

When a firm changes hands, a satisfying deal for both buyer and seller is in the trade-off details.

# Price Equals Value Plus Terms

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BY JOEL SINKIN

## EXECUTIVE SUMMARY

- **BUSINESS VALUATION (BV), SUCCESSION PLANNING** and buy-sell agreements help CPAs prepare a foundation for selling a practice, but the final price of a firm will be affected dramatically by the transaction terms.
- **TO SET A FINAL PRICE, CPAs SHOULD** review the interrelationship of five key variables: the down payment at closing; the length of the payout period on the balance due; the profitability of the deal; the duration of the postclosing retention period with adjustments for lost clients; and the multiple (preferred price based on a multiple of the gross billings).
- **CLIENTS THAT OFFER CROSS-SELLING** opportunities, that are growing and fertile referral sources or that have young ownership will add value to the practice. Aging, slow-paying, underbilled clients will hurt value—as will liability issues such as exposure to malpractice claims.
- **A SUCCESSOR PERFORMING DUE DILIGENCE** prior to acquiring a firm may examine not just what services clients get, but also those which they do not. If the seller has a niche the buyer doesn't have or the successor firm has a niche the seller didn't offer, the framework to develop additional revenues quickly may be in place.
- **SOME FIRMS TRY TO OBTAIN ACQUISITIONS** that will get them into new geographic territories. Acquiring a practice is often the most cost-effective way of

creating another office in a new location.

■ **PRIOR TO CLOSING, BUYER AND SELLER** must focus on what to do to make clients and staff comfortable, what roles to take and what message to send out to the public. The best deals are those where everyone prospers—sellers, buyers and clients.

JOEL SINKIN, is a senior partner in Accounting Transition Advisors, LLC, [www.transitionadvisors.com](http://www.transitionadvisors.com). The firm deals exclusively with mergers and acquisitions of accounting practices. Sinkin has consulted on 650 accounting firm closings and succession plans. He teaches succession planning CPE for state and national accounting associations, including the AICPA, and has published books and articles nationally. His e-mail address is [jsinkin@transitionadvisors.com](mailto:jsinkin@transitionadvisors.com).

**Y**ou've worked hard for many years to build equity in your practice. Now you want to sell. Business valuation (BV) and practice succession procedures will help you prepare your practice or share of it for acquisition, but arriving at a final price for your equity will depend, in part, on the art of the deal. Because *price* differs from *value*, what your business is worth to a "willing buyer" once the process of negotiation gets under way can be affected dramatically by the transaction terms. The factors include the amount of cash exchanged at closing, the deal structure, the seller's financing and the presence of collateral and a security agreement. If you're a practitioner thinking of selling a practice, here are important points to consider when working out the details.

### **PRICING AN UNDER-\$1-MILLION PRACTICE**

The first step for any CPA who wants to sell a practice is to obtain a complete business valuation from an impartial, qualified valuator such as a CPA/ABV. (For more information see "First, Get Organized," and "Have a Fallback Plan," *JofA*, Sep.03, page 57.) It's equally important to look at the sale from the buyer's viewpoint.

Negotiating the price of a practice with less than \$1 million in annual revenues for an external sale comes down to five critical variables, so start the process by reviewing them. No one of them dictates the final amount, but the interrelationship of those important elements ultimately will help determine the price.

■ **Down payment at closing.** The first variable is the size of the down payment, if any. When there is cash up front, the seller is financing only part of the transaction and therefore assumes less risk, making a lower price more appealing. However, not all deals offer cash up front, and the amount of cash is itself affected by many items.

The time of year tied into the short-term cash-flow projections of the practice may have a significant impact. Clearly a buyer acquiring a practice that generates 75% or more of its income in the first four months of the year will want to put less cash down if the closing occurs in May than in December.

How you treat the accounts receivable and work in process (WIP) also affects this variable. If you're

selling a practice with a significant amount of receivables and WIP and want those funds from the first postclosing dollars collected, you're asking the buyer to invest significant capital to pay the overhead and operate the practice for months before starting to participate in cash flow. The buyer therefore will want to pay less up-front cash. In many transactions, payout periods are worked out on the receivables and WIP, thus creating more room for a larger down payment to the seller.

Sometimes purchases are structured as a collection or "earn-out" deal in which the up-front money is treated as an advance against future collections rather than as a down payment. For example, a buyer may offer you an advance against future collections plus 25% of all fees collected from the original clients above the advance over the next five years. A buyer may offer a seller a \$50,000 advance at closing but request it be credited against the first dollars due the seller; or \$40,000 credited back over the first two years; or \$30,000 credited back over the first three years. If the advance is credited against the first dollars due, it likely will be higher than if it is credited over the entire payout period. Other factors may include assets and liabilities that come with the deal.

