

Mergers remain an area of extreme interest for many public accounting firms. Should your firm be considering a merger? If you are already pursuing mergers, how can you be better prepared to be successful? This article will provide you with an overview of the rationale for mergers of accounting firms and some key points to keep in mind as you pursue this strategy for your firm.

The Whys, Why Nots,
How, When, and With Whom

Mergers of Accounting Practices

BY JOEL SINKIN AND TERRENCE PUTNEY, CPA

Reasons to Consider a Merger

Most firms are pursuing mergers either upstream, i.e., looking for a firm to merge into, usually a larger firm, or looking for mergers as a means to expand their firms. The difference between a merger and an acquisition or sale is generally determined by whether the owners of both firms acquire or retain equity in the combined firm. Normally in an acquisition, the owners of one of the firms do not acquire equity in the combined firm. Many mergers are a combination of a merger and an acquisition providing an exit strategy for the senior partners and a long-term growth strategy for the younger ones.

Upstream Mergers

The common reasons firms look for a firm to merge *into* are:

- Succession – Probably the number one reason firms pursue upstream mergers is that they have partners who are closing in on the end of their careers and are not comfortable that they have a viable internal succession solution.
- Quality of life – Partners in the firm, especially the managing partners, may feel that their every day responsibilities are too burdensome. An upstream merger will allow them to focus on the things in their careers they enjoy doing.
- Professional and financial growth – Merging into a larger firm often affords the partners an opportunity to improve their long-term prospects.
- Risk management – Larger firms are not as vulnerable to the loss of specific staff or clients and can compete better in the increasingly dynamic marketplace for CPA firms.

Mergers for Growth

The reasons most practitioners pursue mergers as a means of *growing* their firms are:

- Create or strengthen niche areas – The quickest way to open new practice areas is to acquire a firm that already offers those services. A merger can result in acquiring the talent that is necessary to pursue special service offerings or industry segments. An example is a firm that has a substantial amount of high net worth individuals that merges with one that provides financial services. Another is a practice that has many law firm clients that merges with one that does a lot of litigation support work, valuations, and estate and trust work.
- Enter or strengthen new geographic markets – Access to new clients may require proximity to them; firms that are growing are increasingly doing so through creating multiple office networks.
- Strengthen internal succession teams – The talent a practice needs to successfully transition its senior partners may be found in a merged-in firm.
- Bigger is often better – Larger operations often have higher profits per partner, better brand recognition in the market which leads to more organic growth, and can take advantage of cost synergies resulting from a merger. Larger firms can frequently attract qualified staff, a critical objective of many mergers.

- Absorb excess capacity – Although this is a common objective, the long-term benefits of this strategy can be elusive. Mergers are a good way of absorbing excess partner capacity. It might be better to sublease space than merge only to fill up empty offices.

A common reason firms pursue mergers instead of acquisitions is to acquire the partner level talent. An acquisition normally is an exit strategy for the partners who are bought out of their equity. The key thing to consider is the role of the owners of the acquired firm after the deal. If a practice is expecting a long-term role for the partners of a practice it is pursuing, a merger is often a better approach than an acquisition.

A firm pursuing a merger to acquire talent should be certain the target has the capability, capacity and willingness to execute the intended strategy. An example is a \$2 million firm that was targeted for a merger in part because it had two excellent managers with a lot of upside potential. To take advantage of that potential, some of the managers' existing duties would need to be passed down to senior and junior level CPAs. However, after the merger, management of the combined operation failed to adequately create the necessary lower level staff capacity. Furthermore, the managers were not coached on how to make the necessary changes in their duties. The managers became frustrated because a key objective was not achieved. Both managers left within one year of the merger.

Things to Avoid in a Merger

There have been many mergers pursued for reasons that are not adequately justified. Often, this can lead to an unsuccessful merger.

Overhead Reduction. Some firms consider merging for the single purpose of reducing overhead. There may be better ways to use up excess overhead, including getting rid of it. The benefits of overhead reductions are short lived and will probably not sustain a merger if the combination of the cultures is not going as smoothly as hoped.

Bigger is Not Always Better. There are many advantages of being part of a larger operation. But bigger is not always better. Some clients are with a firm because they like one that size. Some partners of smaller firms may find it difficult to accept the accountability often required by a larger one. If "bigger is better" is the primary objective for a merger, make sure "bigger" helps the partners attain personal, financial, professional, and life-style goals without sacrificing clients and staff who like the current culture of the two smaller firms. Otherwise, some of these key people will not be retained. A proper transition plan can also alleviate much of the attrition risk.

