PCPS
PRIVATE COMPANIES PRACTICE SECTION

PREPARING FOR TRANSITION:

The State of Succession Planning and How to Handle the Process in Your Firm

A White Paper from the AICPA Private Companies Practice Section (PCPS), the AICPA Alliance for CPA Firms

AICPA

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Introduction

The AICPA Private Companies Practice Section (PCPS), the AICPA Alliance for CPA Firms, regularly conducts research into issues that affect CPA firms. The PCPS MAP Top Five Issues Survey, for example, has shown for several years that succession planning is one of practitioners' most pressing concerns. To learn more about this issue, last year, PCPS did a thorough study of nearly 500 CPA firms, including a survey and follow-up interviews, to understand how they were handling succession planning. The results confirmed that given the number of baby-boomer CPAs who will retire in the next 10 years, the shortage of management staff and the likely buyers' market for firms that will evolve, it is critical that practitioners begin succession planning now in order to secure their firms' future.

This white paper reports on selected results of the survey in order to offer practitioners insights into how other firms are handling the issue of succession planning and provide them with an opportunity to benchmark their efforts against those of their peers. It also contains action tips for each practical area that provide ideas on how to address the challenges that firms face.

I. The Succession Planning Process

Change is a constant. It isn't something that will happen when certain partners retire; it's something that occurs in a firm now and every day. Although the retirement of founding or current partners at some point in the future seems like a milestone event, it will only be one detail in the life of the firm. Succession planning is about sustaining the firm throughout constant change. It should be a regular and ongoing practice.

Creating a written succession plan is a prudent step in the succession planning process. However, very few firms appear to have accomplished this goal. In the survey, a surprising 81% of firms said they had not documented their succession plans in writing. Many appeared, however, to understand the importance of succession planning. A total of 62% believed succession planning would be a significant issue for their firms in the near future. Actual progress had not yet occurred in most cases. In fact, of those who did not have a plan, 50% said that they intended to start the process soon, while 22% did not see the need for one and 5% had a plan that had not yet been approved. Only 23% said they had begun and expected to be finished soon.

When facing the issue, a low 28% of firms said they had positive succession planning experiences. Nearly one-third (30%) said they had never managed the issue, 34% were in the process of trying to address it and 8% admitted that they had done a poor job of managing it in the past.

How much pressure are firms under to do something about succession planning? Most firms said they would have succession planning challenges in less than 10 years. Of the total, 28% expected the need to address the issue in five to 10 years, 18% thought they would face it in three to five years, 14% said they would have to deal with it in one to three years and 10% were in the midst of succession planning challenges. Only 16% did not expect challenges for 10 years or more, and only 14% did not believe that whatever succession issues arose would be a problem for their organizations.

As the chart shows, there are many items that typically appear in firm succession agreements, but there is no overall consensus on what to include. The areas most frequently covered in succession agreements appeared to be arrangements under which retired owners will continue working with the firm; forced retirement when an owner has been involved in something illegal; and forced retirement upon owner disability. In some cases, survey participants wrote in items that might be covered in a firm agreement but that had not been included in the survey questionnaire. These included having a 66% vote to fire a partner; owner bankruptcy; the terms of a buyout for a retiring owner; and pre-funding a plan.

Items addressed in a firm's agreement, in order of frequency (Respondents could choose more than one answer)
Acceptable arrangements/situations allowing retired owners to continue working for the firm
Acts that can trigger forced retirement of an owner (illegal activities)
Acts that can trigger forced retirement of an owner (owner disability)
Acts that can trigger forced retirement of an owner (misconduct like sexual harassment, public embarrassment of the firm, etc.)
Key person insurance to cover outstanding obligations of retirement payment obligations
Allowable activity with clients after retirement to ensure retention
Mandatory retirement age
Acts that can trigger forced retirement of an owner (lack of performance)
Personal liability of remaining owners for retired owner's full payout
Specific recourse or cures should a retired owner not be paid in full
Ability of retired owners to block mergers or total sale of the business unless retirement obligation is paid in full prior to transaction
Ability of retired owners to block the sale of a line of business unless retirement obligation is paid in full prior to transaction

Action Steps

What can your firm do to begin tackling this issue? Use these practical guidelines in starting your firm's succession planning process.

