CPA FIRM SUCCESSION: SOLIDIFYING THE FUTURE

The Culture Test

Eleventh in a series: How to assess and manage the most important factor in accounting firm mergers

by Joel Sinkin and Terrence Putney, CPA

As shown throughout this series, there are many types of succession deals and strategies, each with its own advantages and challenges. In the case of a merger or acquisition facilitating succession, the No. 1 key—and threat—to success is easily identified but not so easily defined. The authors have asked hundreds of managing partners over the years what makes a merger successful. "Culture" is by far the most popular answer. Along the same lines, when asked why a merger failed, managing partners usually say something like "the culture of the other firm was not consistent with ours."

This is important to firm succession for many reasons, the most prominent of which is that accounting firm sale prices most often are determined by a specific percentage of fees the acquiring firm collects during a retention period established by the merger agreement (see "How to Value a CPA Firm for Sale," *JofA*, Nov. 2013, page 30). Failure to retain clients and maintain fees results in a lower price to the seller. What is one primary result of a poor cultural fit in a merger? The merged firm experiences staff and client turnover, which leads to lost fees and a bad deal for both sides.

Managing partners understand that culture is key, but they struggle to define it. Consequently, when firms consider cultural assessment in due diligence, they usually don't know what to look for. This article assesses the most important characteristics of culture and also explains how to structure deals to maximize cultural fit and the chances of a successful merger.

Culture is best understood in three categories: organizational, client service, and owner issues. Following are factors firms should consider in each category when assessing the cultural fit of a potential merger partner.

Organizational Issues

- **Work ethic.** This often can be assessed by reviewing the hours logged by the owners and staff. A firm that expects its owners to generate 1,700 billable hours per year usually has a much different culture from one that sets the bar at 1,000 hours. How many work hours does the firm expect of its staff during busy season?
- **Mobility.** Does the firm encourage

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 11th in the series, examines the role culture plays in accounting firm mergers.

PHOTO BY ANGEL HERRERO DE FRUTOS/ISTOCK/THINKSTOCK its professionals to work mostly in the field, or are they primarily office-based? How does firm leadership feel about staff working from home?

- ***Policies and procedures.*** What can you learn about the firm's value system and management style from reviewing its policy manuals?
- ***Organic vs. acquired growth.*** Firms with a history of internal growth sometimes can have more difficulty acclimating to the culture of another firm in a merger. On the other hand, firms that have grown primarily through acquisitions may have an exceptionally diverse culture resulting from the combination of many different organizations.
- ***Gatekeeper vs. team.*** Does the firm encourage management of client relationships through "books of business," or does the firm embrace the "one-firm concept"? A firm with a strong gatekeeper mentality can have difficulty assimilating into a shared-responsibility environment. Similarly, a firm that creates "partner-loyal" client relationships could have trouble if it is forced into a firm that promotes "firm-loyal" clients. Neither is wrong or right, but a sudden change can affect client experience and be detrimental to retention.

Client Service Issues

- ***Billing procedures.*** How a firm determines fees and bills for clients is a huge cultural issue. A firm that mostly uses fixed fees might have trouble transitioning clients to a system strictly based on hourly rates. Billing rates, which often are used as a proxy for culture, are discussed in greater detail later in this article.
- ***Client demographics.*** A firm's culture has to be consistent with what works for its clients, or they would not remain clients. So reviewing the types of clients—i.e., businesses vs. individuals, size, industries, and services provided—provides an indication of culture.
- ***Staff leverage.*** A firm that has, on average, 10 nonowner professionals for every owner is likely to operate much differently than a firm with a 2-to-1 ratio. The difference for staff and owners in their everyday client service roles can be substantial.
- ***Specialists vs. generalists.*** Some firms pride themselves on their professionals' ability to address a broad range of clients and client needs. Other firms are focused on their people having a much narrower range of skills but being experts in an industry or service area. The transition from one approach to the other can be difficult both for staff and for clients.

