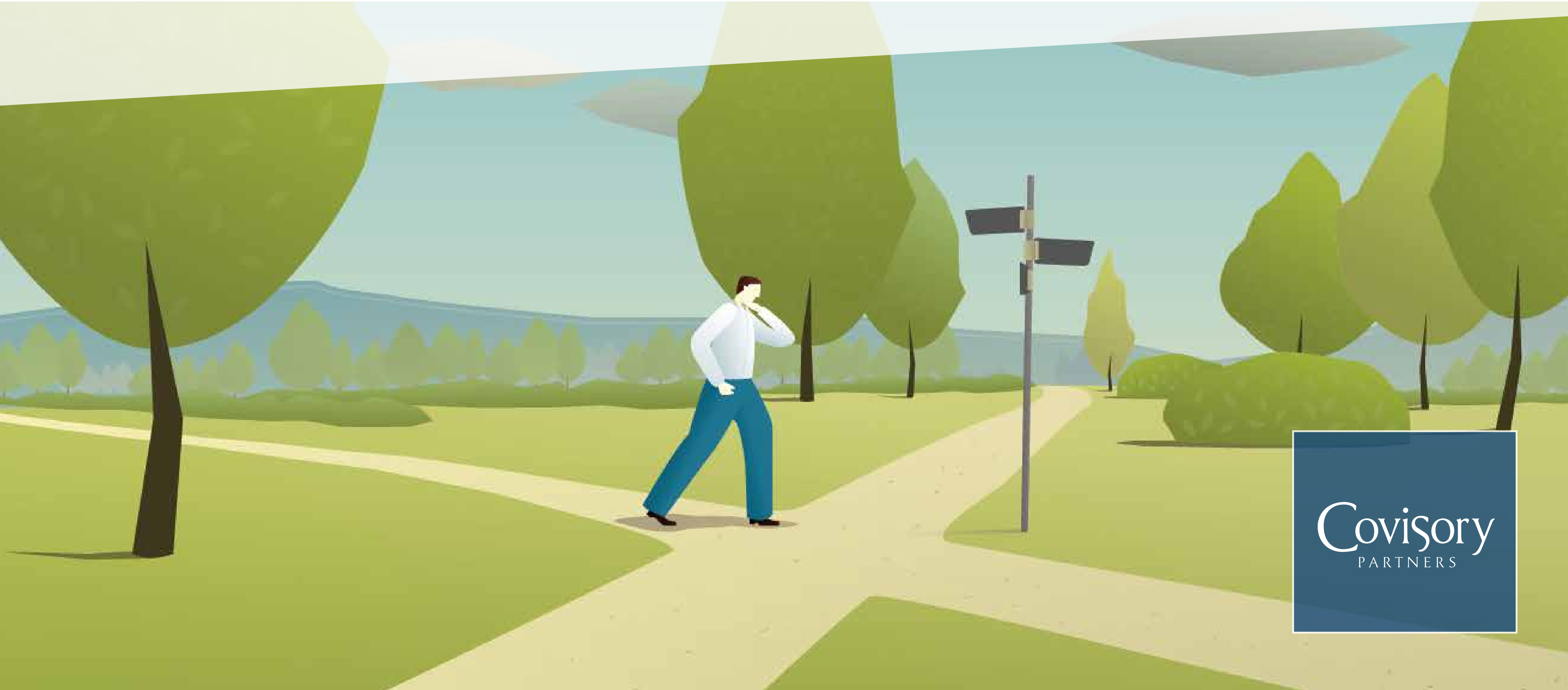
SUCCESSION PLANNING IN A PROFESSIONAL SERVICES FIRM: WHAT IS SO DIFFERENT?



SUCCESSION PLANNING
IN A PROFESSIONAL SERVICES FIRM:
WHAT IS SO DIFFERENT?

BY NIGEL SMITH

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CONSIDER THE FOLLOWING...

The sole business services partner drops down dead of a heart attack at the start of March and 30% of the clients have not yet been filed.

OR...

There is a personality clash between the partners and the company cannot carry on in its present form.

OR...

The rainmaker of the practice decides that they want to go out on their own and they are taking their clients with them.

OR...