- *Recognize the need to plan.* Every action that owners take today builds a foundation for what will happen to the firm five or 10 years from now. As a result, it's better to have a strategic plan for where firm leaders would like to be in ten years — and how they will get there — than to wait passively to see what will happen next.
- *Treat succession planning as an everyday business activity, not one more item on the firm's "to do" list.* Succession planning encompasses many other areas, including leadership, recruiting and retention, compensation and more. It's simply good business to address all of these issues, and this can be accomplished under the umbrella of the firm's succession planning efforts.
- *Put together a corporate structure.* In some firms, owners make decisions about their own parts of the practice on an ad hoc basis. When planning for the future, it becomes clear that transition in particular will run more smoothly if there are firm-wide procedures in place addressing topics such as hiring and firing, compensation and other administrative issues. Firms may also want to consider putting together a board of directors. Even the smallest firm can benefit from a board's advice and oversight.
- *Create a written succession plan.* The process of putting the plan together helps practitioners to address issues in an orderly fashion and organize their thinking about succession. It also documents firm policies. Begin by outlining the important aspects of succession planning, including the following, all of which will be covered in detail in other sections of this document:
  - — Retirement. Issues to discuss and decide on include having a mandatory retirement age, retirement funding and compensation or payouts for retiring owners.

— Client transition. When and how will owners relinquish control over long-standing clients and engagements? How will younger staff become involved in existing accounts?

— Developing future leaders. What is the career path for promising prospective owners? What kind of training should they receive, either on-the-job or through formal seminars? What requirements will there be for new owners?

Each firm will have its own set of issues to address, but this list provides a draft outline for your initial written plan. For each strategic area, add your own questions, like the ones above, until you have a list of topics to discuss. Then begin to form your firm's own answers to all of these questions. (You can also use the checklist in this document for this purpose.) Once the answers are formulated and set in writing, they become your firm's written succession plan.

II. Retirement

Although many firm owners are nearing retirement age, this is an area that practices may tend to neglect. For example, according to the survey, 73% of firms did not have a fully funded retirement program. Among those that had taken this step, the average amount funded was 13%, and 61% had no money at all funded for retirement.

How did the firms' compensation plans address retired partners? Many firms have multiple approaches. A full 37% of firms answering this question did not address retired partners at all, while 25% paid retired partners a percentage for their billings of client work. Another 23% of firms gave retired partners consulting fees and 21% gave them a salary, while 18% paid them to bring in new business. Six percent of firms paid retired owners to remain active in community affairs, serve on boards of directors or be involved in charitable activities.

In determining retiring owner's payout calculation, the largest group — 46% — used ownership percentage as a basis, while 40% relied on an agreed value to the firm and 38% used capital accounts. Another 23% used work in process and accounts receivable, while 21% used personal earnings or fees charged and 16% based it on the retiring owner's book of business retained by the firm. Some firms used more than one activity to calculate payout.

A majority of firms with retirement agreements (51%) would make a change in their arrangement with a retiring partner because of violation of a non-compete agreement. See the chart below for other situations that would trigger a change in the agreement.

The following occurrences will force a change in the payment duration, monthly payment amount, and/or total payout amount of standard calculated retirement pay, in order of frequency (Respondents could select more than one answer)
Violation of non-compete
Early retirement
Loss of retiring owner's clients
Uncollectible Accounts Receivable or work in process
Sale of the business

