

MAKE YOUR MERGER/ACQUISITION WORK

By Joel Sinkin

SEPTEMBER 1997 - Is your firm thinking about a merger or acquisition or maybe an acquisition disguised as a merger? Whichever it really is or whatever you want to call it, problems can arise for the parties on both sides of the transaction for any number of reasons--errors during due diligence, poor matchmaking, miscalculations during transition, and egos to mention only a few. Mergers and acquisitions can be traumatic for both firms' principals, their staffs, and their clients. While many mergers and acquisitions work out reasonably well for both parties, some fall significantly short of expectation.

Are You Ready to Absorb Another Practice?

Whether a merger or acquisition, there are many variables to consider. Most of them relate to your goals, the goals of the other party, being prepared, and timing.

Know Your Goals. Before setting an agenda to merge-in or acquire a practice, be sure your goals are clear. Are you buying additional business because bigger will be better (in which case you must anticipate the additional commitment for you, your partners, and staff)? If, a potential affiliation just means more of the same (e.g., hourly rates and profitability), why are you considering it? Do you want this new affiliation to strengthen your current services, or are you contemplating associating with another firm to create a new niche for the combined practice? The latter may yield the firm increased security through diversification, as well as possibly generating new revenues from existing clients. Make a determination as to why and what added value the new organization will yield. Be realistic!

Staffing. Understanding the strengths and weaknesses of your present staff, including their capacity to absorb additional work, will directly affect what you anticipate doing. Many firms seek an acquisition type merger because they perceive their staff to be very competent and loyal, with excess capacity. Additional billings help to make an established staff more productive and drop additional dollars to the bottom line.

Space. When reviewing your current office space with a possible affiliation in mind, focus on the space available in your office or elsewhere in the building. To a degree,

the available room might dictate the size firm you can associate with, assuming you are tied to a lease. If, however, you're not married to or restricted by having to be in a specific location, your options increase.

Current Technology and Equipment. What technology resources do you have, and what are you looking for? If you are presently lacking in what it takes to be current, you have to consider the cost and effort of bringing your firm up to snuff vs. searching for an affiliation with a firm that has the necessary resources. Sometimes a merger (up, down, or sideways) with someone already where you want to be can be more cost effective.

A Firm Is Identified--What Now?

During the due diligence exercise, in addition to reviewing matters such as billings and collections and the other firm's current profitability and staffing, there are other factors that can make a deal live or die. What are some of them?

Client Duration. How long has each client of your prospective merger candidate (prospect) been a client? The longer a client has been in place, the greater the loyalty that client generally has to the firm. If the successor firm (successor), provides continuity for the clients after combining firms, the more likely it will be that the successor will retain them.

Successor's Profitability. Researching a prospective merger candidate's (prospect's) profitability only starts with its current net income (net). A prospect's net, available for any successor, is usually significantly different than the prospect's net by itself. Absorbing a new or additional practice into your current overhead obviously can increase its profitability. If the prospect is providing services in a manner that you can improve on (e.g., going from manual to computers on certain functions), the successor's bottom line will improve without raising fees. When performing due diligence, you should project what the successor's costs will be for providing the same services to clients. One caution, however: If the prospect shows weakness in the documentation required by professional standards, the bottom line of the combined practice may decrease when the required procedures are imposed.

Cash Flow. Billings must not only be collectible, but they should be converted quickly into cash receipts. Firms have different billing and collection philosophies, and the successor will initially have to abide by the prospect's billing and collection practices or anticipate the possible loss of some clients.

The prospect's accounts receivable must be carefully reviewed. Are their clients on retainers? What does the aging of their accounts receivable look like? How often do they send invoices? A review of these variables will assist you in understanding the cash flow and enable you to determine if that translates into covering overhead and the appropriate timing for generating profits. You may have to set up a payout schedule for

the prospect if collections are a problem. Taking on increased overhead and then waiting months for cash flow to start in earnest can create difficulties.

