Mergers & Acquisitions of CPA Firms

Understanding the roadblocks to successful deals

(Part 1 of 2)

by Joel Sinkin and Terrence Putney

Despite the best intentions of all involved parties, some CPA firm mergers and acquisitions are not as successful as originally planned; indeed, some end as failures. When viewed in perfect hindsight, it often seems that simple common sense, or lack thereof, was the reason for the success or failure of a deal. Unfortunately, there is no specific formula for structuring a perfect deal, but a good understanding of the potential hazards relating to the variables involved and planning for the unexpected can help your firm prepare a better deal structure and business plan.

This article highlights some of the major reasons deals fail to meet the original strategic, financial, and professional objectives of the combining firms. A companion article in the April issue of the *JofA* will take a closer look and offer guidance for client and staff retention in mergers. The minutiae of certain details have purposely been eliminated as it is rarely the numbers (such as the size of the firms' revenue) or a merger's financial terms that cause the failure. The lessons apply to firms of all sizes, whether a small one- to two-partner firm or a national firm.

Why Some Deals Fail

1. Affiliating for the wrong reasons

A merger or an acquisition has a major impact on the partners, staff and clients of both firms. The potential M&A transaction should ideally result in a significant upside or solution to a major problem. Merging to merely reduce overhead in one or both firms (for instance, to fill empty office space, spread technology costs, or utilize excess staff) is a reason for many mergers, but is often a poor foundation for an affiliation. It would be much less traumatic to just shed the excess costs or to set up a space-sharing arrangement between the firms.

Sometimes, the misconception that "bigger is better" can lead to a deal failure. In many cases, bigger will be better only if the combined firm understands and is prepared to take advantage of the benefits of scale, but realizes the efficiencies and efficacy of a larger firm is not automatic. On the other hand, some excellent reasons to merge, sell or acquire are planning for the succession for the owners of one firm, increasing a pool of talent, opening access to new marketplaces, and adding niche services or expanding the reach of existing specialties through cross-selling.

2. Deal structure

A properly structured deal is one in which both firms win. If one party negotiates a tremendous package strictly to their benefit, this may potentially disenfranchise the other party and cause the deal to break down.

For example, in an acquisition or equity buyout, the seller naturally wants to maximize the value of years of sweat equity. But if the buyer is literally losing money during most, if not all, of the payout period, the acquiring firm could lose enthusiasm for the deal. In the end, the buyer will be vital to ensuring that the seller receives the maximum buyout compensation possible. Buyers who wake up after closing to find the deal is not profitable may start to jettison marginal clients, in extreme cases miss scheduled payments, and generally pursue a path more likely to lead to trouble.

Case study. An acquisition transaction was structured with a guaranteed purchase price set at closing. The deal did not contain a client retention adjustment for the seller (Firm A) to get paid on the buyer's (Firm B's) ability to retain clients. Despite this, the partners of Firm A, a $2 million, four-partner firm, informally agreed to stay on and work for an extended time even though they sold the practice at a fixed rate. The buyer, Firm B, a $10 million large local firm, assumed there was sufficient leverage in the compensation package to motivate the Firm A partners to perform post-acquisition.

After the deal, however, when the Firm A partners found themselves "lost in the shuffle" of the new firm, they decided to leave to pursue other careers outside public accounting. Firm B lost virtually all the clients acquired. If the deal had been properly structured with appropriate client retention adjustments, this problem could have been avoided. The Firm A partners would have been financially motivated to stick out the transition.

Effective retention adjustment periods can be limited to as little as one to two years all the way up to the entire payment period in the agreement. The nuances of deal structure, including specifics on retention packages, are discussed in greater detail in "Price Equals Value Plus Terms," *JofA*, Dec. 04, page 67.

3. Introducing change too quickly

Some deals struggle because changes are made too soon in the way one of the firms operates. The successor firm in a merger should recognize in advance that staff and clients liked the way the other firm's practice was run. That's why they chose to do business or practice there. Both constituents will elect to remain with or leave a firm partially based on culture and comfort. In most markets, clients have a plethora of choices in picking an accounting firm. Furthermore, it is difficult to find quality staff, especially partners, who can be the hardest to replace. Don't take either of these resources for granted. Consider how operational changes such as an office relocation might affect existing clients and/or how changes in compensation and benefit plans could affect staff. These are examples of changes that, if implemented too soon after a merger, can hurt its overall success.

Another major issue for clients is fees. Fees that historically have been set annually that are immediately converted to a monthly cycle are an example of a modification that can hurt client retention. Of course, wholesale increases in the level of fees may be rejected if introduced too soon.

