PRACTICE MANAGEMENT / TECHNOLOGY

Building a state-of-the-art M&A target

A firm can enrich its value to prospective suitors by investing in a top-notch IT infrastructure and exhibiting a willingness to embrace new technologies.

By Terrence Putney, CPA, and Joel Sinkin

Technology has become a key consideration when assessing the cultural fit of two firms considering a merger.

Technology has become one of the biggest issues in accounting firm mergers and acquisitions. It is a key concern when assessing the likelihood of a firm combination's success, and it is also increasingly driving firms to seek mergers.

The rise of technology as a critical concern in accounting firm mergers and acquisitions (M&As) coincides with the emergence of cultural fit and synergy as arguably the most important considerations in achieving a merger's strategic goals. A firm's computing resources, network access, and information technology (IT) policies create a technology culture unique to each firm. If two organizations have incompatible technology cultures, a business combination has little to no chance of succeeding. This article explores some of the key issues behind the emergence of technology culture as an essential part of accounting firm mergers.

Note that a "merger" in this article generally describes the business combination of two accounting firms. However, the legal structure of many of these transactions is not a merger, but, rather, an acquisition of assets, the hiring of key personnel, or another type of business combination.

TECHNOLOGY CULTURE
To understand the importance of technology culture, one must have a grasp on what constitutes culture, which can be an elusive concept to define and measure. Answers to the following questions can help reveal a firm's culture:
- What's it like to be an owner in this firm?
- What's it like to be a staff member of this firm?
- What's it like to be a client of this firm?

Technology has a great effect on the answers to those questions. For example, if one firm's staff and owners are accustomed to working in the cloud, they likely are accustomed to working remotely. The same firm's clients are likely to be conditioned to, or even dependent on, interfacing and sharing data through secure portals. In addition, meetings may be held frequently via videoconference. If the other party to the merger does not embrace this level of technology, an integration of the two firms may suffer, as might client and staff retention.

Few, if any, firms would consider a merger successful if most of the acquired firm's clients and staff are not retained. Changes, big and small, in the client experience can have a significant impact on retention unless they are introduced gradually. For instance, a change in accounting software — even just the user interface — could cause much frustration and dissatisfaction. If a technology change creates major headaches for clients, they may soon look to another accounting firm for relief. On the other hand, a smoothly handled transition to an upgraded application or process could engender positive client feelings toward the newly merged firm.

That's a view shared by Jim Bourke, CPA/CITP/CFF, CGMA, a partner and the director of firm technology for WithumSmith+Brown, a large ▶

About the authors
Terrence Putney, CPA, is CEO, and Joel Sinkin is president, both of Transition Advisors LLC, based in New York with local offices throughout the country.

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regional firm based in New Jersey.

"We believe that the synergy created by a smooth and rapid transition of technology from the merging firm into our technology environment will lead to better client and staff retention post-merger," said Bourke, who has led Withum's integration process for a significant number of mergers over the past few years. "A problematic integration of technology will lead to inefficient client service and can create attrition. Young staff especially are attracted to a rich technology environment."

Technology culture can open and close doors to accounting firm mergers. For example, in a recent conversation with us, the managing partner of a top 100 firm looking to expand into a new geographic market said, "Let's say we find two firms generating the same revenue. One of the candidates has less than sterling, but still satisfactory, operating metrics, but the firm has state-of-the-art technology. The other candidate firm, on the surface, has superior metrics. Its net income per partner [NIPP] is very good, productivity is above average, and the firm is

suitably leveraged, but profitability has come at the expense of little investment in technology. We will likely be more interested in the first firm because their technology culture is compatible with ours."

In our experience, differences in operating metrics are rarely the reason for failures in mergers. An inability to integrate cultures is the leading cause of failed CPA firm combinations, and the fast pace of change in technology used by accounting firms is creating significant gaps between firms in technology infrastructures, the way clients are served, and the way staff are managed.

Bourke used to build detailed budgets for the costs associated with the technology aspects of a merger. However, time after time, he found the cost always fell between $10,000 and $12,000 per full-time equivalent. "Even though we are making a significant investment in upgrades, that is ultimately not the real issue," he said. "My primary concern is the acquired firm's willingness to adapt to our technology environment. We have held firm on our 'rip and replace' [ripping out all of the target firm's technology and replacing it with brand-new technology that matches the acquiring firm's technology] stance when entering into mergers. I've been party to only one preliminary discussion with a target firm that did not embrace this approach. We did not do the deal."

IMPACT ON OPERATING METRICS AND PROFITABILITY

We see firms using three key operating metrics to assess how well a merger candidate will assimilate: leverage (total headcount per partner), billing rates, and profit margin (net income before partner compensation over total revenues). Firms with varying

IN BRIEF

- Compatible technology cultures (computing resources, network access, IT policies) are essential for successful accounting firm business combinations.
- An inability to integrate cultures is the leading cause of failed CPA firm mergers, and the fast pace of change in

technology used by accounting firms is creating significant gaps between firms.
- Firms unwilling to invest in new technology, or at least adopt an acquiring firm's technology, run the risk of losing a deal even if they have superior operating metrics.
- Firms willing to invest in a richer-technology environment can see much

higher revenue per partner despite a higher cost structure.
- The basic technologies acquiring firms expect to see in M&A targets include tax software with a major vendor, fully functional practice management systems, engagement management software, and document management software with client collaboration features.

levels of investment in technology can have widely varying metrics. It is important to understand how to accurately assess these differences. Sometimes a metric appears to indicate a poor fit between the two firms, but significant opportunities for profitability improvement become apparent if you take the time to dig deeper. For instance, partner billing rates in smaller firms tend to be lower than in larger firms. Many acquiring firms assume this reflects an overall problem with pricing for services in that firm. However, we have found that lower partner billing rates often are the result of partners' performing tasks that larger firms would assign to lower-level staff. By taking advantage of the better leverage a large firm possesses, the smaller firm's partners should be able to raise their billing rates without a dramatic impact on fees for that firm's clients.