An older partner is reluctant to leave the firm that provides the cash to fund their life-style expectations.

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The best way to mitigate the effect of these or similar scenarios is to have a strong, active succession-planning programme. Such a programme should not only identify possible future partners, but also develop them, using a mix of mentoring, training, and stretch assignments, so they will be ready to buy into the practice when the time comes, having developed a good working relationship with the firm's clients.

At Covisory Partners we have talked with numerous professional services firms about succession planning. We have found that a disturbing number of companies make mention on their websites that they are 'experts in succession planning' but in reality do not have a solid succession plan in place for their own practice. A survey we carried out in 2013 for a group of New Zealand accountants revealed that fewer than a third (28%) of firms had a succession plan in place.

For many professional firms, succession planning is like a New Year's resolution: nice to have, but little attention is paid to it once it has been mooted.

As part of our survey, we found that, although they may have drawn up a succession plan at some time, the plan has not been followed through; they are not actively looking for candidates or haven't found anyone suitable (and if the criteria are not realistic, they may never do so); and they are definitely not providing any extension or leadership opportunities for potential future partners.

Many partners in professional services firms rely on the backstop of 'I can always sell my fees!' to move on to the next phase of their life. Professional practices, be they incorporated or unincorporated, need to shift their focus from the planning of succession (a short-term focus) to succession itself (a long-term focus). They also need to be aware that their succession plan must continually evolve as conditions change - inside the firm as well as outside.

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A PROFESSIONAL SERVICES FIRM DOES NEED A SUCCESSION PLAN

The smart professional services firm will plan for the broad spectrum of issues associated with a partner departing well before the event occurs. Many of these issues are long-term in nature and the plan can take years to phase in.

The issues are best managed in the context of a long-term succession-planning programme geared to achieving the firm's strategy. The succession plan will identify and address the gaps in capability that will inevitably occur, for example, from the phase-down and retirement of a partner.

By adopting a succession plan and ensuring that it is actively maintained is the best strategy for ensuring the firm's continuing success as well as the most politic manner of managing the personal issues raised by succession in a professional services firm.

There is a great misapprehension in many professional service firms when considering succession planning. Many partners are more concerned with exit planning or their exit strategy; that is, the process of ensuring that they have the wherewithal to survive and thrive in their new life after exiting the business. But succession planning is a multifaceted process.

The aim is to develop a business with the ability to continue to grow and thrive despite ups and downs, and develop team members whose lives are supported in facilitating that process. Until those involved in the process understand and accept this fundamental difference then any attempt at succession planning is may be doomed to failure.

WHAT MAKES A SUCCESSION PLAN DIFFERENT FOR

A PROFESSIONAL SERVICES FIRM

The difference in approach to succession planning is due to the traditional structure of the firm.

Professional service firms are based around each partner's personal relationship with his or her clients.

In addition, the professional service firm usually has many owners who are unrelated to each other, whereas the typical family-owned business is usually led by a patriarch.

THE KEY FEATURE

OF A PROFESSIONAL SERVICES FIRM IS THE PERSONAL RELATIONSHIP THE PARTNER HAS WITH HIS OR HER CLIENTS.

Their clients may have been with the partner since they joined the firm, or even prior. With such a long-term relationship, the partner will have seen their clients through many cycles of their lives, both the ups and the downs. For many, they are seen as friends or 'part of the family'. Saying good-bye can be traumatic for both parties. However, there are still opportunities to match younger aspiring partners with the next generation in client's families to ensure the process is repeated again.

Over the years, a partner also has the ability to build up a sizable block of clients. There can be a reluctance to let go of the control of this fee block because of its importance in terms of status, compensation, and leverage.

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FOR A PROFESSIONAL FIRM THERE ARE MANY

OPTIONS TO BE CONSIDERED...

The retiring or exiting professional may decide to start another business, stay on as a technical resource, work for a client, and so on.

The up-and-coming professionals, too, have options: going into industry, starting their own firms, creating a whole new kind of business, exploring government work, or taking on the leadership of the firm. This also needs to be remembered when dealing with them, as the younger generation may not see the same value in fees or in an ownership interest in the business as the vendor sees.

With everyone's choices expanding, determining the right direction for the firm's succession plan is becoming more complex – and in today's competitive business climate, there's not much margin for error.

