
# Do's and Don'ts of Due Diligence

Last in a series: The when, what, and how of making sure everything checks out in a merger.

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## About the Series

Powerful forces are transforming the accounting profession in the United States. The Baby Boomers are heading into their retirement years. Baby Boomer CPAs are in charge of most U.S. accounting firms, and most of those firms don't have a signed succession plan or practice-continuation agreement in place.

The *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This month's installment, the 12th and final part in the series, examines the due-diligence process in accounting firm mergers.

This article marks the 12th and final installment in a yearlong look at issues affecting succession for CPA firms. The series started in July with an explanation of why mergers have become a dominant trend in accounting firm succession strategies. The series ends this month with a dive into what should be one of the last stages of an accounting firm merger or sale: the due-diligence period.

Due diligence is the assessment of the legal, financial, and business risks associated with a merger or acquisition. It is totally appropriate and recommended for both parties to a transaction to perform due diligence on each other, regardless of the deal's nature and whether you are buying, selling, or merging. This article discusses when you should conduct due diligence, what you should review, and how to interpret and react to the findings.

## When Should You Perform Due Diligence?

Due diligence starts the first time you meet a potential candidate for a business

ILLUSTRATION BY RICHARD MIA/GERALD & CULLEN RAPP combination, even when you first review data on the firm. Every step along the way, you should be assessing whether a combination of your firm and theirs would meet your financial and business goals.

However, there is a specific intensive review that you will undertake referred to as "field due diligence." Too often, firms start field due diligence much too soon in the deal process. A better course is to perform field due diligence only after the following steps have been completed:

- The parties have exchanged enough summary financial and operating information for both sides to make a determination of the deal's appropriate terms, relying on the assumption the information is accurate.
- The parties have discussed and agreed to a nonbinding terms sheet, offering memorandum, or letter of intent, pending the field due diligence that will follow.

Why wait to perform due diligence until you have agreed to deal terms? First, one of the key things you need to review in due diligence is how the terms will affect your objectives for the deal; you can't do that until you know what the terms are.

## Case Study: Business Plan Issues

A sole proprietor found a firm that appeared to be her perfect successor. The financial terms depended on the successor firm retaining her clients, as is the case with most acquisitions. The seller was confident the successor could do that because the firm operated essentially as she did. Their billing rates were similar. Their offices were close. Their personalities were compatible.

In due diligence, however, she found all of the successor firm's partners were so busy they could hardly keep up with their existing client work. They had no plan for who would take over her client relationships. She realized that while this looked on the surface like the perfect deal, and all the financial and legal due diligence checked out, the other firm appeared incapable of executing the business plan.

## Case Study: Client Concentration Risk

A four-partner firm was merging into a somewhat larger firm. Three of the partners in the smaller firm were staying on indefinitely, and one was retiring in three years. The larger firm was initially comfortable that client retention would not be a big issue, so it agreed to fix the retirement obligation for the acquired partners following a 12-month lookback period. However, in due diligence, the larger firm discovered that a group of clients managed by the short-term partner were related and in total made up 20% of the acquired firm's volume. The larger firm modified the merger's terms to change the retirement payments for the short-term partner to be partially based on five years of retention of fees for that client group following his retirement.

Second, field due diligence is an invasive process, and it can lead to premature disclosure that a transaction is imminent. There is no reason to take that risk until you are fairly certain a deal is viable. Finally, field due diligence requires a lot of time and effort pulling together information, especially on the part of the party being reviewed. It is a colossal waste of time doing that until you know the time investment is worthwhile.

### What Should You Review?

Obviously, you want to determine in due diligence what financial and legal risks will be associated with a merger or acquisition. Generally, you'll be reviewing historical financial data, details on owners and employees, client categories and specific material clients, service methodologies, benefit plans, policies, procedures, the quality-control system, legal matters such as litigation and licensing, and the condition of assets being acquired.

Many firms don't pay enough attention to the business risks. Every participant in a merger has a business plan in mind. The other side might bring sterling credentials—financially strong,


## EXECUTIVE SUMMARY

- **Intensive, or "field," due diligence should take place after the parties in merger talks have agreed in principle on terms for the deal.** While some due diligence should be performed from the beginning of the process, the intensive investigation of the other party is an invasive and time-consuming process that requires some knowledge of the deal's terms to adequately assess how they affect the merger's objectives.
- **Firms should pay special attention to business plan risks during due diligence.** The other side might have great financials, superior quality control, and a sparkling client base but be unable to meet your objectives in a merger.
- **Due diligence should be broken into three categories of information:** (1) things readily available and easily delivered; (2) things that require some effort to pull together; and (3) information that must be gathered in the field.
- **There are three ways to react to unexpected due-diligence findings:** (1) walk away from the deal; (2) modify the deal terms; or (3) modify your business plan for the deal.



