



# More Than Face Value

*It's all about variables when it comes to valuing an accounting firm for merger or acquisition.*

By Joel Sinkin and Terrence E. Putney, CPA

**ARE YOU CONSIDERING BUYING OR SELLING YOUR PRACTICE? THEN** you'll need to understand the criteria for valuing the firm in today's marketplace.

## Small Practices

Several variables will be used to value a firm that is generating less than \$1 million in annual revenues and seeking to sell to an external buyer. The interplay between the following variables ultimately will determine value:

**Guarantee periods.** The time period for the sale should allow for adjustment of the purchase price depending on the number of clients retained. It's the rarest of deals that closes with a fixed price and pays in full at closing, regardless of post-closing retention.

An important key in selecting the retention period is the frequency upon which the seller typically meets with clients. For example, if a practitioner meets only annually, a one-year retention period will give the buyer only one opportunity to meet the clients and then lock-in price. However, if clients are seen every month or quarter, clearly there is greater opportunity for the buyer to make the clients comfortable, and therefore to transition them.

**The profitability of the deal for the buyer.** Accounting practice values are not based on what the seller is netting alone, but also on what the buyer anticipates in profits. For example, if a seller is operating from his/her home and netting 90 percent, versus an identical practice that operates from an office with more overhead, which practice has greater value? The value to the buyer is the same, which means the value is not based on the seller's net.

If a buyer can absorb a practice into his/her current infrastructure, the net is also typically higher than a buyer who needs to take on additional overhead in terms of staff, space, etc. This means that, when measuring the value of the practice, you have to factor in an estimation of the buyer's benefit.

**Tax treatment.** If a buyer is acquiring a practice, paying for it over 5 years, but deducting the price over 15 years, this will result in a reduction in value. Proper tax planning can create a better deal for both parties.

**Client bases.** A client base that is fertile, young and growing, and that is referring other clients, is clearly worth more than a stagnant practice comprised of clients who soon will retire or sell their businesses. Another aspect to consider is whether the buyer will offer services that the seller does not currently render. If the buyer provides niche services such as financial services, IT and valuations, for example, and these services were not previously offered, then the client base may be ripe to receive them. This potentially adds value to the firm.

**Payout period and cash down.** If a seller insists on receiving 100 percent of the compensation for the practice at closing, he or she will diminish the value as compared to a lower down-payment and a payout period. Generally, practices in this revenue size have three- to seven-year payout periods.

**Assets.** Most firms receive little or no consideration for their hard assets, but occasionally there are exceptions to the rule. This frequently depends on the buyer's needs. For instance, if a buyer is acquiring a turnkey operation, he or she may pay additional compensation for the assets. But if the buyer already has all the furniture, fixtures and equipment needed, he or she places no value on these items.

**Multiple of gross revenues.** Most practices are sold based on a multiple of gross revenues. This multiple is greatly impacted by all the other variables. If a seller requested little or no money up front, structured the tax consequences favorably to the buyer, and provided an extended payout and guarantee period, the value clearly would be much higher than a request for a faster payout, more cash up front, all goodwill treatment, and so on. Hence, the multiple is the effect; the other variables are the cause.

## **Larger Practices**

Practices in excess of \$1 million in annual revenues are valued and viewed differently. While all the above are important considerations, there are other variables involved, such as:

**Staff.** More often than not, many larger firms acquire smaller practices to increase their own talent pool, as well as adding revenues. They may need the talent to assist in their own internal succession plan, to help provide work, or to add a niche.

**Cross-selling opportunities.** Larger firms typically are more likely to have additional niches and their purpose for targeting a practice for acquisition may be to provide a service/niche that is not yet offered.

**Markets.** Many larger firms are seeking ways to increase their market share or to open up an office in a different area, which may play into their valuation of certain practices.

Generally speaking, larger practices tend to go for lower multiples and longer payout periods than their smaller counterparts. The reason: Many smaller firms can be absorbed with little additional cost to a buyer, and they typically net a higher percentage than larger firms. This means that, if a larger firm is struggling to make the one-third profit goal (one-third overhead, one-third labor, one-third profit), it cannot pay back a significant portion of the revenues each year to a seller, and needs a longer payout period to reach certain benchmark goals.

## **Internal Sales**

An internal sale to a fellow partner or long-term employee is treated in a vastly different manner. It typically sees lower values than an external sale, longer payout periods and different requirements, such as: Sellers need to start the transition process before they reduce their time commitment to the firm. Since the practice will be partially valued based on retention, the seller needs the buyer to retain clients to receive maximum value. This is in everyone's interest.

Furthermore, don't forget that you cannot buy and sell people. Clients have many choices when selecting their accountant. A proper transition plan enables the clients to focus on the gains represented by the new team, not on the loss of the former owner.

Most people have precious little experience in the sale of an accounting firm. The right help can make all the difference for both parties involved. □

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