Which way is the wind blowing?

The State of Consolidation of Accounting Firms

By Max Krotman and Joel Sinkin

In Brief

Where Do Things Go from Here?

The new year has seen a decline in the consolidation and merger announcements that so recently seemed to dominate the accounting press. It is anyone's guess as to what this means for the profession: Has the consolidation movement lost its momentum? Or is this just the end of the first phase of consolidation, to be followed by something else entirely?

The authors review the current state of the consolidation market and the impact it has already had in the structure of firms and the accounting profession. What have traditional accounting firms learned from the consolidators' successes—or failures? What forms of organization can we foresee for the near future? The history of the consolidation movement contains valuable lessons about what does and does not work in the marketplace; where it will lead in the future remains to be seen.

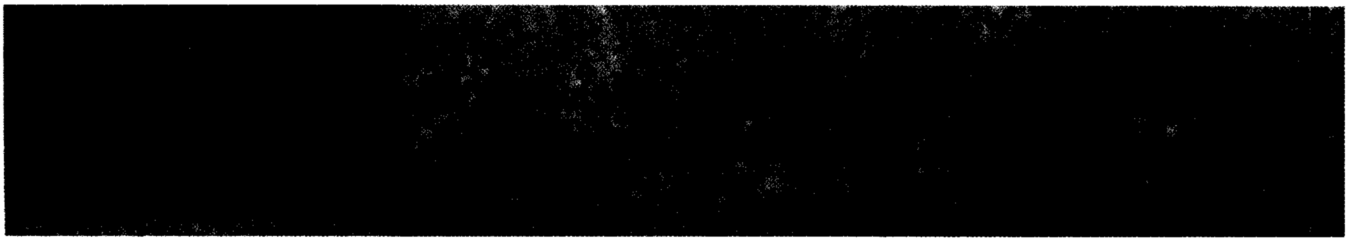
The consolidation of accounting practices dominated business headlines in 1998 and 1999. All around the country, symposia and conferences on consolidation drew thousands of accountants trying to stay on top of their world. Rumors abounded about tremendous compensation packages and multiples for any firm that sold out to a consolidator. Many accountants dreamed about getting rich overnight; others had nightmares of being put out of business.

The August 1998 AICPA conference in Naples, Fla., was one of the first public conferences to focus on the plans of competing consolidators. It sold out, and the AICPA had to rerun the event in January 1999 just to accommodate the overflow. At the time of these conferences, the number of companies that had successfully consolidated even two firms together was dwarfed by the number rumored to be imminently launching new operations. Now, $2\frac{1}{2}$ years later, most of these "imminent" consolidators are nowhere to be found and the marketplace, [at press time], is quiet. This provides the opportunity to look back on the consolidation wave, examine what it has done to the structure of the accounting profession, and speculate as to where it might lead in the future.

The Class of 1998–99

CBIZ (originally known as Century Business Services), the fastest and most successful of the first wave of consolidators, has suddenly lost its appetite. Officially, high-priced acquisition activity has been replaced by the decision to explore "strategic alternatives to enhance shareholder value." In fact, CBIZ was widely rumored to be abandoning consolidation and entertaining offers to sell the entire accounting division. Poor performance led to a recent plummet in the stock price, which has frustrated stockholders, among them partners of acquired firms. CBIZ's future has become the target of gloomy speculation. Many feel it will eventually be acquired by another consolidator.

Centerprise Advisors originally appeared to be the crown jewel of the consolidator community. Led by the experienced Robert Basten, formerly of American Express, Centerprise developed a unique roll-up approach. Centerprise started with several large firms from different regions that would become "partners." It then successfully courted additional partner firms, stoking anticipation in the process. Its initial public offering (IPO) of stock with the SEC was approved for sale.



Then, suddenly, Centerprise stopped cold: The IPO was withdrawn. A satisfactory explanation for the eleventh-hour decision was never given. Perhaps the market placed a much lower estimate on the future profits of the untested consolidation than Centerprise had anticipated. Shortly before Centerprise's planned IPO, CBIZ announced disappointing earnings, which probably soured the market on consolidation ventures.