Owner Issues

- ***Owners' compensation system.*** How does the other firm pay its owners? Are there performance evaluations? Does the firm use a formula-driven approach or rely on subjective evaluations for a substantial portion of owner compensation? Evaluation of the owners' compensation system provides a bird's-eye view of what the firm values in its owners' roles. To what extent, if any, is weight given to owner billable hours? Is practice development specifically compensated? Is there any emphasis on activities for the firm outside an owner's managed book of business? Which specific areas of management, such as staff development, are considered in owners' evaluations?
- ***Owners' agreement.*** In a similar vein to the owners' compensation system, the owners' agreement also gives an important view of a firm's culture. Most agreements contain an owner retirement plan, which is, in essence, how the firm allocates value among the owners. Is this done based on books of business, an equity ownership percentage, or a multiple of compensation? Is there a concentration of ownership in a few people? Does the firm have tight restrictions on the owners' ability to leave and take clients, or is a lot of freedom allowed? Freedom to leave the firm with business in tow might seem to be a positive if you decide you made a mistake in picking a merger partner. However, the lack of a contractual commitment to the firm can lead to instability and a "free-agent" culture within the firm.
- ***Compensation level and range.*** Two important indications of culture are the absolute level of average owner com-

EXECUTIVE SUMMARY

- **Managing partners cite culture as the No. 1 key to success in accounting firm mergers—**and poor cultural fits as the top reason that mergers fail.
- **Accounting firms struggle to define culture.** They know it's important, but they don't know what it is.
- **Three main components to culture are** organizational, client service, and owner issues.
- **Deal structure plays a critical role in determining culture and its effects on a merger.** Firms should focus on how the merger terms will affect staff and client retention.
- **There are many ways to address cultural differences.** One possible approach is to remove contingencies from the terms of the deal.

Joel Sinkin (jsinkin@transitionadvisors.com) is president, and *Terrence Putney* (tputney@transitionadvisors.com) is CEO, both of Transition Advisors LLC in New York City.

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.

pensation and the range from the highest-paid to the lowest-paid owners. It is not necessarily a deal killer if one firm's average owner compensation is $175,000 and another firm's is $400,000 if it's clear what is causing the difference and what is likely to happen over time.

Is there a good chance the gap can be narrowed due to the lower-compensated owners' taking advantage of a more profitable operating environment? Will resentment develop if the gap isn't closed? Is there little difference in the compensation range, or, in the extreme, are all the partners compensated equally? Little variance in compensation indicates that the firm values the collegiality of its owner group, although it also can indicate conflict avoidance at the expense of performance. A large range from top to bottom can indicate a culture that values the difference in individual performance within its owner group. In its extreme form, though, it can indicate that the firm places little value on the owner group's working as a team.

Effect of Deal Structure on Culture

The type of deal that is being contemplated should have a significant effect on the relevant cultural issues. If you are considering a sale of your practice with a short-term working arrangement with the successor firm, many of the cultural issues above may not be important. Normally, if you focus on the cultural issues that affect your clients, you can ignore the rest, such as most of the owner issues. Client retention following an acquisition almost always affects the value you are paid for your practice. If it is important to you that your staff be retained, most likely because of the impact their loss could have on clients, then consider how the integration of your culture and the other firm's culture will affect them, too.

In a sale, the departing owner often will work for three years or less at the acquiring firm and usually under a compensation arrangement that is formula-driven without regard for how the acquiring firm pays its owners. The fact that you, the seller, would not necessarily have chosen to work at this firm for 20 years or more due to its culture should be irrelevant if the firm can achieve your primary goals for the acquisition, especially client retention. The deal provides you with a succession team you don't have now and keeps the practice intact to maintain its value. This can be especially difficult for owners of small firms to understand. They often will never find a firm that fits the culture they built in their firm because that culture was so dependent on them.

