ACCOUNTING
TRANSITION ADVISORS

Case Study Number 4: A Local CPA Firm Seeking to Merge Upstream for Professional and Financial Growth

The Firm Seeking an Upstream Merger

This firm, Firm A, was generating $5,000,000 in annual fees and with five partners. Firm A has a specialty niche related to real estate run by one of the partners. The rest of the practice is a standard practice with small to mid-size businesses and high income and net worth individuals. There was some tension in the firm with the specialty partner and early in the process he decided to leave the firm and set up his own practice. This was accomplished separate from the merger negotiations with our assistance. The four remaining partners merged into the new firm. Because of that tension in conjunction with the firm's partners feeling they could not adequately provide for the succession of all the firm's partners, they sought to merge into a larger firm that could provide a strong operational and partner foundation to deal with these issues. The firm had one partner that were wanting to retire in two to four years, one that was seven to ten years away from retiring, and two that were likely at least twenty years away from retiring.

The Successor Firm

The successor firm, Firm B, is a large local firm which at the time was generating over $25,000,000 in annual fees with sixteen partners. The firm is diversified and offers a variety of high value consulting services. Firm B was very interested in establishing a presence near where Firm A's offices are to provide access to that part of their metro area both to attract staff and to have closer proximity to existing and target clients. Firm A's offices were retained as a part of the merger. In addition, due to the diversity of Firm B's partner group, and the firms' overall strength, Firm B was able to provide Firm A the foundation they sought to keep them successful. The merger was synergistic on the top line as Firm B was able to provide Firm A's client base a deeper set of services and because Firm A was able to attract clients to the combined $30 million firm better than they could their separate $5 million firm. Cost synergies were achieved, despite the fact offices were not combined, because Firm A's partners were no longer responsible for as many administrative duties freeing them up for more billable work and practice development, the combined firm was much more efficient on staff utilization than Firm A was on its own, some overhead savings were achieved, and Firm B found it would be able to attract lower cost staff to the combined firm in Firm A's lower cost area of the overall market.

Negotiation Process

After initially meeting several firms of varying sizes ranging from $20,000,000 to $60,000,000, Firm A narrowed the field to Firm B. The reason for their decision was 1) the culture was very much in line with theirs, 2) they were very understanding of the issues related to the departing partner and willing to assist in those negotiations, and 3) their partnership agreement was in line with Firm A's existing agreement. As a result, all of the partners of Firm A were admitted as equity partners in Firm B and no modification of Firm B's partnership agreement was necessary to accommodate the short term Firm A partner. We assisted in drafting a proposal laying out the parameters for a merger. Several additional meetings were held and a verbal agreement was

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reached. We then assisted in the preparation of a letter of intent, and with our guidance, due diligence lists were exchanged and field reviews were performed by the parties. The successor firm drafted merger contracts and we worked with both firms to develop a transition plan to retain the clients and staff.

Deal Terms

Under the merger agreement, the merged-in partners were initially kept whole in earnings compared to what they were making in the recent past. This was based on them keeping their existing client list intact and maintaining their time commitment to the practice. Partner billable time was used as a proxy for maintaining margins which was the actual objective. Income was conditionally guaranteed for the first two years. This removed one Firm A's primary concerns, the risk that their contributions to the combined firm would not be adequately recognized in their compensation by the successor firm. It was an easy commitment for Firm B to make because the deal resulted in some cost savings and a new presence in an important sector of their market. Firm A's partners were provided equity in the firm based on relative revenues of the two firms. Firm A's partners contributed their existing equity (mostly made up of accounts receivable and WIP) to Firm B as their contribution to capital less some adjustments to take into account some tax issues. In addition to their conditionally guaranteed compensation, Firm A's partners were entitled to participate in firm profits. The allocation of profits would be determined based on the compensation methodology of the successor firm which considered level of client-managed billings, partner productivity, new business development, and a subjective performance evaluation.

Benefits to Both Parties

Firm B, the successor added partners, staff and additional clients (with the attendant revenues) and a strong foothold in a growing sector of their marketplace. The transition was very smooth. This created many synergies that provided additional profit margin from the outset. Firm A now has the resources to continue to grow their practice and earnings and is no longer concerned about managing change in their partner group. They have protection for the value of the firm in the event of a health issue or worse of key partners. The younger partners became part of the successor firm's long-term succession team which provides them a better professional future and financial opportunity.

Certain facts and descriptions have been altered to protect the confidentiality of the parties involved in the above transaction.

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