MERGER (COLUMN 4) – WHERE DO WE GO FROM HERE?

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Thus far in our past three columns on this topic, we have talked about why firms typically look to merge, what to consider in a merger candidate, and why younger and soon-to-be retiring partners with often vastly different expectations of the firm are motivated to find common ground solutions. So, let talk about where we might go from here.

Remember, when firms first start considering the idea to merge into a larger firm, they do it with the intent to solve a problem. Common problems distressing enough to motivate this transaction are:

1) **Leadership**: Not enough future partners on the ground or in a near-future pipeline to be able to take over and retain the client relationships of the retiring partners while simultaneously continuing to nurture and develop new clients. This concern tends to be expressed frequently by senior partners when they share their discomfort with the level of risk they are accepting regarding their future buyout.
2) **Capacity:** The existing talent gap between the partners and the personnel a level or two down in the firm (whether that is director, senior manager or manager) is too large. In other words, given the technical nature of the work being performed, there is not enough capacity at the right levels of skill to continue to produce the existing work, and certainly not enough to support any growth in work. This issue is typically brought to a head simply by senior partners asking the remaining partners to identify who has the time, capacity and talent to do the actual work that needs to be transitioned.
3) **Investment:** The firm has grown to a size where they are faced with the need to move away from their silo approach of operating under an "Eat What You Kill" (EWYK) type of model to more of a "Building a Village" (BAV) or One-Firm Concept. To make this change, the partners recognize that they would need to invest a lot more time and money than they have been in this kind of process, not to mention the additional insecurity of making changes they are not comfortable with or don't have experience doing. Therefore, merger not only has the potential to save the mergee partners a great deal of money (because the mergee firm goes from maximizing partner income under the EWYK model directly to maximizing it under the mergor firm's BAV model), but eliminates the risk of being able to successfully make this transition since they simply are adopting the mergor firm's operating model.
4) **Accountability:** A firm can't hold the partners individually accountable for their actions or inactions due to limitations expressed in the partner agreement, strong partner coalitions in existence, operating model utilized, etc. There is not a governance structure in place (votes to force compliance and the will to follow through) that allows this type of dysfunction to be addressed. There is a high likelihood that deadlocks are more commonly occurring every time substantial changes are recommended. Because of these typical conditions, and due to fact that this type of situation breeds significant distrust between partners or partner groups, the firm has to look to a merger to allow it to survive once a few key consensus building partners start to retire.

Although this by no means is an all-inclusive list of problems that firms are trying to resolve through an upstream merger, it represents those we see most often. And while we have run across plenty of others areas of concern, one or more of the four listed above are almost always at the forefront of our discussions with the partners groups.

So, is merger the only choice? The answer obviously is "No." But is merger a financially sound, low-risk solution when one or more of these conditions exist – "Absolutely." So, what is stopping everyone from merging? It is simple … it comes down to "control." One of the great things about our profession is that a CPA working in a small firm can make a lot of money, starting as a solo practitioner. And while the numbers prove it every year in the practice management surveys, even though owners of small firms do well financially, generally the larger the firm the higher the average partner compensation. So, the reluctance to merge clearly isn't about money because as an owner, merger is likely to get you more of it. This is really about Burger King … it is about the younger partners wanting to do it "their way." And there is nothing wrong with that. They have almost completed their servitude as junior or next generation partners and it is absolutely fair that they want their crack at running the business. This same "control" issue was probably an important factor as to why the current senior owners split off from their old firm to form this one, or bought out the previous senior owners.

Let's digress a moment and look at these four issues from both viewpoints – that of the partners soon to be leaving, and the perspective of the partners soon to be taking over.

