SUCCESSION PLANNING: LIFE AFTER DEATH FOR SINGLE-OWNER FIRMS

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There are basically two types of succession plans. One addresses the transfer of the practice at a time of the owner's choosing, while the second addresses a transfer in the event of death or disability of the owner (a "disaster"). We encounter many owners who do not know when they will transfer the practice. It is often an uncomfortable subject and easily put off. However, a disaster plan is a necessity and something that can't be put off, as we never know when disaster will strike. A number of people, in addition to the owner, have an interest in the continuity of a professional practice including the clients, employees and heirs. Disaster affects a single-owner practice more severely than a multiple-owner practice. This article addresses key points that need to be considered in every disaster plan for a single- owner practice.

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What happens to a single-owner or small professional practice if the owner dies or becomes disabled? Who will take over? How will the transition process be handled?

CONSIDER THE FOLLOWING:

- Is there a key employee or co-owner who could buy the practice? Do plans exist that would allow them to continue the practice?
- Can the surviving spouse operate the practice until the right buyer is found?
- Without a concrete plan in place, would the operations of the firm cease immediately: leaving clients, employees and the owner's remaining family with no direction or succession plan?
- Is there a plan in place to transfer client files to a successor firm(s) in the event that a sale of the entire practice could not be arranged?

A solid plan will provide departing owners with a market and a fair price for what is probably their most valuable asset, which might otherwise be difficult to sell. At that same time, it would permit key employees or remaining owners to prevent an unqualified individual or surviving spouse from acquiring an interest in the practice. This would also minimize business disruptions resulting from disagreements among surviving owners, key employees and family members. A carefully crafted succession plan will also provide assurances to clients, employees, suppliers and creditors that the business will remain strong through an owner's untimely death or transition.

A small-practice succession plan is far too important to leave to chance. The following considerations are crucial to attempt to protect a smooth transition of the business:

- Consistent, updated practice valuations based on cash flow;
- Liquidity options in the lending market;
- State of the art mechanics of the succession plan; and

- Comprehensive risk management tools to plan for contingencies.

PRACTICE VALUATION – CASH IS KING

There are a number of ways to value a professional practice. In the past, general economic growth, growth in the marketplace, new market opportunities and inflation often provided cover for high valuations. Those days are over. In our view, value must be justified by cash flow. This is not a new concept, just one that has become more important. Put simply, the buyer must be able to pay for the purchase price out of the cash flow of the practice, whether financed by the seller or a lender. The cash flow used for valuation purposes must be based on historical results and modified for expenses that the buyer is expected to incur (or not incur). Part of the value of the practice will be determined by the continuity of existing clients.

> "IF SOMETHING HAPPENS TO A PRACTICE OWNER, CASH FLOW MAY VERY WELL STOP, RESULTING IN A PRACTICE WITH VERY LITTLE VALUE."

If something happens to a practice owner, cash flow may very well stop, resulting in a practice with very little value. Some consultants recommend that the firm owner enters into a practice continuation agreement with a larger practice. Three things that are important to clients are relationships, location and fees. Transferring a practice to a larger firm most likely will result in the loss of all three. On the other hand, transferring the practice to a key employee, assisted by per diem professionals, can retain all three. If ownership by a key employee is not a viable long-term solution, the practice may be operated by a key employee until a buyer is found. Maintaining a relationship, location and fee structure is likely to retain much of the value of a practice. This can only be accomplished if a plan to do so is developed in advance.

LIQUIDITY OPTIONS IN THE LENDING MARKET

Many professionals, whether buyers or sellers, mistakenly think that cash flow lending for small practices is difficult both now and for the foreseeable future. However, buying or selling a practice may be something a professional does once in his or her career. There is liquidity in the lending market through loan programs that can provide financing for up to 70% of value for CPA practices. A 10-year fixed term for the acquisition note is a realistic assumption for bank financing. For CPA practices, seller financing is often required as part of the transaction. We suggest a term of no more than five years for a seller note. In addition, most professionals think that obtaining financing can be a painful process that takes weeks or even months.

The truth is that there are lenders who can finance an acquisition quickly and effectively based on an updated cash flow business valuation. This framework will allow a smooth transition of the practice for both the buyer and the seller.