In one satisfactory collection/earn-out sale of a \$500,000 compilation/tax-oriented practice, the buyer paid the seller \$50,000 at closing. The balance due was based on 25% of collections received by the buyer from the seller's original client base for the following six years, less the first \$25,000 the seller would have been entitled to in years one and two. In addition, the deal was structured to provide the successor firm a current deduction, and it included all the nonpersonal furniture, fixtures and equipment the practice used and reasonable transitional assistance from the seller (a personal introduction to the clients, reasonable phone availability to the buyer and former clients and an orientation to the files).

■***The length of the payout period on the balance due.*** This is a basic cash-flow variable. If a buyer has a longer period of time to pay off the purchase, the annual payments will be lower, thus enhancing the buyer's cash flow. Some sellers allow payout periods as long as 15 years, but some insist on being paid in full at the time of closing. Most deals in the under-\$1 million size range have three- to seven-year payout periods.

■***The profitability of the deal.*** Some sources suggest it isn't a seller's profitability that's important in pricing a practice but the successor's profitability in the deal. Take the following example: The owner of a \$200,000 CPA firm operates from home, handles all the work personally and nets 80% of revenues. A year later he moves into an office, hires staff and nets 40%. At which time was the practice worth more to a buyer?

The answer lies in the profitability of the deal for the buyer. If a buyer is able to acquire a practice with little to no incremental increase in overhead, he or she can afford to pay a premium for the practice. If, however, the acquisition requires retaining an additional location and extra staff, the business will be less profitable and the buyer will pay less.

Other factors may affect profitability. A key concern is the tax treatment of the payments from buyer to seller. If you (the seller) want 100% goodwill in a deal and a payout period of five years, the profit goes down considerably for the buyer who must deduct those payments over a 15-year period. Conversely, if you accept all or some of the purchase price in a form that provides the buyer a current deduction, the profitability of the deal increases—and so does the purchase price. Billing rates, how

clients are serviced, by which level staff, whether work is mailed in or clients are visited are among the other factors that affect profitability.

■ ***The duration of the postclosing retention period and adjustments for lost clients.*** This variable deals with the time frame in which to adjust the balance due for clients who leave the firm after it is sold. Retention periods (or guarantee periods) typically range from one year to the entire duration of the payout, though some deals have no retention period. If a deal is based on collections or an earn-out arrangement, the retention period typically is the payout period.

Several factors determine the length of the retention period. If a practice has predominantly annual clients, a one-year retention period may be risky for the acquirer since it allows for only one CPA visit to each client, barely enough for a solid relationship to “take.” A two-year retention period enables buyers to truly evaluate whether they’ve kept the clients.

Some sellers fear long-term retention periods. Many deals I have structured use a “stepped” retention period, with an additional time frame that permits purchase-price adjustments for clients lost not to another local accountant but because the client no longer needs a local accountant at all. That helps protect buyers from paying for clients who die, close or sell their businesses, or relocate.

You and the buyer also must understand what a retention clause guarantees. Some retention periods are based simply on clients’ staying with the firm. However, most retention terms guarantee the actual amounts to be collected from clients over a specific time frame. In some deals a seller participates in fee increases, at least for a continuation of services that were provided in the past. The parties must specify how fee increases will be calculated during the retention period. This is reassuring for sellers who make collections deals since it is unfair to suggest you participate only in losses and never in gains. Some deals cap a seller’s participation in fee increases.

■ ***Price/revenue multiple.*** When asked what they think their accounting practices are worth, most CPAs typically expect to sell for a price based on a multiple of the gross billings. For example, if you have a practice that generates \$500,000 in billings, you may want a 1.25X multiple, or \$625,000. If a deal includes an adjustment mechanism for gains or losses of clients or fees, that figure may vary.

A multiple is not an appropriate target because it is the effect of the first four variables. This is based on the following formula: The lower the cash up front, the longer the retention and payout period—and the more profitably the deal is structured for the buyer, the higher the multiple. (Of course, the opposite is true, too.) To better illustrate this point, here’s an example of a sale based on the following assumptions:

■ The practice generates only \$200,000 in revenues.

■ The acquirer can absorb this practice into a current infrastructure without any additional costs in labor, rent, staffing or other overhead.

■ The seller participates in increases in fees during the retention period.