Covisory's role is to assist professional service firms to understand that transitions are inevitable and there are multiple choices for the firm.

An essential ingredient for the future well-being of the firm is empowering younger team members to assume new responsibilities. Arming them with the resources and skills to help take the firm to its next level of development and success helps everyone, regardless of the options they choose, because having a strong business is key for the exiting professionals as well as for the new leaders. If you do not do this, then they may seek these opportunities elsewhere as they are likely to be aggressively looking for the chance to climb the ladder.

WHAT ARE THE UNIQUE ACTION POINTS

THE PROFESSIONAL SERVICES FIRM MUST TAKE INTO ACCOUNT?

1. Building a team environment
2. Training
3. Client relationships
4. Administration
5. Sales and marketing
6. Communication
7. Planned & unplanned succession

These action points will help to grow the firm, improve the firm's viability, and enhance the team environment, whilst also establishing a sound platform for the exit or retirement of key professionals.

BUILDING A TEAM ENVIRONMENT

For a succession plan to work well and to ensure the long-term viability of the firm, the management team must act to change the traditional culture of a professional services firm and make the mental shift from being a firm made up of separate entities with unique clients to being part of a team environment with the clients belonging to the firm as a whole. Adopting a team vs. silo perspective is at the heart of the challenges a professional services firm faces. The management team, when developing the succession plan, needs to consider and discuss how the firm can go about integrating clients into the firm and moving towards a team approach. Whether these discussions commence as a practitioner transitions out or earlier can create a whole new landscape for the firm, but succession planning can be the catalyst for the firm changing from a silo to a team. The clients, the firm, and all of its team members can then become the new family. This will assist with both planned and unplanned succession by increasing the likelihood that clients are retained through the succession process.

BUILDING A TEAM ENVIRONMENT

Fostering a strong team environment and emphasising the importance of quality client service across the board will improve the firm's retention rate.

Changing the firm's culture as an integral part of the firm's succession plan will help to give the potential successors confidence that there will be a revenue stream that they can rely on - making them feel more comfortable in making the investment.

The firm's team members have a better chance of being engaged, bonded to the firm, and supportive of clients and the firm's well being when adopting the 'firm as family' mind-set. Building a team environment moves the firm away from the insulating and isolating focus of 'my clients' to an 'our clients' philosophy. Succession, exit, and transition planning become an integral part of the firm's planning process, not an isolated phenomenon that kicks in only when someone decides to retire or exit.

TRAINING

It is essential that additional training be put in place for both individual talent and other team members.

Training should encompass all areas of:

- Client history and general information;
- Unique client characteristics & needs;
- Skills and technical information that will be required.

CLIENT RELATIONSHIPS

The management team must develop a working relationship between all of its clients and its team members - not just those with direct responsibilities to clients, but with support personnel as well. For good reason, the receptionist is often called the 'director of first impressions'.

ADMINISTRATION

To ensure the needs of the whole firm are effectively met, the firm needs to develop a much more robust administrative platform to handle the duties that were previously handled by partners or other revenue - generating professionals. For example, the role of Practice Manager may be moved to that of a COO in order to more effectively handle the needs of the whole firm.

SALES AND MARKETING

With the ever-increasing pace of the marketplace, the sales and marketing skills of all team members need to be enhanced. Sales and marketing may require the creation of a business development process within the firm to help assure continued growth, attract new clients, and expand the revenue bases for existing clients. Emphasis on improving the staff's ability to see opportunities with existing clients is essential to the viability of the firm, both in improving clients' perception that the firm is looking out for them, identifying possible opportunities, and increasing revenue from the work that is generated.

REMEMBER: It costs seven times more to attract a new client on board than to retain an existing client.

When did you last talk to your clients about what services they would actually like you to be able to provide for them?

COMMUNICATION

It is important to improve communication and increase the opportunities for interaction within the firm as well as outside it.

The new approach will see the firm reaching out more to its team members as well as to its clients and referral sources.

