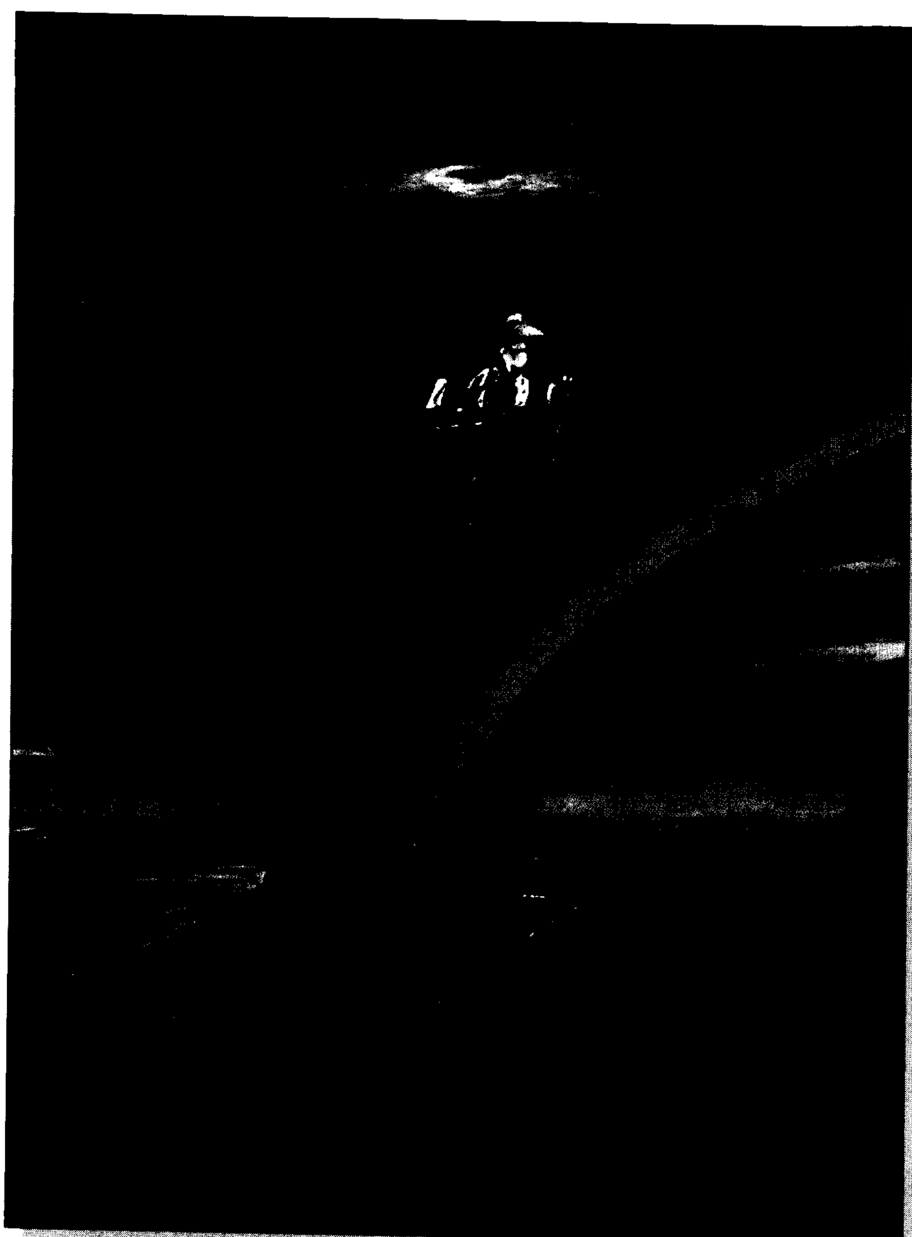
The Search for the Perfect Merger Candidate for Your Accounting Firm

By Stephen Weinstein



All over the country CPA firms and individual practitioners are talking merger and whispering acquisition. This article covers some considerations and guidelines when contemplating a merger or acquisition—upstream, downstream or lateral.

Merger and acquisition activity among CPA firms has reached monumental proportions. Probably every CPA firm, from the smallest to the largest, will be approached or will seek some form of involvement with another firm during the next 12 months. This article is designed to:

1. Help practicing CPAs decide whether they should consider merger or acquisition;
2. Clarify the pros and cons of different types of mergers or acquisitions;
3. Highlight the extremely important planning steps;
4. Provide alternative approaches for locating prospective candidates; and
5. Reduce the risks of making a mistake by keeping the process on the right course.

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WHY THIS ACTIVITY IS BOOMING

During the 1980s, many CPAs became conditioned to the steady growth of their practices. The recession hit these practitioners like a ton of bricks and has created an atmosphere of insecurity. The principals in these firms are struggling with a series of financial and emotional woes associated with reduced incomes, serious collection problems, staff layoffs, and even intra-firm squabbles. These negative feelings have been accentuated by the loss of clients due to bankruptcies, business failures, or other signs of the times, including following a departing partner or staff person or simply lowering fees.

