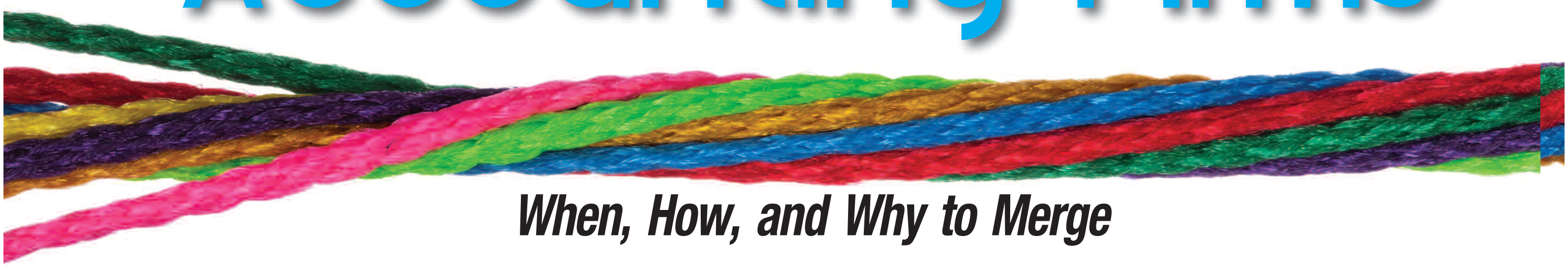
Mergers and Acquisitions of Accounting Firms



When, How, and Why to Merge

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IN BRIEF

Mergers and acquisitions are a typical way for accounting firms to grow, expand into new markets, build expertise, and provide for succession. But not all mergers are true combinations of equals, not all firms are ideal matches, and not all acquisitions are structured the same way. The authors provide an overview of the variations of both types of transactions, under a variety of circumstances, with practical advice for reaching an agreement that will be to the benefit of both parties.

It seems that every week, there is news of another merger within the accounting profession. Legally speaking, however, very few combinations of accounting firms are true mergers. Most transactions are legally structured as an *acquisition,* wherein the acquiring firm's owners assume ownership of the acquired firm; however, a *merger* is more properly defined as a combination of firms whereby at least some of the owners of both firms become owners of the combined firm. The other major deal structure is an acquisition whereby the owners of the acquired firm do not acquire an ownership interest in the combined firm. There are also cases where only some of the owners of the acquired firm become owners of the combined firm; these are called *hybrid* transactions.

The choice of which approach is best should be based on several factors, but one issue stands out: how long the owners of an acquired firm plan to continue working full time. If their timetable is more than five years, a merger is probably the best option; if they are five years or less from slowing down or retiring altogether, an acquisition makes more sense. This issue also leads to hybrid deals, as some owners in the acquired company may still have long careers ahead of them, while others with a short horizon are better suited for a buyout.

Mergers

Reasons for merging. Firms consider merging for many reasons, but the following are the most common:

Bench strength. Talent is in short supply in the accounting profession; therefore, firms are increasingly using mergers to add talent for growth. An additional goal is creating an internal succession team for the long-term security of both the successor and the acquired firm. The merger not only adds depth of staff and partners, but it can also create opportunities for growth, leading to better opportunities for internal promotion of talent.

Niche services. Successor firms are often looking to strengthen an existing niche service or create a new one. In addition, the client mix for the firm's existing specialty services might be underserved; in this case, an acquired firm with the same specialty can provide more capacity. The owners of the

acquired firms, meanwhile, are normally looking for the larger client base; the richer menu of consulting services also presents an opportunity for growth. Often these firms have been referring out services as routine as auditing, let alone niche consulting; a merger offers the opportunity to retain those services in the newly combined firm.

Geography. Many larger firms have a geographic growth plan; for example firms in Manhattan may seek to expand into Long Island, New Jersey, or Westchester. In addition, some firms believe a presence in certain markets is necessary for their brand's prestige. Advances in technology have made it easier for firms to operate in a multi-office environment; for example, the authors recently helped a firm in the Washington, D.C., area merge with a firm in Florida. The successor firm in D.C. managed all of the administration; this operational synergy allowed the Florida partners to focus on practice development and cross selling. Another firm that specialized in services for labor unions merged with smaller firms in other areas with the same niche, creating the opportunity for significant growth due to their national reputation and stronger service mix. The authors also advised a New York City–based firm merging with a firm in the Albany area; the combined firm created a service center of sorts in Albany utilizing that market's lower cost structure to produce work product for New York City clients. Acquired firms in this situation often find themselves in the advantageous position of managing the combined firm's operations in their local market.

