled to transition their clients, how has that process been going?

Are the clients getting acclimated to the successor? Yes ___ No___

What additional steps need to be taken to ensure continuity, client, and staff retention?

The Next Generation

Do we have any partner-level talent within our bench? If so, what skills do we need to enhance to get them ready to step up?

How are we doing in recruiting and developing young talent?

What added steps do we need to take to successfully attract young talent?

Business Changes

Have there been any other significant changes to our business in the last year? Examples include the following:

- Addition or closing of a niche
- Addition of another location
- Loss or gain of an important client(s)
- A significant change in revenues
- Upturn or downturn in the overall economy or local market
- The unexpected loss of any partners or staff

If yes, should we make changes to our succession plans as a result?

Are the firm's insurance policy terms up-to-date with our succession plans and needs?

The Partnership Agreement

The partnership agreement should be reviewed and updated at least annually. When was the last time ours was reviewed?

Do all of the major terms of the agreement remain valid for partner buyouts and new partner admissions?

APPENDIX C

Sample Practice Continuation Agreement

> This Agreement made this _____ day of ___________ [month], _____ [year] between ABC & Company (hereinafter referred to as ABC) [firm seeking PCA protection], with its principal place of business located at ___________________, John Doe (hereinafter referred to as Doe), the sole owner of ABC, and XYZ Partnership (hereinafter XYZ) [firm providing PCA protection] with its principal place of business located at ___________________. ABC, Doe, and XYZ are hereinafter sometimes referred to individually as a Party and collectively as the Parties.

WHEREAS, ABC has been engaged in the practice of certified public accounting (hereinafter Practice) servicing the clients (hereinafter Clients) set forth on the client list (hereinafter Client List) attached to this agreement (hereinafter Agreement) as exhibit A, and

WHEREAS, no less than once per calendar year ABC shall provide XYZ an updated Client List and critical passwords to the systems, and

WHEREAS, ABC and XYZ now desire XYZ to service the Clients in the event of Doe's Temporary or Permanent Disability (as subsequently defined) as well as Doe's death (as subsequently defined),

WHEREAS, ABC and XYZ agree that this Agreement shall be effective commencing on the date hereof, WHEREAS, ABC and XYZ agree that XYZ will commence service to the Clients commencing on the Effective Date as subsequently defined,

WHEREAS, the compensation as defined hereunder will be computed based upon gross service fees collected from the Clients less any charges for out-of-pocket costs separately stated on invoices to Clients (hereinafter Collections),

NOW, THEREFORE, in consideration of the promises and mutual covenants and conditions herein contained, the Parties hereby agree as follows:

1. DEFINITIONS

For the purposes of this Agreement, the following terms are defined as set forth:

(A) Temporary Disability shall mean when Doe is unable to perform his functions in the Practice for up to _____ days due to sickness or injury. Temporarily Disabled shall mean when Doe is in a state of Temporary Disability. Upon a determination by Doe or his representative that he is Temporarily Disabled, Doe or his representative shall notify XYZ as soon as practical after such determination of his Temporary Disability.

(B) Permanent Disability shall mean Doe shall not be able to perform his usual functions on behalf of the Practice for more than ________ consecutive days. Alternatively, if Doe is unable to perform his usual functions on behalf of the Practice for any ____ weeks out of any _____ consecutive weeks, Doe shall be deemed to be Permanently Disabled. Furthermore, if a physician certifies in writing that Doe's medical condition is likely to result in Permanent Disability, Doe shall be considered Permanently Disabled upon such certification. Permanently Disabled shall mean when Doe is in a state of Permanent Disability. Upon a determination by Doe, a physician, or his representative that he is Permanently Disabled, Doe or his representative shall notify XYZ as soon as practical after such determination of his Permanent Disability.

(C) Effective Date shall mean the earliest of the following:

i. the date of Doe's death,

ii. the date of Doe's Temporary Disability, or

iii. the date of Doe's Permanent Disability.

2. ASSUMPTION OF SERVICE TO THE CLIENTS

(A) On the Effective Date, Doe or his agent or representative shall turn over to XYZ, and XYZ shall accept the Clients and their successors and assignees together with the pertinent workpaper files necessary to provide services to the Clients (hereinafter Files). Doe, his heirs, representatives, or assignees shall take all steps reasonably necessary for XYZ to be engaged by the Clients based on Doe's ability to do so. As of the Effective Date, ABC or Doe's representative shall supply XYZ a current list of Clients. XYZ shall not be required to accept Clients or provide services to Clients if (1) such acceptance or services would violate the professional ethics or regulations of any governing body XYZ is a member of or licensed by, or (2) if such Client or services would adversely affect the professional reputation of XYZ. XYZ agrees to make available all the Files to Doe or his representative for such time periods as are (1) necessary for Doe to comply with his professional responsibilities following the transfer of the Practice to XYZ and (2) customary within the accounting profession. XYZ further agrees to make its best efforts to service and retain the Clients. Specifically excluded from this Agreement is any obligation on the part of XYZ to acquire the assets of ABC (except those listed herein) or to assume the liabilities of ABC.

(B) As soon as practical after the Effective Date, XYZ shall notify the Clients of its obligation to provide services to the Clients and of the circumstances that have triggered the transfer of the Practice to XYZ. In the event ABC is able to participate in such notification, XYZ shall allow ABC to make such notification on behalf of XYZ or shall approve the nature and content of the notification.

(C) Upon XYZ's receipt of a written notice from ABC that Doe is no longer Temporarily Disabled prior to the date, if any, Doe is determined to be Permanently Disabled, XYZ shall cease providing services to the Clients and shall return to ABC the Practice including the Files.

3. COMPENSATION

(A) In the event of the Temporary Disability of Doe, conform to the following:

(1) XYZ shall render normal accounting services to the Clients, which services are defined herein as the dispensing of business or financial advice, the provision of forecast reports, the production of written reports of any nature, the solicitation of new clients, and the performance of any of the customary and usual tasks of an accountant generally associated with the regular servicing of an accounting client, such as regularly meeting with clients, preparing general ledgers,

financial statements, tax returns, and other reports, and providing such other recurring services as are generally associated with representing clients on a regular basis.

(2) While Doe is Temporarily Disabled, XYZ shall devote adequate partner and staff resources, including ABC's staff, to continue providing services to the Clients.

(3) XYZ shall retain ____ percent of Collections generated from the services provided to the Clients and XYZ shall pay ABC ____ percent of Collections for work that requires staff time. When XYZ devotes partner time, XYZ shall retain ____ percent of Collections pertaining to such work and pay ABC _____ percent of Collections pertaining to such work to ABC.