PLANNED AND UNPLANNED SUCCESSION

To help both the client and the firm with both planned and unplanned staff exits, the management team must ensure that it has a good working relationship with all its clients, as well as maintaining dynamic communication channels. For the firm's most significant clients, it is prudent to put in place a minimum of two contact points. They should be regularly in touch with the client to ensure that there is a good level of communication taking place. This will ensure that the client has an unbroken conduit into the firm in the case of one of their contacts leaving - whether unexpectedly or in a planned manner.

CURRENT ISSUES

WE SEE FACING PROFESSIONAL SERVICES FIRMS

1. The ageing partner
2. Succession planning is not part of the firms culture
3. Running a practice within a dynamic business environment
4. When a partner leaves: impact on the leadership of the firm
5. The increasing sophistication and complexity of client's problems
6. The demographics and interests of the potential future partners
7. Ownership transfer
8. Are mergers a solution?

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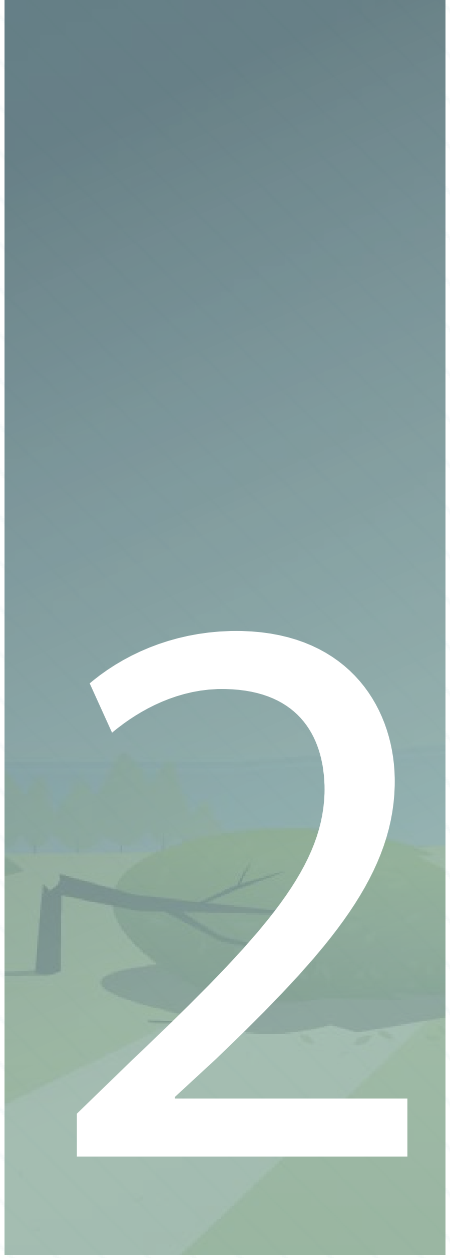
THE AGEING PARTNER

Today, we are seeing a reluctance of partners in professional service firms to retire. There is no legal reason for retiring, and many have got used to the financial rewards that working provides them with.

They feel that although they may slow down - and they may not be able to get through the workload they used to carry - they will just carry on as usual, albeit with a smaller workload. Succession isn't on their radar at all. Many can't afford to retire, and some simply have nothing to look forward to doing in retirement.

These problems should be evident well before retirement and can be addressed. Forward planning is critical.



SUCCESSION PLANNING IS NOT PART OF THE FIRM'S CULTURE

Just as a partner has a close relationship with their personal clients, the other partners in the firm are part of the family.

People find it pretty hard to bring up subjects like succession with their partners if succession planning is not already inherent in the culture of the firm. This awkwardness has been known to raise barriers and harm relationships among partners.

For others, succession planning can be seen as a threat to their security or their reputation. How do you tell a friend and colleague that it may be time to start thinking about retiring? Equally, how should you break the news that you are leaving the firm to set up in business by yourself?

RUNNING A PRACTICE WITHIN A DYNAMIC BUSINESS ENVIRONMENT

The traditional, silo structure of the professional services firm can make it difficult to achieve a collective firm culture in which a team of fellow professionals supports and services a single client base. Thanks to the increasing pace of business and the dynamic role that technology is now playing, this narrow approach no longer works as effectively as it did in the past. This is especially true of succession planning. A professional services firm needs to adopt a management succession plan that is an intrinsic part of the regular management practice of the firm, and is recognised as being applicable to each partner in their turn. We feel that this approach is the most unbiased, offering the best chance of a smooth transition, and providing the best method of dealing with succession in the professional services environment.