Once the professional or their heirs know the financial valuation of the practice, they can set a fair market price and maximize the price for which the practice is sold.

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COMPREHENSIVE RISK MANAGEMENT TOOLS NEEDED TO PLAN FOR CONTINGENCIES

To protect the value of the practice, preserve cash flow and ensure smooth transitions, buy-sell insurance and key-person insurance are common risk management tools used by professional practices. When the professional leaves the practice unexpectedly, the business can come to a halt unless the proper components are in place to ensure the practice will continue. If there are multiple owners, buy-sell insurance provides the funds for surviving owners to purchase the shares of a deceased owner, usually from the deceased's estate as directed by a clear agreement.

Other strategies should also exist in order to keep the practice intact, particularly during key-person succession. Whether the practice is owned by a sole practitioner or additional owners, each key person in the practice plays a unique role that directly affects the bottom line. Key-person insurance can take several forms, but most commonly it is a life insurance policy — or until recently — a disability insurance plan on the lives of the owners or key employees with the practice as the beneficiary.

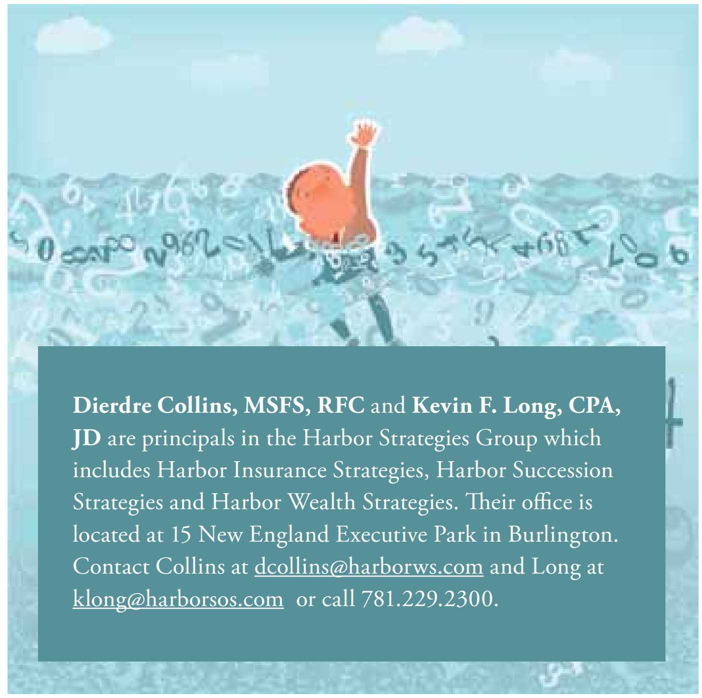
Integrated planning, implemented while the owner is actively working in the practice, is also a very important risk management tool. Common mistakes made by sole practitioners and small CPA firms are often caused by focusing on financial and estate plans, while ignoring business succession planning.

The larger picture includes the development of a retirement and estate planning strategy with the objective of minimizing the eroding effects of taxes wherever possible, while incorporating the sale of the practice long before retirement. Recent estate and pension reform tax law changes have affected the nature of qualified plans, retirement distribution strategies and the overall estate and succession planning processes. It is important to analyze and evaluate existing integrated plans, to confirm or redefine retirement estimates.

All professionals should implement a system that will allow them to determine sufficiency of retirement income to age 100, taking into consideration all assets and income streams. Next, they should identify any potential estate tax and income tax liability on all assets. Consideration should also be given to the impact of the practice sale on the overall retirement and estate plan, current asset allocation and distribution strategies. How will these assets be protected throughout retirement? Is the right life and long term care insurance in place? How long will it last and are the premiums too high? Monitor, update and modify your plans as often as necessary.

As the sole professional or small-practice owner gets closer to selling a business, the dreams of what can be attained from the sale come closer and closer to realization. Once the professional has the proper succession plan in place and knows the financial valuation of the practice, it's possible to set a fair market price, maximize the price for which the business is sold, and to plan to use the income stream to help fund a

Whether or not a professional has a plan in place, these considerations should be reviewed frequently as business and life endure many changes throughout one's pre-retirement life.



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