



Getting out

In the final article in their series on the life cycle of a practice, Kato's **Andrew Jenner** and **Phil Shohet** look at succession and exit strategies for the smaller firm

Small independent practices are faced with a problem that will not go away and which could be as great a threat to their existence as anything they have had to contend with in the past 20 years. The problem is succession: how to fund the retirement of older partners while maintaining the profitability of the practice and making it an attractive proposition for potential incoming partners.

In the past 10 years, the make-up of the profession has altered. Initially, we went through a period where technical and compliance work was a low-growth area for small firms, and when, for the majority of practices with a client base consisting mainly of owner-managed businesses and small companies, there was an increasing emphasis on added value work as their main source of profitability (such as consultancy services that the client views as adding value to their business).

The practice needed to offer a wider range of skills and for partners to be businessmen rather than technicians. Latterly, the recession has hit hard, fees are under strong pressure, advisory and consultancy work has fallen away,

profitability has dropped, and the gross recurring fees cushion is harder to maintain. Society too has changed: we marry and have children later and would like to retire sooner. If that retirement is to be comfortable we must start planning exit routes earlier.

Plenty of opportunities

For the well-organised firm, however, there is plenty of work and opportunities, and a profitable existence to contemplate, yet for most firms the most crucial factor is one of age. With 40% of partners aged 55 or over, accountancy has become a middle-aged profession. A significant proportion of partners will be looking to retire in the next five to 10 years, and many firms will simply not have the financial resources to cope with the exodus.

The most pressing concerns are:

- * Access to suitable people to replace outgoing partners (but not necessarily like for like);
- * Insufficient resources to maintain reserved area working;
- * Insufficient breadth of skills to service future client needs;
- * No retirement plan for the partners;

- * Out of date partnership deed (or no deed at all);
- * No agreement on the treatment of goodwill (but frequently an expectation that it will be paid);
- * Partnership annuities and pensions that are too onerous.

It would be logical to assume that firms affected by any of these issues would have identified the problem some time ago and devised an exit-and-succession strategy to overcome it. Unfortunately, this is far from the case, and many firms have given little or no thought to the subject. The partnership deed (if it exists at all) is often out of date and/or contains no strategy for succession, with nothing to truly clarify entitlements; there is no retirement plan for the partners and no agreement on the treatment of goodwill. Sometimes where entitlements are set out there has been no financial planning or forecasting on the impact for the ongoing partners, with the result that the financial burden placed on incoming partners to fund retirements makes the firm an unattractive proposition for any young potential partner.



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In the face of this, many firms will struggle to find a way out that maintains their profitability and their independence. Indeed, in the past five years, mergers and acquisition activity in this sector has increased dramatically, with an upsurge resulting from prompting by the recession, and there is no indication that this trend will end.

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For those who would prefer to solve the problem organically, and have sufficient time on their side, there is no doubt that recruiting talented young people as potential partners is the key. However, the lure of an equity partnership in a small firm is not what it used to be. In real terms, the financial rewards have not increased materially in the past 10 years, and many younger people feel the risks of partnership outweigh the advantages. For young accountants in their thirties, perhaps with the responsibilities of a mortgage and a young family, there is no incentive to take those risks when a position in industry and commerce or as a salaried director can be sufficiently lucrative for their needs.

The changing market for accountancy services requires the appointment of new partners who will increase the firm's skill pool; who can take on the role of trusted adviser to their clients; who are entrepreneurial and will drive the business forward. Few firms have nurtured such talent in-house and must go into the marketplace to find it. Unfortunately, the cultural divide between the big firms (where these specialist skills are largely developed) and the medium-sized and smaller firms (which need to employ them) can be vast, which makes it difficult to achieve a harmonious fit.

Firms are starting to change their attitudes and make greater efforts to create a structure and culture that will

make them an attractive proposition for the young and talented people that they so desperately need, but progress has been slow.