(B) In the event of Permanent Disability or death of Doe, conform to the following:

(1) Starting on the Effective Date triggered by Permanent Disability, or Doe's death, XYZ shall pay ABC ____ percent of Collections received from Clients for work performed by XYZ from such month through the end of the 60th month following, when collected. Payments for each month shall be made on the 15th day of the month next succeeding the month in which the Collection is received for such work.

(C) In the event ABC requests XYZ to perform services for ABC and or its Clients when Doe is not disabled or dead and XYZ agrees to same, ABC shall reimburse XYZ based on ____ percent of XYZ's normal billing rates for the level staff devoted for each such mutually agreeable task.

(D) XYZ shall deliver to ABC, or Doe's heirs, representatives, or assignees a statement on or before the due date for each payment due under any provision of this Agreement, setting forth all relevant Collections received by XYZ during the prior month.

(E) ABC or Doe's representative shall have 90 days from the date it receives statements from XYZ to review its records with respect to Collections from Clients. XYZ agrees to allow ABC or Doe's representative full access to XYZ's records with respect to such Collections from Clients during its normal business hours, upon written notice to XYZ of ABC's intention to review such records. If ABC or Doe's representative determines that XYZ's statements are inaccurate, they may dispute such statements and if the dispute cannot be resolved between the Parties, then the dispute shall be resolved in accordance with the arbitration procedures set forth in Paragraph 11 (G).

(F) XYZ may acquire some or all of the furniture and equipment used by ABC in the Practice at XYZ's option in the event of Doe's Permanent Disability or death, at a price to be mutually agreed to by the Parties at such time.

4. COLLECTION OF RECEIVABLES AND WORK IN PROCESS

(A) The value of the outstanding receivables from the Clients as of the Effective Date shall be retained by ABC. The value of all receivables for work performed after the Effective Date shall be retained by XYZ.

(B) XYZ will complete any work in process for the Clients as of the Effective Date and invoice and divide the collections derived from such work pro rata in accordance with the percentage of each Party's standard time (hours multiplied by standard rates) on each such case bears to total standard time on that case by all parties.

(C) XYZ will attempt to collect the outstanding receivables as of the Effective Date and the work in process as of the Effective Date that is subsequently billed to the Clients on behalf of ABC. XYZ shall use its reasonable efforts to collect such amounts but XYZ makes no representations that all amounts will be collected and shall not be liable to ABC, Doe, or Doe's heirs for a failure to collect all such amounts. ABC shall have the right to participate in the effort to collect all outstanding receivables and work in process as of the Effective Date at its discretion. XYZ shall retain _____ percent of the collection of ABC's receivables as an administrative fee.

(D) XYZ shall pay ABC for the collection of ABC's receivables on the 15th day of the month following the receipt of such funds. Such amounts shall be excluded from the computation in compensation to be paid ABC in Paragraph 3.

5. XYZ RESTRICTIVE COVENANT

(A) With respect to Clients, XYZ agrees that it will not, for as long as this Agreement is not terminated and for the period of time two years after termination, solicit accounting business, perform any accounting or tax services, whether for compensation or not, or in any way interfere with ABC maintaining its fees to any such persons or businesses unless requested by ABC or approved by ABC. Only Clients that have been periodically reported to XYZ as Clients shall be covered by these provisions. Furthermore, these restrictions shall not apply following Doe's Permanent Disability or death, unless this Agreement has been terminated prior. ABC and XYZ agree that the restrictions of this paragraph are reasonable in time and in scope, and are fair in all respects.

(B) In the event XYZ breaches the restrictions of this Paragraph 5, conform to the following:

(1) In addition to any rights ABC may have at law, ABC shall have the right to, and XYZ consents to granting and does not oppose, injunctive relief, to enjoin XYZ from performing any acts prohibited herein.

(2) When such breach results in the loss of fees from any Client covered by this Agreement, XYZ shall pay ABC liquidating damages in the amount of 150 percent of the prior 12 months collected fees for any such Clients, whenever collected. Such amount shall be made in 24 equal monthly payments paid consecutively, commencing 1 month after the date of such breach.

6. ABC AND DOE'S RESTRICTIVE COVENANT

(A) With respect to Clients, ABC and Doe agree that they will not, for as long as the compensation described in Paragraph 3 is being received by ABC due to Doe's Permanent Disability and for the period of time two years after such compensation terminates, solicit accounting business, perform any accounting or tax services, whether for compensation or not, or in any way interfere with XYZ maintaining its fees to any such persons or businesses unless requested by XYZ or approved by XYZ. ABC and XYZ agree that the restrictions of this paragraph are reasonable in time and in scope, and are fair in all respects.

(B) In the event ABC or Doe breaches the restrictions of this Paragraph 6, conform to the following:

(1) In addition to any rights XYZ may have at law, XYZ shall have the right to, and ABC and Doe consent to granting and do not oppose, injunctive relief, to enjoin ABC and Doe from performing any acts prohibited herein.

(2) When such breach results in the loss of fees from any Client covered by this Agreement, Doe shall pay XYZ liquidating damages in the amount of 150 percent of the prior 12 months collected fees for any such Clients, whenever collected. Such amount shall be made in 24 equal monthly payments paid consecutively, commencing 1 month after the date of such breach.

7. XYZ'S WARRANTIES, REPRESENTATIONS, AND COVENANTS

XYZ represents, warrants and agrees that

(A) XYZ has the full right, power, and authority to enter into this Agreement, and by the execution of this Agreement, XYZ has not caused a default under nor breached any provision or any other written or oral agreement into which XYZ has previously entered.

(B) XYZ shall not hold itself out as having any authority to represent ABC, nor do anything which may tend to expose ABC to any debt, liability, or claim nor anything which may adversely reflect upon the reputation of ABC.

(C) XYZ shall indemnify and hold ABC harmless from any malpractice claims, judgments, preparer penalties, or the like, with regard to any work performed or that should have been performed after the Effective Date, by XYZ or its employees, affiliates, or associates. XYZ shall defend ABC in any such action for which it holds ABC harmless, and reimburse ABC for any reasonable legal fees, expenses, and disbursements ABC may incur in connection therewith.

(D) XYZ shall protect any collected fees in its possession or fees to be collected from any loss, lien, or taking by a third party arising out of any claim against XYZ or its Partners by a third party for malpractice, negligence, breach of contract, injury, liability, or other cause of action in law or equity. XYZ and its PARTNERS shall reimburse ABC for fees lost or not paid as agreed because of any event described herein.

(E) ABC is not assuming any liabilities or debts of XYZ and all debts and liabilities of XYZ shall remain XYZ's obligations. To the best of XYZ's knowledge, there are no outstanding judgments, claims, or lawsuits pending against XYZ which may materially affect the obligations of XYZ hereunder.

8. ABC'S WARRANTIES, REPRESENTATIONS, AND COVENANTS

ABC warrants and represents that:

(A) the Practice is free of all encumbrances, liens, and security interests.

