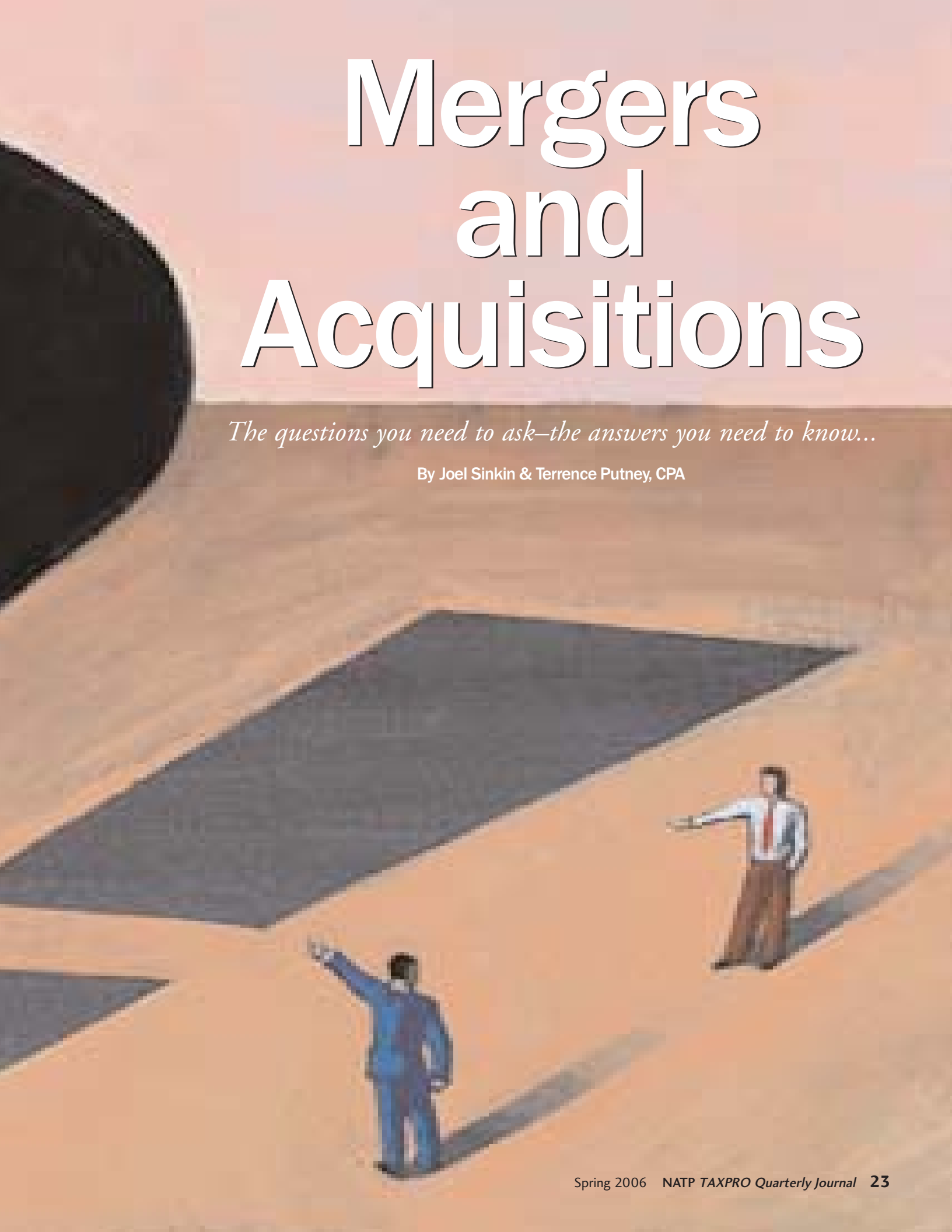




Mergers and Acquisitions

The questions you need to ask—the answers you need to know...