Given those elements, if you were to ask for 17.5% of collections from original clients for 10 years,

with no cash down, structured in a manner that provides the buyer a current deduction, most buyers would enthusiastically accept the deal despite the fact that the multiple is 1.75X. The current value of the practice has little to do with the potential price if one premise is that you (the seller) will participate in fee increases (which may be more profitable than any interest factor).

Alternatively, if you want a \$40,000 down payment at closing, the balance in five years, a locked purchase price after the second year following the closing, payments structured as 50% capital gains and 50% to provide the buyer a current deduction, the purchase-price multiple could drop to a range between 1.25X and 1.50X.

If you insist on all cash at closing, all capital gains and, obviously, no retention or payout period, very few buyers would even consider the deal at 1X.

Those examples aren't exact, since an actual transaction would involve additional information not described here. The intent is to demonstrate how the most attractive deal price may not be an absolute multiple, but rather a package that makes sense after you and a buyer review the interaction of the variables. Other factors—such as types of clients, billing rates, firm assets and liabilities and qualities unique to your practice—have a bearing on the end price, too. For example, clients that offer cross-selling opportunities, that are growing and fertile referral sources or that have young ownership will add value. Aging, slow-paying clients billed at discounts will hurt value, as will liability issues such as exposure to malpractice claims.

## **NEGOTIATE A LARGE-FIRM PRICE**

To determine an external sale price for firms with more than \$1 million in annual revenues, the above variables play a role, as do others such as

■ **Types of clients and services.** Most large CPA firms today have focused on adding consulting to the services they traditionally provide. Certain clients by nature are better prospects for cross-selling additional services to generate new revenues for the firm. Many times a successor practice performing due diligence prior to acquiring a larger firm examines not just what services clients get, but also what they do not. If you have a niche the buyer doesn't have or the successor firm has a niche you didn't offer, the framework to quickly develop additional revenues may be in place. Understanding the client base may reveal a great deal about how much in new receipts might be possible.

■ **Staff.** Many larger firms seek to acquire other practices to increase their talent base. The trend toward fewer new accounting graduates going into public practice has increased the value of exceptional talent, sources say, whether it's to add a niche or grow the firm's depth.

■ **New marketplaces.** Some larger firms seek acquisition partners to help them branch into new geographic areas. Acquiring a practice is often the most cost-effective way of creating another office in a new location.

■ **Absorptive capacity.** It's a misconception of some CPAs that small firms are worth lower multiples than large firms. For a \$6 million practice the most likely buyer will be an even larger firm, but few can absorb an entity of such size without incurring significant incremental increases in overhead (space, rent, labor, insurance). Also, many larger firms net less per client and struggle to maintain the

one-third operational ratio: one-third labor, one-third overhead and one-third profit. A firm netting 30% won't be in a position to give up 25% of collections for many years. Larger practices typically sell for lower multiples with smaller payouts over longer periods than small firms do, although there always are exceptions.

## **NEGOTIATE AN INTERNAL SALE**

If you're a retiring principal, your most likely buyers are your existing partners, and the price will generally be lower than in an external sale. Still, the variables that influence an external sale also apply, with a few additional considerations. Many firms have capital accounts, and how the payback of those accounts is structured, along with accounts receivable and WIP at the time a partner leaves, plays a significant role in shaping final terms. In many cases the partnership agreement provides a buyout framework. Some agreements have vesting periods that pay more the longer the partner is with the firm.

Pay attention to

■ **Buyout agreements.** We live in a constantly changing business environment, and terms worked out 10 years ago may not achieve the win-win goal for all today. Make sure all principals have reviewed and updated the partnership-buyout agreement. This should be done at least once a year (see "Pass the Baton Without Missing a Beat," *JofA*, Mar.02, page 43, and "Make the Most of Buy-Sell Agreements," *JofA*, Oct.04, page 37). A good buyout deal compensates you (the retiring partner) well for your years of sweat equity while enabling surviving partners to enjoy additional income.

*Note:* Every buyout agreement should include disaster contingency language to protect the practice's cash flow and extend the payout period in case of calamity (see "The Best-Laid Plans," *JofA*, May04, page 46).

■ **Pricing a partner's equity.** You and your partners should review the total compensation you take from the firm, inclusive of all payments for draw, profits, perks and benefits. From this sum the firm should subtract the costs of replacing you. The difference, if everything else remains stable, is the additional cash flow available to the firm upon your retirement. This should provide a starting point for calculating a price, since the parties will need to agree on what percentage of the additional cash flow will go to each party and for how long.