Action Steps

- *Set a mandatory retirement age and stick to it.* While it can be difficult to ask firm leaders to leave at a certain time, practice management experts agree that this step is crucial for the health of a firm. It assures future leaders that they can count on taking control at a set point and it makes client transition easier.
- *Define "retirement."* To prevent misunderstandings and ongoing frustration or disagreements, practice management experts recommend that retirement should mean the partner is no longer an equity owner and is not involved in key decision making. The retired partner may remain connected to the firm as a consultant, but firms should be careful to clarify that this will be done on an as-needed basis and that the new firm leaders will determine the extent of the retired partner's involvement.
- *Consider setting up a funded retirement plan.* When owners know that their retirement funds are already in place, it takes much of the pressure out of the succession process. Turning over the firm to new owners — whether junior members of the firm or an outside buyer — becomes purely a business deal rather than a matter of securing retirement funds and your family's inheritance.
- *Set fair and realistic compensation or payouts for retiring owners.* In many firms, former partners make a part-time contribution to the work of the firm but continue collecting full-time compensation. This is a drain on the firm's resources and discourages promising new leaders who are putting in full-time hours. While departing owners should be compensated fairly, they should not continue to be paid as if they were still involved full-time.

III. Developing Future Leaders and Managing Client Transition

Does this scenario sound familiar? A firm is run by ambitious founders who take full responsibility for developing new business and handle most client contact. Staff members do the technical work but rarely meet clients and have only minimal management responsibilities. As a result, when the founders move toward retirement, the younger professionals are not prepared to take over leadership responsibilities.

Grooming promising potential firm leaders and passing on client responsibility to them is one of the most important issues in the succession planning process. And yet, many firms fail to encourage or benefit fully from their own in-house talent. When this happens, they not only miss out on day-to-day opportunities, but they also rob the practice of future leadership.

In the survey, 36% of firms said they did not have any owners retiring within the next five years, so they were not addressing the issue of client transfer. However, as you'll see in our action steps, experts recommend that five years is the minimum amount of time needed to mentor a potential leader, so it's never too early to begin this process.

Among the firms that were addressing client transition, 35% asked retiring partners to begin transferring clients two to three years before their departure. Another 21% were not asked to make any client transference efforts until about one year before retirement. This brief transition period does not leave much time for new leaders to get to know clients and their engagements, and enhances the possibility that clients will be lost.

Virtually no firms — 1% each — either paid departing owners for clients transferred or penalized them financially for failing to transfer a certain number of clients in a set period.

In written responses to an open-ended question on how new leaders were being developed, firms offered a wide range of answers that reflected everything from solid plans to none at all. Many firms allowed senior staff to participate in management decision making or receive training in areas such as leadership, communication or marketing. Some firms brought in consultants to smooth the process, while one had created its own leadership lab and others simply hired more experienced people to take on management duties. Not everyone was well organized, however. One firm's plan — "keeping our fingers crossed and praying" — reflected the reality described by many respondents.

What challenges did firms face in implementing their succession strategy? Once again, there was a wide variety of responses. Some firms cited the lack of talented young "rainmakers" or any younger professionals interested in taking on ownership. Workload demands or declining fees or client bases were other reasons. Tough buy-in requirements hampered some firms, while client transition or other internal disagreements were problems for others.

In describing the resources they had used to address the issue, the answers ranged from "60 years of trial and error" to "six months of discussions." Many firms turned to outside resources, such as consultants or continuing professional education or conferences available from the AICPA and other sources. (Readers can find a resource list on succession planning in Appendix B.) The majority of firms do not have formal written requirements, but rather informal ones based on the perspectives of the current owners.