Case study. A $1 million sole proprietor (Firm C) merged upstream into a $3 million, three-partner firm (Firm D) in a suburb of an East Coast metro area. Instead of considering the current mode under which Firm C had been used to operating, Firm D immediately increased the fees of Firm C's clients by about 25%. Firm C had allowed its staff members to work under a flexible policy, allowing files to be taken out of the office so staff members could work from home. Firm D did away with these privileges, and converted the software Firm C used in early January. This led to major frustrations for the staff in doing client work during the combined firm's first busy season. Following the end of busy season, three of Firm C's six staff members left the firm. That, in combination with the fee increases, led to a 30% decrease in fees for Firm C's clients due to a significant loss of their clients in the first year following the merger.

Firm C's former owner elected to demerge following the second busy season. We were brought in as consultants after the fact to help Firm D solve its staffing shortages as a result of the de-merger. It was clear that the two firms had inconsistent operating models to begin with, and Firm

EXECUTIVE SUMMARY

- **A potential merger or acquisition should ideally result in a significant upside or solution to a major problem.** Merging to merely reduce overhead in one or both firms (for instance, to fill empty office space, spread technology costs, or utilize excess staff) is often a poor foundation for an affiliation.
- **A properly structured deal is one in which both firms win.** If one party negotiates a tremendous package strictly to its benefit, this may potentially disenfranchise the other party and cause the deal to break down.
- **Some deals struggle because changes are made too soon** in the way one firm operates. The successor firm in a merger should recognize in advance that staff and clients liked the way the other firm's practice was run.
- **The critical notion of firm "culture" can take many forms,** such as the level of services provided to clients, the formality of how a firm operates (think dress codes, rigidity of staff schedules and office hours, and whether socializing is promoted in the office), and expectations regarding the roles of partners and supporting staff.
- **The agreements for most mergers should include the ability to de-merge** if the deal is not succeeding in either's eyes.

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Tips for a Successful Affiliation

These tips can improve the chances for success in an affiliation:

- In an acquisition, the financial terms for the successor should create positive cash flow, hopefully from the beginning. This does not mean the selling firm has to accept less proceeds. A longer payout period may be sufficient. In a merger, both firms should usually contribute billed and unbilled receivables instead of one firm expecting to cash in. This will relieve the burden of carrying overhead until collections from combined operations start rolling in.
- Prior to a merger, both firms should have a complete business plan to which they are committed that addresses the combined name, marketing, roles of each partner and key staff member, a complete transition plan including the message that will be given to clients and staff, and the method to be used to notify varying groups of clients.
- Make sure culture is addressed early in the process. Employees transition best when their original work environment is maintained to the extent possible to accommodate existing policies and other operational features.
- Get help. If there are 50 things a person needs to know about making a deal successful, the smartest among us may only think of 35. Consult your peers who have gone through affiliations and find out what worked and what did not. Consider hiring an outside consultant with substantial experience in the mergers and acquisitions of accounting firms. A lawyer or consultant who has been involved in few deals or who doesn't specialize in accounting firms may not give you access to all the expertise you need.

D's inflexibility and focus on the wrong things from the start, contributed to a failed merger.

4. Culture

The culture of two firms considering an affiliation is often cited as a key to success for the deal. But culture can be a hard-to-define intangible. Many firm leaders base their understanding of another firm's culture on "knowing it when you see it." However, there are some more specific ways to define culture that should be considered.

The way individual firms provide customer service is important to how clients define a firm's culture—for example, some firms may "spoil" their clients by providing services that go above and beyond those of a normal firm. The formality of how a firm operates—including dress codes, rigidity of staff schedules and office hours, and even the manner in which staff are expected to address partners—can vary widely. Some firms promote socializing in the office. Other firms see this as a deterrent to productivity. Clients have expectations regarding the roles of partners and supporting staff, new business development, and what they can expect of supporting personnel members in the firm. These are all key components comprising a firm's culture that should be considered prior to a merger.

Case study. Firm E is a semi-national firm with more than $200 million in annual revenues that acquired a $3.5 million, two-partner firm (Firm F) with a construction niche that Firm E coveted for one of its local offices. The partners of Firm F were looking for the ability to focus on their niche, not succession.

Governance became a problem. Firm F's partners were accustomed to operating with a large degree of autonomy, far less bureaucracy, and little accountability other than to their clients. Unfortunately, the pre-merger negotiations focused primarily on the deal's financial aspects, such as partner compensation and partner retirement plans. Neither firm made it clear to the other what their expectations were regarding partner accountability, policies that would affect staff, and governance.

Firm E had gone through many successful mergers before. Its due diligence was quite thorough regarding workpapers, firm profitability, operating metrics, exposure and other quality control features. The culture issues were left to the local office of Firm E. In his excitement to do the deal, the local Firm E partner-in-charge did not adequately discuss Firm E's culture, hoping that potentially controversial issues would work themselves out afterward. Unfortunately, these issues did not go away. Eighteen months later, one of Firm F's partners became frustrated and left to become CFO of one of the firm's large construction clients. As a result, the merger was viewed as falling short of expectations.

