accountingTODAY

Voices Making 2+2=5 in a merger

By
Terry Putney
Joel Sinkin

Published
October 29 2018, 12:49pm EDT

When assessing a target firm for a potential merger or acquisition, many acquiring firms make the mistake of projecting future profit solely based on the historical profitability of the selling firm. When we consult with our clients we recommend the acquiring firm certainly use historical profitability as guide.

However, the real test is evaluating how profitable the seller's practice will be once combined with the acquiring firm's operating environment. This approach can result in the conclusion that the practice will be more profitable than it was as a stand-alone or – unfortunately -- less profitable. This article examines a few variables that impact the profitability of an acquired practice.

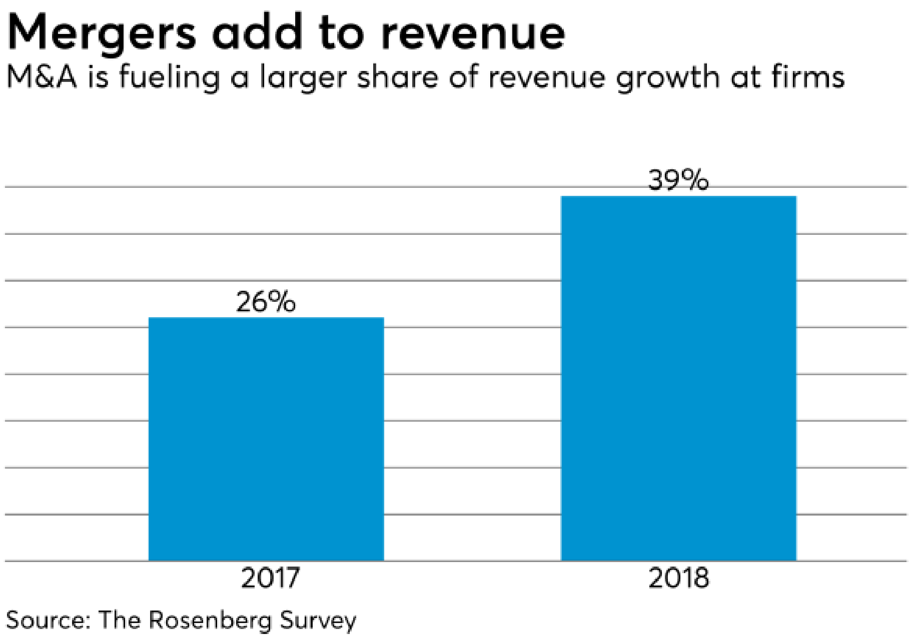
1. Technology

In a recent merger, the firm merging up was on a dated IT platform. The acquiring firm rightly baked into their evaluation the cost of the necessary technology upgrades. However, they initially overlooked the upside potential their up-to-date IT environment would create. The technology platform the acquiring firm used was expected to improve the efficiency of the workflow for the target firm. The net impact was the acquiring firm would be able to cut a lot of time off client service projects, which would increase profitability without raising fees. The result was an expectation of making the acquired firm incrementally more profitable in the acquired firm's operating environment despite the upfront investment required.

2. Leverage

Last year we were consulting on a merger of a small two-partner firm generating approximately $1.5 million in annual fees. The firm operated uniquely in that the two owners did all the heavy lifting. Their staff was basically made up of bookkeepers and clerical personnel. The acquiring firm was initially concerned about the fact these two partners' billing rate was $200 per hour, which was more than $100 below their partner billing rates. We suggested to the acquiring firm they dig deeper. We had already determined that the partners in the target firm were working on a lot of client service tasks that a partner in the acquiring firm would be delegating. In fact, it appeared a significant amount of partner billable time in the target firm could be done by staff in a larger firm that might have a $150 hourly rate. Thus, after further review, the acquiring firm concluded that the lower partner billing rates were not an issue in this case since they would be able to delegate the lower level work to staff the target firm didn't even have. The target firm partners agreed to this strategy and were happy to adopt a $300+ billing rate for true partner level work.

