Pricing Issues for Small Firm Sales

What partners need to know to maximize proceeds when selling their practice

by Joel Sinkin and
Terrence Putney, CPA

For CPAs looking to sell their accounting practice, it can be a big plus to be in a small firm. That's because small firms generally can command higher multiples than big firms, and external sales usually produce higher prices for accounting practices than internal ownership transfers.

Those are two of the trends that will be explored in a three-part series on valuation issues in accounting firms. This article focuses on small CPA firms. The next two articles will address valuation issues for large CPA firms and internal transfers of ownership.

Here are a couple of definitions specific to the series:

PHOTO BY WRAGG/ISTOCK

- Value is not meant to be consistent with the conclusions that a CPA Accredited in Business Valuation (ABV) would reach in a formal business valuation performed for, say, litigation or an estate. Instead, value refers to the price to be paid for the practice—which often is expressed as a multiple of revenues, as is discussed in further detail later in this article.
- Small firms, generally speaking, are those with four or fewer owners. This is because the vast majority of business combinations involving the acquisition of firms with more than four owners are at least partially a merger rather than a sale.

In a merger, some or all of the acquired firm's owners become owners in the successor firm. This is an important distinction because, in a merger, the successor firm's owners' agreement usually dictates the value of the equity for owners who are a party to the agreement (though not always, as will be explored in next month's article on large firm valuations).

In transactions with smaller firms, it is much more likely the transaction will be in the form of a sale. The sale can be immediate, meaning the payment of the proceeds commences at closing, or in the form of a two-stage deal, in which the proceeds are delayed for a few years, with the selling owners continuing to work full time while transitioning the practice (see "A Two-Stage Solution to Succession Procrastination," *JofA*, Oct. 2013, page 40).

The primary factors that drive the value of a small firm in a sale are (1) the terms of the transaction; (2) the number of buyers potentially interested in the practice; (3) the attributes that will affect the profitability for the buyer of the practice; and (4) the nature of the practice. This article explores those factors in more detail.

1. The Terms of the Transaction

As mentioned earlier, the price paid for a firm often is expressed as a multiple of revenues. However, the multiple a seller is willing to sell the practice for, and the buyer is willing to pay, is directly related to other terms of the transaction. The five primary terms that affect the multiple are (1) the upfront purchase payments; (2) the number of years the remaining payments are made; (3) the period during which the payments are subject to adjustment for retention of acquired clients and the extent of the possible adjustment; (4) the tax treatment of the payments; and (5) the potential profitability of the practice for the buyer. The more those factors favor the seller, the lower the resulting multiple will tend to be and vice versa (see "How to Value a CPA Firm for Sale," *JofA*, Nov. 2013, page 30).

Retention of acquired clients tends to be the factor that most significantly affects a small firm's value. The reason for this is that client relationships in smaller firms tend to be much more connected to the firms' owners. Those owners are often much more hands-on with clients, who often can't differentiate their relationship with the firm from their relationship with one of its owners. The larger the firm becomes, the more likely it is that clients will see their relationship as institutional. In those cases, the clients will have relationships with several key people in the firm and be less tied to a particular owner.

In virtually any deal that places value on the transfer of client and staff relationships, provisions restrict the seller from competing with the buyer firm for those relationships for a reasonable period following the sale. Without this type of restriction, the buyer has no assurance that the acquired relationships, which represent most of the practice's intangible value, can be sustained.

In most cases, the seller's direct involvement in the transition of client relationships is a key to transferring loyalty to a successor in the acquiring firm. To ensure that happens and to motivate the seller to execute the plan, most deals have clauses that directly tie the seller's purchase proceeds to the buyer's client retention over a certain period. For example, assume a buyer agrees to pay a revenue multiple of one times for a $1 million practice. The deal calls for the buyer to pay over five years based on the percentage of clients that stay with the firm for two years after the sale. If clients representing 80% of the revenue stay with the successor firm through the second year, the seller will receive $800,000 for the practice.

Retention periods tend to fall into three categories: (1) one-year retention periods; (2) two-or-more-year retention periods; and (3) full-collection deals. The duration and nature of the retention period can affect the final sale price in a variety of ways.

> In most cases, the seller's direct involvement in the transition of client relationships is a key to transferring loyalty to a successor in the acquiring firm.