Two key elements required are:

- having the necessary agreements relating to succession issues in place, and;
- working to a succession plan that rolls out over the long term.

PASSING ON OWNERSHIP IN A PROFESSIONAL SERVICES FIRM

Documented agreements covering partnership arrangements are essential to a managed succession process. The key issue to be addressed in a partnership agreement is the arrangement for buying out the withdrawing shareholder's or partner's interest. It this process is not formally addressed, the firm can be put in a vulnerable position.

For a sole practitioner, a practice continuation agreement plays a similar role. This is a contractual arrangement with another practitioner or firm. It provides that, in the event of death or disability, that party agrees to immediately take over the practice under a predetermined compensation formula and payment schedule. This agreement provides security and certainty for the practitioner's dependents.

- Integral to a partnership agreement is the buy/sell agreement. Your firm's specific circumstances will determine the nature of the most advantageous type of agreement – cross-purchase agreement, repurchase agreement, open market sale, or an employee buyout.

- The buy/sell agreement includes the valuation method of a retiring partner's share. This needs to be reviewed as the business develops. An inappropriate valuation formula can bankrupt a firm in some circumstances, such as a partner's sudden death.

MAINTAINING THE FIRM'S VIABILITY

A further element to consider in the succession plan involves developing a phase-out programme that can be translated into continuity procedures for critical business processes. This plan should be using a planning horizon of at least 5 to 10 years. It should include provision for:

- Retaining the partner's clients. This includes putting in place a set procedure for signalling to the clients in a timely fashion that a partner is leaving.
- Maintaining professional expertise and a range of functional management skills (marketing etc.), and identifying what staff and skill-sets need to be either organically grown or acquired. For instance, what are the rainmaking abilities of the remaining partners and how can they be improved or augmented?
- Continuing strong firm management and leadership.
- Generating new business.

Once the plan has been agreed by the partners, a phase-out plan can be activated when a partners hits a predetermined age (established in the partnership agreement). Having a mandatory transition period does not necessarily also mean having a mandated retirement date, but it does mean that the business will be in the best possible position to deal with the transition, whenever it may occur.

For many professional services firms, most of the value of the business resides in their client list. If there is no plan for an orderly transition, clients can be lost in the shuffle.

The knowledge and experience that resides in a partner forms a substantial proportion of the firm's intellectual property and its intellectual capital. As far as is possible, that knowledge and experience needs to be passed on to potential successors. By having a succession plan that is an essential part of the firm's day-to-day operations the firm is in the position to address the various situations that may arise:

- When the retiring partner also has a special function, such as CFO, it presents an opportunity to consider alternative strategies to fill the gap; for instance, appointing a CFO rather than training the proposed successor in finance.
- If the retiring partner has been the rainmaker or has been a major contributor to attracting new clients, provision must be made to continue the active recruitment of clients. In this case, the succession plan must address how to attract rainmaking talent or develop it in a potential successor, and provide opportunities and training to develop existing staff who are identified as having this ability.
- For multigenerational family clients, the firm should actively work to match the younger generation with younger staff and partners.

Succession planning is an on-going process that allows firms to grow and their team members to transition successfully—and that's what helps make exit planning a reality.

WHEN A PARTNER LEAVES: IMPACT ON THE LEADERSHIP OF THE FIRM

We all know that, when you remove a person from a close-knit group, the group dynamics can change dramatically. The same is true when adding a person to an existing team. Personality clashes, politicking, and fights to establish the pecking order can intrude if the process is not handled well. Some of the issues the firm needs to take into account are:

- Is there a replacement available?
- Was the exiting partner equity or salary? What about their replacement?
- The impact on services provided by the firm when a partner or staff member leaves.
- Understanding the clients and their ages.
- Has there been enough done to prepare the clients? Are they happy with the change?
- Will the clients be happy with a younger partner? Whose best interests are to be considered - the clients or the incoming replacement?
- The new partner will have different methods of approaching client relationships and getting through the work – how will this be dealt with?
- Are the firm's staff prepared and happy with the change?

