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Voices The emotional side of firm M&A

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While much has been written about the technical and financial aspects of mergers and acquisitions between accounting firms, one of the most important but often overlooked stages of the process involves the emotional side of an affiliation.

This holds particularly true for the firm that is selling or merging up.

Change is always challenging. For many smaller firms entering an upstream merger, having additional accountability can be a daunting concept to accept.

Many times we have heard practitioners who are contemplating merging upstream confide to us that their biggest fear is becoming a small fish in a big sea, as opposed to staying the course where they are "master of their own domain." Some of these concerns are a bit exaggerated but, conversely, when you merge up to a larger practice, there are more partners in the mix, and thus a greater degree of accountability. But getting comfortable with the benefits of having a deeper team with greater resources will far outweigh remaining with the status quo.

Emotions play a role in varying aspects of accounting firm M&A. For instance, take the firm name. Emotions may surface when the name of the combined firm is up for debate.

But for the overwhelming majority of firms, the firm name is far less critical than many owners realize. Although this may seem counterintuitive, it is particularly true for the majority of firms whose clients are "partner-loyal" as opposed to "brand-loyal." Spreading the message that it is not the loss of the seller firm but rather the gain of the successor is far more vital than which name is on the door.

Client fears

If you understand and help overcome the four main fears many clients have when they hear of a merger, this will help you maximize retention. Those four main fears are:

- Is the partner I am used to dealing with still going to manage my account?
- Is this going to cost me more money for the same services?
- Will I have to drive somewhere very inconvenient to see my accountant?
- Is the staff I'm accustomed to working with still going to be there and work with me?

If you can reassure the clients on all of these counts, other factors such as the name of the firm become a non-issue. Why would a client go to a complete stranger as opposed to remaining with the people they trust?

Generally speaking, smaller firms have more emotions in play, while for most large firms it is more of a traditional "business deal." We cannot tell you how often we have heard owners of small firms say, "No one can retain my clients if I'm not there." Well, if that is true, then the harsh reality is that your firm has no value. The truth is, if you are selling, it is essentially the same as a merger. It is the message you need to send about the gain of the successor firm versus the loss of your firm, coupled with a proper transition, that lays the foundation for a successful affiliation and helps maximize client retention.

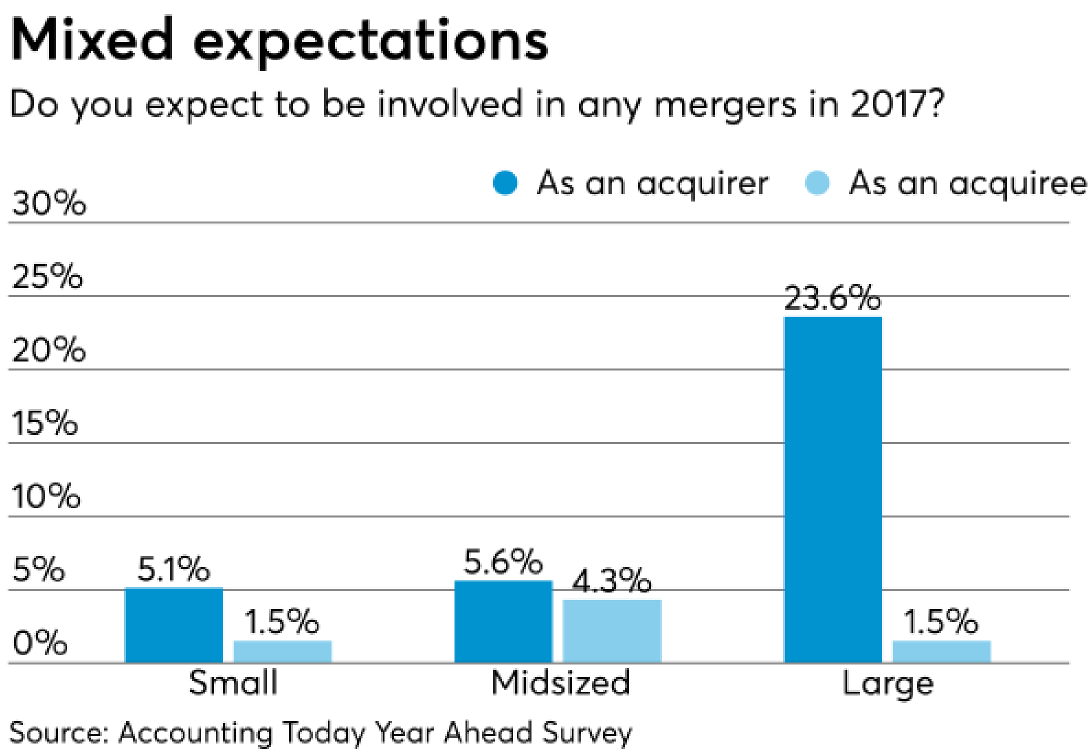
Many small firms are emotional when they equate retirement with death and that their clients couldn't survive without them. Another example is when the seller firm fights for retaining their office space even though the successor firm is geographically sensitive. We have seen mandatory retention of a clerical person who has no client contact but has been with the seller firm a long time become a formidable roadblock to the success of a deal. A sense of loyalty is critical, but at the end of the day it is a business arrangement that needs to make sense for both parties.