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Structure of mergers. Owners of acquired firms are primarily concerned with the following issues:

Compensation. In most mergers, the owners of the acquired firm are not expected to reduce their compensation, since it is unrealistic to suggest that they maintain the same level of revenues, devote the same time and effort, adapt to the successor firm's control environment, and also take a cut in compensation. Thus, it is common for successor firms to offer conditional compensation guarantees for one to two years, typically requiring that the new owners' time commitment and client revenues remain at historical levels. After the conditional guarantee expires, the new owners are usually expected to adapt to the successor firm's compensation plan, which does not necessarily mean a drop in compensation, but rather a different method of determining it.

Equity. Equity does not mean the same thing in every owner agreement. In some agreements, it governs almost everything, including compensation, governance, capital contribution requirements and the value of retirement buyouts; in others, it means virtually nothing. A first step for firms considering an upstream merger is gaining an understanding of what equity means in the owner agreement of the potential successor firm. The authors have found that, generally speaking, the larger the firm, the less important equity is.

Many mergers use a basic fractional formula for determining equity for each owner; the numerator is the gross revenues of each firm, and the denominator is the combined firm's revenues. If one firm has $5 million in revenue and the other has $10 million, 1/3 of the equity is allocated to the first firm's owners and 2/3 to the second. The allocation to individual partners is often left to each firm to decide, as long as the result is reasonable. In the case of two West Coast firms the authors worked with, however, the larger firm felt that only 80% of the smaller firm's revenue should be counted for this purpose due to the disparity of metrics such as realized billing rates, infrastructure, and technology.

In reviewing the larger firm's owner agreement, which was slated to be the combined firm's agreement, the authors discovered that the only thing equity affected was voting for "major decisions," which included merging with another firm and admitting and terminating partners. As it turned out, the variance in equity amongst the partners was spread fairly equally, and the parties were convinced that any concerns other than relative revenues were not relevant.

Retirement buyout valuations. The trend for internal retirement buyouts is a decrease in valuations, and this seems to be continuing. This is heavily influenced by firms finding a way to balance the amount of baby boomer owners seeking a succession solution, the competition for talent, the difficulty of attracting partner-level talent, and the desire to avoid strapping the next generation with an unaffordable buyout. For larger firms, the approach to valuation will likely be based on a multiple of compensation; the current average, according to experience and surveys, is between two and three times compensation, distributed over 10 years and treated as retirement payments. Smaller firms are more likely to use an approach based on a multiple of revenues time either equity owned or book of business managed. The current average is between 75% and 100% of revenues paid out over five to 10 years, most often treated as retirement payments.

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What makes a firm attractive to another firm seeking a merger? The authors have found that firms looking to grow through a merger look favorably on the following characteristics:

- Up-to-date technology
- Strong operating metrics, such as billing rates, productivity, realization, and profit margins
- Clients that pay and provide information on time
- Strong staff, and especially staff with long-term partner potential
- Good time records, even for owners
- A service model wherein owners are not the only ones who deal with clients
- A commitment to delivering quality service and compliance with professional ethics.

Regarding profit margins, there can be too much of a good thing. A very high profit margin (net income before any owner compensation, perquisites, and benefits), in excess of 50% for example, can create several issues. The compensation level relative to an owner's managed book of business may be very different from that of the successor firm, which can be a problem with cultural fit. That level of profitability also implies a low-cost structure, which means it will be harder to find cost synergies. If such a merger goes through, the acquired firm's owners might not see a pro rata increase in compensation compared to the growth in revenues they help create.

Owners of successor firms should keep in mind that their firm's owner agreement will determine the value of the acquired firm's owners' interests. If the agreement sets a low value for an owner's interest, as compared to the market, the firm might not be an attractive merger opportunity. Owners need to be able to demonstrate how merging with their firm will create an upside opportunity, such as the capacity to support merger candidates, a strong IT environment, a compensation system that will reward the expected growth, and new services to offer the acquired firm's clients. Another key attribute is flexibility towards the merger and respect for what the other firm brings to the table.

Both the acquired firm and the successor firm should consider "the four Cs" when evaluating merger candidates:

- *Chemistry:* Most people spend more waking hours with their coworkers than their spouse, so having good chemistry is critical. This is a key factor in choosing clients and staff, so it should be the same with choosing partners; after all, the relationship between the combined partnership will inevitably trickle down to the clients and staff. The authors' rule of thumb is not to merge with anyone who is not a good candidate for sharing regular lunches with.