5

THE INCREASING SOPHISTICATION AND COMPLEXITY OF CLIENT'S PROBLEMS

Another complication facing professional service firms today is the changing nature of its clients with their need for more sophisticated assistance in their businesses, and with the increasing use of technology and the new ways being used to take advantage of this technology has changed the whole nature and role played with the client. Long gone are the days of straight compliance work.

Increasingly clients want advice on business, employee relations, products, technology, and the possible systems that would help with their specific needs and integrated packages. We have to adapt.

THE DEMOGRAPHICS AND INTERESTS OF THE POTENTIAL FUTURE PARTNERS

How will the firm handle the changing nature of the potential partners? Their age and interests, as well as their view of the firm's future direction, may be highly divergent from those of the incumbent partners.

The management team must be aware and consider the impact on the firm of different issues:

- If the exiting partner is selling, what will the impact of capital expectations between the buyer vs. the seller have on the firm and the remaining partners?
- What happens if your expectations are not met – can you ever leave?
- Will your prospective partners be prepared to buy in and take on all the risk and compliance costs?
- What are the real barriers to entry for someone wanting to set up on their own?
- What will attract younger professionals to the firm & to stay?

The answers may depend on:

- Compliance
- Offering senior staff the option of becoming a salaried partner vs. full equity buy-in. This has two advantages: it bolsters the ego without the potential monetary stress, and usefully increases their public visibility and association with the company.
- Are your top staff prepared to wait for partnership opportunities?
- Why shouldn't they set up their own practice?
- Are they prepared to be locked into a job for life? Even if they become partners, there is no guarantee they will stay on until retirement, or even past the succession of a retiring partner.

OWNERSHIP TRANSFER

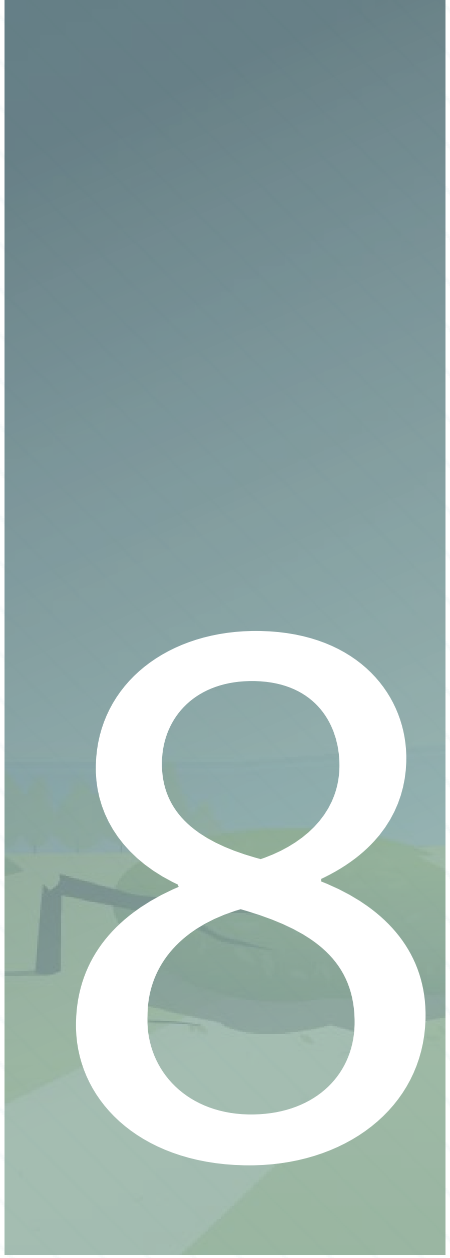
Whether a partner or owner is retiring, the firm is downsizing, or the business is being sold, merged, or allied with another firm, ownership will be transferred. There are a number of possible buyers to consider:

- The firm itself. If it is a company it can purchase the shares of the exiting owner.
- The other partners and partners-to-be can purchase ownership shares.
- The external revenue-oriented buyer. Since their sole focus is on adding revenue, this kind of sale often means rapid cost-cutting and a very short transition period.
- The external strategic buyer, who may be looking for locations, talent, a niche, or technology to enhance their business.