Most successor firms have a much deeper bench than firms they are considering for an acquisition. A key part of the due diligence analytics that a successor firm needs perform on a firm they are acquiring or merging in is to determine if they can reasonably expect to leverage work down to lower-level professionals, thus potentially increasing the profitability of the deal. The key to assessing profitability due to client service pricing metrics is to determine if the fees the successor firm will have to charge for various deliverables are similar to what the target firm is charging. Hourly billing rates alone can be misleading.



3. Quality control

This has the potential to sneak up on a successor firm that is not looking at the quality control process of a firm they are targeting. In a recent merger we consulted on, we pointed out that the target firm they were evaluating had a very thin audit team. One audit partner was managing all the audits without a secondary review. That partner was also doing a lot of the actual work on the audit. Meanwhile, the successor firm's QC system was much more robust. For instance, they required two reviews by professionals that had not performed the audit procedures. The problem became evident when they matched up fees charged with audit workpaper files in a representative sample of audits. They could see they would have to either significantly increase fees or accept poor realization. As a result, the parties identified specific client engagements that might be at risk for loss due to increased fees and they modified the terms to address that risk.

4. Synergies versus upfront investment

Post-merger profitability can be positively impacted by synergies. Most mergers or acquisitions will generate synergy through cost savings if you are willing to identify the opportunities and execute the plan. Generally, you will have a better chance of cutting costs if the two firms do indeed combine under one roof. You'll likely save on rent and other infrastructure costs even if you have to expand your office space. Savings in personnel are most likely going to come from administrative personnel. Don't forget that retiring partners in the target firm will be accretive to the combined firm's partner compensation pool, too.

So, how should you factor in the benefit of cost synergy when evaluating a merger or acquisition opportunity? If the two firms are not on the same IT platform, an estimate of $10,000 per person is often used for the cost of migrating and training on the new system. Updating websites, transition and integration costs, closing fees, moving, and training the new team members are additional expenses you can expect. It is not unusual for the acquiring firm to invest 10 percent to 15 percent of an acquired firm's revenue in upfront costs. Some firms that are considering an acquisition or merger can't get past that investment. However, those are one-time costs. Whatever cost synergies you can find are ongoing and often will offset the upfront cost within a year or two, and can also be as much as 10 percent to 20 percent of the acquired firm's revenues.

5. Tax consequences

Often in acquisitions, the two parties focus on the terms of the deal, but fail to identify the tax structure of the deal until the end. We consulted with an acquiring firm recently that told us they worked everything out and just needed our guidance on integration, transition planning and agreement review. When we inquired as to the deal terms, they shared with us a pricing multiple that was agreed to, term for payments, and how client retention would affect the payments. They thought that was all they needed to address. Not only did they not consider the treatment of the target firm's AR and WIP, and other critical issues, we found there was no agreement or even discussion of tax treatment for the payments. As often happens when the matter is overlooked, the parties were at opposite ends. Many sellers in acquisitions assume they will be selling assets and will be able to treat the deal as a capital gain. Buyers, on the other hand, usually assume the deal will be structured to be deductible as paid. We've seen too many deals fall apart because the parties got too far into the negotiations before tax treatment was addressed.

The profitability of a deal for the buyer and seller depends on tax treatment. Increasingly, we are seeing some deals structured to give the seller better tax treatment through at least a partial asset sale in exchange for a longer payment period. If the payments are paid over 10 years, for instance, and the assets are amortized over 15 years, the effect on the buyer is minimal and the seller has a much better after-tax outcome, which can make waiting for the payments worthwhile.

If there are 50 things you need to know about completing a successful merger or acquisitions, the smartest person in the room will typically get to 35 of them. Hopefully this article will help get you closer to the 50.

Terry Putney, CPA, is the CEO of Transition Advisors.
Joel Sinkin is the President of Transition Advisors.