Action Steps

- *Give people throughout the organization the power and responsibility to do their jobs autonomously.* This doesn't mean that each functional area should set up its own rules and regulations; in fact, that is recommended against. Instead, create a corporate structure that enables all staff — and particularly potential leaders — the chance to develop the kind of initiative and independence that will serve them well as they advance within the firm.
- *Chart your firm's skill sets.* What kinds of talent and experience does your staff possess? Do they reflect the firm's future needs? Will they help achieve your strategic goals? Are they being developed in line with your strategic goals? In other words, do you have the proper staffing — or hiring and promotion plans — to support current and future client needs?
- *Identify managers or other staff with potential.* Once you have staff members working independently and you understand what kind of talent you have, the firm should develop formal or informal processes for judging how well younger staff manage people and situations. Depending on budget and size of staff, you may also consider providing training for the most promising candidates.
- *Understand the difference between a top-notch manager and a leader.* Partner candidates should have not only strong technical skills but also entrepreneurial instincts and demonstrated leadership talent.
- *Mentor promising staff.* Employees need good technical skills, but they also must understand what it means to handle clients and run a business if they are to take over the firm one day. Give them responsibility, and if they run into problems, help them understand how to resolve them. Don't lock them up in the office. Introduce them to clients and to the kinds of challenges that come up in the field.
- *Don't just talk about mentoring and client contact; get partners actively involved.* This step is avoided at many firms because partners want to maintain client relationships without intrusions from outsiders. While this might seem prudent in the short run, it is a bad long-term policy for the firm. The practice will stagnate if younger CPAs aren't introduced to existing clients and taught how to bring in new ones. While the firm should help younger firm members to handle client contact, it may turn out that some of them may not have a talent for building client relationships. If that's the case, it's better for them to learn that early in their careers than in the last few months before a partner's planned retirement.

- *Include junior staff in decision making.* While key decisions must still be made by top leaders, consider how the firm can include younger staff in selected decisions and perhaps delegate some choices to them. This not only offers them greater responsibility but also improves morale and aids in the retention of talented people.
- *Set your firm's requirements, financial and otherwise, for new owners.*
- *Get formal leadership training for the appropriate firm members.* This should complement but not replace day-to-day mentoring by senior leaders.
- *Set up a timetable for new leadership.* Will the new managing partner (MP), for example, take over when all the senior partners have retired, or will the reins be passed sooner than that? Many consultants recommend that a new MP be installed while older partners are still on the job. These partners should offer advice and support without trying to interfere with the new leader's authority.
- *Don't underestimate the amount of time it can take to groom a new partner.* Some CPAs believe it can take as long as five years to nurture the requisite leadership abilities. In planning for a transition, the firm should allow enough time for the person to qualify for and grow into his or her new role.
- *In choosing a new managing partner, consider this person as the "face of the firm."* What kind of image does the firm want to convey? Distinguished seniority or fresh authority? Asking these kinds of questions can help in the choice of the new leader.
- *Create a compensation plan.* A clear-cut compensation system offers the kinds of incentives and rewards that help retain staff and motivate promising future leaders. Established compensation levels and programs also support a successful succession plan.

IV. Considerations for Sole Practitioners

Clearly, the most dramatic succession changes occur in solo practices. Although steady firm leadership and a smooth transition are crucial to keep the client base intact and maintain the life of the practice, many sole practitioners are not addressing this issue. For example, the survey found that 92% of these CPAs had not put together a practice continuation agreement, a document that establishes who will take over the firm in case of the owner's death or disability, how the owner's family or estate will be compensated and how staff and clients will be handled.

Solo practices reflect their owners' unique approaches to accounting practice and firm management. However, they all share the same challenges when it comes to transferring control of the practice to new leadership. Here are some action steps for solo practitioners that address the issues and offer advice on how to handle them.

- *Create a practice continuation agreement.* The firm — and your investment of time and money in it — has a much better chance of survival if another CPA is ready to step in if an emergency occurs. These need not be complicated or lengthy documents but can instead address the basic issues of who will take over if you are unable to maintain the practice and what kind of business arrangement will be involved.
- *Accept the fact that change is inevitable.* Many practitioners report that they have experienced disappointments when they attempt to merge with another firm or bring in a new partner. A CPA who has merged his or her practice into a larger one may not like working in the bigger firm or there may be disagreements among the new partners. These are legitimate challenges that you may face in attempting to provide for your firm's future, but don't let them discourage you from continuing to seek a long-term answer for succession. Many practitioners feel that they are losing control when they give up solo practice, but by taking control over the succession process they are more likely to fashion the most satisfying solution.