It is essential to openly discuss the culture of both firms before a merger or an acquisition is pursued. This should be one of the first subjects broached in meetings to discuss a potential affiliation. During these preliminary discussions, ask questions that will make it possible to gauge whether the firms (or firm owners) share the same values and visions. If you don't feel comfortable with what you learn, how do you think your staff and clients will relate to them in the event of a merger?

5. De-merger clauses

The agreements for most mergers should include the ability for both firms to de-merge if the deal is not succeeding in either's eyes (see "Untying the Knot: Planning for a De-Merger," *JofA*, Oct. 07, page 46). There is clearly a trade-off between achieving the safety a de-merger clause creates and the risk that the ability to have an out will lead to slow integration of the two firms. Normally a de-merger clause that has a one- or two-year limit is a good compromise.

Case study. A $16 million Midwestern multioffice firm (Firm G) merged with a $2.7 million, four-partner firm (Firm H). One of Firm H's partners was seeking succession within five years and another planned to leave in 10 years. The remaining two partners were young and looking for a long-term career with the combined firm. Within one year of the merger, the successor firm was approached by a larger regional firm (Firm I), and the management team elected to merge. The two Firm H partners who were expecting to eventually be bought out were concerned about their clients being retained by the larger firm (Firm I) and, therefore, thought the value of their buyout might be decreased. One of the younger Firm H partners was not offered a position as partner by the larger firm. The merger agreement contained a demerger clause that would allow either firm to unwind the deal. Firm H's partners decided they could find an alternative for their long-term succession and career needs and elected to de-merge. Firm G went through with the merger with Firm I.

Next month in Part 2 of 2: Guidance for client and staff retention in mergers. ❖

AICPA RESOURCES

JofA articles

- "Untying the Knot: Planning for a De-Merger," Oct. 07, page 46
- "Two-Stage Deals," March 06, page 43
- "Price Equals Value Plus Terms," Dec. 04, page 67

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Publications

- *The Adviser's Guide to Mergers, Acquisitions, and Sales of Closely Held Businesses: Advanced Case Analysis* (#091027)
- *Compensation as a Strategic Asset: The New Paradigm* (#090493)
- *Mergers and Acquisitions Basics: The Key Steps of Acquisitions, Divestitures, and Investments* (#WI675180)
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10 Biggest Reasons Mergers Fail

1. ***Ego.*** Normally this is manifested in unwillingness on the part of the partners in both firms to adapt to the new way of doing things required to make a merger work. Even in the case of a much smaller firm merging into a larger one, there should be some give on both sides to allow for the formation of a cohesive and motivated team.
2. ***Firm name.*** The surviving name should be worked out before the merger is completed and a strategy developed for how the name change will be communicated to the market, which is a critical part of the process. There are many hybrid methods such as creating a bridge entity, using the predecessor firm's name as a byline in the letterhead, forming a new name combined from both names, and adopting a generic name.
3. ***Culture***. While the larger firm's culture usually primarily survives, adopting features of both firms' cultures will normally lead to a better environment after the merger.
4. ***Change***. Instituting change slowly wherever possible will lead to less impact on clients and staff and can help maximize the retention of both types of constituents. Mergers without high levels of staff and client retention often are not successful.
5. ***Inadequate capacity***. In mergers where some partners may soon be leaving due to retirement or succession, or where there is planned staff attrition, professionals need to be replaced soon after the merger is effective. If the successor firm lacks the existing excess capacity to handle the new requirements, and fails to execute on its plan to acquire new resources, in most cases the deal will eventually fail.
6. ***Staff transition***. Staff are accustomed to their roles, the expectations the firm has for them, compensation level and methods, and perks and benefits. Maintaining the status quo for staff wherever possible will reduce the stress that change places on them and lead to higher acceptance and retention.
7. ***Technology***. Normally, for a merged firm to start operating efficiently, technology platforms have to be brought into conformity. However, a failure to invest adequate resources in upgrades, conversions and training can lead to poor execution of the technology transition, causing frustration and, in the end, higher costs.
8. ***Poor transition planning***. All aspects of the operational transition must be thought out in advance. Otherwise, inadequate resources will be devoted to the execution, and the staging can be off, causing additional stress on the staff and clients.
9. ***Impatience***. Some changes need to be introduced immediately; some things can wait. For example, the time and billing system is normally a core management tool and must be adopted immediately whereas certain client service systems (such as write-up software or even tax prep software) can be phased in, especially after seasonally busy times of the year. Not forcing change for its own sake can lead to better acceptance and execution.
10. ***Communication***. Management teams that fail to fully communicate to the combined team the rationale for the transition plan, what is expected, and how to obtain help when it is needed may find people not executing the plan and resentment building.