CHAPTER 1
The Marketplace

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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.

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[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.

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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.

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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.

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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%

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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.

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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

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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.

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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.

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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.

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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

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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.

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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.

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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.

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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.

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