Partners Who Are Soon to be Taking Over:

The younger or next generation partners recognize the enormous obstacles they face with a leadership and capacity shortage. But the likelihood is that they have been shouting for help in both of these areas for a long time. The most common reality is that the younger partners aren't spending enough time in leadership roles because the senior owners don't want to vacate the roles. And you can be sure that the junior partners are aware of the capacity problem. They are probably unable to fulfill the complete roles and responsibilities of being client service partners because they still have to do some of the technical work – manager level work – for the senior partners. This is partially true because there is not enough talent and capacity ready below them to allow them to delegate their old work down. Without being able to shed their old responsibilities, it makes sense that they won't be able to fully take on the work embodied in their new partner positions.

They also can see how, without some significant governance changes, some partners previously held in check by dominant personalities could easily become unmanageable when specific senior partners retire. As well, there are likely what we would call "classically operating technical partners" that have seniority over some younger, talented client service partners. So, without a change in the decision-making process, there is no easy way to put the control of the firm in the hands of the marketing-oriented partners. This means it could easily fall into the hands of the "work horse charge hours" oriented partners.

The investment issue is rarely a big deal for the younger partners for two reasons. First, generally, the largest salaries are earned by the senior owners, so large additional expenditures –

while probably split proportionately – are still shouldered by the senior owners. Second, the younger partners will be able to continue to reap the benefit of whatever investment is being made long after the current senior owners retire, so they know they will have plenty of opportunity to reap the ROI of this cash focus.

Regarding accountability – rarely does anyone seek it for themselves. But since CPAs are very intelligent as a group, even though they don't like accountability for themselves, and because they see the need to have it for everyone else in the firm, they know deep down that this is a necessary change to embrace personally as well.

Partners Who Are Soon to be Retiring:

On the other side, the senior owners usually hate the idea of making large investments in anything during their final three to five years for one or more of three common reasons:

- First, infrastructure improvements such as governance, people development processes, compensation and accountability changes can take a nice bite out of annual earnings for a few years before the efforts start contributing to the bottom line.
- Second, their retirement benefits will be likely impacted, especially if benefits are tied to a multiple of compensation. There also will probably be a short-term negative impact for other variations of the buyout formula as well since the focus of a lot of the firm's resources will shift to internal matters (to people development, governance structure, etc.) instead of external issues (such as client development or acquisition).
- Third, the real benefits and profit enhancements accrue to the remaining partners as the larger economic reward for these kinds of changes usually lag several years behind the investment. Naturally, for the senior owners, it is financially more prudent for them to just move everyone to a firm that has already put this kind of operation in place.

Regarding accountability, capacity and leadership, it is hard for the senior owners to see a light at the end of this tunnel on one or more of these areas. It is likely that the firm has attempted to fix these issues during the last 10 years, and clearly because those weaknesses still exist, they know they don't have much to show for their efforts. So, to them, the question becomes why "now" is going to be any different than their previous attempts to resolve this. Naturally, the senior partners range from being skeptical that real change will occur in any of these areas, to being able to make a good case for why they are justified in being total non-believers.

What Do We Learn from All of this:

We go full circle. Everyone sees the changes that need to be made, yet little progress is made. So, this leads us to the single biggest reason why mergers are such a good answer for many firms. It is:

CPA firms are notorious for trading off long-term *Effectiveness* for short-term *Efficiency*

Firms continuously under-invest in their organizations so the partners can take out more money now which therefore leaves their firms in various states of neglect that compound over time due to this deferred maintenance and repair. As an example, the firm may not spend enough time and money in training and closing competency gaps. As a matter of fact, most firms can't even tell you what competencies they expect people to have at each level, so it makes sense they have a difficult time determining how to close them.

Or the firm might allow partners to operate in silos and doesn't force everyone to follow the same standard operating procedures and processes. This might maximize the individual productivity of a partner over the short term. However, it also generates more training problems for the staff and virtually no ability to hold partners accountable to the firm's strategy. This is because the focus is on individual partner performance rather than the performance of everyone in the firm. Or the firm may not clearly define responsibilities at each level within the firm, especially at the partner level, so they create organizations built around specific people rather than people filling roles within the firm. This generates a nice return until one of the pieces of the puzzle (a partner) is removed, and then a whole new organization has to be built around the successor key players. And we could go on and on for pages (okay, even books, since we have several out on this topic).