Firms that have recently invested in a technology upgrade tend to experience a temporary dip in profit margin. Not only does the technology investment itself impact the bottom line, but also the training on and adaptation to the new systems, especially new software, may have a temporary adverse effect on the firm's productivity as measured by billable hours and realization. A potential acquiring firm should go beyond the raw numbers to see if this is truly a temporary dip in profitability or an excuse for poor profit management.

When productivity is defined as revenue per person, the use of technology allows the firm to replace staff with technology, which often leads to an increase in the productivity metric. Sometimes billing rates can be increased because some of the routine tasks typically assigned to staff have been replaced with technology. However, if the result of a strong technology investment is an increase in the leverage metric, profit margins may also be lower. Many firms with high NIPP have lower profit margins, which may seem counterintuitive. Firms with above-average NIPP often also have above-average leverage rather than high profit margins. Creating more leverage requires investing in more staff and infrastructure, including technology. The result should be a higher cost structure, but also much higher revenue per partner.

If a target firm is willing to embrace a move to a richer-technology environment, the potential for improved profitability can be significant. Unfortunately, we sometimes see acquiring firms back away from candidate firms that are short on technology because of the upfront investment required to get them up to speed. In contrast, if the technology

investment the acquiring firm originally made in its own firm paid off, the same should be true in an acquired firm. Among firms that pursue mergers as a regular growth strategy, one school of thought says it is harder to get a lot of operating synergy out of an acquired firm that is already operating at peak efficiency. A firm that will benefit from an investment in a stronger infrastructure, such as a technology upgrade, offers more upside potential.

EMBRACING TECHNOLOGY MAKES YOUR FIRM MORE ATTRACTIVE

Leaders of firms seeking an upstream merger in the near future often ask what they can do to make their firms more attractive to potential acquirers. Bourke offered the following advice.

"First, consider the size and type of firm you will be targeting," he said. "Will it be a top 100 firm, a G400 firm, or smaller? Then ascertain the type of technology environment those firms are likely to be using. Consider working with a technology consultant if necessary. Make sure your technology is up to that standard."

At a minimum, Bourke said, most acquiring firms will expect to find the following systems in place for firms they might acquire:

- Tax software with one of the major vendors.
- Practice management systems that are fully functional.
- Engagement management software.
- Document management software allowing the firm to be paperless, including client collaboration features.

It is highly preferable for all systems to be in the cloud. If a firm is a few years away from merging upstream, Bourke recommended the firm avoid investing in new server hardware and make the switch to the cloud.

If you are looking at this issue from the perspective of a firm seeking to grow through M&A, be realistic with your expectations. Round pegs for round holes are hard to find. Technology is an area that is increasingly a differentiator between firms, especially those of disparate size. Even though the investment of financial and other resources necessary to bring an acquired firm up to your technology standards might seem overwhelming, there may be no better place to realize synergy in the combined operating environment.

"We don't expect the firms we merge with to be on all the same systems we use," Bourke said. "What we need to know is the firm will embrace the migration to our systems."

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One more aspect to consider in all business combinations, but especially in those with material technology considerations, is project management. There are many variables to address in any combination: technology, people, physical space, communication, policies and procedures, financials, and the challenge of finding a common vision. Accountants are, for the most part, not trained in project management (even though most engagements are really projects). It is vital that any combination of significance be managed as a project with clear benchmarks, budgeting, and goals. This will provide a level of assurance for success of the combination that cannot be otherwise achieved.

TRENDS IN ACQUISITIONS OF NICHE CONSULTING FIRMS

A recent trend in M&As, especially within the top 100 firms, is an emphasis on business combinations with nonaccounting niche consulting firms. Technology is at the front of this wave. Cybersecurity firms are in high demand. Other hot targets include cloud migration, data recovery/forensics, and software selection and implementation. Also in high demand are accounting firms/practice areas that offer outsourced business process and outsourced CFO services, which usually depend on a strong technology platform. We are also seeing emphasis on acquiring and growing international tax, human resource consulting, health care consulting, and wealth management through M&A.

MAINTAINING A COMPETITIVE EDGE IN TECH

Technology has become a key consideration when assessing the cultural fit of two firms considering a merger. Ideally, every aspect of two firms' operating environments fits like a hand in a glove. However, differences are likely. Going forward, an efficiently run firm operates with unified technology platforms. If the long-term strategy for your firm includes the possibility of a merger, you should continue to invest in keeping your technology up to the best practices in the profession — or you need to at least be open to adapting to the more robust technology environment your future merger partner uses. ∎

AICPA RESOURCES

Articles

"Tax Compliance After M&As," *JofA*, Dec. 2017, tinyurl.com/yc5sguhn

"How to Keep Clients After an Accounting Practice Sale," *JofA*, Sept. 2016, tinyurl.com/y96r8wmr

Conference

Digital CPA Conference, Dec. 3–5, National Harbor, Md.

For more information or to register, go to aicpastore.com or call the Institute at 888-777-7077.

Webpages

PCPS Succession Planning Guide & Tools, tinyurl.com/ycumqlos

PCPS Succession Readiness Assessment, tinyurl.com/yby53qh4

PCPS Succession Timing Calculator, tinyurl.com/ydxmdxro

Private Companies Practice Section and Succession Planning Resource Center

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.

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