- *Know what you're getting into.* When merging or bringing in a new partner, determine as many details as possible in advance. This will include not only financial, client and practice area concerns, but also issues such as management responsibilities and marketing duties. Also, ask yourself questions about your potential partner's personality, work habits and professional values. If you are in sync in these areas, you are more likely to be happy under the new firm arrangement.

V. Succession Planning Checklist: What Do We Do Next?

Here, in checklist format, are a series of questions that firm leaders can ask to determine where they stand in the succession process and what further actions need to be taken.

Succession Planning: The Process

- What succession planning steps are we taking already?
- How is succession planning a part of our everyday business practices? For example, is it considered in our recruiting and retention efforts? Compensation? Practice development?
- Do we have a written succession plan?
- Does the succession plan document our policies on retirement, developing future leaders and client transition? What other areas should be included?

Retirement Concerns

- Is our retirement plan funded? Would a funded plan eliminate many of our succession planning challenges?
- Has our firm set a mandatory retirement age?
- Have we defined retirement? For example, how will retiring partners be compensated? What will their level of control or ownership be? What kind of client contact will they have? Will they continue to represent the firm to the public?

Developing Future Leaders and Client Transition

- What kind of autonomy do employees have to fulfill their responsibilities? Do we encourage them to take initiative?
- What kinds of skills and experience do our staff members have? How are we nurturing these skills today and what might they mean to our firm's future?
- What characteristics do we seek in future firm leaders? What requirements do we have for firm owners?
- Which staff members are potential firm leaders? How do we identify these people?
- Are partners responsible for nurturing future leaders? How can we encourage owners to provide promising staff with management responsibilities and client contact?
- Do we provide staff or leaders with leadership training?
- How can we involve junior staff in decision making?
- Do we have a leadership timetable? When will current owners be retiring? How soon should potential new leaders be groomed for leadership?
- Does our compensation plan reward people for taking on new responsibilities and demonstrating leadership?

Appendix

A. Vital Statistics

Who was interviewed in the survey? What can we tell you about their firms? This section of selected data introduces you to the firms that participated so you can understand the similarities to and differences from your own firm.

Age, Retirement and Ownership

As might be expected, most partners were at least nearing their retirement years. A total of 60% of firms had owners between 55 and 62 years old, while 77% had them between 45 and 54. At the same time, 55% had owners between 35 and 44 years old, while 16% had them between 63 and 65. Five percent had them between 66 and 67. Finally, 4% each had owners between 68 and 72 or over 72.

Among these age segments, the 45-to-54-year-old group owned an average of 45% of the firms; the 55-to-62-year-olds owned 28%; the owners 44 and younger owned 18%; and those 63 and older owned 10%.

Because of the size of the baby boom generation, those born between 1946 and 1964, it is clear that there will be a large number of CPAs moving into retirement in the next 10 years. In fact, 56% of the firms surveyed said they would have one person retiring in the next five years, and 18% expected to have more than one person retiring in that time. This transfer of management and ownership is expected to have a profound effect on firms.

What Does the Firm Look Like?

The survey was aimed at firms on the smaller end of the practice spectrum. The majority — 72% — had 19 or fewer employees. A total of 15% of firms had between 20 and 39 employees. Another 7% had between 40 and 74, while 6% had 75 or more.

On average, the firms that participated had about six partners and an average of 25 CPAs (not including partners). They averaged about nine administrators and about 40 employees.

We broke this data down to look particularly at firms with fewer than 200 employees. In this group, there was an average of 3.5 partners, about 10 CPAs (not including partners), five administrators and about 19 employees.

Services and Revenues

The firms derived most of their revenues from either audit- and assurance-related services — 39.8% — or from tax and tax-related services (37.3%). Other services were distant runners-up, including client management support (such as controllership, outsourcing, bookkeeping, payroll) at 5.1%, valuation and litigation at 2.5%, technology consulting at 1.8%, financial planning and wealth management at 1.2%, and all other services, such as business advisory, at 12.3%.