- *Capacity:* This is even more important for sellers who must be replaced shortly after the merger. Most mergers include a goal that the combined successor firm will create capacity and room for growth through cross-selling and new client development. Capacity is not just about office facilities; it is more about the organization's ability to grow as necessary and to put people in place at the needed levels to manage growth, especially as others slow down.
- *Continuity:* Clients and staff like the way the firm's ship is sailing. If a merger would require wholesale changes that might cause those clients and staff to leave, it is unlikely the merger will be successful. Some change is necessary, and in some cases it may be substantial; the key is to manage the pace of change so the combined firm remains sensitive to clients and staff.
- *Culture:* This concept can be defined many ways, but the authors suggest comparing what it is like to be an owner in each firm, what it is like to be a staff member, and what it is like to be a client. Some cultures are hard to combine; for example, a firm that pays its owners on an "eat-what-you-kill" basis usually has a very different culture than a firm that embraces the "one-firm" philosophy. The cultural differences are likely to affect not just compensation, but every aspect of how the firm is managed and operates. A firm that has embraced current technology will be much different from a firm with older technology.

Acquisitions

When seeking to sell or buy a firm, many of the same considerations for mergers apply, but there are also stark differences. The following considerations are usually of primary concern for both parties.

Value of the acquired firm. The terms of a transaction are as important as the price. The seller needs to be paid fairly for its years of sweat equity, and the buyer needs to make a profit on the deal. The price is best thought of in terms of the multiple; a 1x multiple of a firm with a value of $1,000,000 means the selling price is $1,000,000. The terms of how that amount will be paid, however, make a huge difference. Ideally, the multiple should be the result of the structure of the rest of the terms. The less money paid to the seller up front, the more client retention adjusts the payments and the longer the payout period lasts. The more profitable the acquisition for the successor firm is, the higher the multiple is likely to be. (Note that the payout period referred to is for the amount of the deal that is seller financed. To the extent a transaction is financed by the buyer obtaining third-party financing, the amount of that financing is effectively a down payment.)

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Anything is possible with regard to the terms of a merger—but there will need to be an offsetting adjustment for the deal to make sense to the other party. In a recent deal the authors were involved with in the Southeast, a small firm was offered three different deals from the same buyer. Deal number one had a 1.25× multiple based on 12.5% of collections from the seller's original clients for 10 years with no cash down. Deal number 2 was a 1× multiple paid out over five years based on 20% of collections from the seller's original clients with no cash down. Deal number 3 was a .76× multiple based on 19% of collections from the seller's original clients for four years, with a 20% down payment and the price locked in after two years. None of the three offers had any allocation for goodwill. The buyer offered three options because he knew certain terms would be more important than others to the seller. If obtaining the highest multiple was the most important issue for the seller, she could choose the first offer. If limiting the period during which client retention could affect the price or receiving a down payment was the most important issue, she could choose the third offer. All the offers were satisfactory to the buyer because all appropriately offset certain terms with an adjustment to the multiple.

Multiples for the acquisition of larger firms tend to be lower and payout periods tend to be longer than with smaller firms; however, there are also shorter retention periods for acquisitions of larger firms, because many buyers believe a larger firm's client base is more brand loyal than partner loyal. Another consideration is that larger firms tend to have multiple owners; if all of the selling owners are not leaving at once, the owners staying behind can play an important role in retaining the clients previously managed by the departing owners. Therefore, buyers tend to be less concerned about client retention following the closing. That said, there are still some deals with larger firms that include a retention period equal to the payout period.

Structure of the deal. The way a sale or acquisition is structured needs to fit the situation, especially true for the seller. For example, if a seller is ready to immediately slow down or retire, the structure of that deal should be different than if the seller wants to continue working full time for several years. Some situations call for a "cull out sale," which involves selling only part of the practice. The following are examples of common approaches the authors have seen used.

One firm in the Mid-Atlantic region wanted to retain its wealth management practice but sell its traditional accounting and tax work to a firm who would not compete in wealth management. A firm was found that was looking for an affiliation with a firm that provided wealth management but was not interested in doing that work themselves. The two firms moved in together, and clients were told the reason for the "merger" (although the underlying transaction was a sale of the accounting practice) was to allow the seller to focus his attention on the wealth management part of the practice. This is an example of a cull out sale.

Another frequent structure is called a two-stage deal (TSD). This structure is designed for practitioners who are one to five years from slowing down but recognize that the transition of their practice, and therefore the eventual value, will be optimized if they begin acclimating their clients to the successor firm now. Although they recognize the need for a succession plan, they are also reluctant to give up control of their day-to-day professional life and their current level of income. The first stage involves the seller moving into the successor firm's practice, either physically or operating as a satellite office, and operating the practice as if the firms have merged. The seller continues to make the same money during this stage, providing time commitment and revenues remain steady, while gradually getting clients comfortable with the successor firm. The buyer is not asked to maintain the seller's level of income while simultaneously paying for the practice value, which most buyers would not be willing to do. The second stage is the actual buyout.