(B) XYZ is not assuming any liabilities or debts of ABC, and all debts and liabilities of ABC shall remain ABC's obligation. To the best of ABC's knowledge, there are no outstanding judgments, claims, or lawsuits presently pending against ABC.

(C) ABC and Doe shall not hold themselves out as having any authority to represent XYZ, nor do anything which may tend to expose XYZ to any debt, liability, or claim, or anything which may adversely reflect upon the reputation of XYZ, except as set forth herein.

(D) ABC shall indemnify and hold XYZ harmless from and defend any action on behalf of XYZ and reimburse XYZ for any reasonable liabilities, legal fees, expenses, and disbursements XYZ may incur in connection with any malpractice claims, suits, actions, judgments, preparer penalties, or the like in regard to any work which was performed or should have been performed by ABC or its associates prior to the Effective Date.

(E) ABC and Doe have the full right, power, and authority to enter into this Agreement, and by the execution of this Agreement, ABC and Doe have not caused a default under or breached any provision or any other written or oral agreement into which ABC or Doe have previously entered. ABC and Doe are not bound by any agreement with anyone that prohibits all or any part of this Agreement.

9. TERMINATION

Either Party may terminate this Agreement with 60 days' notice by providing such notice in writing prior to an event that triggers the Effective Date.

10. NOTICES

Any notices required or permitted to be given under this Agreement shall be sufficient if in writing, and if delivered personally, or sent by registered mail or certified mail, to the address of the Party set forth or subsequently changed in writing pursuant to the provisions of this PARAGRAPH. Such notices shall be deemed to have been given at the time when personally delivered to and received by the Party, or their representative, getting such notice.

11. MISCELLANEOUS.

(A) The Parties will execute any instruments necessary to give effect to the intent of the Parties as herein expressed.

(B) No provision in the Agreement may be modified or amended, except by written consent of the Parties. In the event any part or parts of this Agreement are found to be void or unenforceable, the remaining provisions of this Agreement shall nevertheless be binding, with the same force and effect as though the void or unenforceable part or parts were deleted.

(C) This Agreement shall be binding upon and inure to the benefit of the Parties and their respective heirs, successors, and assigns.

(D) This Agreement shall be governed by and construed and interpreted in accordance with the laws of the State (Commonwealth) of _________.

(E) This Agreement represents the entire understanding of the Parties, and no modifications or additions thereto have been agreed to or will be binding hereafter unless executed in writing by all of the Parties hereto.

(F) This Agreement, and a Party's obligations hereunder, may be delegated or assigned with the prior written consent of the other Party, which will not be unreasonably withheld, provided, however, that any such assignment shall not relieve XYZ or the principals thereof or ABC of their rights and respective obligations hereunder.

(G) Any controversy or claim arising out of or relative to this Agreement, or the breach thereof, shall be submitted to arbitration before a single arbitrator, subject to the commercial arbitration rules of the American Arbitration Association, with venue for all proceedings to be held in City name here, State name here, with the nonprevailing Party to pay the cost of the Arbitrator, legal fees, and expenses. The parties shall select an arbiter within 30 days. If the parties cannot mutually agree on an arbiter then the American Arbitration Association shall appoint one. The arbitration shall be heard and concluded within 90 days.

(H) This Agreement may be executed in any number of counterparts, each of which shall be deemed one and the same instrument.

(I) Failure to insist upon strict compliance with any of the terms, covenants, or conditions hereof shall not be deemed a waiver of any such term, nor shall any waiver or relinquishment or any right or power hereunder, at any one time or more times, be deemed a waiver or relinquishment of such a right or power, at any other time or times.

(J) The warranties and representations made herein shall survive the closing.

IN WITNESS WHEREOF, each of the Parties hereto have executed this Agreement on the date set forth.

For: ABC

____

Printed Name Title

____

Signature Date

John Doe, for himself

____

Signature Date

For: XYZ

____

Printed Name Title

____

Signature Date

EXHIBIT A

Client List

APPENDIX D
Sample Client Announcements

SAMPLE CLIENT ANNOUNCEMENT IN CASE OF TEMPORARY DISABILITY

Dear **[Client]**,

Due to an unexpected illness, my clients will be served for the time being by the partners of ABC & Company. They have stepped in to ensure that you benefit from the same excellent service and personal attention that you have always received from our firm. Your fee structure, of course, will remain the same.

This arrangement was planned well in advance in case of an emergency and I will remain of counsel to the firm during my illness. ABC & Company is made up of high-quality, committed professionals and I have ensured that they are familiar with my clients' histories and their needs. ABC & Company shares the same values we do and has the same the tradition we have for excellent service and deep expertise, and an environment our clients and associates want to be a part of. Our associates **[Name]** and **[Name]** will continue to work with ABC and with our clients during my absence. They will work **[from our own offices *or* from the ABC offices at] [address, city, state, zip, as of (date)]**. Our existing phone numbers and e-mail addresses will continue to be operational.

I am confident that ABC is well equipped to take over during my illness and ensure that all of your needs are met. In the meantime, **[Name]** will be your personal contact at ABC**. [Details on the contact's background and qualifications to serve clients.]**

I am grateful to you not only for giving us the opportunity to provide you with accounting services, but for your loyalty and friendship which have enriched our relationship. I look forward to working with you again when I am able.

John Smith, CPA

Smith & Company

SAMPLE CLIENT ANNOUNCEMENT IN CASE OF DEATH (IF SENT BY THE FAMILY OR AGENT OF THE CPA)

Dear [Client],

In light of the passing of John Smith, CPA, his clients will now be served by the partners of ABC & Company. They have stepped in to ensure that you benefit from the same excellent service and personal attention that you have always received from Smith & Company. Your fee structure, of course, will remain the same.

Thankfully, John planned this arrangement well in advance in case of an emergency. ABC & Company is made up of high-quality, committed professionals who are familiar with the histories and needs of Smith & Company clients. ABC & Company shares the same values as Smith & Company and has the same tradition for excellent service and deep expertise, as well as a friendly and welcoming environment for clients and associates. Smith & Company associates **[Name]** and [**Name**] will become employees of ABC and continue to work with Smith & Company clients. They will work [**from our own offices *or* from the ABC offices at] [address, city, state, zip, as of (date)].** Their existing phone numbers and e-mail addresses will continue to be operational.

Rest assured that ABC is well equipped to meet the needs of Smith & Company clients. **[Name]** will be your personal contact at ABC. **[Details on the contact's background and qualifications to serve clients.]**

On behalf of both firms, we are grateful to you not only for giving John the opportunity to provide you with accounting services, but for your loyalty throughout the years. ABC & Company looks forward to working with you.