Valuations

Even the value assigned to a seller firm can spark an emotional response. It can be viewed by many as a "scorecard" of their firm's success. We have also seen firms argue that they spent a multiple of 1.5x when they acquired the firm or bought out a retiring partner 20 years ago. They feel they cannot sell it for less despite the fact they have gotten 20 years of value and the market has changed. Firm valuations are noticeably less than they were 20 and even 10 years ago. We have seen firms battle toward getting more money upfront, claiming the need for the successor firm to have some "skin in the game." But consider this: Between replacing a seller's accounts receivable and work in progress, integration costs including IT, and relocation and closing costs, successor firms frequently are investing roughly 35 percent of the annual gross fees the seller is generating, prior to even realizing their first dollar from an acquired client. Doesn't that translate into having some skin in the game? Demanding a large down payment typically reduces the audience and the multiple, which makes little or no sense in most cases, but once again emotions are in play and can cloud better judgment.

Another area where we have seen emotions get the better of someone is when a seller places demands that are unrealistic regarding their compensation for staying on post-closing in a part-time role. Recently, we had a CPA explain he would never work for less than $150 an hour. He was getting 20 percent of gross collections as his purchase price and wanted $150 an hour, although he was only billed out at $200 an hour. We explained to him that between his requested compensation rate, which was 75 percent of what he is being billed out for, and add to that the 20 percent he was getting in collections for the purchase price on work he performed, the firm would have to pay him 95 percent of the collections received, even though the firm netted only 35 percent. That obviously was impractical. We strongly recommended working for the cost of replacement labor or, for example, one-third of what he was billed out for. Foolishly, he refused to blink. It's now been more than two years since his closing and the successor firm has rarely asked him back to work on a part-time basis.

As much as practitioners don't want to change after a merger, neither do their clients. Thus, reassuring those of continuity as opposed to change will go a long way toward client retention. An important aspect of having a strong transition is another critical emotional issue — "letting go." If you remain the only person who speaks to and manages a client, and you need to transition them, letting go is critical. This doesn't mean abandonment and moving the trust away from you to someone else, but rather bringing someone else into that sacred circle of trust.



How it's done

Just last year we witnessed a textbook example of a proper transition strategy. A firm client called and asked for a partner who was reducing their time commitment and currently focused on the transition plan. The client insisted on speaking to "John," the owner, explaining that he received the same letter from the government that they had some eight years earlier and it was, in his words, "a nightmare to deal with." The client was adamant: "John will remember how to handle it."

John called the client back and agreed that it was indeed a difficult situation to resolve. But instead of discussing how to address the problem, he said that his partner Jane (who was the designated successor of this client) had a lot of expertise in this area. John further explained a lot of laws had changed and getting Jane's feedback was critical. Jane ultimately called the client back with the plan on how to address the issue. Had John answered that original question of what to do next, no transition would have taken place.

Another critical aspect surrounding the emotional side of M&A you'll see is in the timeliness (or lack thereof) of communication between the successor firm and the firm merging up or selling. For a firm merging up or seeking succession, this is, for most, the last and most important decision they'll face relating to their firm. Furthermore, it is most likely the most important thing on their desk. When/if they get a feeling that the successor firm doesn't view it with the same degree of importance, emotions can quickly take over.

Recently, there was a firm going through an upstream merger — the affiliation was, for some partners, growth-oriented, while for others it was for succession. The managing partner of the seller firm asked the successor practice for some basic information, which was in all likelihood readily available. When it took far longer than it should have to forward the request, the firm merging up called us and suggested the larger firm "must be so busy based on how long it took to get this information to us that either they don't have the capacity to take our firm into theirs or perhaps this is just not that [high of] a priority." In this case the proverbial adage, "Time kills all deals," was true based on the unintentional message sent and the emotional reaction to it.

Equity can also be more emotional than reality in some circumstances. For example, if someone is merging into your firm and retiring two years later, is equity really a good thing for them to have? Emotionally, some feel, "I have always been an owner and must be one post-merger." Well, we would have advised that they want to be held out as a partner but not accept any equity or the liability and exposure that accompanies equity. In some mergers, the firm merging up made someone a very small equity owner, frequently as a tool for retention. Now as this firm goes to merge up, does anyone believe the successor firm is going to make someone who is a 2 percent equity owner in the smaller firm an equity partner in the combined firm?

Not very likely. But emotionally, it can be difficult for this minority partner to accept a non-equity position, even though it may make a ton of business sense. A possible method of addressing this situation is if the successor firm would make them a non-equity partner and define a path to equity. Sometimes it calms the emotions if they can still have a title of partner, even if they are a non-equity partner.

Speaking in general terms, emotions can lead to unneeded "must-haves." They include but are not limited to the firm name, location, staffing, titles, valuations and per diem rates. We frequently see the heart getting in the way of the brain where emotions stop even common sense. All that said, we totally get it and respect these emotions and respect where most come from. Most CPAs we work with have a strong connection to their client base.

Our recommendation to the successor firm is that they include in their deal-making focus the fact that emotions will often play a strong role in the negotiation process. Understand that, in many cases, the firm merging up or selling has been operating in a similar way for decades. They have seen clients grow and now are serving the second and even the third generation of their original client base. They believe their clients are comfortable with how their accounting firm is managing them, and thus the very real fear of change.

Helping the merged-in firm see how you are focused on many of the same issues is critical to success. Share with them that most changes will be done gradually. Show them your respect for what the seller or merger candidate has developed that makes their clients want to remain, and explain in detail your plan to make everyone comfortable. The financial terms will often work out easier than the emotional ones.

Remember, no one acquires a firm to lose money and sellers don’t have to be Santa Claus with regard to over-generous terms. Working the fine line for the successor firm to reap a benefit from an affiliation, and the sellers being paid fairly for their years of sweat equity, is a manageable strategy.

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