SUCCESSION OPTIONS

MODULE 3: GROWTH AND SUCCESSION GUIDE

INTRODUCTION

Who will buy my practice is a question that is increasingly being asked. With the average age of public practitioners now well over 50, an increasing number are contemplating how they will succession manage their practice. For many the focus is on the capital value of the practice and how they can extract this capital value to assist in their retirement planning. Succession though, isn't always about retirement. There are a whole range of events that can be a catalyst to the sale of a practice.

Currently, there are approximately 9,000 public practice firms in Australia, and of these 83% are represented by sole practitioners and two partner firms. You have a large number of small practices delivering similar services to a similar client base. These firms are typical of small business in Australia. CPA Australia public practice statistics identify that approximately 42% of members may have a succession event for their practice within the next five years.

Where does this place public practitioners looking to plan and implement their succession?

The main options are:

- sale of a fee parcel
- outright sale
- merger
- sale to existing partners
- internal succession
- introduction of new partners
- orderly wind up of the practice.

Each of these options, with the exception of the last one, will seek to generate a return of working capital and also a return on your investment in plant and goodwill. The critical factors will be timing, pricing and planning. Your approach to the sale of your firm will vary depending on which sale option you are planning to pursue.

The difference between taking a structured approach to this and a last-minute rush to find a buyer can be many thousands of dollars. Planning the sale of your practice is about maximising the value of your asset and also managing an orderly transfer of your professional obligations in respect of your clients and your team.

Given the expectation of an increasing number of firms and fee parcels coming on to the market, without question we will see buyers gravitate toward value. A clear message is that we should all be planning for the ultimate sale of our firm – irrespective of whether we expect to be in practice for two or 22 years.

Every firm should be developed with view to the ongoing succession and ultimate sale of the business. The great thing about doing this is that you build a strong and profitable business from day one. And when the time comes for you to move on, then you have an asset that is attractive in the market and one for which there should be strong demand.

This guide has been designed to provide you with some of the practical tools that will assist you to plan and position your practice so that it is attractive in the marketplace and to manage your succession. It is particularly focused on small and medium size practices, although the fundamentals hold true for all.

SUCCESSION OPTIONS

This module looks at the different succession options available to you and identifies some of the key issues you need to consider with each option, which are:

- sale of the practice
- sale of a fee parcel
- progressive sell down
- merger
- internal succession
- admission of a new partner
- buyout by existing partner/s.

Some issues will present themselves with virtually all options, whereas others are more unique to a particular option. Many of the issues will be negotiable between the parties. Issues raised are common positions that frequently arise in a transition.

In proceeding down a succession pathway, it makes sense to have considered in advance some of the issues you may face. It will allow you to be better prepared for them.

SALE OF THE PRACTICE

This is currently the most common succession option. In most areas there is an active market for good quality accounting firms. There are a significant number of mergers and acquisitions being completed at the moment as many existing firms are looking to bulk up through acquisition.

Larger firms who are looking for accelerated growth are also completing tuck-in acquisitions. This may present a succession opportunity or a transition path for your succession. In addition, there are always practitioners seeking to enter public practice by way of acquisition of an existing firm.

It is likely that there will be an increasing number of firms coming on to the market over the coming years. This may lead to supply exceeding demand. If this is the case, then buyers will have a greater number of firms to choose from and will become more selective. Where your firm ranks in the top quartile of performance benchmarks you are better positioned for acquisition.

You will need to decide on the timing of your sale. Accept that you may not be able to nominate your precise exit time. Rather you should work to an exit time window. This window may cross over one to two years. A range of factors including market conditions will determine the best exit opportunity time. It’s a good idea to have some flexibility here.

A sale of a practice is commonly a sale of business assets, rather than the underlying entity structure. Typically, a purchaser will purchase the plant, equipment and goodwill only. Debtors and work in progress, unless otherwise agreed, tend to be the responsibility of the vendor.

Checklist of typical buyers

Your practice is most likely to appeal to someone with existing public practice experience but who would like to take over an established business rather than go through the set up and establishment process themselves.

Typical buyers	Comments / Potential Buyers
For fees $500k or less: - employees from other public practice firms looking to go into practice by themselves - a key employee within your own firm - first time entrants into public practice - a tuck-in merger by a small partnership	
For fees more than $500k: - an acquisition or tuck-in merger by an existing practice - acquisition by one or more employees: employee buy-out	

Download Sale of practice checklist.

