CPA FIRM
SUCCESSION PLANNING:
A PERFECT STORM

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HOW THE SUCCESSION PLANNING CRISIS EVOLVED

Succession planning: The CPA profession's "perfect storm"

Let me warn you in advance – reader discretion is advised.

Succession planning is a very sobering topic. During several retreats I have led, this issue has literally brought tears to partners' eyes. They start popping Prozac like M&Ms. Why? Because succession planning forces us to confront our own mortality. This is never easy – just ask your estate planning clients.

Before the recession, the AICPA's survey of firms' top practice management issues consistently reported succession planning as the
#1 area of concern. More recently, recession-related issues such as bringing in new clients, client retention and fee pressure have pushed succession planning back to #5, but most industry observers regard it as *the #1* endemic problem in the CPA profession. And it's going to get worse before it gets better.

A "crisis" is an intensely challenging time when difficult decisions must be made. Sometimes, the enormity of the decisions paralyzes people like deer caught in headlights. This is the situation at many local CPA firms. Indeed, only about 30% of firms have formal succession plans in place, according to Jim Metzler, vice president for small firm interests at the AICPA.

Succession planning is the "perfect storm" of CPA firm practice management, brought about by the simultaneous presence of several turbulent forces:

Aging partners. More than 60% of all partners in small and medium-size firms are 50 years of age or older. Baby Boomer partners have either reached retirement age or are close to it.

Shortage of talent. According to AICPA Studies of Accounting Graduates, the number of students enrolled in university accounting degree programs decreased by one-third between 1995 and 2000. Despite encouraging news that enrollment in accounting programs has increased steadily since the Enron/Andersen fiascos of 2001, 2010 enrollment *still* lagged that of 1995. Tens of thousands of young men and women, who in previous generations were ready and eager to become CPA firm partners, never entered the field. Thus, there is a shrinking pool of professionals available to succeed retiring partners.

Brain drain: A further complication is the lack of qualified accounting professors at U.S. universities. Now that the number of students electing to major in accounting is on the rise, there are not enough professors to teach them. My recent conversations with several university accounting department heads indicate that this problem too is going to get worse before it gets better.

Fundamental flaw in CPA firm management. While the difficulty of succession planning is significantly impacted by the *external* factors cited above, another obstacle is of *internal* origin – the way CPA firms are managed. Most local CPA firms falter at succession planning, even when there is a decent supply of young partners and potential partners. Evidence of this deficiency abounds. Just look at the top 25 list of local firms in any large city from the 1980s and compare it to today. A significant number of firms have disappeared.

Most successful businesses have experienced, knowledgeable professionals heading up departments dedicated to sales, marketing, manufacturing, R&D, finance, human resources, and the like. But at many local CPA firms, the partners handle all of these functions themselves. As a result, partners are extremely overloaded. Devoting most of their attention to getting clients, *keeping* clients and performing client work, they lack the time and mental focus to develop people.

Exacerbating this situation is the sad reality that partner compensation systems of local CPA firms, for the most part, fail to reward partner efforts at developing staff and helping them grow.

This flawed governance system has been in place at CPA firms since the dawn of the first firm, and continues to this day at many firms. Until this system changes, CPA firms will continue to struggle with succession planning, even if the supply of CPAs should unexpectedly increase.

Starting to get the picture? Without younger partners to buy out the older partners, the most favored exit strategy of most partners – passing their firm on to younger partners – is not a realistic option.

The result is a genuine succession planning crisis.

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WHAT *IS* SUCCESSION PLANNING?

When most of us think of succession planning, we envision a process by which firms identify and develop people with the potential to fill key leadership positions. There is no question that leadership development is the most important part of succession planning. But at CPA firms, much more is necessary. A successful succession plan requires:

1. <u>Consistent revenue and profit growth</u> to provide opportunities for your best staff. Regularly promoting staff to partner helps assure a desirable spread in partner ages. The death knell of CPA firm succession planning is when seemingly, in the blink of an eye, a firm finds itself with too many "older" partners close in age. This situation is untenable because the concurrent retirement of key partners places too heavy a burden on the remaining partners to make retirement payments and take on the clients of retirees.