Managing Cultural Differences in a Merger

Some differences in culture can be overcome by executing a plan to *change* a cultural difference—for instance, owner-level billing rates. It is not unusual for acquiring firms to conclude strictly based on a difference in owner billing rates that the cultures of the two firms are incompatible and, therefore, walk away from

AICPA RESOURCES

***JofA* articles**

CPA Firm Succession series

- Part 10: "How to Maximize Client Retention After a Merger," April 2014, page 42
- Part 9: "Managing Owner Transition Through an Owners' Agreement," March 2014, page 42
- Part 8: "How to Manage Internal Succession," Feb. 2014, page 38
- Part 7: "Alternative Deal Structures for Succession," Jan. 2014, page 42
- Part 6: "Seven Steps to Closing a Succession Sale," Dec. 2013, page 48
- Part 5: "How to Value a CPA Firm for Sale," Nov. 2013, page 30
- Part 4: "A Two-Stage Solution to Succession Procrastination," Oct. 2013, page 40
- Part 3: "How to Select a Successor," Sept. 2013, page 40
- Part 2: "The Long Goodbye," Aug. 2013, page 36
- Part 1: "Mergers Emerge as Dominant Trend," July 2013, page 52

Other *JofA* articles

- "Succession Planning: The Challenge of What's Next," Jan. 2013, page 44
- "Planning and Paying for Partner Retirements," April 2012, page 28
- "Mergers & Acquisitions of CPA Firms," March 2009, page 58, and "Keeping It Together: Plan the Transition to Retain Staff and Clients," April 2009, page 24 (two-part article)

Use **journalofaccountancy.com** to find past articles. In the search box, click "Open Advanced Search" and then search by title.

Publications

- *CPA Firm Mergers & Acquisitions: How to Buy a Firm, How to Sell a Firm, and How to Make the Best Deal* (#PPM1304P, paperback; and #PPM1304E, ebook download)
- *Management of an Accounting Practice Handbook* (#090407, loose-leaf; and #MAP-XX, one-year online subscription)

CPE self-study

- Advanced Mergers, Acquisitions, and Sales: Complex Case Study Analyses for Closely-Held Businesses (#732868)
- Making Key Financial Decisions: Practical Tools and Techniques for Making Your Key Financial Decisions (#733835)
- The Strategic Planning Process: A Complete Practical Guide (#745272)

Conference

- Practitioners Symposium and Tech+ Conference, June 9–11, Las Vegas

For more information or to make a purchase or register, go to **cpa2biz.com** or call the Institute at 888-777-7077.

Survey reports

- *2012 PCPS Succession Survey* (sole proprietors), **tinyurl.com/ptyegnk**; and *2012 PCPS Succession Survey* (multiowner firms), **tinyurl.com/qzhabug**

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** and the Succession Planning Resource Center at **tinyurl.com/oak3l4e**.

the opportunity before investigating further.

However, when you dive deeper, you may find that this problem is easily overcome. Smaller firms don't have the luxury of assigning tasks to a wide range of experts on staff. As a result, owners can find themselves doing work that a senior staff person could handle. When this happens often enough, it tends to cause the firm to hold down its standard billing rates to avoid frequently mispricing its services. Even though an owner might have a standard hourly rate of $150, when that professional is truly functioning at his or her highest level, he or she could easily be worth $250 per hour or more. After merging into a firm that has a wider range of staff expertise available, an owner might be able to raise his or her standard rate without increasing the price of services to clients, by distributing work to lower-level staff. The key to overcoming that cultural difference is for the merging owners to recognize this opportunity and execute a plan to raise their rates.

Another way to address cultural differences is through contingent terms. From the acquirer's perspective, if there is a concern the clients and staff may not assimilate well into a different culture, contingent terms for the buyout can lead to (1) more motivation for the seller to execute the integration plan and (2) protection from the risk of lost business due to a poor integration of cultures.

From the seller's side, the authors have seen deals set up in which a contingency is removed from the deal if the buyer doesn't follow through with a commitment to execute a plan to incorporate a dissimilar culture into its practice. For instance, if the acquiring firm does not offer a service the selling firm offers, the seller might rightly be concerned whether the buyer will retain that portion of the business so the seller can be paid. Assuming the buyer commits to a plan to offer that service (if the buyer doesn't and it's material to the seller's value, it might be best to walk away), the deal could be set up to lock in the price with respect to that portion of the practice if the buyer doesn't live up to that commitment. ❖

> Client retention following an acquisition almost always affects the value you are paid for your practice.