SALE OF A FEE PARCEL

This option will most likely occur in one of two different situations. You may be looking to sell off a part of your practice. Alternately you may be in a partnership arrangement where either the other partners do not wish to purchase your fees or by prior agreement it is anticipated that each partner is expected to deal with their fees in isolation.

The sale of a fee parcel normally does not involve the transfer of any assets other than the clients. As such it should be a simpler transaction. The size and quality of the fee parcel will determine the time required to complete the sale. A typical buyer will look for database records that can stand up to due diligence and which provides clear details of the clients, client groupings, historical fee levels over the past three years and the range of services being provided. It would also be expected that you would provide copies of all work completed for transferring clients and including copies of workpapers. They may also want to examine your tax invoices to assess services being provided against fees charged. The better the quality of your records the easier the sale process is likely to be.

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Checklist of typical buyers

Typical buyers	Comments / Potential Buyers
For fees $500k or less: - first time entrants into public practice - a key employee within your own firm - an existing sole practice or small partnership	
For fees more than $500k: - an acquisition or tuck-in merger by an existing practice - acquisition by one or more employees: employee buy-out	

Download Sale of a fee parcel checklist.

PROGRESSIVE SELL DOWN

This option seeks to achieve a full sale of the practice or the fee parcel on a progressive basis. This may be done in conjunction with the admission of a new partner or alternately a progressive sell down to existing partners.

This succession option has two key features. The first is the negotiation of the price for the sale. The second is the underlying agreement by which the sale will be completed over time. This agreement is quite critical because under this option there is not a single succession event but rather a progression to the completion of the sale. This extended timeframe increases the risk with the sale. It is important to ensure that your agreement not only locks in the purchaser but also provides appropriate protection in the event of any default. Good legal advice is essential and the agreement should always be executed under an enforceable contract. As a vendor you accept the increased risk that payment will be made over a period of time. This can create some problems where the circumstances of the purchaser have changed over time or where their perception of the value of the practice they are buying has changed.

Your buyer will look at the practice and its performance over the past three years. Normal review and due diligence should be expected. There is also an additional element in this type of transaction. You and the buyer will be working with each other over the period of the progressive sell down. This may be a number of years. There needs to be a reasonable cultural fit. You both need to be able to get on and work together. This is an area you need to satisfy yourself on.

Checklist of typical buyers

Typical buyers	Comments / Potential Buyers
- Your existing partners	
- A staff member being admitted to partnership in the firm	
- A new partner introduced to the firm	

Download Progressive sell down issues checklist.

MERGER

There has been a significant increase in merger activity. Mergers as a route to managing succession will be popular, particularly where practitioners are engaging in long term planning of their succession. Using this option is a two-step approach. You will need to first manage the challenge of a merger, with your succession exit being the second stage.

It is essential that all partners in the merged firm have a clear and common understanding of the arrangements. Your partnership agreement has an increased importance under this option. It should clearly detail not only the relationship and arrangements between the partners, but it should also document how and when succession will be completed. Where possible, you should avoid the documentation of the succession arrangements being deferred. They should be included in the original merger and partnership agreement.

In most cases the valuation of your share, on ultimate exit, from the merged practice will be determined by the performance of the practice. This means that you need to be confident of the performance of the merged firm and your ability to work with the partners in the firm. Where a valuation formula can be agreed in advance this will assist in giving all parties transparency over what value is likely to be at a future point.

In most cases a merger will take between six and eighteen months to settle in. During this time, you should expect the practice to under-perform. The extent of this under performance will vary based on the merger. You should allow sufficient time post-merger for practice performance to be realised that will produce a reasonable valuation return. Normally this would mean a gap of three to five years between merger and your succession exit.

Again, ensure that there is a good cultural fit between the partners. You will be working with them for a number of years.

Not surprisingly mergers tend to be the most complex succession option. A merger has much greater impact on all the stakeholders in both firms. It will require significant planning, timing and patience. Throughout the process there should be a high level of communication with your staff. There also needs to be strong attention to the detail.