The Family or Agent of John Smith

Sample Client Announcement in Case of Death (If sent by the successor firm)

Dear [Client],

In light of the passing of John Smith, CPA, his clients will now be served by the partners of ABC & Company. We have stepped in to ensure that you benefit from the same excellent service and personal attention that you have always received from Smith & Company. Your fee structure, of course, will remain the same.

Thankfully, John planned this arrangement well in advance in case of an emergency. ABC & Company is made up of high-quality, committed professionals who are familiar with the histories and needs of Smith & Company clients. ABC & Company shares the same values as Smith & Company and has the same tradition for excellent service and deep expertise, as well as a friendly and welcoming environment for clients and associates. Smith & Company associates **[Name]** and **[Name]** will become employees of ABC and continue to work with Smith & Company clients. They will work **[from our own offices *or* from the ABC offices at] [address, city, state, zip, as of (date)].** Their existing phone numbers and e-mail addresses will continue to be operational.

Rest assured that ABC is well equipped to meet the needs of Smith & Company clients. **[Name]** will be your personal contact at ABC. **[Details on the contact's background and qualifications to serve clients.]**

On behalf of both firms, we are grateful to you not only for giving John the opportunity to provide you with accounting services, but for your loyalty throughout the years. ABC & Company looks forward to working with you.

The Partners and Associates of

ABC & Company

Appendix E
Due Diligence Tools

Standard Due Diligence Review: Buyer

This abbreviated checklist has been used by many buyers for succession deals that are 100 percent based on collections postclosing.

- ☐ Billings versus collections for the past year to verify the volume and collectability.
- ☐ Cash collections by month.
- ☐ Clients, including annual fees and industry, sorted by partner, with information on how long they have been clients, and services provided. The industry and services provided can simply be noted on time and billing reports.
- ☐ Accounts receivable and work in process age analysis.
- ☐ Sample of work papers for various types of services.
- ☐ Information on billing and collection procedures. How do the seller's policies differ from the buyer's?
- ☐ Leases the buyer may assume, such as equipment or office facilities.
- ☐ Financial statements or tax returns for the last three years.
- ☐ Staff census: roles, title, compensation, billing rate, client contact, tenure, and commitments made to them.
- ☐ Employment agreements, if any.
- ☐ Confirmation of firm net income before owners' compensation, benefits, and perks. It should at least match the margin assumed in the agreement.
- ☐ Based on details on the state board of accountancy website, status of the firm and individual licenses.
- ☐ Descriptions of any legal proceedings, malpractice claims, or other claims or litigation in the last three years, especially concerning clients.
- ☐ Descriptions of any employee benefit plans and policies. How do they compare with what the buyer will offer any remaining employees?
- ☐ Employee manual, to compare policies and how any changes may affect staff retention.
- ☐ Copies of standard engagement letters, if any.
- ☐ Information on matters brought before any tax authorities in the last three years.

- ☐ Information on computer systems and their compatibility with the buyer's systems.
- ☐ Condition of other office equipment.
- ☐ Peer review report.

Summary Merger and Acquisition Due Diligence Checklist for the Buyer or Successor Firm

FIRM NAME:

HISTORY AND BACKGROUND

- ☐ Obtain a summary history of the firm, including any recent transitions, such as partners who have left or been added, mergers and acquisitions, and other major events.

FINANCIAL DATA

- ☐ Obtain a copy of last three years' accrual basis financial statements, including balance sheets (cash basis if accrual not available) and tax returns.
- ☐ Confirm the profit margin before partner compensation adjusted for personal expenses, fringe benefits, and unusual items.

Receivables

- ☐ Compare billings to collections for the last year to determine historical collection rate.
- ☐ Obtain cash collections by month and review seasonality of cash flow.
- ☐ Obtain aged accounts receivable and work in process summaries and review.
- ☐ Determine the firm's policies for prebilling and collecting retainers from clients.

EMPLOYEES

- ☐ Obtain the following for at least the key employees (consider obtaining the information for all employees, if practical):
  - Name
  - Title
  - Major duties
  - Compensation
  - Tenure
  - Licenses
  - Planned attrition, if any
- ☐ Obtain an estimate of annual attrition rates for employees.

☐ Obtain a copy of the employee manual. Review it to understand the policies and procedures to which employees are accustomed.

☐ Obtain copies of standard employment agreements used by the firm, if any.

☐ Obtain information about employee benefit plans and determine the effects, if any, that adopting the successor firm's benefit plans will have on employees from the merged firm.

CLIENTS

☐ Obtain a full client list, including fees and type of service for each. For the full list, or at least for the major accounts, get information on tenure of clients, who performs the work, where it is performed, how many clients drop off work, how many clients require face-to-face time with partners, and industry concentrations. Try to determine the general cost of providing the services the way the clients are accustomed to receiving them.

☐ Obtain an estimate of the annual average attrition rate for clients.

QUALITY CONTROL

Workpaper Review

☐ Review several workpaper files to see the types of services the firm provides and compare quality of work against industry and firm standards. At a minimum, include audits, reviews, compilations, and business tax returns.

☐ Obtain samples of engagement letters and review engagement letters policies.

☐ Review procedures and forms for controlling work flow and quality, such as process sheets and checklists.

☐ Obtain copies of most recent peer review reports.

Professional Liability Insurance and Litigation

Does the firm have professional liability insurance? YES ___ NO ___

If yes,

Carrier ____________________________ Limit of claims coverage (attach description)

Annual premium ___________________

Does the firm have or has it ever made a claim against the professional liability coverage? If yes, attach explanation.

Does the firm have any outstanding professional liability claims or pending litigation that have not been reported to the insurance carrier? If yes, explain.

Does the firm have any outstanding or pending litigation for matters other than professional liability? If yes, explain.

Does the firm have or has it ever had any disputes or censures by a regulatory agency, such as the state board of accountancy or the Internal Revenue Service? If yes, explain.

Licenses

- ☐ Using the state board of accountancy's website, review the firm's registration status.
- ☐ Obtain verification of current CPA license of all partners and other key licensed personnel.
- ☐ List all important licenses, such as securities and insurance licenses. Describe who holds the license and determine status.

Entity Status

☐ Confirm the firm's entity status with the relevant secretaries of state.

OTHER

Complete the following for each office location:

Description of office location	
Owned or leased	
Square feet	
Description of type of building	
Standalone or multitenant	
If multitenant, description of other tenants	
Lease term remaining	
Average annual total cost of remaining lease term	
Relationship of landlord, if any, to firm	
Estimated percentage of capacity currently unused	
General description of condition	

Computer Equipment

Generally describe the firm's computer equipment (desktops, laptops, printers, servers, brands) and their condition.

Describe firm's Internet connectivity and speed.

Other Furniture and Fixtures

- ☐ Obtain a copy of the firm's depreciation lapse schedule or other listing of office equipment. Review condition of any office equipment and furniture the firm will be bringing with it.