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*To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.*

## Case Study: Profitability

A two-partner firm was seeking to be acquired by a much larger firm. On the surface, all the numbers matched, and the small firm was highly profitable. During due diligence, the larger firm found that the smaller firm's partners regularly visited their clients and did much of the work themselves. The firm's staff was not very productive or strong. Because the partners were doing so much of the work, their need for review wasn't considered necessary much of the time. The larger firm realized it could not replicate the profit margins the seller had produced within its quality-control structure and walked away from the deal because the terms could not be modified enough to make it profitable.

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The Private Companies Practice Section (PCPS) is a voluntary firm membership section for CPAs that provides member firms with targeted practice management tools and resources, including the Succession Planning Resource Center, as well as a strong, collective voice within the CPA profession. Visit the PCPS Firm Practice Center at aicpa.org/PCPS and the Succession Planning Resource Center at tinyurl.com/oak3l4e.

no undisclosed liabilities, a top-notch quality-control system, squeaky clean legally—and still be incapable of meeting the objectives you have for the deal. Consider what assumptions you have made about the other side's ability to deliver on the plan, and then try to confirm if those assumptions are reliable.

The first step as you start formal due diligence is to exchange lists of what each side wants to see. To manage time and priorities, break the review down into three categories:

- Things that are readily available and can easily be delivered, for instance, by email. Examples are financial statements, tax returns, employee handbooks, leases, and employment agreements.
- Things that might require some effort pulling together, such as accounts receivable, breakdowns of client information (fees, industries, tenure), and operating metrics on productivity.
- Information that can be gathered only in the field, such as a review of workpaper files and quality-control processes, inspections of office and equipment, and interviews of key people.

## Call for Questions

Have questions on accounting firm M&A, succession planning, valuations, deal structure, due diligence, owner agreements, or related topics? Send them to Joel Sinkin and Terrence Putney via jofa_feedback@aicpa.org. If asking about a specific situation, please include as much information as possible. For M&A deals, for example, it is helpful to know gross revenues, number of partners, and location of the parties involved. It also is helpful to have the question categorized as either (1) selling/upstream merging; (2) acquiring; (3) internal succession; or (4) owner agreement. No names will be revealed in any published answers to submitted questions.

## Case Study: Billing Rate

AB Co. was in discussions to merge into XYZ & Associates. AB had two partners who generated more than 1,700 chargeable hours each at $175 per hour. XYZ was concerned because its partners billed out at $275 per hour. Rather than walk away, XYZ inquired if AB's partners would raise their billing rates to match their partners' rates. It turned out that AB's partners were billing at much lower rates because they didn't have enough lower-level staff to assign simple tasks to, and, as a result, they didn't think they could justify the higher rates. However, because XYZ could supply the AB partners a more diverse array of staff, the acquiring firm believed it could focus the acquired partners on higher-level tasks while assigning much of their current work to lower-level staff (not client handholding but client service). This would allow the acquiring firm to raise the rates on the partners' time without increasing what they charged their clients. The acquired partners also would be freed from more mundane client work, allowing them to focus on practice development and more valuable services.

If you stage the requests for data so the easy things can be done earlier, the process is not so daunting. Scheduling office visits can be difficult, and there is no reason to delay the review of historical financial information while trying to arrange the field due diligence.

### How Should You React to What You Find?

Problems surface sometimes in due diligence, and occasionally the matters are serious enough to kill the deal. However, most of the due diligence the authors have been involved with has not turned out this way. This is largely because the parties had quite a bit of information upfront, before field due diligence commenced and before the deal was struck. Accounting firms are inherently complete, accurate, and honest with each other. However, if you do find something troubling in due diligence, how should you handle it?

You can take one of three steps in response to unexpected due-diligence findings: (1) walk away from the deal; (2) modify the deal terms to mitigate the risk you have found; or (3) modify your business plan for the deal.

### Keep in Mind These Typical Business Issues When Conducting Due Diligence

- If you are acquiring a practice with a short transition period for the owner, find out how long the clients have been clients. The longer a client's tenure, the more likely the successor will be able to retain the client.
- If you are selling a practice, find out what kind of attrition rate the successor has for its client base. The rate is likely to be the same or worse for your clients after the sale.
- If a firm you are acquiring doesn't have employment agreements with its staff, consider whether the staff will sign your employment agreements and what impact and potential risk there would be on client retention if any refuse to sign.
- If you are merging into a firm to address a succession problem, make sure the successor firm has the capacity and skills to replace your firm's owners who will be leaving soon.
- Review who at the firm really does the work and manages the relationships with the clients and how that might affect retention. Don't assume that just because a client is on a partner's billing run, that partner controls the relationship. ❖