Who Does the Work and Where? A successor organization can provide the continuity clients look for by minimizing changes in who services them and where. This is one of the most overlooked items in performing due diligence and a major problem for client retention. You must be aware of not just who does the work, but also where! If a client is used to having a principal spend a full day on scheduled visits, that's part of the way they justify the fee they pay. A successor cannot suddenly institute dramatic changes such as sending in a junior to pick up the work and bring it back to the office. Continuity is critical. Understanding service patterns affects many decisions including staffing, time requirements, and whether the practice can be absorbed and the clients retained. Although in time you can change the manner in which a client is serviced, it should be done gradually to reduce client losses.

Client Services Provided by the Prospect. During due diligence, you should carefully note what services the prospect's clients are receiving. Can you continue to deliver these services efficiently and profitably? Can you bring added value to these clients? This is important, especially as it relates to you and your staff's available expertise and technology. Also, in today's world of peer review, you should be sure the prospect's work papers meet requirements or recognize the additional time necessary to bring them up to standards.

The Prospect's Due Diligence

It is amazing how little firms about to be acquired or merged-in tend to look at the dominant member in the successor firm. Due diligence works both ways on many of the issues.

Financial Strength. Always review both the business and personal financial strengths of the principals in the firm with which you are affiliating. Even if the business appears to be running profitably and smoothly, that alone is insufficient. A partner's personal finances can have negative effects on future sharing of profits.

Retention Rate/Growth Rate. Understanding a firm's track record on retention can give excellent clues to what may be expected post closing. If the acquiring firm has gone through a merger or acquisition in the past, how did the other parties fare? Look at their lost clients, especially if they came to the firm as part of a prior merger. Review where, how often, and what kinds of new clients the firm is generating. Obviously, a successful track record of retention and growth from internal referrals are positive signs.

Quality. Quality should be the prime focus of every professional firm. Satisfy yourself that whether you are merging up, down, or whatever, that your new associates feel as strongly about quality as you do.

Other Items. Verify licenses, peer review results, CPE credits, etc. Never take for granted that all practitioners are up to date and properly licensed. How long have the partners, and to a lesser extent the staff, been together. Are you affiliating with a firm whose partners just got together? What happens if a year later they are not happy? How will that affect you, your clients, and your expected compensation? Review the firm's fixed expenses and understand the variable ones. How long is their lease? How are their work papers? The successor firm should be dealing from strength only.

The Agreement

Most parties concentrate on how everything will flow when the affiliation works out well. All too often in their contractual agreement, firms do not consider the negative aspects related to an affiliation. When participating in the preparation of an agreement to affiliate in some manner, both parties should address what would happen if the arrangement is not working.

De-merge--how? The participants' firms should always have a form of divorce clause or perhaps something akin to a prenuptial agreement. This agreement should address items such as who gets each of the original clients; how are clients distributed that were developed after the date of the agreement; possible future firm name restrictions; restrictive covenants as to future professional activities; and disposition of staff, equipment, and office space, to name a few.

A provision in the agreement calling for the American Arbitration Association to arbitrate or mediate disputes can substantially reduce costs in the event of disagreement. Most of the items that are difficult to verify through due diligence should be spelled out in clauses.

Transition--Two Housekeeping Items

The Announcement Letter. Transition in the eyes of the clients involved generally starts with an announcement letter. There are several important items to incorporate into an announcement letter. Be sure to note that the people (partners and staff) the clients have known and trusted all these years will be an integral part of the new team. Mention that the fee structure will remain intact and that you will still be geographically sensitive. Give at least one reason for this new affiliation. An excellent strategy should include describing the new services, technology, and support the successor can deliver. Stressing improvements and deemphasizing other changes will help retain clients.

Address the Staff. Key staff of both firms must be addressed. Retaining the professionals who have the greatest client contact is a key factor in client retention. Integration of the partners and staff of any two firms, considering that differences always exist and there are egos involved, is at best a delicate matter. Prior to closing the deal, be sure that the roles of all key players have been identified and they know what their roles in the new organization are going to be. Among any other items you deem

appropriate, tell them the name of the successor firm; how the merger firm will operate; how clients will be serviced and by whom; and how they are to be notified and introduced to the new firm. *

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