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Poor Chemistry. Mergers are like marriages. A good, simple rule of thumb is: If you do not want to eat lunch with someone, do not merge with them! Make sure the values and service approaches for both practices are compatible.

Starting the Process

If seeking an upstream merger, when should a firm start the process and how does it find the right match? If succession of one or more of its partners is the purpose, the merger should be in place approximately five years prior to those partners reducing their time commitment to the firm. In most practices, many clients are primarily seen by partners annually. Clients may interact with the firm more often, but it can be rather eye opening to review the amount of clients the partners see in person; it's often on a limited basis. For these clients, five years may mean only five more personal visits! It takes time to transition loyalty. Creating a gradual, smooth transition that allows for enough time can be a big factor in the successful retention of clients after a merger.

For the purpose of succession, when choosing a practice to affiliate with, the following attributes should be considered.

Chemistry. If you do not feel comfortable with the partners in the other firm, why would your clients and staff feel comfortable with them?

Capacity. The successor operation must have, or be able to create, the excess capacity to replace any partners who will be reducing their time commitment soon after the merger.

Location. Some clients and critical staff are probably geographically sensitive to the location of the office. If this is a significant issue, the criteria should include the other firm's locations or willingness to establish new offices close to your current location. For many clients, a part-time or even virtual office can be a satisfactory solution to this problem.

Specialties, Licenses and Culture/language Issues. If a practice has any special needs, make sure the combined practice will be able to provide your clients those ongoing services in the manner they require.

If the people in your practice with those special skills are staying on, this is probably less of an issue.

Rates. Clearly, the successor cannot triple fees charged to clients and retain them. This issue is usually more than looking at hourly billing rates for various levels of staff and partners. Each firm has its own way of producing the work, and the billing rates may be misleading. Look at what each is charging for various kinds of work, such as average fees for tax returns, audits and monthly work. This can provide a better indication of rate compatibility. A smaller firm may be billing a lower hourly rate on certain work than a professional in a similar role in a larger firm, but the larger firm may be able to pass work down to lower level staff or produce work more efficiently. As a result, there may be no negative impact from a difference in billing rates.

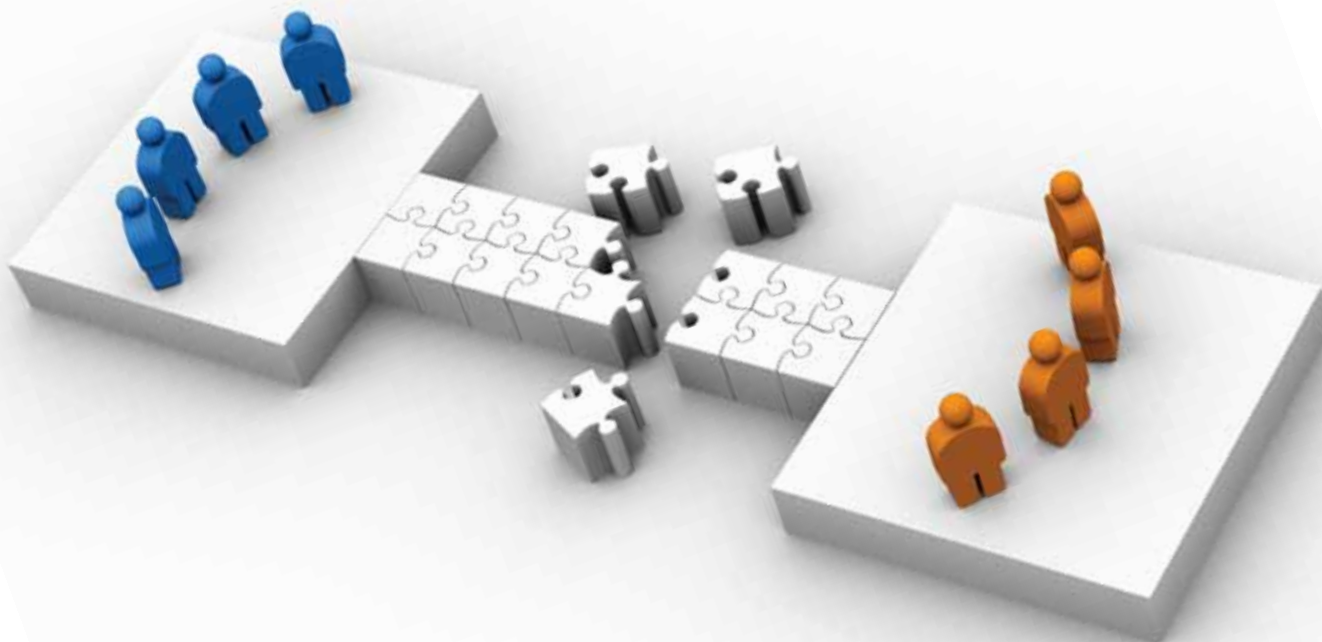
Long-term Commitments to Partners. Evaluate any long-term commitments to retired and soon to be retired partners. Consider the impact of impending plans to admit new partners. If the practice has undergone any recent mergers, investigate how those went.