In addition, the weakened economy has reduced the opportunities for new business and caused many existing clients to cut back on services or defer additional services. Furthermore, new business start-ups are much less prevalent than in the booming 1980s.

The decline in volume, increased competition and shrinking margins have created feelings of insecurity in the minds of many proprietors and partners. For some, this insecurity is a leading motivator for considering a merger or acquisition. This trend is likely to continue for some time to come.

The boom in merger and acquisition activity is also being affected by other factors. For example, the demise of some of the nation's leading CPA firms (e.g., Laventhol & Horwath and Spicer & Oppenheim) has severely disturbed many practitioners.

Increased competition for clients has also elevated anxieties. Many firms have experienced or will experience the retirement or loss of a key rainmaker, and rainmakers are extremely difficult to replace. Often, the remaining partners will look outside the firm for people who they believe can develop new business, in turn sparking merger or acquisition activity.

THE ECONOMY IS NOT THE ONLY REASON

Internal operating problems are also a motivating factor. While these factors vary, they do tend to fall into basic categories.

Quality Control. Developing, maintaining, or improving the quality of a firm's work frequently encourages the firm's principals to look outside to other firms that have either a better system or the technical people to assure that quality is maintained. Sometimes, this includes the need for specific expertise that the existing firm does not have.

The search for quality control has also been motivated by a fear of lawsuits, enough to stir even the most complacent practitioner.

Management and Administrative. The entrepreneurial spirit exhibited by many partners is often accompanied by strong opinions on how the firm should be run. Many partners want their firms to run perfectly (i.e., their way) but are unwilling or unable to spend the appropriate time accomplishing this. The lack of leadership takes its toll on profit margins and often leads to bickering and internal strife. The search for solutions to management problems can drive people to seek a merger or acquisition.

... a variety of needs, fears, and/or differences can initiate the search for a merger or acquisition.

Internal Partner Problems. If a key partner leaves or retires, if a particular partner is perceived as not carrying his or her weight, or if the planned direction of the firm or operating philosophies of the partners do not mesh, the result may be the break-up of the firm, or the partners may seek a merger or an acquisition.

EXPLORING THE ALTERNATIVES

Mergers and acquisitions can be categorized into three basic types, often described as *upstream, lateral,* or *downstream.*

An upstream merger is really an acquisition of a smaller firm by a larger one. The smaller firm's name usually does not survive the merger and the larger firm's policies and procedures generally prevail.

In theory, a lateral merger is the only true merger. The firms are generally of similar size, and the result is a pooling of resources and a balanced recognition of partners from both firms. Who gets which position, whose name goes first, and who has the final say, all must be negotiated in advance.

A downstream merger is basically the view from the other side of an upstream merger. A downstream merger occurs when a larger firm seeks out and acquires a smaller practice.

Any firm can actively seek to initiate a downstream, lateral, or upstream merger. The critical issue is whether all the principals have thoroughly and carefully considered all aspects of each option. Each type of merger has advantages and drawbacks. The key to achieving a successful result is the time and effort spent *prior to making contact with the other firm.* Knowing what you want and proper planning are critical to avoiding a potential disaster.

CONSIDERING A MERGER OR ACQUISITION—A PRACTICAL APPROACH

Partners in a firm must recognize that this is not an issue to plan in the typically informal business lunch setting or even as an agenda item of a partners' meeting. Partners should devote whatever time is necessary exclusively to this topic and should do it outside the office in a quiet setting, isolated from interruption (i.e., no telephones). I recommend using an outside consultant or facilitator to help assure that the discussions are productive, balanced, and complete.

At this meeting, all participants should be asked to provide reasons why the firm should consider any of the three types of mergers. All the reasons should be listed on a flip chart. After everyone has exhausted his or her contribution of possible reasons, the group should rate the reasons. For example, a simple one to five rating system might provide the following guidelines: 5—critical (most important); 4—important; 3—neutral; 2—unimportant; 1—should not be considered.

... develop a "wish" list of what the partners want from a merger or acquisition.

The flip-chart pages should be displayed in front of the room so that the reasons are kept in sight throughout the discussions.

The next step is to develop a "wish" list of what the partners want from a merger or an acquisition. This list should not only include everything they would like to achieve, but also should include those things they do ***not*** want. For example, a strong positive on the list might be to remain in the firm's existing office space; whereas ***don't want*** items might include such things as a small 1040-oriented practice or a partner who will retire (and must be bought out) in less than 10 years. The wish list should be all encompassing. Anything that a partner feels strongly about should be included.

The partners then should explore the pros and cons of each of the three types of mergers based on the wish list criteria. This discussion should be exhaustive and result in clearly stated conclusions, such as: we should actively seek a downstream merger with a firm with the following attributes . . . , but we are definitely not interested in a lateral or upstream merger and should not pursue any such possibilities.

Once conclusions are reached, the firm's approach should be discussed. The determination of who will do what, and by when, must be clarified and a definite timetable established. Because merger activity may present risks with clients and referral sources, the principals involved should agree on an approach that will maintain maximum confidentiality. This is true, particularly if the plan might be perceived by others as a sign of weakness or problems within the firm.

