PRACTICE MANAGEMENT

Roadblocks to avoid in accounting firm M&A

Whether you are buying or selling, these tips can help you navigate the potential pitfalls on the road to closing the deal.

By Terrence Putney, CPA, and Joel Sinkin

THE PAYOFF

- Potential impediments to closing a firm sale or purchase.
- Firm M&A from buyers' and sellers' perspectives.
- Solutions to common M&A problems.

Due to the current explosion of interest in CPA firms' using mergers and acquisitions as a tool to deal with succession, promote growth, and achieve other strategic goals, many firms find themselves discussing the possibility of combining with another firm. If you find yourself becoming serious about pursuing a merger, acquisition, or sale, several potential roadblocks need to be overcome to complete the transaction successfully.

PLANNING ROADBLOCKS

Ill-defined goals

Develop a clear set of strategic goals for your merger. If you are seeking to solve a succession problem for yourself or your partners, what is the timetable for slowing down? What kind of role would you like to have in a successor firm until you retire? If you are seeking to grow your firm through a merger, define what kind of growth you are seeking. Are you attempting to enter new geographic markets, acquire new skills, or acquire clients to which you can cross-sell services?

Having "bigger is better" as your only goal can lead to acquisitions that are disruptive and fall short of expectations. Also, make sure you understand the other party's strategic goals and expectations for the business plan. Any transaction should be structured in a manner that promotes the execution of the business plan envisioned for the combined firm. The authors too often see business plans driven by the deal terms, which amounts to the tail wagging the dog.

Insufficient information

If you are seeking to acquire or be acquired, think about the four C's (see "How to Select a Successor," *JofA*, Sept. 2013, page 40):

- **Chemistry.** You can usually assess in the initial meeting if there is a fit with the key players. If you don't sense the right chemistry, consider walking away.
- **Continuity.** Maintaining some continuity is a key to retaining clients and staff. Define what you believe is essential to the way you operate your firm so you can assess how merging with another firm would affect clients and staff.
- **Capacity.** If you are seeking to solve a succession problem, the successor firm will likely have to replace you or a partner in the near future. Make sure the firm has or will have the right person—or people—in place to do that.
- **Culture.** When considering a merger partner, ask yourself, "What is it like to be a client of this firm? What is it like to be a partner or staff in the firm? What does this firm value as keys to success? Are those values compatible with the way we operate?"

If your firm is seeking to be sold, develop key operating and demographic data about it and be ready to provide the information early in the process. What services do you offer? Which kinds of clients do you serve? How do you serve them? What in general are they paying? What is the makeup of your professional staff? What does the technology environment look like? What are the ▶

ILLUSTRATIONS BY RETROROCKET/ISTOCK

Copyrigt 2015. American Institute of CPAs, Inc. All rights reserved. Reprinted with permission from the Journal of Accountancy.

requirements and limitations with respect to office locations and leases?

This information should be shared no later than soon after the first meeting, or even before the meeting, if circumstances allow. Information shared at this time should be generic and not include client names. Later, when the framework for a deal has been agreed to and both sides are ready for more robust due diligence (see "Do's and Don'ts of Due Diligence," *JofA*, June 2014, page 26), be sure to sign nondisclosure agreements before sharing the information.

Develop an understanding of what is realistic for the deal structure. If you are selling, the buyer firm is unlikely to agree to terms that will lead to negative cash flow for longer than the first year, if even that long. If you are making an acquisition, don't expect anyone to join your firm and take a big reduction in compensation without an adjustment in workload or role.

DEAL ROADBLOCKS

Inflexibility regarding firm name

A common roadblock in mergers is the name of the successor firm. Acquired firms often worry about losing their brand identity, but that fear usually is unfounded. Firms frequently change their names for reasons other than a merger or acquisition with no negative effect. The fear of name changes often is rooted in the belief that clients and the community will make negative assumptions about what did or did not happen in the merger—based strictly on the successor firm's name. For example, a merger can outwardly appear to be a "takeover" because of the naming convention.

The proper way to convey the consequences of a merger is by thoroughly communicating why the firms merged and how the client base benefits from the merger. That message carries more weight than a name change. That said, there may be valid marketing reasons to retain an acquired firm's name if it has significant brand equity. This can be the case with firms that have a dominant niche. In these situations, it is common for the acquired firm to be referred to as a division of the successor.