For example, a New York CPA who was generating about $800,000 in revenue with a 35% profit margin wanted to work full time for three more years. The deal was structured so that the buyer assumed the entire overhead necessary to operate the seller's practice, the selling practitioner operated as a contract partner in the buyer's practice, and the buyer paid the seller 35% of the collections from the seller's clients as compensation (provided the seller devoted the same time to the practice as in the past), and the seller agreed to retire from working full time and stay on in a part-time counseling role with the successor firm after the third year, at which time the seller's buyout payments would commence. If the seller had tried to be paid for the value of his firm while still working in the practice full time, the buyer would likely either offer below-market value for the firm or require the seller to accept a significant reduction in compensation in order to avoid negative cash flow. Neither of those outcomes is necessary with a TSD.

The authors routinely run into situations with larger firms that have partners with different career plans, which are ideal for hybrid transactions. For example, one firm in New York City had four partners; one was seeking to slow down quickly, one wanted to work four more years then slow down, and the other two had long-term career aspirations but lacked the capacity to take over for the two senior partners. The deal structure was effectively four separate deals; the first partner sold his interest in the firm (which was determined based on his equity) to the buyer and started his buyout immediately, the second entered into what was effectively a TSD, and the other two were admitted as equity partners in the successor firm.

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Choosing the right firm. Sellers should focus on the 4 Cs discussed above when evaluating buyer candidates. In almost every case, the value and success of the sale of the practice will be affected by the clients retained after the sale, and a critical driver of that success is finding the right buyer firm.

Location can be an important factor because it implies continuity; however, staying in the exact same location is typically not as critical as one might believe. Partners should first ask themselves how many clients actually come to the office and where they come from. Insisting on a successor retaining a specific location dramatically limits the number of buyers that will be interested and might lead to a lower valuation from firms that already have an office in the same area, while enabling the successor firm to absorb the practice into its current location creates synergies. The more money the buyer makes, the more the buyer is motivated to pay the seller and still realize a profit.

In the areas of continuity and capacity, consider any specialties or licenses the successor will need to take over the client base. For example, in New Jersey a CPA must also be an RMA to audit municipalities and counties; a firm with that kind of client base obviously must find a successor with that additional certification. Other examples are the successor firm's reputation in the community, results of prior mergers or acquisitions, and the successor firm's own track record of retaining clients and staff.

In interviews with potential successor firms, ask about the firm's interest in the client base. Look for hints that they might only want some of the existing client base. This is usually a matter of scale and a willingness on the part of the successor firm to maximize the value of the practice by retaining as much business as possible while still assimilating the practice into its culture.

The same four Cs require buyers' attention as well. Successor firms should make sure that they have the capacity to take on the work, that they can promote strong continuity to clients, that the cultures of the two firms align, and that the chemistry between the parties is solid. Then, when discussing the acquisition with the seller firm's owners, promote how these will be addressed. Stress what joining the acquiring firm will provide for the clients and staff of the seller firm, rather than what they will lose in leaving the seller firm.

Comparison of operating metrics between the parties is also important for both buyer and seller. For instance, if the level of fees the seller has been charging clients is substantially below what the buyer charges, that is probably unsustainable unless the work can be given to lower-level staff, where the fees make more sense. Total expected work hours for staff is another example of a metric that can indicate a culture issue.

Many successor firms do not consider how emotional the decision to sell their firm can be for the seller. For buyers, the transaction is a business decision and the financial results are most important; they tend to make decisions rationally. Sellers go through the same rational evaluations, but are also making a decision about the end of a 40-to-50-year professional career. It is important for both sides to recognize the emotions involved in order to be the most effective in the negotiations.

When to start the process. Potential seller firms should start as soon as possible. In almost every situation, the value of the practice is going to be affected by how well clients are retained after the sale. For smaller firms, clients tend to be very partner loyal rather than as opposed to brand loyal. Adding to the challenge, many practitioners rarely see their clients face to face; between the cloud, phone, and e-mail, statistics claim that as much as 87% of clients are only in the same room physically with the owner who manages their account once a year. Clients cannot be effectively transitioned remotely, so taking advantage of these meetings is a key to a successful transition. Therefore, the more time allowed for the transition and the more active the selling partners are in it, the better it will go. This is why a TSD, as described above, is such a powerful tool for succession.

Achieving the Desired Results

The life cycle of any sufficiently large or long-lasting accounting firm will inevitably involve a merger, an acquisition, or some combination of both. When the time comes, it is important to find the right firm to sell or buy, taking into account chemistry, capacity, continuity, and culture. Preconceived notions of equity or valuation should be reconsidered, and firms should be open to more flexible deal structures that suit the specific circumstances. Firm partners need to be aware of all of the intricacies and possible permutations of a transaction in order to achieve a beneficial result for themselves, their clients, their staff, and the other party.❑

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