Firms had average total revenues of about $4.3 million, with an average of $539,156 per partner and $113,563 per employee. The highest average revenue per owner was $3 million and the highest average per employee was $492,857.

How Are They Doing?

The average percentage change in gross revenue increases had declined slightly for the firms over a recent three-year period, falling from 7.5% in 2001 to 5.7% in 2003. While 6.9% had negative growth in 2001, 14.1% had negative growth in 2003. Among the fastest-growing firms, 7.6% saw an increase of at least 20% in 2001, while 6.9% experienced that level in 2003.

Management
What kind of role did the managing partner play? In one of the top choices, 28% of firms had an MP who respondents said was in charge of administrative functions, with each owner overseeing his or her own client responsibilities. Another 28% had an MP whose job was to build consensus among the other owners to reach shared vision, budget, objectives, targets, compensation and other decisions. In 18% of firms, the MP ran day-to-day operations, and suggested the vision, budget, etc., for the board's approval. Another 8% had a managing owner but used an executive committee made up of a group of owners to make day-to-day decisions unless a majority of owners opposed a specific step. Finally, 7% had an owner who ran the firm according to his or her discretion unless a majority of owners opposed a decision.

Compensation and Compensation Systems
Many firms use a mix of measures to compute compensation figures. An overwhelming 86% of the firms provided a salary or base draw as compensation. A total of 48% used an ownership percentage, while 38% relied on the size of the owner's book or fees managed. A total of 32% used billable or collectible hours, while 28% factored in new business developed and the same number based salary on the performance of certain functions, such as chairing committees or taking on a leadership role. At the same time, 15% considered capital accounts, while 17% added in expanding business with a current client and 11% included cross-selling. Another 8% gave credit for business transferred to other partners or managers and 5% based compensation on client satisfaction goals. Respondents could select more than one answer for this question.

Participants also wrote in various approaches they used in their own firms, including agreed-upon bonus percentages; voting on profit allocation; equal allocations to all partners; bonus- or income-sharing points based on performance; cash collected; and managing partner or partner discretion.

When asked how closely an ownership percentage reflected the book of business that the owner managed, 49% said that there generally was not a correlation between the two. Another 38% said there was a fairly consistent connection, while 11% said the connection was fairly consistent, especially for high-percentage owners, and 2% said it was fairly consistent, especially for low-percentage owners.

B. AICPA Succession Planning Resources

Books

- *Securing the Future: Building a Succession Plan for Your Firm,* by Bill Reeb
  Includes a two-hour bonus DVD containing over 20 checklists and sample agreements and a discussion by the author and a panel of experts.
  No. 090486; $48 PCPS members; $76 AICPA members; and $95 Non-members.
- *Practice Continuation Agreements: A Practice Survival Guide,* by John A. Eads
  No. 090210; $24.80 PCPS members; $31 AICPA members; and $38.75 Non-members.

Webcasts Available on CD-ROM

- *Positioning Your Firm for Successful Transition*
  No. 780053HS, with CPE; $79. No. 780054HS, without CPE; $59.
- *Strategies to Facilitate Transition and Increase Firm Value*
  No. 780055HS, with CPE; $79. No. 780056HS, without CPE; $59.

CPE

- *Strategies to Protect the Value of Your Firm,* DVD/Manual
  No. 180321; $128 PCPS members; $160 AICPA members; and $200 Non-members.
  Preliminary CPE recommendation: 10 CPE credits.
  Additional manual. No. 350320; $45 Members and $56.25 Non-members.

Journal of Accountancy Articles

- *Succession Planning Dos and Don'ts,* https://www.cpa2biz.com/News/Journal+of+Accountancy/February+2005/Succession+Planning+Dos+and+Donts.htm
- *Have a Fallback Plan,* https://www.cpa2biz.com/News/Journal+of+Accountancy/2003/September+2003/Have+a+Fallback+Plan.htm

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