Whoever is recruited, there is always the danger that the existing partners will be looking for 'people just like us'. Where all the partners have worked in the same practice for many years, and

where people have trained and qualified, never having ventured away from the firm, they may have become institutionalised and laissez faire, more resistant to changes in working practices. What they actually need are partners with the relevant client handling and specialist and business-development skills that are complementary to the current partners, and which are essential to maintain and grow the practice.

Unexpected changes

All retirement and succession strategies should be flexible enough to allow for unexpected changes in circumstances over the years. Inadequate drafting of either the partnership deed or the retirement plan could, and often does, raise issues. The funding required for retiring partners' exit routes can place an excessive financial burden on a practice that is unprepared. Not only must consideration be given to the source of the funds, but to

ensuring that they are available in accordance with the planned retirement dates of individual partners. The partnership deed should stipulate the retirement notice required and the repayment term. For the former is this six or twelve months? Will balances be paid out over one, two or three or more years, or immediately on retirement? Will only one partner be allowed to give retirement notice in any one year, or any number can do so?

Perhaps the biggest difference between the expectations of entrepreneurs in company and partnership scenarios respectively is with regard to goodwill. In the company context, the value of shares is a reflection of the overall market worth of the business, which is likely to be measured as a multiple of turnover or profit as it is to be related to the value of the underlying assets. In partnership, however, the only way for this to be reflected is in the concept of 'goodwill', and this can mean different things to different people, and raise confusion about how the valuation should be made.

Increasingly, partners are expecting to extract 'value' when they retire, whether or not they have paid to acquire their partnership in the past. If there is no entitlement in the deed, however, any arrangement entered into is, frankly, a deal; and for every deal made in the firm, there will be a demand for a similar deal on another occasion by another partner. That is human nature. This is awkward territory, and further underlines the importance for a clear and unequivocal

*AVAILABLE EXIT ROUTES

- * Retire with balances and possibly goodwill, an annuity or consultancy;
- * The admission of a new partner, promoted from within or recruited, who inputs capital and possibly pays for goodwill;
- * The admission to partnership of a team of partners from another firm;
- * MBO to manager(s);
- * Merger or sale to another practice, either a larger or a smaller firm;
- * Sale of proprietorial interests to a corporate vehicle such as a 'consolidator' or financial institution;
- * Incorporation of the practice (possibly followed by the issue of shares or loan notes to a third-party investor).

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deed to be in place, and for certainty at all times. One solution might be for partners to make their own personal pension provision as they progress, and for this to be re-affirmed annually at a partners' meeting.

Current economic circumstances further emphasise how essential it is that firms arrange a practice structure that will efficiently service the needs of the clients, help to improve profitability and ensure continuity through effective retirement and succession planning.

Times have changed

Historically, accountancy practices were organised as partnerships to give comfort to clients: partnerships could be relied upon to be financially stable because, in case of default, the partners themselves would be entirely liable. However, times have changed and to minimise personal liability, more firms now look to create a practice structure that will cater for this and allow them the flexibility to take advantage of opportunities in the marketplace, service their clients effectively and grow their business.

Incorporation as a limited company is on the increase (and strategic alliances using limited company status for services such as financial services, IT and consultancy), as is LLP status. By being organised in this way the firm has options. For example, it can: retain equity ownership in a small number of people but have status for non-equity directors; organise profit-sharing arrangements; create value in the shareholding that can be realised on retirement or sold to new owners.



None of these things are, in themselves, a short-term solution for retirement and succession, unless it be merger or sale. Even if firms are not in a 'forced sale' situation and have time to plan ahead, there are many pitfalls to be avoided if a successful 'marriage' is to take place. Any practice contemplating this route would be well advised to exercise extreme caution in the selection of an appropriate firm. The firm must stress planning ahead and financial control.

The essence of being in practice is to get a good living out of the business, as the rewards are then commensurate with the risk and responsibility of being an owner. The essential thing is to build a practice of value, whether doing regulatory or non-regulatory

work, and this is reflected in the value of the practice on exit. Looking attractive to excite interest and attract suitors is of fundamental importance if you are to secure a good exit route.

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*ACCA/KATO EVENTS

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