Leases and Other Obligations

- ☐ Determine if the firm's leases, obligations, and commitments should or should not be assumed, including equipment leases, software licenses, maintenance agreements, consulting or marketing agreements, organization dues, and so on.

Employee Census

Name	Duties, Area of Emphasis, Specialties, Credentials, or Licensing	Total Annual Hours Worked, if Not Full-Time	Years With Firm	Current Estimated Total Compensation	Annual Chargeable Hours

Comprehensive Merger and Acquisition Due Diligence Checklist

FIRM NAME:

FINANCIAL DATA

- ☐ Obtain a copy of the last three years' accrual basis financial statements, including balance sheets (cash basis if accrual not available) and tax returns.
- ☐ Determine net income before partner compensation and benefits.
- ☐ Obtain a copy of any available forward-looking financial information, such as budgets for forecasts, and compare to historical statements. If none are available, ask about expected increases or decreases in revenues and profitability. Look for trends in revenue growth and profit margins. Obtain an explanation of any decline in revenues or unusual increase in revenues historically or projected.
- ☐ Obtain details about any business combinations or divestitures in the last five years.

Revenue Summary (accrual basis)

$ ________ Last Fiscal Year Ending

$ ________ First Preceding Year

$ ________ Second Preceding Year

Receivables

Accounts Receivable	As of Last Fiscal Period End	As of Last Interim Period End
0–30 days	$	$
31–60 days	$	$
61–90 days	$	$
over 90 days	$	$
Total	$	$

Work in Process	As of Last Fiscal Period End	As of Last Interim Period End
0–30 days	$	$
31–60 days	$	$
61–90 days	$	$
over 90 days	$	$
Total	$	$

- ☐ Determine the firm's business and accounting policies for prebilling or collecting retainers from clients. If the liability, if any, for unearned revenue is not reflected properly on the financial statements or as a contra to accounts receivable, determine the adjustment necessary to the financial statements and the transaction agreement.

Retirement and Other Withdrawal Obligations

- ☐ Obtain a copy of the firm's partnership or shareholder agreement. Even if partners of the acquired firm are expected to sign the successor firm's partnership or shareholder agreement, look for material differences in the approaches to partner benefits, perks and retirement payments, and so on to determine any transition issues.
- ☐ Describe the firm's unfunded liability to retired partners, including number receiving payments, amount and number of payments remaining for each, and potential for adjustment in payment amounts.

Owner Census
(Complete as many pages as are necessary to cover all owners)

	Owner ___	Owner ___	Owner ___	Owner ___
Name				
Description of duties				
Area of emphasis or specialized expertise				
Credentials and professional licenses				
Years with company				
Ownership percentage: capital				
Profit allocation percentage				
Related to another owner or key employee?				
Annual base draw or salary				
Year-end bonus or allocation of profits (most recent fiscal year)				
Size of annual client billings directly managed				
Estimated number of business clients managed				
Number of clients that make up more than 10% of managed billings				
Total annual fees for clients that make up more than 10% of managed billings				
Number of 1040s managed				
Total annual fees for 1040s managed				
Annual chargeable hours on own production				
Average standard billing rate on personal chargeable hours				
Estimated amount of new business generated in most recent fiscal year				

Side Businesses

Are there any side businesses the owners as a group or individually are involved in that could create a conflict of interest, create financial risk, or require significant time commitments? If yes, describe them here.

Partner Benefits

Describe partner perks provided, such as insurance, auto and other expense reimbursement.

Employee Census

In evaluations of small firms, complete the following for all nonowner employees.

In evaluations of large firms, complete the following for all key nonowner employees

Name	Duties, Area of Emphasis, Specialties, Credentials, or Licensing	Years With Firm	Related to Another Owner or Key Employee?	Current Estimated Total Compensation	Annual Chargeable Hours	Realization rate on chargeable hours	Estimated size of client billings directly managed

If full employee census data has not been obtained, complete the following for nonowner employees:

Level	Number	Range of Compensation	Range of Annual Chargeable Hours	Range of Hourly Billing Rates
Principals				
Senior managers				
Managers				
Supervisors				
Seniors				
Staff				
Paraprofessionals				
Administrative management				
Administrative nonmanagement				

Does the firm have employment agreements that restrict post-termination competition or solicitation of clients from nonowner employees? YES ___ NO ___

If yes, from what levels of employees?

- ☐ Obtain a sample copy of the firm's standard employment agreement.

Employee Benefits

Describe the firm's policies for incentive compensation and overtime.

____

____

____

Describe the firm's policies for paid time off, insurance benefits, and reimbursements.

____

____

____

- ☐ Obtain a copy of the firm's employee handbook.

CLIENTS

Service Area	Approximate Number of Service Units*	Percentage of Total Fees
Audit		
Reviews		
Compilations		
Noncompilation write-ups		
Business tax		
Individual tax		
General business consulting		
Other:		
Other:		

* Number of audits, tax returns, clients, and so on.

Industry Concentrations

Industry	Approximate Percentage of Total Fees	Approximate Number of Clients
Construction		
Manufacturing		
Wholesale		
Retail		
Governmental		
Medical services		
Other professional services		
Financial services		
Not-for-profit		
Real estate		
Publicly traded companies		
Other:		
Other:		
Other:		
Other:		
Other:		

Clients by Size of Annual Fees

Client Annual Fees: Business Clients	Number of Clients
Under $2,500	
$2,501–$10,000	
$5,001–$25,000	
$25,001–$100,000	
Over $100,000	

Individual Client Fees

Number of individual clients for whom no business services are performed ___________

Average fees for individual clients $ ______________

Minimum fee, if any, for new individual clients $ _________

Billing Methods

Billing Method	Approximate Percentage of Total Fees
Hourly rates	
Fixed or semi-fixed	
Monthly retainers	
Other retainers	
Other (describe)	

Major Clients

Information for 10 largest clients in prior year annual fees.

Client Industry	Client Approximate Annual Revenues	Tenure as Client	Prior Year Total Fees	Next Year Expected Fees	Services Provided

(continued)

Client Industry	Client Approximate Annual Revenues	Tenure as Client	Prior Year Total Fees	Next Year Expected Fees	Services Provided

QUALITY CONTROL

Workpaper Review

- ☐ Review several workpaper files for the types of services the firm provides and compare quality of work against industry and firm standards. At a minimum, include audits, reviews, compilations, and business tax returns.

Engagement Letters

Describe the firm's policy for obtaining engagement letters from new and existing clients and review representative samples of engagement letter templates.

____

____

Client Acceptance and Retention

Describe the firm's procedures for client acceptance and retention (applies primarily to multipartner firms).

____

____

Registration (Check boxes where appropriate.)