Checklist of typical merger partners

Typical buyers	Comments / Potential Buyers
For fees $500k and less: - merger of two sole practitioner firms - merger of a sole practitioner with an existing partnership firm	
For fees more than $500k: - an acquisition or tuck-in merger by an existing practice	

Download Merger issues checklist.

INTERNAL SUCCESSION

This succession option anticipates that senior staff will be ready to progress on to partnership and that partner retirement will be managed in part through the appointment of new partners. Internal succession can occur by chance or through a planned and developed practice succession program. Succession by chance provides no real certainty. There may be the best of intentions within the firm but without proper planning realisation will always be at risk.

Effective internal succession requires:

- growth within the practice that facilitates progression to partnership
- recruitment of staff who aspire to and are capable of being partners
- a manager and partner development program
- practice performance that makes the firm attractive for partnership aspirants.

In some firms there are capital funding arrangements that assist incoming partners to take up equity in the firm. This may include a partial contribution from profit entitlements.

Internal succession programs need to be well developed over time. Such programs are much more effective than those where it is dealt with as a one-off event

Checklist of typical internal succession candidates

Typical buyers	Comments / Potential Buyers
Will normally be an existing manager within the firm. Ideally, should have a minimum of three years with the firm.	

Download Internal succession issues checklist.

ADMISSION OF A NEW PARTNER

Another way to manage succession is through the introduction of a replacement partner, externally sourced.

Introducing external partners normally increases the risk to the firm. Not only is there a need to manage the transition of the exiting partner, but also the requirement to manage the induction of a new partner, who is perhaps not well known to the rest of the partner group.

This option may be used as an alternative where internal succession is not possible and where the existing partner group does not want to acquire the retiring partner’s interest. An example of where this option could be used is where there is not a significant age separation between the partners and where the continuing partners do not want to take up the capital of the first partner to retire.

This option has a higher degree of success where the incoming partner is introduced into the firm twelve months in advance of the partner transition. This may be possible through appointment as a salaried partner for the first twelve months. Documentation is critical here, both in terms of the partnership agreement and the exit agreement for the retiring partner.

Managing a partner transition of this type will require a high degree of planning and adequate time. Key stakeholders where the transition will need to be managed include:

- the existing partner group
- staff
- clients.

Checklist of typical partner candidates

Typical buyers	Comments / Potential Buyers
- A partner from another firm looking to change firms - A manager from another firm looking to change firms - A sole practitioner seeking to be part of a larger firm - An experienced accountant seeking to enter public practice	

Download Admission of new partner checklist.

BUYOUT BY EXISTING PARTNERS

This option allows for arrangements between existing partners. It may include all remaining partners taking out the share of the retiring partner under pre-emptive rights, or by arrangement between individual partners within the firm. Arrangements of this type may be contemplated within the partnership agreement or alternately may be discussed and agreed within the partnership group over time.

Where you have expectations that the partnership or certain of the partners will take out your partnership interest it is a good idea to build into your partnership agreement the terms and conditions of the succession plan and also the valuation model that will be used. Where these terms can be agreed when no succession event is on hand, this normally allows the partners to reach an agreed position with no tensions around immediate interests.

It is also important to look at the age spread across the partnership. Unless you have a reasonable age spread with new partners coming on there will not be a natural buyer group. The other key is to ensure that partnership performance is such that will encourage partners to take up greater equity in the firm.

Managing partner retirement should normally be planned three to five years out from the succession event. Some firms have a mandatory retirement age or an age where retirement can be requested by the partner group. Whilst this can often be managed on an informal basis there is some merit in having trigger events that allow the parties to formalise retirement plans. Having a partner continue in the firm beyond the time when they should can cause issues within a firm and stifle succession.

Download Buyout by existing partner issues checklist.

FURTHER RESOURCES

- Unplanned succession (PDF)
- Valuation and pricing (PDF)
- Succession implementation (PDF)
- Succession planning
- Roadmap to practice growth and succession (PDF)

- Growing your business

About the author
Greg Hayes, Director, Hayes Knight (NSW) Pty Ltd, has broad experience and knowledge in the area of public practice succession. With over 20 years experience as a public practitioner, Greg's focus is on business consulting and taxation. He specializes in strategic planning techniques and is well known in the areas of practice management and business development, having been an active commentator in this area for over 15 years.

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