By Joel Sinkin & Terrence Putney, CPA



Lately there's been a tremendous amount of news about the buying and selling of accounting and tax practices. After a stressful tax season, perhaps you've given some thought to selling your practice. Maybe you're one of those business owners who enjoys a good challenge, and you've contemplated growing your practice through a merger or acquisition. Regardless of your intentions, it's important to examine valuation techniques and market evaluations. Here are some M&A Q&A's to consider.

Is it a seller's market or a buyer's market?

There's no clear-cut answer here. For practices in densely populated areas, firms looking to sell or otherwise transition ownership are still highly desirable. In regions of the country where there is an abundance of practices, there are more firms looking to grow through acquisition than there are firms looking for succession. As a result, the supply and demand curve in larger metropolitan areas favors the seller. This imbalance in sellers and buyers not only creates more opportunities for the seller, it causes the buyer to be more aggressive in pursuing any existing opportunities.

For practices in less populated areas, the number of interested buyers is much more limited. As a result, the supply and demand curve is inverted. In these markets, buyers have more of an advantage. This is particularly true for the traditional 1040 practice, where clients are served face-to-face in the firm's office. Moving a practice out of the neighborhood will have a negative impact on client retention. Thus, the buyer is almost forced into retaining the current location to retain the client base. This limits the number of interested buyers to those who want the seller's space, or space that is in close proximity. In these regions, valuations tend to be lower, the number of buyers who are interested is fewer, and interested buyers are better able to dictate more of the terms of the transaction.

What are the factors that drive the valuation of an accounting and tax practice?

The marketability and value of each practice is determined by several specific variables—location and terms. For practices that are heavily 1040-oriented, with a majority of clients physically visiting the office, terms of the lease, parking, and convenient access can make a practice more or less appealing. If the practice is not in a good location, the lease and office clearly become less of a factor in the deal. Value is affected by the package of the terms. Following are the most critical considerations:

- **Who accepts the risk of client retention?** Many practices are sold wherein the seller takes the risk if clients aren't retained.
- **The amount of down payment.** The amount of down

payment is often more of an issue for the buyer than the seller.

- **The profitability of the practice.** The tax treatment is often a big factor here; the buyer's expectation of net margin is what is most important; many buyers, though, are influenced by the seller's historical margins.
- **The duration of the payout period.** Often no interest is paid on deferred payments, so the term of payments matters.
- **The nature of the services performed and mix of the client base.** In practices where business clients are served year-round, average fees per client are higher because the firm offers a broader range of services. These practices have a higher value than others that only cater to 1040 clients.

The value for accounting and tax firms is often expressed as a "multiple" of revenues (billings or collections). Multiples fall into a large range in today's market, from as little as .4 times to as high as 2.0 times. The range is large because of the tremendous variations in the terms of transactions, perceived risk, and expected profitability. Obviously, a longer payout and retention-guarantee period, less money upfront, and higher expected profitability generates a higher multiple. Little to no retention-guarantee period, all or a lot of cash at closing, less favorable tax treatment for the buyer, and low expected profit margins will result in a lower multiple. And, of course, the valuation is also affected by the level of competition between prospective buyers for a particular seller.

Service mix is also a factor in value. But it's not just what the client base currently uses or what the seller offers; it's also the potential for new services that the buyer can offer. There are many practices that have added service niches (such as financial planning and investment management). This can dramatically impact the value for certain buyers who place a premium on that niche. Some practices offering financial services have revenue annuities that will benefit the buyer based on the seller's past efforts. As an example, asset management engagements are often labor intensive up-front but require little effort to maintain. A lot of assets under management are normally given a high value. A buyer may covet a tax practice with wealthy clients, even if the seller doesn't currently offer financial services; the practice is worth more to a buyer who provides that niche service.

Are there any differences in the way a franchised or publicly held company values a practice from that of an individual practitioner?