All outside observers can know for certain is that Centerprise elected to withdraw its IPO, and a low stock valuation would have been a major factor. Centerprise's failure to go public and raise the capital for expansion dealt an unexpected blow to the consolidation movement and had to dim accountants' expectations of reaping an enormous financial reward through selling out to a consolidator.

American Express Tax and Business Services (TBS, a subsidiary of American Express) appears likewise to have decelerated its acquisition program, the recent acquisition of Hausser + Taylor in Cleveland notwithstanding. Although rumors persist, American Express appears to have transferred its focus from accounting firms to technology-related businesses. IT services seems to be the hot item that American Express has selected to add to its one-stop shopping menu in 2000.

HRB Business Services (HRB, a subsidiary of H&R Block) appears to be hot on the consolidation trail. Its affiliation with McGladrey & Pullen was the only real headline acquisition during 1999. That sizeable transaction, however, instantly made HRB/McGladrey the dominant player in the consolidation market and changed the dynamic of HRB's consolidation plan. What the future holds for the branding and expansion of this consolidator is unknown, but the answers may be coming soon, as the integration of HRB and McGladrey is completed.

Gilman + Ciocia has concentrated on merging tax practices and utilizing the clients as a stepping stone to financial services. The firm has been highly successful in making acquisitions in several areas of the country. It is also one of the few consolidators still aggressively pursuing deals.

Many of the other groups that were "imminently" seeking to become consolidators in 1997–98, such as the Allegis Group and Integrated Professional Services, are not making acquisitions that reach the industry press.

Unfortunately, it is too early to even guess at the success of the deals that TBS and HRB have put together.

Why the Slowdown?

The consolidation movement has lost some of its momentum: The question is, why? The answer may help us predict whether the slowdown is a momentary glitch or a time to reorganize and rethink the consolidation course.

Until Wall Street jumps on board, momentum is totally stalled for those consolidators that depend on public investors to fund their expansion. Is Wall Street on the sidelines because it feels consolidation must first prove itself? Is it too busy with the technology and Internet sectors? Is Wall Street wary because it got burned badly by the medical consolidations of the 1990s? Is it because the present consolidator model is defective? Or is it because the consolidators themselves are individually ill equipped to get the job done? Had Wall Street placed a higher value on Centerprise, it would have been public by now. Perhaps the consolidation players have been frightened off by Wall Street's reticence in the face of the market's current hunger for speculation. Maybe Wall Street has been put off by industry leader CBIZ's disappointing profits.

The momentum may have slowed because some of the more successful consolidators have paused to digest their acquisitions and concentrate on streamlining their new organizations. Or they may need to test the cross-selling theory before they acquire more ordinary accounting practices. These consolidators also are looking into other kinds of professional services that will enable additional affiliations and cross-selling opportunities.

The revelation of unreal expectations may have decreased the supply of accounting firms available for consolidation at the "right price." The gap between real offers and rumored offers disappointed many targeted firms that might otherwise have sold out to consolidators. In the early stages of the consolidation movement, the industry touted deal prices with as many digits as telephone numbers. Ultimately, the offers were much lower and often featured tax-deferred stock rather than cash.

What's Next?

The consolidation movement may be lying low, but it is far from dead. The current players will retrench and new players will join the fray. Regardless, the consolidation movement has already changed the structure of public accounting forever. All the major players are thinking bigger and seeking synergies and cost reductions through mergers and miniconsolidation.

The consolidation movement is not just limited to the major players discussed above. Second tier accounting firms are also in a position to become consolidators. BDO Seidman, for example, recently appointed Denis Field, an aggressive leader who has already voiced the goal of competing with the current consolidators, as its managing partner. Also, the possibility of multidisciplinary practices (MDP) opens the door for accounting firms to expand into other professions, and vice versa. For example, several large players in the insurance and investment industries have been rumored to be planning to enter the accounting marketplace. The "urge to merge" has never been greater.