Registered with PCAOB ___ Member of PCPS ___

Is a formal quality control system in use? Yes ___ No ___

Has a peer review been conducted? Yes ___ No ___

If yes, give date of review ___

Report issued ______________________________

Describe nature of qualifications or comments.

____

____

____

Has the firm received other than clean peer review reports in past reviews? If yes, describe nature of reports and when received.

____

____

____

Professional Liability Insurance and Litigation

Does the firm have professional liability insurance? YES ___ NO ___

If yes,

Carrier ______________________ Limit of claims coverage (attach description)

Annual premium _______________

Does the firm have or has it ever made a claim against the professional liability coverage? If yes, attach explanation.

Does the firm have any outstanding professional liability claims or pending litigation that have not been reported to the insurance carrier? If yes, explain.

____

____

Does the firm have any outstanding or pending litigation for matters other than professional liability? If yes, explain.

____

____

____

Does the firm have or has it ever had any disputes or censures by a regulatory agency such as the state board of accountancy or the Internal Revenue Service? If yes, explain.

Trustee Services

Do any owners serve as trustees for client trusts? If yes, describe extent and nature of these services.

Licenses

- ☐ Review the status of the firm's registration with the state board of accountancy through the board's website.

List all important licenses that the firm relies upon to conduct its business such as securities and insurance licenses. Describe who holds the license and determine status.

Entity Status

Determine the status of the entity the firm operates through with the relevant Secretary of State.

Associations

Check if firm is a member:

AICPA ________ State CPA Society __________

Other: Firm associations (describe)

OTHER

Complete the following for each office location:

Description of office location	
Owned or leased	
Square feet	
Description of type of building	
Standalone or multitenant	
If multitenant, description of other tenants	
Lease term remaining	
Average annual total cost of remaining lease term	
Relationship of landlord, if any, to firm	
Estimated percentage of capacity currently unused	
General description of condition	

Computer Equipment

Generally describe the type of computer equipment the firm uses (desktops, laptops, printers, servers, brands) and condition.

Does the firm intend to make a major investment in new technology in the near future? If yes, explain.

Describe firm's Internet connectivity, including type (T-1, cable, DSL, dial-up) and speed.

Other Furniture and Fixtures

Obtain a copy of the firm's depreciation lapse schedule or other listing of office equipment.

Sample Confidentiality and Nondisclosure Agreement

Agreement between Seller or Mergee firm name here and Successor firm name here

This Confidentiality and Nondisclosure Agreement (Agreement) will define the mutual understanding of the undersigned in connection with the provision and the receipt of INFORMATION regarding their business operations.

1. INFORMATION means all oral or written data, reports, records, or materials, including the name, address, and type of business of the parties; the knowledge that the parties may be considering an affiliation; or even the fact that information has been provided. INFORMATION shall not include, and all obligations as to nondisclosure by the undersigned shall cease to any part of such INFORMATION to the extent that such INFORMATION (*a*) is or becomes public (other than as a result of acts by the disclosing party), (*b*) can be shown to have been already known to the other party at the time of its disclosure hereunder, (*c*) has been independently obtained from a third party having no duty of confidentiality to the party whose INFORMATION is disclosed, or (*d*) is independently developed without use of any INFORMATION supplied hereunder.
2. INFORMATION is being furnished solely in connection with the undersigned's consideration of the possible affiliation of their accounting practice and shall be treated as secret and confidential and no portion of it shall be disclosed to others, except to those officers of either party who shall assume the same obligations as the undersigned under this Agreement. The undersigned further agrees that they will not interfere with any business of the other through the use of any INFORMATION or knowledge acquired under this Agreement or the use any such information for its own account.
3. All information from one party to the other shall be safeguarded and promptly returned or destroyed, as directed by the other.
4. It is understood that (*a*) no representation or warranty is being made as to the completeness or accuracy of any information and (*b*) any and all representations and warranties shall be made in a signed agreement.
5. The undersigned acknowledges the responsibility to perform a due diligence review at its own cost and expense prior to any affiliation.

6. The respective obligations of the parties under this Agreement shall survive for a period of 12 months following the date hereof.

AGREED TO AND ACCEPTED BY:

Signature	Signature
By: ______________________	By: ______________________
Printed name	Printed name

CLIENT QUESTIONNAIRE

Name of Firm:	Date completed:	
Satellite office(s) if any:		
Website:	Phone: ( )	Fax: ( )
Cell numbers for important communications:		
Name	Number	
Main contact person for sending information and practices via e-mail:		
E-mail address of contact person:		

Partner Name	Age	Billing Rate	Years With Firm	Special Licenses	E-mail

Are your e-mails private? Yes No

STAFFING	Number	Billing Rate	Special Licenses	Range Annual Compensation
Managers				
Other CPAs				
Non-CPA pros				
Para pros				
Clerical				

Firm Specialties:

Firm annual volume last three years starting with most recent:

$ $ $

Percentage of net profit to partners including their salaries %

Service Rendered by Percentage	
Audit	%
Compilation	%
Review	%
Write-ups	%
Tax	%
Other Explain:	%

Accounting associations (small and large) that you are a member:

Have you acquired or merged in firms before and, if yes, are they available for a reference?

Does your firm currently have excess capacity on the following levels?

Partner Yes No

High-end staff Yes No

Low-end staff Yes No

The lease for your office space(s) expires when? (please describe for your primary offices)

Do you have additional space for additional staff? Yes No

Do you have additional space for private offices? Yes No

Are you peer reviewed? If yes, what was the date and level of your last report?

Check all that apply—Our firm is interested in:

☐ Acquiring a firm ☐ Merging in talent ☐ Adding a niche

☐ Merging with a larger firm to help transition their partners

If you do not have a satellite office, would you consider establishing one to accommodate an acquisition opportunity? Yes No
If so, where?

The size of the firms you seek range from $ to $

Does your firm have a partnership or shareholder agreement? Yes No

If yes, have all of the owners executed it? Yes No

Are all of the owners satisfied with the terms of your owner agreement? Yes No

Does your firm have a plan for internal succession of its partners? Yes No

Are all owners satisfied with this plan? Yes No

If not, briefly describe the nature of their dissatisfaction.

Briefly describe how you determine partner compensation:

Does your firm have the talent on board to replace future retiring partners? Yes No

Briefly describe how you compensate partner retirement:

Miscellaneous information we should know about your firm and goals:

Miscellaneous information a mergee or seller should know about your firm:

APPENDIX F
Sample Transition Letters

Upbeat and poised for new opportunities; that is the general tone that firms should set in communications with clients after a transition. Clients fear change, so communications should emphasize what will stay the same, such as staff members who are staying on. Anyone with client contact should be given at least informal training on the best way to respond to client questions. If the person fielding the call does not know how to answer a question, the call should be directed to the managing partner. Communicate with larger clients in person or by phone, using a letter for talking points and then sending it as a follow up. Smaller clients might only receive the letter.