The financial arrangements to be sought in a merger should also be clearly delineated. Everyone should be in full agreement about any potential financial impacts.

ALTERNATIVE APPROACHES TO "THE SEARCH"

Finding a suitable merger candidate can be a difficult and time consuming process. As previously noted, there are also possible risks associated with others becoming aware of a firm's merger plans. Accordingly, various alternative search approaches should be discussed.

Use of your firm name can be very positive, especially if the ad is worded right.

The starting point in a search should involve those firms already known to one or more of the partners. A decision should then be made whether any of these firms can fit the plan, followed by an evaluation of the pros and cons of contacting one or more of the firms. If the conclusion is negative, alternative approaches should be considered.

Reviewing the names in a phone book or other geographical listing, if not overwhelming, is an appropriate vehicle to determine if any partners recognize a firm that might be a prospect for merger.

If these steps are not fruitful, the following approaches should then be considered:

1. Place an advertisement in *The CPA Journal,* a state society newsletter, or other publications read by CPAs. Usually you will choose to have a blind ad (i.e., using a box number instead of your firm's name). The pros and cons of using your firm's name must be carefully evaluated. Sometimes the use of your firm's name can be very positive, especially if the ad is worded well and it is not likely to be perceived as an indication that the firm is experiencing problems. Also, many practitioners will not respond to a blind ad.
2. Write or call specific firms. This technique might be used if you are able to isolate those firms that fit the description of the type of merger you are seeking. Cold calls and letters are being utilized more frequently with positive results.
3. Write to all firms in a geographical area. This blanket approach can be expensive and risky but clearly gets the word out.
4. Make inquiries through the firm's referral source network. For example, attorneys and bankers may know of firms that fit your requirements. Again, the associated risk must be evaluated.
5. Use the services of an outside consultant or consult with your state society executive director, local college faculty, or other persons in contact with CPA firms.

PITFALLS TO AVOID

Over the years, I have witnessed many poorly organized merger and acquisition searches. Time is often wasted pursuing an inappropriate match doomed to fail from the beginning. How do you avoid these potentially costly and time-consuming problems?

The Key is Planning. Carefully formulating the firm's goals, fully evaluating all the reasons, and thoroughly exploring each partner's opinions and concerns are absolutely critical aspects of the process. The steps enumerated previously must be carefully followed. Obtaining full support and commitment from all participants is critical. If someone has serious reservations they must be addressed. If a partner is not willing to go along with a certain type of merger, he or she should state his or her alternative plans (ie., to leave). This should be evaluated and the impact on the firm should be considered.

Stay on Track. It is common to start looking for an X-type merger, but when a Y-type presents itself, to say "why not see what's in it for us?" This approach may work, but it is more apt to lead to a lot of wasted time. For example, one firm I know completely disregarded their agreed-upon candidate description and began pursuing a totally different type of merger candidate. After several months of discussions, many anxious moments, and an incredible amount of unproductive time, talks broke down when the realization set in that the merger did not alleviate the critical problems recognized during the planning phase.

. . . remember . . . "it ain't over 'til it's over."

Emotions often affect people and can get the project off track. For example, a partner can get caught up in a possible merger because he or she is enamored by the potential size of the combined firm. His or her ego or other emotional needs start to direct the approach and critical considerations are conveniently overlooked or overshadowed.

Sometimes partners can be very short-sighted. Some have been known to become overwhelmed by current fears or concerns, e.g., loss of a major client, and become focused on one aspect of a merger that might seem to solve a particular short-term concern. Unfortunately, this can produce a long-term disaster because other key aspects of the merger are overshadowed by an individual's particular need.

Some firms move too fast or too slowly. A firm going too fast tends to decide a merger is right long before all the nitty-gritty is explored. Disaster occurs when the problems start to come out of the woodwork after the merger is finalized. On the other hand, some firms move too slowly; the partner responsible for coordinating the discussions becomes preoccupied with other matters or allows the project to stall or become disorganized. This can often turn off or cool down the prospective candidate, and the deal falls apart.

Finally, remember that "it ain't over 'til it's over." Partners often start thinking and acting like the merger is a done deal because various issues have been agreed to. Remember, until the documents are signed, the merger talks can end (and very often do).

PLANNING, DISCUSSIONS, AND PERSEVERANCE

Although the pressures on practitioners to seek mergers or acquisitions will be intense over the next few years, firms should approach this matter in a careful and organized fashion. The key is adequate planning, which must include complete and open discussion.

The morale of partners is greatly affected by a firm's merger and acquisition plans. Each person's future is tied to the results. Starting this type of activity and then not achieving positive results can be disappointing at best. Achieving poor results can spell disaster.

Partners must constantly reevaluate the firm's agreed-upon plan. This should be done formally at least once a year if the type of merger is lateral or upstream. A merger or acquisition can help solve a firm's problems, but quite often poor planning and coordination result in calamity for one or more partners (or the entire firm). **Ω**