■ **Formulas.** Many partnership agreements pay retiring partners based on a multiple of billings of the firm multiplied by the retiring person's equity. Another method becoming popular bases retirement dollars on recent income. Firms take an average of the retiring partner's last three years of income, apply a multiple such as 2X and pay it over a period of seven years, for example.

■ **Penalty buyouts.** More and more practices include multiple buyout formulas in partnership agreements. Retiring partners who are vested, provide ample notice and assist in the transition get the maximum price; those who don't are penalized with lower prices or longer retention guarantees to protect the firm's survival.

■ **Retention period.** Many internal-sale agreements specify a short client retention period—or none at all—because the firm expects to go on with minimal change. However, when the retiring partner provides little notice or is the main or only contact for certain clients, keeping those clients isn't a

given. If you allow ample time for a careful transition, a retention period may be less critical. An orderly retirement transition may require as much as 10 years, some sources say.

■**Insurance buyouts.** Most firms' partnership agreements include buyout formulas that address partners' potential death or permanent disability, usually through insurance. Many firms now have partners take out personal insurance policies and compensate them to offset the cost and lower the buyout, which results in a more favorable tax treatment all around.

Company-paid insurance policies traditionally either become the buyout vehicle or are credited toward it. If the latter, payments due a former partner's estate may need to be deferred to give the firm time to get back on a strong footing as it recovers from the loss. Partners should check insurance policy terms yearly to ensure they keep up with current equity value.



## PRACTICAL TIPS TO REMEMBER

- CPAs should look at the sale of their practices from the buyer's viewpoint, too.
- A buyer acquiring a practice that generates 75% or more of its income in the first four months of the year should put less cash down in May than in December.
- Pay attention to the successor's profitability in the deal, which is more important in determining a price than the seller's profitability.
- Selling CPAs should give buyers a longer period of time to pay the balance so annual payments can be lower, thus enhancing the buyer's cash flow.
- Sellers that tie payment terms to client collections should participate in gains as well as losses.
- CPAs should make sure all principals review and update a partnership-buyout agreement at least once a year.
- A buyout agreement should have disaster contingency language so that if a calamity befalls the practice, cash flow is protected and the payout period is extended while the firm recovers.

## VALUE IS WHERE YOU FIND IT

There's an unproven theory that audits and general business work are worth more than tax work. In truth, though, while individual tax clients are more transient in nature than business clients, they often are superior from hourly billing rate, profitability, liability and collection-headache perspectives. With a two-year minimum retention period guarantee, there's no reason why a tax practice should be less valuable than an audit practice. In fact, firms that offer financial services view individual tax clients as a fertile market for niche services and covet them over audit clients.

Low interest rates have encouraged many recent buyers to borrow the money to make a large down

payment and thereby reduce the practice price. There are arguments on both sides of this issue, but if a buyer can lower the price while retaining the clients, the profitability of the acquisition may rise.

In valuing a firm, remember that assets can include space at a great value, name recognition and—a growing consideration—Web sites and databases. Technology may add value, too. For example, a recent merger between two large firms was partially based on the fact that one lagged in its technology. With several partners nearing retirement, the chance to get a return on their investment by upgrading was limited. The firm chose to merge with a larger one that was already there from a technology standpoint.

And finally, prior to closing on the sale of an accounting practice, seller and buyer must focus on what they need to do to make clients and staff comfortable, what roles they need to take and what message to send out to the public. The best deals are those in which all parties—sellers, buyers and clients—prosper.

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Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881  
Editorial: (201) 938-3292  
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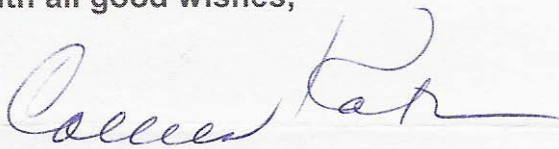
Dear Mr. Sinkin:

It gives me great pleasure to tell you that your article, *Price Equals Value Plus Terms*, which appeared in the December 2004 issue of the *Journal of Accountancy*, received exceptionally high praise by our Board of Editorial Advisers.

The Board of Editorial Advisers, which evaluates our articles, consists of over 70 CPAs who represent all segments of the profession. Each month they read and numerically rate every article in the *Journal*, and we tabulate the results.

We thought you would like to know how well your work was received. Thank you for doing such a superb job, and I hope you will write for us again.

With all good wishes,



Colleen Katz  
Publisher/Editor-in-Chief