This appendix includes five sample letters for a sale or affiliation and two for a merger that firms can use to present the transition in the right light.

Letter for an Affiliation #1

Date

Dear Client:

I am pleased to announce I have affiliated my practice with________ **(successor firm name).** We have combined our offices and are in the midst of relocating to________________**(list new location and address)**.

In today's world of constantly changing tax regulations, software requirements, and so on, I felt associating with the right partner(s) and staff will help us to continue to produce the quality work and services we have taken pride in delivering for decades. To better service my clients, I elected to affiliate with a firm that is state of the art for providing tax and accounting services so we can focus on keeping your tax liabilities as low as possible **(if the buyer can offer additional niche services, add that language here)**, all while operating under the same fee structure.

After interviewing many firms and practitioners, I decided to affiliate with_________**(successor)** and their team, who are experts in the modern tax laws and accounting technology, and shall enable us to specialize and offer you additional services while operating under the same fee structure as the past. _______**(Discuss the background of the partners in the successor firm. Also, the seller firm can break down the client list based on services or industries and describe the successor firm's expertise in customized letters to each type of client.)**

I look forward to working together with you and _______**(successor)** to handle all your accounting tax and financial needs. Please do not hesitate to call either of us directly, anytime.

Sincerely,

(Seller Name)

LETTER FOR AN AFFILIATION #2

Date

Dear Client:

As we come to the end of another prosperous year, I would like to take the time to say thank you. Our growth and success is measured by your ability to reach your financial goals. As a local accounting tax firm, I strive to meet the changing tax needs you face each year. I continually evaluate the service we provide and the manner in which we provide it. As a result of this process, ___________ **(seller firm)** is in a position to further raise the level of service to which you are accustomed.

I am pleased to announce I have affiliated with______________ **(buyer firm)** for tax planning, preparation, and accounting services. As my practice has grown, so have the multitude and complexity of my clients' tax and accounting issues. Over the last several months, I have analyzed the firm structure and concluded that the best solution for our clients is to segregate my expertise with professionals whose focus is primarily in certain categories as it become increasingly impossible to be the expert in them all. After interviewing many firms and practitioners, I decided to associate with________ **(buyer first name and last name)** and his team, who are experts in the modern tax laws and accounting service technology. _____________ **(buyer first name)** and I decided to affiliate because we both believe that a larger organization will allow us to provide a wider array of services and a greater depth of knowledge. In today's world of constantly changing tax and accounting regulations and software requirements, I believe associating with the right team will allow me to continue to produce the quality tax and accounting assistance I have taken pride in delivering for years. ______ **(buyer first name)** and I have combined offices and I am in the midst of relocating to ________ **(buyer or seller address, city, state, and zip)**. We will work closely together and operate under the same fee structure while seamlessly providing expanded tax and accounting services.

_________**(buyer first name)** is a CPA with____ **(number of years)** experience delivering the same high-quality service that you have been accustomed to. ________**(buyer first name)** clients are small businesses requiring tax service very similar to the clients we have been providing for years. You will find___________ **(buyer first name)** personable and engaging. He has a genuine concern for the wellbeing of his clients and will work closely with you as I have over the past years.

Please feel welcome to call me or ______________ **(buyer first name)** to answer any questions regarding your current work, the firm structure, or additional services provided with this affiliation. I can be reached at __________________ **(seller or buyer phone number)**. We are all very excited about our new generation of capabilities. Please join me in welcoming __________ **(buyer first name)** and his team to our family.

Very truly yours,

(Seller Name)

LETTER FOR AN AFFILIATION FOR A FIRM CULLING OUT A NICHE AND SELLING THE REST

Date

Dear Client:

I am pleased to announce that our firm is instituting some changes to keep up with our client needs. In today's world of constantly changing tax regulations, software requirements, and so on, I have found it more than challenging to help my clients with their financial planning and wealth management needs, as well as stay on top of the minute-to-minute changes in the stock market and increasingly complicated tax law amendments. To better service our clients, we will be dividing the firm so we can each focus on our niches.

My new focus will gradually become almost exclusively financial planning for our client base, and my partners **(or successor firm)** will assume the responsibility of managing your tax and accounting needs. I will remain of counsel to the firm and work in the same office and the same dedicated team of professionals will be here with me. Our firm will also continue to operate under the same fee structure. As a result, you can expect the same level of service, the same long-term continuity of your accounting and tax needs, and you can count on me working with you on everything from investments to planning so we can reduce your tax liability and address all aspects of your personal financial wellbeing.

Because I will be staying in the same office, I remain available to help you and advise my partners on what we have done together so we can keep the ship sailing and moving forward in the same direction it has been. Due to the state laws, we must operate the wealth management end of the business through a different entity, so I will be providing these services under the firm name of______. Your accounting and tax needs will still be handled by ___________.

I look forward to continue working with you. Please do not hesitate to call anytime should you have any questions.

Sincerely,

(Seller Name)

Merger Letter

Date

Dear Client,

We are pleased to announce our forthcoming merger with _________ **(merging firm name)**. It is scheduled to take place officially on ____ **(date)**. Our combined firm will operate as ________**(new firm name)**.

Our firm began its professional practice in________**(year)**. Its growth over that span of time has been predominantly internal, stemming from the referrals of our client base and those of other professionals. The growth and development of our professionals staff has evolved in a similar manner. We have attracted high-quality, committed professionals and invested in their training, development, and growth. As a result of those efforts, we have experienced tremendous growth over the past several years. This has been directly related to the success our clients have had in their business and personal pursuits.

We decided to seek an affiliation because we believe that a larger organization will allow us to provide a wider array of services and more depth. As you know, in our area of the country, finding and retaining excellent people is a constant challenge. A larger organization will also mean our associates will benefit from even more and stronger career opportunities.

__________**(merging firm name)** shares the same values we do. We conducted an extensive search within our region looking for an opportunity like this. __________**(merging firm name)** exceeded our hopes for a firm we can combine with and continue the tradition we have for excellent service, deep expertise, and an environment that our clients and associates want to be a part of.

There are many new services and areas of expertise that we will be able to provide to you in the future. We look forward to discussing those in more depth with you. However, there are several things we want to point out that will not change:

- You will continue to work with the same people in our firm that you have in the past. All of our people are being retained in their current roles.
- Our fee structure will not be modified.
- The services we have provided to you in the past will continue.

__________**(firm name)** will be moving **(our or their office)** to __________**(firm name, address, city, state, and zip)**. Our existing phone numbers will continue to be the ones you will use to contact us.

If you have any questions about this exciting news and what it will mean for you, please contact any of us at any time. We look forward to introducing you to some of our new partners and associates.