One-year retention period. In deals with this term, the final purchase payments are based on the collected billings from the seller's clients for the first year following the closing. While many sellers believe a shorter retention period results in less risk for them (due to less time for clients to leave the buyer firm and lower the seller's proceeds), that has not been the authors' experience. When the deal locks in the price after the first year, most buyers counter (if they will even consider the deal) as follows:

- They offer a reduced price multiple because of increased perceived risk.
- They are less patient with the transition and tend to institute changes quickly. Most buyers understand they are much better off losing a client during the first year than shortly after the retention period expires. An aggressive transition can cause greater client attrition.

Two-or-more-year retention period. Retention periods for less than the full payment period can be defined many ways and must be drafted carefully. For instance, in a two-year retention deal, the retention adjustment may be based on the average of two years' collections or on the second-year collections for clients *retained* at the end of that year. Collections from repetitive services might be the only ones included in the calculation, with special one-time services treated entirely differently.

Two-year retention periods tend to work better than one-year periods because buyers understand that most clients retained *after* the first year have affirmed their transition to the successor firm. Thus, there is less risk of losing clients in subsequent years. A two-year-or-longer retention period can often lead to a better offer and a more gradual transition, resulting in better retention. It should be noted that very large clients (for instance, those individually making up more than 10% of an acquired firm's fees) may require longer retention periods due to the concentration of attrition risk.

Collection deals. An example of a collection deal is a transaction in which a seller is paid 20% of collections from a sold client list for the full payment period of five years (a 100% multiple). Using the same multiple if the seller is paid over four years, the price would be based on 25% of collections during the payment period. The advantage this approach has for the buying firm should be obvious. The firm pays only for the clients retained based on fees generated during the payment period.

This is advantageous for the selling firm. First, the seller often is in a position to negotiate a higher multiple due to removing the risk of client attrition from the transaction. Second, though some loss of clients is inevitable, if the seller selects the right successor firm, there is a good chance fees will increase for the clients that are retained. In a collection deal, the seller usually sees an increase in purchase proceeds due to an uptick in fees, especially from increased services. It is not unusual for the most successful combinations to result in higher fees and much higher purchase proceeds than the seller would have received even if the price had been fixed at closing.

2. The Number of Buyers Potentially Interested in the Practice; and 3. The Attributes That Will Affect the Profitability for the Buyer of the Practice

Why can owners of small firms expect higher multiples for their practices than most of their big firm counterparts? The answer is pretty basic: the law of supply and demand. There simply are many more firms able and willing to snap up a firm with four or fewer owners than there are firms looking to acquire larger operations. Consider the following reasons:

- The vast majority of accounting firms are small, as shown in the 2012 AICPA Private Companies Practice Section (PCPS)/Texas Society of CPAs Management of an Accounting Practice (MAP) Survey. That study split firms into seven categories by annual revenue. Of those categories, only the top two, composed of firms with at least $5 million in revenue, had an average number of partners per firm of at least five. Only about 6% of the firms that participated in the survey had at least $5 million in revenue. That leaves precious few firms with the resources to absorb an accounting practice with five or more partners.
- It is usually easier and quicker to profitably add a small accounting firm than a large one. That's because small firms tend to have less overhead. For example, the authors have encountered many firms capable of absorbing a small firm with little extra costs, if the small firm is not tied down by a long lease and does not demand the retention of redundant administrative staff. A $3 million or $4 million firm often can absorb a $500,000 practice without having to add office space or nonbillable staff. Firms with five or more owners usually require the acquiring

EXECUTIVE SUMMARY

- **Small firms generally command higher multiples of revenue in sales than large firms do.** Small firm deals also tend to produce higher value than internal transfers for ownership.
- **Four primary factors determine the price paid for a small firm.** These factors are the transaction's terms, the number of interested buyers, the firm's profit potential for the buyer, and the nature of the firm.
- **Client retention is essential to maximizing proceeds from a small firm sale.** Most CPA firm sales calculate the amount paid to the seller based on the percentage of clients the buyer retains during a certain period after the sale closes. Small firm clients tend to be more loyal to partners than to the firm as an institution.
- **CPA firm sales have three main types of retention periods.** Full collection deals and retention periods of two or more years tend to produce higher multiples for the seller than one-year retention periods.
- **It's usually easier and quicker to profitably add a small firm than a large one.** That's because small firms generally have less overhead that acquiring firms have to absorb.
- **Baby Boomer retirements are putting more small firms on the sale block.** This increase in supply is driving down values, though the demand for small firms remains high.