There are definitely pros and cons to these two types of buyers. A franchise or public company is normally better capitalized, will frequently pay a larger down payment, and will make deferred payments over a shorter period of time. Many of these buyers are looking for the "seller" to stay on in a management position. Retention-guarantee periods for these buyers tend to be shorter, often one tax season. They'll want to take a very aggressive approach to client transition to make sure the clients they buy will stay long-term. They may even go so far as to make sure any clients who won't stay don't

make the transition in the first place. Valuations by larger firms will normally fall in a range of .4 times to 1.25 times.

Large firms typically buy practices to support growth for their specific business strategy. Anything that doesn't mesh with the business plan won't be bought or may be given a low value. For instance, many national tax preparation firms don't offer business services in most of their offices. Any bookkeeping a seller provides might be given little or no value by this type of buyer. These buyers are looking for the following attributes in a selling firm:

- **Location.** Many large firms are seeking to increase market penetration and a location in an area they feel is fruitful. Practices with a good location tend to receive a higher value.
- **Client base.** Many buyers are seeking to cross-sell additional services. If a practice has a client base that lends itself to the services the buyer seeks to offer, it will have a higher value.

Small, privately held buyers generally have less capital. As a result, the terms tend to require less capital up-front. However, these buyers are generally much more flexible in the way they intend to operate the practice, which could result in a smoother transition. Buyers who perceive a smooth transition may place a higher value on the practice.

What does the future hold?

Technology. Today, young members of the workplace tend to be much more computer savvy than their older counterparts. How many of these potential customers will seek to do their own tax returns by purchasing do-it-yourself software? Gaining new clients from this segment of the market requires being able to demonstrate value beyond just the ability to complete forms.

Financial institutions. In some cases, banks and investment firms are already offering free tax preparation to their clients in order to attract them to services with higher profit potential. Some larger tax preparation firms bundle their services with providers of other services or market them jointly to attract new clients. These approaches threaten existing client relationships for practices that only offer tax preparation.

One-stop shopping. Many large accounting firms offer additional services beyond traditional tax and accounting services to both their business and individual clients. These services include investment advisory services, estate and trust planning, information technology, human resources, litigation support, forensic accounting, business valuation, and general consulting. These firms may attract your best clients who enjoy the convenience of getting all of these services in one place. Because the value of a client increases for a firm that provides multiple services, larger firms, now more than ever, are interested in attracting smaller business and individual clients.

Summary

The market for sellers of accounting and tax practices right now is excellent. Most indications are that the market will remain a seller's market for most of the country in the near

future. However, just as the dot.com boom of the late 1990s ended abruptly, so can the market for accounting and tax practices shift to the buyer's advantage. Many futurists are already predicting this will happen soon because of the demographic profiles of many accounting and tax practice owners. The best approach for near term sellers of accounting and tax practices is to focus on making their practice and expected deal terms as attractive to potential buyers as possible. There will always be buyers for well run, profitable practices that have upside potential. ♦

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How to Compete

Offer multiple services yourself! If you feel your clients could benefit, why not add additional services to your offerings? Many practitioners today are offering financial services and computer consulting. This practice will help you retain clients and generate additional revenue. It's also a strategy that will help offset the loss of clients who decide to use do-it-yourself software to prepare their own returns or who are attracted to a financial services company that will do it for free.

Co-opetition. The first time we heard this word was from Ron Stewart, a CPA in Louisiana, a man ahead of his time. Co-opetition is born when an accountant affiliates with competitors who offer niche services, thus creating a referral network. These competitors agree not to compete with you other than in their niche. This gives your clients the same advantage of a one-stop shop without you having to invest in building new niches.

Specialization. A counter-approach to one-stop shopping is specialization. Many prospective clients are looking for a firm to provide services and expertise that meets what they perceive to be their unique needs. An example of this strategy is to position your practice as having expertise in IRS representation. Your marketing message would ask, "Why go to a department store when you can go to a specialty store, perhaps even for a better price?"

How well your firm is positioned to compete affects its value in two ways: 1) Better financial results happen from your ability to compete more effectively today; and 2) Potential buyers are looking for and value a firm positioned to compete effectively in the future.