No matter who the buyer may be, a new owner has his or her own goals and objectives, which will impact on the firm. They include:

- Enhanced profitability
- Expanded client base
- Additional services
- Appreciative clients
- Quality team members
- An expanded career and ownership
- Increased value.

One of the best ways to pass on one's legacy after retiring is to sell to team members, partners, and partners-to-be. In this scenario, understanding how best to address the needs of both sides of the firm - the 'family' inside and the family member who is exiting - is crucial in ensuring the firm's future success. Successful succession means creating a more attractive and profitable environment for everyone, not just the retiring or exiting professionals. By bearing 'firm as family' in mind, everyone will have a better chance of finding ways to bridge the needs and wants of both sides, improving the chances of a win for all - including the clients.



ARE MERGERS A SOLUTION?

Often this is the best option for sole practitioners. The problem is everyone wants to be on top. Sadly, a two-partner firm will often expect a sole practitioner to want to merge with them, rather than looking to merge into a larger firm themselves.

Bigger firms will always have an advantage over smaller firms when attracting potential partners. Employees want to work for successful and financially secure organisations that offer career advancement opportunities. If you want to attract quality staff, you need to ensure you have real opportunities for them to advance.

WHO ARE THE FIRM'S POTENTIAL PARTNERS

In creating the succession plan, the management team must work out what skill sets are needed. If you don't know what you are looking for, how will you find it?

One possible way is to look at the psychometric profiles of the senior staff and partners, in order to understand their strengths – and their differences. The management team needs to ensure that their staff are not carbon copies of themselves.

WHAT IS THE POSSIBLE SKILL SET FOR A POTENTIAL PARTNER?

They will need to demonstrate a wide range of skills, such as:

- Rainmaker – the ability to generate fees
- Staff management skills
- Technical skills
- Possible new skill sets – non-traditional
- Solid technical base
- Profile in the community
- Ethics
- Client relationship skills
- Basic business management skills
- Willingness and ability to learn
- Ability to work effectively
- Problem-solving ability

But you must understand no one is perfect! You are more likely to not find a person who has all the skills you are looking for and do understand that people will grow into the role so don't be quick to judge potential partners. There are two key steps here however: firstly to determine what you actually really need, and secondly how close a candidate comes in the key categories.

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At present, we have up to three generations working in the workplace. Given the propensity of partners not to retire, there is potential to have up to four generations working within the same workplace. Each brings their distinct mannerisms, outlook, work ethics, motivations, and expectations onto other generations. It is essential that the management team understands how to work with each generation and what drives them to operate differently.

Successful succession plans will harness these differences, turning them into opportunities.

For example, when dealing with 'Millennials' you need to provide them with opportunities for flexible hours, work-life balance, allowing them to develop their interests, whilst rewarding them earlier (with the promise of more), offering praise and a fun work environment.

IN SUMMARY

In today's competitive business climate, there is not much margin for error. For any business the need for a succession plan that is organic and continually evolving. It is essential, in our view, that the succession plan is a central part of the on-going management plan of the business.

Although in the past the focus of the professional services firm was on exit planning, rather than succession, we are now seeing a change. The professional services firm's options with succession planning are expanding rapidly. But what we are finding is that few are actually following through and putting a succession plan in place.

An evolving succession plan that reflects your practice's unique character will allow your firm to respond effectively to the changing, fast-paced environment we now operate in.

There are many options to consider. The retiring or exiting professional may decide to start another business, stay on as a technical resource, or work for a client. The up-and-coming professionals, too, have options: going into industry, starting their own firms, creating a whole new kind of business, exploring government work, or taking on the leadership of the firm. With everyone's choices expanding, determining the right direction is becoming more complex.

Knowing that transitions are inevitable and choices abound, the essential ingredient for the future well being of the firm is empowering younger team members to assume new responsibilities. Arming them with the resources, skills, and opportunities to help take the firm to the next level of development and success helps everyone, regardless of the options they choose, because a strong business is key for exiting professionals as well as for the new leaders.

This is a timely reminder that having an organic and evolving succession plan is just as important as working on the services provided, profitability, budgets, return on investment, staff development and retention, and capital return.

If you would like to know more on this subject, please email us to request a call back:
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