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.

firm to pick up the costs of additional office space and administrative personnel. Those costs affect the acquired operation's profitability. The target for cost synergies in an accounting firm sale or merger is 10% to 15%. Those goals can be hit in a large firm merger, but it usually takes a few years. Many firms won't consider an acquisition that isn't cash flow positive (net revenue minus costs, including acquisition costs) in the first year or two.

4. The Nature of the Practice

Certain types of practices tend to command a lower multiple. Some client bases are viewed as difficult to transition because of the unique relationship between the clients and the seller. Litigation support practices are sometimes seen as creating this kind of obstacle.

Another factor driving down the multiple is a practice with a low profit margin. A common example is an outsourcing practice with a relatively low markup on labor costs. A practice with a 20% profit margin (before owners' compensation and benefits) is not going to command the same multiple as a practice with a 40% profit margin.

Certain types of practices also can command a higher multiple, usually because of the opportunity for significant synergy that a specific type of buyer can exploit. For instance, practices that have a significant number of high-income and high-net-worth individual clients often can obtain a premium valuation from a firm that offers wealth management services. The same holds true for firms with client bases that offer the opportunity for cross-selling high-value services by a specific buyer firm. However, a buyer firm that primarily focuses on business services may view a firm with a concentration of high-income and high-net-worth clients as less valuable. Value is always in the eye of the beholder.

TRENDS IN SMALL FIRM VALUATIONS

A flood of Baby Boomer accounting firm owners nearing retirement has created a surge in the number of small firms seeking buyers. The net result is the authors are seeing firm values dropping to some extent in almost every market nationwide. Whereas revenue multiples of 1.5 to 2 were common 15 to 20 years ago, multiples today tend to range from 0.75 to 1.2. Again, the law of supply and demand is in effect, and trends point to growth in the supply of sellers seeking external solutions, which is outstripping growth in the number of buyers interested in providing those solutions.

The good news for small firm owners is that they likely will always be in position to command higher multiples than large firm owners—thanks to the supply-and-demand issues explained in this article. In addition, because large firm acquisitions tend to be at least partially in the form of a merger, the value of the acquired firm is determined at least in part by the successor firm's owners' agreement. As will be explained in greater detail in the third installment of this series, internal valuations are usually lower than external valuations. For those reasons, the authors have seen many more small firms acquired for multiples of one times or higher—a big plus for small firm owners. ❖

AICPA RESOURCES

JofA articles

- "How to Maximize Client Retention After a Merger," April 2014, page 42
- "Managing Owner Transition Through an Owners' Agreement," March 2014, page 42

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

Publications

- *Business Valuation Practice Management Toolkit* (#PPM1208P, paperback; #PPM1211E, ebook; and #PFVSBVTO, one-year online access)
- *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)
- *Essentials of Valuing a Closely Held Business* (#056605PDF, online access)
- *Navigating Mergers & Acquisitions: Guidance for Small and Mid-Sized Organizations* (#PGN1302P, paperback; and #PGN1302E, ebook)
- *Securing the Future: Volume 1: Building Your Firm's Succession Plan; Volume 2: Implementing Your Firm's Succession Plan* (#PPM1307HI, volume 1 & 2 set, paperback; #PPM1305P, volume 1, paperback; #PPM1305E, volume 1, ebook; and #PPM1306P, volume 2, paperback)

CPE self-study

- Critical Tools for Today's Controller and CFO (#741277, text; and #163080, one-year online access)
- Introduction to Business Valuation (#745785, text)
- Understanding Business Valuation (#732886, text)

Conference

- Forensic & Valuation Services Conference, Nov. 9–11, New Orleans

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

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**.

FVS Section and ABV credential

Membership in the Forensic and Valuation Services (FVS) Section provides access to numerous specialized resources in the forensic and valuation services discipline areas, including practice guides, and exclusive member discounts for products and events. Visit the FVS Center at **aicpa.org/FVS**. Members with a specialization in business valuation may be interested in applying for the Accredited in Business Valuation (ABV) credential. Information about the ABV credential program is available at **aicpa.org/ABV**.