How to Value a CPA Firm for Sale

Fifth in a series: Methods and results differ for external transactions and internal transfers. by Joel Sinkin and Terrence Putney, CPA

One of the key components of a CPA succession plan is the sale or transfer of the retiring CPA’s ownership interest. How is the value of that interest determined? In most circumstances, the value of an owner’s interest is different when selling to an external buyer than it is in an internal transaction.

EXTERNAL SALES

The most common question about accounting firm sales the authors are asked when teaching CPE courses is “What is the multiple (of billings)?” The multiple is determined by four main factors:

1. Cash Upfront, If Any
In more than 90% of the 900-plus deals the authors have consulted on in the past 24 years, the down payments have ranged from nothing to 20%. The authors have seen many more deals with no cash down than with 15% to 20%. A typical down payment is 10%. The factors that affect buyers’ thinking include:

   The time of year. For example, if a selling firm bills 65% of its revenue by May 1 and the closing is May 15, the buyer may have to carry the practice at a net loss or break-even for months, so the amount of the down payment, if any, tends to be less. Obviously, the same practice closing Jan. 1 is likely to get more upfront. As with almost all deals of this type, the buyer’s ability to obtain a return on investment quickly usually affects the terms offered.

   Treatment of accounts receivable. Most sellers expect to retain their receivables—that is, the money they are owed for work they’ve already completed, plus work still in progress. This is logical. However, consider that the buyer will have to replace those funds, resulting in negative cash flow upfront from the operations. The situation is exacerbated if the acquired client base is accustomed to paying slowly, meaning that the buyer could have to wait months before seeing revenue come in from the buyer’s billings. In those situations, the buyer will have to contribute more capital to meet expenses. This can result in lower down pay-
2. Retention Period

The majority of external accounting firm deals base payments on collections. That is, the buyer pays a specified percentage of the fees it collects for a specified period after the deal closes. If the buyer loses clients and the fees fall during that period, then the seller receives less money. Conversely, if fees increase, the purchase payments do as well. It's an arrangement that seems to fly in the face of most business sales, in which the buyer pays a negotiated price. Many of the accountants the authors have worked with over the years were surprised that accounting firm sale prices were determined by a formula based on collections. These are not “buyer beware” sales; rather, such deals are shared-risk transactions unique to accounting firms because the value of firms lies for the most part in client relationships, not hard assets.

Most external sales have a retention period that adjusts the balance due to the seller based on client retention and fees collected. Some retention periods can be as short as one to two years, but many deals are structured with payments based on a percentage of collections over the entire payout period. Rarely do the authors see one-year retention periods. Instead, the recent economic difficulties have led to longer retention periods, which offer more security to buyers afraid that clients will go out of business or otherwise reduce the fees being paid to the buyer.

3. Profitability

This can be a confusing variable to many because it doesn’t refer to the seller’s profitability but the buyer’s. Here is an example: A CPA owns a small firm operated from her home, with her spouse as the only labor. Her profit margin could reach or even exceed 85% because she might not count her spouse as a cost. Now, the CPA moves into an office and hires staff, driving her margin to less than 50%. At this point, would her firm be worth more to the buyer?

If a CPA is selling a firm with little overhead, then a buyer can absorb the practice much more profitably than it can a firm that has lease and staff obligations. Why can’t the buyer just jettison staff after the sale? One reason is that many deals require the buyer to keep certain staff. The reasons for such terms are varied, but one often is the seller’s belief that holding on to certain staff will lead to higher client retention. Remember, the amount being paid to the seller in most deals depends on how successful the buyer is at keeping clients. The trade-off is that any overhead the buyer is forced to take on will likely result in a lower offer to the seller for the practice. As another example, if the buyer has to treat the purchase as goodwill instead of deducting the payments as made, the deal is more costly.

4. Duration of the Payout Period

Most deals use a range of three to 10 years for the payments, and most do not include added interest. Smaller firms usually are paid in four to six years, and acquisitions of larger firms traditionally have longer payout periods.

The Multiple

The multiple, finally, is produced by the interaction of all of these other terms and factors. Think of the following equation: the less money upfront, the longer the payout and retention periods, and the more profitably structured for the buyer, the higher the multiple. On the other hand, more money upfront, shorter payout and retention periods, and a less profitable structure for the buyer will result in a lower multiple.

Other factors also affect the sale price. Higher-quality firms—with great clients, higher billing rates and realization, etc.—tend to obtain a higher value. If a CPA is in a marketplace where many accounting firms are looking to buy CPA practices, the demand for the practice is greater and the value is higher. In more remote areas, the supply-and-demand curve is different. The authors have seen small firms sell for as high as 1.25 times billings, even occasionally more in cities such as New York, but have seen firms in more remote areas struggle to get 1 times billings.

Volume also plays a role. Larger firms traditionally receive smaller multiples and longer payout periods. This is predominantly because, in densely populated areas, there may be many firms that can absorb a $500,000 firm into their firm with little to no overhead increases, but no one can absorb a $10 million firm, for example, without substantial increases in overhead. Also, smaller firms tend to yield a higher percentage of profit to the bottom line than larger firms.
INTERNAL TRANSFERS

Although all of the variables of external sales also play a role in an inside transfer of ownership interests, there also are distinct differences. Inside valuations traditionally use a lower multiple of billings than external deals. Most retiring partners don’t expect their partners, who helped build the business, to pay the same price as a stranger. Plus, the terms of inside transfers often fix the price at the date of retirement, and the firm is obligated to acquire the ownership interest, both of which justify a lower multiple. Many inside transfers are based on a multiple times billings times ownership interest.

The most popular multiple is still 1 times billings, but less than half of agreements now use that multiple. Very few use more than 1 times, and more than half use less than 1 times. In some cases, the multiple is applied to the book of business the partner managed rather than overall firm billings. Larger firms tend to use a multiple of compensation as opposed to equity. Most of these firms use a formula that looks at the average compensation of a partner over a period of time, multiplied by between two to three times, in most cases, and paid over eight to 10 years (plus capital).

For example, if a retiring partner made an average of $100,000 over the past four or so years, the deal could be structured to pay him or her $300,000 over 10 years. That’s in addition to the capital payment. Usually, the capital refers to the retiring partner’s share (say 20%) of the accounts receivable and work-in-progress. Most retirement packages are paid in a manner that provides the firm a current deduction such as guaranteed payments to a partner on a Form K-1 or deferred compensation.

So what multiple should be used, whether it is based on equity, a book of business, or compensation? It’s good to start with the following premise. The firm has likely helped dozens of clients value a business they were considering buying. In these situations, a CPA would rarely, if ever, tell a client, “If you buy this business, you will lose money, maybe break even for the next seven years. It’s a great deal!” The CPA firm’s partners should also have financial upside from buying a retiring CPAs interest instead of losing or running in place for seven to 10 years. How can the firm attract young partners if it makes less money after the CPA retires? The following “work backward” formula can test whether the buyout works.

The formula starts with the amount of compensation the retiring partner is making, then subtracts the cost of replacing this partner’s labor. That may be as simple as calculating the cost of a high-level staff person to replace the billable time. That leaves the firm with the annual net cash flow it needs to pay the buyout and leave behind reasonable upside. So long as the multiple and other terms the firm chooses enable the remaining partners to have some upside, it is at least a workable start.