

# Eight Strategies for 1 to 3 Partner Firms Considering a Merger or Acquisition

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When developing an expansion plan that involves mergers or acquisitions of accounting practices, there are many vitally important items to review. Below are 8 key things to initially keep in mind.

## 1) Identify and Document Your Objectives

You can create better outcomes if you document the firm's objectives. It will assist you in better understanding the type of practice you can and cannot affiliate with, what to review in due diligence, what steps you may have to undertake in advance to prepare for this step and generally focus you better on the specifics of what you need to do in lieu of focusing on acquiring in general.

There can be several reasons why you might pursue expansion through mergers and acquisitions. The most common are:

- Increase profitability by taking advantage of the return on investment that is normally built into most acquisition transactions
- Expand the firm's presence into additional offices in your existing market
- Create momentum to spur organic growth
- Absorb excess capacity or create fixed overhead cost synergies
- Expand the overall client base for specialized service offerings
- Acquire or expand niche services offerings
- Address concerns for your internal succession needs through the acquisition of potential new partners

For example, let's say your objective is to acquire a practice for immediate additional profit. A documented acquisition plan will allow you to:

- Identify practices you could absorb with as little incremental increases in overhead as possible
- Use benchmarks to evaluate the opportunity that are aligned with your objectives
- Execute a business plan that has a better chance of succeeding since your goals were clearly stated and identified.

Developing an expansion strategy that includes a complete analysis of your firm's goals and objectives also gives you a better chance to capture alternative opportunities you might otherwise miss.

## 2) Due Diligence Should Cover Business as well as Financial Risk

Typical due diligence procedures usually are designed to assess financial risks and standard accounting industry performance benchmarks. Aspects of performance such as quality and productivity obviously should be reviewed. There are two areas of risk that are often overlooked in due diligence: key assumptions in the business plan and operational elements of specialized service lines.

Unless the merger or acquisition is a standard one that will not materially affect your existing operations, you should prepare a financial model that analyzes the business case supporting the plan. There is always risk that key assumptions will not materialize. Due diligence should address the key assumptions you are making in the business plan.

Operational risk is much greater than normal when your firm is acquiring a specialized service line that it does not

have prior experience with. You should have a complete understanding of the new target markets, competition, and key operational success factors. Consider obtaining outside expertise to assist in the due diligence process. Otherwise, you may be relying on the acquisition candidate firm for that expertise.

Don't focus just on historical data but attempt to convert this information into a forecast that includes the time and effort it will take your firm to absorb the practice and service the clients as well as other changes that will occur. This will enable you to base your decision on your future profitability, not just understand the seller's current results.

### **3) Manage Risk Through Incentives in the Deal**

You cannot buy and sell people. You also cannot assure a person or a group will behave the way you assumed they would when you prepared the assumptions that supported the business case for the merger or acquisition. This applies to the clients of the firm you acquire, the partners, if any, that remain after the transaction, and other personnel. The terms of the deal should normally include incentives for the people of the firm you acquire that have responsibility for execution of key aspects of the business plan. Normally these incentives will apply both to the acquired firm's staff being retained and the seller.

Risk should be addressed in the value of the deal. There are two ways to do this. One approach is to discount the deal to recognize unusual risk. For example, you may determine that due to the nature of the client base retention could be a major problem. Because a valuation should reflect future cash flow, a discount in this case is normally appropriate compared to a more stable client base. The other approach is to use contingent terms such as earn out or collection deals. This is the basis for variable terms using future client retention as the means for determining value.

Contingent transaction terms have the advantage of creating incentives and mitigating risk. The potential value of the contingent portion of the deal can provide the currency for the incentives as well as protect the acquiring firm's investment. This concept can apply to a merger as well as an acquisition. A look-back provision in a merger that adjusts the relative valuation of the acquired firm due to post merger performance problems can be an effective tool to mitigate risk.

### **4) Time Kills All Deals**

If all the parties are aware of the goal and purpose of the affiliation, it should not take more than 4 to 8 weeks to come to an oral agreement. In an acquisition or a merger of unequals all the documentation should be completed shortly thereafter as well. The longer the negotiations the more likely bad things can happen:

- Staff and or clients may find out what is going on and feel nervous about their security and start making plans to leave the firm.
- The longer two firms negotiate the more adversarial it can get. It is very hard to consummate a deal with an adversary. If it does become contentious and the deal still closes, it can have negative ramifications later.

A merger of equals will often be more drawn out because the resulting business plan is more complicated to work out. Often new agreements such as partner compensation and partner retirement have to be addressed in a merger of equals whereas the dominant firm's policies and agreements frequently are used in a merger of unequals.

### **5) Reach a Complete Agreement Before You Close the Deal**

You can't and shouldn't work out all the minute operational details of the post acquisition business plan during negotiations. However, all *key* operational assumptions need to be addressed. If an item does come up and you have difficulty reaching a resolution, do not fall into the trap of agreeing to agree later. It won't be easier to resolve it after the transaction. An inability to reach an agreement may be an indication the deal shouldn't be done.

Key operational assumptions fall into two categories. Those are:

- The items the parties need to know to understand the risks they are assuming. These normally include any

contingent or formula-based transaction terms such as collection of accounts receivable, treatment of WIP, and assumption of liabilities.

- The things the individuals need to know to do their jobs in accordance with the business plan. These include job descriptions, compensation methods, brand names, facilities, transitional strategies for staff and clients, and modifications in client service and management.