What this really comes down to is that the partner group continually makes short-term decisions regarding operations in order to maximize the amount of <u>this year's</u> annual compensation available for distribution. Here is the most common example: When a firm promotes a manager or director to partner, if a successor is not readily in place to take over that person's work (which is rarely the case), then the firm can make more money in the short term by asking the new partner to continue fulfilling a lot of their old role as manager while simultaneously taking on their new role as partner. There is a belief that they are squeezing more out of their new owners by having them do two jobs rather than just one. But the reality is that these people deemed talented enough to be added to the partner group are put in a position to doing two jobs poorly instead of one job very well. And the sad part of this story is that the one job they are not being groomed to do very well is far more important to the long-term success of the firm than the job they are trying to leave behind.

The typical partner group does not want to risk their income stream by allowing the new partner and his or her replacement to develop into their new roles, which would require both of them to operate at less than their normal levels. In other words, it would be inefficient for the firm to, for a while, have two people being somewhat unproductive as they learn new skills. The person identified to fill the position of the recently promoted partner needs nurturing and training, which translates to a lot of non-chargeable time in order to get up to speed and become capable of filling the new position. And then when you factor in the time the new partner needs to spend transitioning work and assisting his or her replacement, there is even more downtime. Add to this the loss in production as the new partner spends time learning his/her new role and spending more time building client relationships, and even more non-chargeable time is added to the pot.

Yes, we understand that it <u>IS</u> efficient to keep everyone as chargeable as possible. However, it is much more effective and profitable over the long term for the firm to invest immediately to better train both the manager replacement and the new partner, allowing both to more competently fill their new roles more quickly for many years to come.

This is just one example of many. Firms routinely choose to under-invest in their training, infrastructure, successor development, operating processes, and so much more because of the ridiculous desire for everyone to constantly be productive. While this approach will help you become successful as a small firm, the more successful you are, the more the same approach will begin to undermine and limit your future. And when you focus on production and short-term gain long enough, you start expecting to take all the money out of it every year. Quite frankly, in the beginning, it can easily appear as if you are getting away with this under-investment, which begs the question as to whether it was necessary in the first place.

On one hand, you could argue that you have maximized your take home pay by milking your cash cow firm for the past 20 years. And now, you can skip that investment and headache altogether by simply merging into an organization that was willing to spend the time and money putting all of this in place. Sounds like you are way ahead! However, consider the reality that the firm you are considering merging into likely has higher average partner salaries than you have been able to generate, has greater success in the market, stronger training and development processes, leadership being groomed, and has been making this investment all along. This really challenges the logic and validity of the “no loss of production” or “over-focus on efficiency” approach.

When you reflect on the whole situation, the answers, regardless of where you look, are the same. You need to address the issues above every day. And yes, they will take time and money to do so, with potential short-term negative impacts on partner compensation. But by addressing them, you will position your firm to be more profitable sooner and for a longer period of time. And if you don’t, as you get close to a few key people leaving, you will find yourself in a position to have to merge into a firm that had the foresight and initiative to continually solve these problems.

So, as I just said, the answer is the same; either you will start making the investment now and from now on, or at some point, you will join a firm that has made the investment. But in the end, long-term success requires continuous investment in these four areas. If you are one of the firms that have chosen not to make this investment and your time for correction is limited, then there is good news for you. The market for merger is very good right now, so you probably will do just fine.

For those of you that still have time, we would suggest that you begin a strong regimen of vigilantly maintaining your firm and start addressing the four issues above immediately. You win three ways with this approach:

- First, you will be building a stronger, more sustainable firm, and therefore a more valuable one.
- Second, while you may find at times that you are risking some short term distributions, you will more than make up it for it by the improved performance of key people and processes sooner as well as for years to come.
- Third, expecting the merger market to be there when you need it is just poor business management. You always have that choice, but let’s make sure it is a choice rather than a requirement.

Good luck in whatever direction you decide to take!