We are grateful to you not only for giving us the opportunity to provide you with accounting services, but for your loyalty and friendship which has enriched our relationship. We are confident that our new affiliation will serve us all well.

Sincerely,

(The partners and associates of new firm name)

Upstream Merger Letter

Date

Dear Client,

We are pleased to announce our forthcoming merger with __________ **(merging firm)**. It is scheduled to take place officially on __________ **(date and year)**. On that date our combined firm will begin conducting its practice as __________**(new firm name)**.

Our firm began its professional practice in _____**(year)**. Its growth over that span of time has been predominantly internal, stemming from the referrals of our client base and those of other professionals. The growth and development of our professional staff has evolved in a similar manner. We have attracted high-quality, committed professionals and invested in their training, development, and growth. As a result of those efforts, we have experienced good growth over the past several years. This has been related to the success our clients have had in their business and personal pursuits.

We decided to seek an affiliation because we believe that a larger organization will allow us to provide a wider array of services and more depth. As you know, in our area of the country finding and retaining excellent people is a constant challenge. A larger organization will also mean our associates will benefit from even more and stronger career opportunities.

__________**(merging firm)** shares the same values we do. We conducted an extensive search within our region looking for an opportunity like this. __________**(merging firm name)** exceeded our hopes for a firm we can combine with and continue the tradition we have for excellent service, deep expertise, and an environment that our clients and associates want to be a part of.

There are many new services and areas of expertise that we will be able to provide to you in the future. We look forward to discussing those in more depth with you. However, there are several things we want to point out that will not change:

- You will continue to work with the same people in our firm that you have in the past. All of our people are being retained in their current roles.
- Our fee structure will not be modified.
- The services we have provided to you in the past will continue.

We will be moving our offices to __________**(firm name, address, city, state, and zip)** on __________**(day and date)**. Our existing phone numbers will continue to be operational for the time being, although we anticipate consolidating phone numbers as soon as possible.

[Alternatively]

We will continue to operate from our current offices. All the contact information for us will remain the same with the exception of our e-mail addresses. The convention for those addresses are __________ **[first initial] [lastname] @ abccpa.com**.

If you have any questions about this exciting news and what it will mean for you, please contact any of us at any time. We look forward to introducing you to some of our new partners and associates.

We are grateful to you not only for giving us the opportunity to provide you with accounting services, but for your loyalty and friendship which has enriched our relationship. We are confident that our new affiliation will serve us all well.

Sincerely,

(The partners and associates of new firm name)

Appendix G
Practice Summary Sheets

Practice Summary Sheet (Sole Proprietor)

Practice name:

Date completed:

Practice gross volume $

PRACTICE BREAKDOWN

Business Clients			
Total number of business clients		Monthly	
		Quarterly	
		Annually	
Estimated percent of business clients regularly visited or served in client offices			
Estimated percent of business clients that mail in or drop off work			
Individual Clients			
Total number of individual returns			
Revenue from individual returns			
Estimated percent of individuals interviewed in the office			
Estimated percent of individuals who are related to business clients			
Five Largest Clients—Do not include client names			
Specify Industry			Annual Fee
1.			
2.			
3.			
4.			
5.			
Services Rendered by Percentage			
Audit		Writeup	
Compilation		Tax	
Review		Other	

Staffing Information—Number of FTEs by Category (personnel can be counted in all three categories)			
	Number	Total Annual Compensation	Billing Rate
Partner	1	See profit margin below	
Managers			
Professional staff			
Paraprofessionals			
Clerical			
Total FTE headcount			
Professionals—CPAs			
Number of part-time personnel			
Other Information			
Lease Information	☐ Third-party lease	☐ Self-owned	
Approximate Square Feet		Monthly Cost	Expiration
Net profit margin of the practice to the owner before compensation and benefits			%
Please attach a description of any specialty practice areas including amount of fees and approximate number of clients.			
How many more tax seasons does the owner want to continue to work full time?			

Practice Summary Sheet (Multiowner Firm)

Practice name:

Date completed:

Practice gross volume $

PRACTICE BREAKDOWN

Business Clients			
Total number of business clients		**Monthly**	
		Quarterly	
		Annually	
Individual Clients			
Total number of individual returns			
Revenue from individual returns			
Five Largest Clients—Do not include client names			
Specify Industry			**Annual Fee**
1.			
2.			
3.			
4.			
5.			
Services Rendered by Percentage			
Audit		**Writeup**	
Compilation		**Tax**	
Review		**Other**	
Staffing Information—Number of FTEs by Category			
	Number	**Total Annual Compensation**	**Billing Rate**
Partner		**See schedule below**	
Managers			
Professional staff			
Paraprofessionals			
Clerical			
Total FTE headcount			
Professionals—CPAs			
Number of part-time personnel			

Owner Information			
Owner name or other ID			
Ownership %			
Age			
Compensation before perks			
Client billings managed			
Standard billing rate			
Expected years to work full-time			
Briefly describe current agreement for owner buyout			
Other Information			
Lease Information	☐ **Third-party lease**	☐ **Self-owned**	
Approximate Square Feet		**Monthly Cost**	**Expiration**
Net profit margin of the practice to the owner before compensation and benefits			**%**
Please attach a description of any specialty practice areas including amount of fees and approximate number of clients.			

BUYING, SELLING, OR MERGING YOUR CPA FIRM?

Learn what steps you can take right now to position you and your firm for success. Written with both buyers and sellers in mind, this comprehensive resource aims to ensure that both parties to a transaction achieve their goals.

Authors and transition experts Joel L. Sinkin and Terrence E. Putney demonstrate how you can arrive at a reasonable deal in which retiring partners are paid a satisfying price for the practice they've built, remaining partners make more than they did before, and new owners take on a practice that is poised for continuing success and potential growth.

Sinkin and Putney share their best advice on how to:

- Determine your firm's value,
- Get to know your potential partner in a deal,
- Select a successor your clients will love,
- Structure alternative deals,
- Avoid roadblocks,
- Prepare a practice continuation agreement,
- Perform due diligence,
- Execute a win-win deal, and
- Time and plan for your transition.

Each chapter concludes with an Action Agenda to help spur your planning. This book also includes a collection of practical tools to assist you through the process of buying, selling, or merging, including practice summary tools, an annual succession planning checklist, sample practice continuation agreement, sample client announcements, due diligence tools, and sample transition letters.

Joel L. Sinkin and Terrence E. Putney are the founders of Transition Advisors, LLC, a national consulting firm that provides services exclusively to CPA firms related to ownership transition including mergers and acquisitions, succession planning, owner agreements, and owner compensation plans.
www.transitionadvisors.com.

ISBN 978-1-94023-512-7
9 781940 235127

PPM1304P

AICPA American Institute of CPAs®

aicpa.org | cpa2biz.com