The best agreements are in writing. Your merger or acquisition agreement will obviously be written. Put other important business plan items and commitments in writing as well to avoid future misunderstandings.

## **6) Create a Proper Transition Strategy**

You and the other firm will agree that you have merged your client lists and that your employees will work for the successor firm. However, the clients and staff, where appropriate, have to decide to stay in order to make this work. Experience tells us they *will* stay if the proper transition plan is implemented. It starts with how the change is communicated.

Clearly, the clients liked the way they have been serviced by their original firm. They have come to expect certain procedures, fee schedules, staff and many other items they grew accustomed to. The staff likes where they are working, their firm's policies and procedures, and culture. There isn't any reason that their experience with the successor firm should be less gratifying than their previous experience. If it will be, you may be merging with the wrong firm because your cultures may be too dissimilar.

Don't assume the clients and staff will automatically determine that the new environment will be as good or better without specific information. It is more likely they will have reservations than excitement. It is important to be very clear about new policies and procedures and not leave people to fill in the blanks for themselves. The key to a proper transition plan is emphasizing what the clients and staff will gain with the new successor firm, not what they might perceive they will lose of the old.

The outcome of a transition plan can hinge on the most minute details. Which firm's envelope is used to send the letter notifying clients of the change can make a difference in ensuring the clients open it. The appropriate transitional strategies will help make the deal work for clients and staff which is the foundation of a successful merger.

Develop a plan for governance of the merged firm that is fair but also effective. Make sure you aren't creating an environment that will lead to gridlock. You should have a specific governance system spelled out in the merger document, including naming people to specific positions.

A unique technique for acquiring practices that you might consider is called the Two Stage deal. We have used this tactic to bring about many acquisitions that otherwise would not have been done. Many smaller practitioners decide that they need to address the succession of their practice before they are ready to quit working. This creates a conundrum because they assume the two events have to occur simultaneously. A Two Stage deal can be a means of allowing the transitioning practitioner to have their cake and eat it too while at the same time protecting the succeeding firm from the risks and effort of a straight merger. Using this approach will allow you to differentiate your firm from other firms seeking acquisitions making you more competitive for prospective deals. See our separate report on Two Stage deals for more information.

## **7) Plan for a Worst Case Scenario in a Merger**

Make sure you have a pre-nuptial agreement or de-merger clause (unless your deal is for a short-term succession of all the owners). Most firms spend all their time figuring out how the merger will work based on the single premise it WILL work. What if 6 months later the merger is a failure? Have a way of de-merging spelled out in advance. In the event there is a need to dissolve a merger, there are enough difficulties without having to come up with a plan to de-merge. Draft in advance and be sure to include things relating to each firm's original clients, new clients that come in after the merger, clients who insist on staying with the other firm, staff, facilities, and technology.

Make sure your plan is realistic. Both firms will have made significant investments in the combined operations. Unless

the successor firm is still operating in the original facilities of both firms with essentially all the same staff and clients as before, the break up can be expensive (although necessary if it truly isn't working).

## 8) Find Expert and Experienced Help.

In acquiring an accounting practice, there are a voluminous amount of things to be worked out including valuing the practice, structuring the deal, what to review in due diligence, and documentation of the deal. Even if your firm has undertaken many mergers or acquisitions in the past, using a professional who has years of experience *specific to accounting practice mergers and acquisitions*, can be very helpful. The advantages of outside expertise include:

- Assisting in developing and documenting an expansion strategy using mergers and acquisitions
- Providing data regarding target markets
- Communicating with target firms anonymously in the initial solicitation
- Identifying practices that fall below the traditional radar screen
- Assistance in the structure and terms of the transaction by providing insights into the other party's motivations
- Assistance with the design of due diligence programs
- Insights into transition strategies and alternative deal structures

Should you have any questions or comments, please feel free to call us directly or e-mail us at one of the addresses below.

If you want to find out more about how mergers and acquisitions can work for you, including the use of Two Stage deals, we will provide a free consultation. Contact us to find out more about how to get the process started.

Go to our Web site, [www.transitionadvisors.com](http://www.transitionadvisors.com) and view on articles for more information on buying, selling, and merging accounting firms.

Since 1990, [Joel L. Sinkin](#) has exclusively provided merger, acquisition, and succession plan consulting to accountants nationwide. He has personally been involved in closing over 650 such transactions. He is the co-author of *Guide to Buying and Merging CPA Firms* published by Practitioners Publishing Company. He is a frequent speaker at national accounting conferences and has been an instructor in dozens of CPE courses. He has been published in *Sum News* (Massachusetts Society of CPAs), *The New York State CPA Journal*, *Insight* (Illinois CPA Society), and *TAXPRO Quarterly*, the AICPA's *The Practicing CPA*, and he is frequently quoted in local and national mediums. His article, [Price Equals Value Plus Terms](#), is featured in the December, 2004 issue of the *Journal of Accountancy*.

[Terrence E. Putney CPA](#) has over 25 years experience in the CPA profession. For six years, he was Managing Director-Mergers and Acquisitions for RSM McGladrey, the fifth largest accounting firm nationally, and held several executive positions with its corporate parent. He structured and negotiated many transactions resulting in the acquisition of accounting and consulting firms ranging in size from \$200,000 to \$30 million. Prior to joining McGladrey, Terry was the Managing Partner of Donnelly Meiners Jordan Kline, a 60 person CPA firm in Kansas City.

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