2. <u>A new partner buy-in plan</u> that is fair to the new partner and the firm. If your firm's buy-in is too onerous, partner candidates will balk at your partnership offer. A few years ago, I worked with a successful small firm that wanted to make a superstar manager a partner. The terms of the buy-in package for the manager were prohibitive to the extent that he left the firm and is now flourishing as a young partner at another firm. Firms need young partners who will enhance and energize the firm and are willing to write partner retirement checks because it's a good deal for *them.*

3. <u>A partner retirement/buyout plan</u> that is fair and competitive. Without this, younger partners will refuse to obligate themselves to make the payments. Firm retirement plans must avoid the appearance of being a Ponzi scheme - a plan in which younger people keep contributing while fearing there will be nothing left for *them* when *they* retire.

4. <u>Client transition efforts</u> must be effective. Otherwise, the clients of the retiring partner may not stay with the firm. The best client transition takes place at firms where clients are truly the *firm's* clients instead of *partners'* clients.

5. <u>Institutionalizing clients</u>. This process involves multiple personnel servicing clients, each providing different services. The result is that clients feel like the *firm* is servicing them instead of one person, making it less likely those clients will leave if their key provider suddenly leaves the firm. Successors are automatically in place.

6. A high degree of ownership and engagement by the Managing Partner. His/her leadership is essential to making all of the above happen.

Why are CPA firms deficient at succession planning?

It is abundantly clear to partners that they have succession planning challenges. Partners overwhelmingly prefer the exit strategy of passing on the firm to younger partners vs. merging out of existence. So, what holds partners back from addressing their succession planning challenges?

The answer lies in the classic *Pogo* cartoon line: "We've seen the enemy and the enemy is us."

Here is why partners are ineffective at succession planning:

1. **Affluence**. The average partner in a multi-partner firm earns $350,000 a year, a darn good living for most people. Though partners prefer the exit strategy of being bought out by younger partners, they reason that if leadership development fails, a fallback position is to merge up. Little do they know the merger market is gradually moving from a seller's to a buyer's market.

2. **Misguided partner compensation systems**. Most local firms allocate the lion's share of the income according to traditional production measures such as book of business and billable hours, mixed in with non-performance-based factors such as equal bases and ownership percentage. Firms virtually ignore the development and mentoring of staff as a compensation factor. As a result, partners don't focus on leadership development as much as they should.

3. **Lack of partner accountability**. An apocryphal question to partners goes something like this: Question: "Do you believe in partner accountability?" Answer: "Yes… (and after a long pause)…as long as it doesn't affect me."

   Partner accountability means there are *consequences* to *not* performing as expected. Most local firms struggle mightily with partner accountability. Important succession planning practices don't get accomplished because there are no consequences for partners who fail to do their part.

4. **Weak mentoring skills**. Most partners at small and medium firms are simply ineffective at mentoring, training and leadership development. They need training for this, but firms are often penny-wise and pound-foolish in seeking assistance.

5. **The partners don't want to retire**. Less than 1% of all partners retire "cold turkey" when they reach a normal retirement age. Most want to continue working full or part-time, controlling their client base. This defers transition

efforts and turns off the firm's young professionals, all of which flies in the face of effective succession planning.

Why do succession planning?

1. **To stay independent.** The favored exit strategy of the vast majority of firms is to remain independent and be bought out by younger partners. Many partners are convinced that life as they have known it will cease to exist when they merge into a larger firm. Some view the act of merging out of existence as a failure.

2. **To preserve the value of the firm**. The average partner in a CPA firm anticipates a buyout of roughly $1 million upon retirement. That's a lot of money to most partners, so it makes perfectly good sense to ensure this payday by means of a viable succession plan.

3. **To maintain control**. The main reason cited by partners for staying independent is to preserve the control and freedom they enjoy as an owner of a smaller firm. No boss. No one telling them what to do. No one questioning when and how they work. Not having to be accountable is an unspoken perk for most small firm partners.

4. **To develop** a talented, ambitious, energetic staff.

5. **To enhance firm marketability**. Even if a firm ends up merging out of existence, their bargaining position will be much stronger if they bring along a talented group of young professionals.

6. **Higher profitability**.

7. **To preserve a legacy**. You've been a partner at your firm for 30 years. You've been successful. You helped build brand recognition and a solid reputation in your community. It's nice to know that after you retire, the firm will continue to exist.

Topics Covered in
CPA Firm Succession Planning: A Perfect Storm

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- Strategic Planning Cycle of a CPA Firm
- Partners' Specific Retirement Plans
  - Mandatory Retirement – Retirees Working Part Time
- Overarching Initial Decisions
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