Develop an Understanding and Agreement

Practitioners should identify the goals for merging before starting the process. Unfortunately, many practitioners start by considering a specific merger opportunity and then attempt to make a plan around it. A better approach is to develop an understanding and agreement within the firm for all the critical reasons to seek a merger. The plan should include identifying the characteristics of potential targets and their owners that will help the firm achieve its goals. Then start the search process with clearly identified goals in mind.

It is important to make your operation as easy to merge with as possible. If you can, the following should be avoided when looking for mergers:

- long-term lease commitments;
- mergers or acquisitions that have long-term, material liabilities; and
- large investments in new infrastructure such as new technology.



What are some important deal points to consider? Compensation issues can be the hardest topic to agree on in a merger. Find a way for every partner in the combined firm to make at least the same income as he/she did before the merger for a minimum of a couple of years, and the deal will have a much better chance of acceptance.

As an example, a one-partner, \$1 million firm recently merged into a much larger one. The larger practice used a fairly complicated approach to partner compensation that effectively rewarded key performance attributes. However, the larger practice realized that its system presented a significant amount of risk for the partner of the smaller practice which could prevent reaching agreement on the deal. So it guaranteed that partner a level of compensation for three years consistent with his historical income. An adjustment in the guarantee would be justified if the partner failed to achieve pre-set minimum chargeable hour goals or the firm experienced a loss in business from the existing and new clients the partner managed.

There are other important deal terms to consider.

Equity. This can be a highly emotional issue, as well as a practical one. Not all partners should be allocated equity or should even want equity in a merger. For instance, partners who are soon retiring may not need to be allocated. If compensation and retirement are not based on equity in the partnership agreement, then the amount of equity may be a moot point. If equity normally is the basis for key allocations, an alternative approach is to use specially constructed agreements for some partners who do not require equity.

Name of the Combined Firm.

Unfortunately, every detail can be worked out and at the 11th hour, the deal can fall apart over the combined firm's new name. Strong feelings on this matter should be presented early in the negotiating process.

Transition Plan. Avoid closing a merger without having a transition plan developed. The plan should address how clients and staff will be notified and how files, practice management information, technology, and every other aspect of operations will be transitioned. Make sure both firms agree on these steps in advance.

De-merger Clauses. Plan for the worst case scenario. Many practices invest an appropriate amount of time into planning the merger and never consider what they would do in the unlikely event the merger fails. Having a stipulation that details how partners can or cannot leave should normally be a key part of the agreement. Define the rights partners leaving have to take clients, staff and contributed assets, as well as the treatment of work in process, accounts receivable, etc. An exception to this rule is a merger for the purpose of succession of partners. Typically, in these cases, the commitment firms make to each other needs to be irreversible to avoid an undue level of risk for both parties.

Pay Attention to the Details. Make sure the agreement covers the treatment of accounts receivable, work in process, exposure from past acts, treatment of known liabilities for each party such as lease commitments and partner retirement, as well as every other detail regarding financial and operational matters.

Seek Advice From Experts

Mergers are a powerful method of accomplishing strategic, professional and personal financial goals. One of the most critical steps to ensure success of a merger is to acquire advice from experts in the industry such as consultants or others who have experience with multiple mergers.

Experience with one or two mergers and the experience that most CPAs have helping their clients through business combinations is not likely to be sufficient to help avoid the pitfalls and develop an understanding of what it takes to be successful. Consider finding an advisor who has extensive experience with mergers and acquisitions, specifically as it relates to public accounting firms. ❁

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