One option for accounting firms is to become miniconsolidators. Many firms have decided to create their own opportunities through acquisitions and affiliations that will allow them to offer clients the same one-stop shopping the consolidators promise. They either acquire niche organizations or affiliate with them to make sure their client base has access to desired specialties. The term "co-opetition" is frequently used to define an affiliation where actual competitors share their specialties with each other through formal arrangements. These affiliations also protect member firms through noncompetition and nonsolicitation agreements. Another alternative is to bring in specialists in growing nontraditional niches such as information technology, financial services, and forensic accounting. Firms have varying goals for making these arrangements. Some seek to insulate themselves from consolidation by expanding their services up to the same competitive level. Others hope to make themselves more attractive targets for consolidators. Some firms have one simple reason: higher profits.

The Lasting Impact

The accounting industry has changed dramatically over the past 10 years, and the next will undoubtedly see more changes. A decade ago, the Big Eight were all CPA firms, promoting their accounting and auditing skills. Today, the Big Five call themselves consulting firms, promoting their skills in general business knowledge. Who knows what tomorrow will bring, as the Big Five actively seek to divest themselves of their consulting businesses, seeking to satisfy regulators' independence questions and unlock their businesses' growth potential.

The next generation will be even more technology oriented. Companies will have available to them powerful software that will continue to reduce the demand for traditional accounting services. Revenue will continue to shift from traditional accounting and auditing services to the niche services. For accounting firms to prosper, they must develop and offer new services that build on and complement accountants' traditional strengths. The consolidators understood this sooner than most and have put forth what are currently the best alternative ways of restructuring practices to face these challenges.

Other aspects of the consolidation movement have already affected the profession and will continue to have an impact:

Attraction and retention of talent. Perhaps the greatest current problem in the accounting profession is finding and keeping talented individuals. The consolidators have an edge over traditional firms in this area. Publicly held companies have deeper pockets and can offer tremendous benefit programs, the flexibility of different career paths, and the incentive of stock options, all of which are difficult for most traditional accounting firms to compete with. The consolidators' ability to attract the best of the best will surely be noticed in a marketplace where talent is in short supply. The consolidators have brought home to many traditional firms the importance of attracting and retaining talent through enhanced employee benefits, profit sharing, and other techniques.

Cross-selling and niche development. Developing and bringing in a niche service can immediately increase firm revenues. For example, when a New York firm serving high-net-worth individuals affiliated with a financial service professional team last year, they saw their net income rise more than 40% by introducing estates, trusts, personal financial planning (fee-based), and valuation services. Offering loyal clients additional services is at the heart of the consolidation movement, and many firms are now actively developing this capability. Absent the consolidators' example, how many firms now providing additional services would have undertaken to do so?

The "urge to merge." The consolidation movement convinced many firms that they needed to merge in order to compete. Many professionals have at least considered the merger option and many have taken the plunge. Although the urge to merge is simply contagious, staff shortages have led practitioners to consider alternative practice structures that they never would have before.

Taxation. Suddenly tax is not such a dirty word. Ten to fifteen years ago, the "high quality" firms and professionals were audit and review oriented. Now tax work has reemerged as a positive business for firms. High-net-worth individuals interested in the new services are now generating fees from what used to be an unlikely source.

The Future

No one can accurately predict what is in store for the profession, let alone the consolidators. The authors believe that although this new movement will continue and be a factor in our industry for years to come [and, at press time, there are indications of resurgent merger activity], it will not encompass the majority of accounting firms and professionals. Some firms will become extremely specialized as a means to compete; others will continue to branch out into alternative services. Mergers will continue to be a way to overcome the staffing crunch as well as compete with the consolidators.

Although for years many have foretold the death of the sole practitioner, this segment is actually growing. There will always be consumers that prefer service on the individual level. Many closely held businesses want and insist on the personal attention that only sole practitioners and small firms can render. While consolidation has had and will continue to have a strong impact on the accounting community, its marketing resources will also continue to teach accountants what works and what does not and, perhaps, offer a glimpse of what the future holds. ❑

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