Incomplete or nonexistent partner agreements

If you are seeking to merge in a firm and make new equity partners as a result, evaluate the attractiveness of your partner agreement. Avoid these potential pitfalls:

- If you don't have a signed owners' agreement, create one. Simultaneously negotiating a new agreement with not only the new firm's partners but also among your own partners may significantly delay the process, lowering its probability for closing. Finalize an owners' agreement before exploring the M&A market.
- Your owners' agreement is the currency for the deal. If your partner retirement terms are significantly below market, you may have difficulty persuading new partners to join. If you aren't willing to modify those terms, you may be able to overcome this barrier by targeting firms where this will not be a priority. New partners who are 20 years away from retirement are likely to place less emphasis on their eventual buyout than a partner who is six years away from retirement. Be prepared to grandfather certain items, such as vesting, for new partners, when necessary.
- Your approach to owner compensation will have a major impact on how potential merger partners view the opportunity you present. Drastically modifying your owner compensation method usually isn't necessary. However, if owner compensation is based on subjective factors, you may need to limit the risk for new partners for the first couple of years to make them more comfortable.

IN BRIEF

- Several roadblocks can stop the sale or purchase of an accounting firm. These can be divided into three categories: planning, deal, and process.
- Planning roadblocks may include ill-defined goals and insufficient information about culture, business plans, and key operating and demographic data.
- Deal roadblocks can be related to the firm's name, partner agreements and admission policies, and entrenched location and lease positions.
- Process roadblocks can consist of excessive delays, piecemeal contract negotiations, surprises during final draft negotiations, and intense emotional reactions by the parties involved.

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.

Sample timeline for accounting firm M&A

Time required	Step	Comments
2–4 weeks	Introductory meetings	Try to come to the first meeting ready to exchange information about each firm. Be ready to talk about the proposed business plan, what success looks like, and deal terms at no later than a second meeting.*
1–2 weeks	Nonbinding offer letter or letter of intent	Document the specific terms of a deal and gain an agreement between the parties.
1–2 weeks	Perform field due diligence	This involves reviewing files and facilities and confirming data exchanged earlier in the process.
2–4 weeks	Final agreements	You can shorten the time required for this step if you start it during due diligence.
6–12 weeks	Complete process through closing	
Throughout the process	Transition planning	Includes planning for the communication with clients and staff as well as operational integration. This should be performed during the due-diligence and agreement phases.

* If the parties are unfamiliar with each other, a first meeting strictly for the purpose of making sure the cultures and personalities are a fit might be required. Once that step is completed, make sure you discuss potential deal terms at no later than the third meeting. Remember that not all introductory meetings need to be in person. Once a face-to-face meeting has been held, subsequent meetings can be by phone to expedite the process. Keep in mind the effective date of the deal can be later than the closing. This may help make a shorter timeline for the deal process more palatable.

Entrenched lease and location issues

Disputes over office locations and leases trip up far too many deals. Whether you are a buyer or a seller, being flexible on this issue enhances the chance of successfully closing a deal. Sellers often attach undue importance to maintaining their existing offices. Granted, most sellers can't abandon an unexpired lease of three or four years and have a deal make financial sense, but subleasing, even if at below cost, can make this problem much easier to manage. Requiring a buyer firm to operate from the seller's location for an extended period limits the population of potential buyers to those that want to be in that location and/or that don't have an existing office nearby. Buyer firms are growth-oriented, and they may be hesitant to get locked into office locations and leases that limit their growth.

Similarly, a buyer firm can hamstring its efforts by demanding that a selling firm be willing to close its office(s) and move into the buyer firm's space. This approach limits the market for acquirable firms to those that don't have geographically sensitive client bases and staff, in addition to virtually no unexpired lease terms. A more flexible approach would call for operating from the acquired firm's offices during a transition period and a willingness on the buyer's part to share or cover the reasonable cost of an unexpired lease.

Inequitable or inadequate equity related to partner admissions

Equity is another issue that raises unnecessary roadblocks. Sometimes, a buyer firm is unwilling to admit all of the selling firm's partners as equity partners in the combined firm. Legitimate reasons may support this position, but the more partners in the targeted firm you refuse to grant an equity share in the combined firm, the less likely you'll be able to close the deal.

Sometimes you need to think beyond the norms you have for admitting new partners. In a recent deal the authors were involved in, a firm whose average equity partner managed $1.5 million in fees was negotiating with a $2.5 million firm that had four equity partners. The two younger partners managed books of business of $300,000 each. The buyer firm could not justify admitting four new equity partners, and if someone had to step back, it would have to be the younger partners due to their lack of adequate client volume. However, this approach made no sense in the long term. The senior partners at the selling firm were two or three years away from retirement. They didn't need to become equity partners in the successor firm as long as they retained the title of "partner." Their eventual buyouts could be governed by separate, stand-alone agreements. And because the younger partners were the logical primary successors to the senior partners' clients,

they were in position to achieve one of the firm's standards for equity partners in a few years. The firm admitted the younger partners as equity partners from the outset to avoid asking them to accept what they would have perceived as a demotion.

Another common tool that helps overcome equity issues is the use of nonequity-partner status for young partners in acquired firms who don't meet minimum standards. So this issue doesn't become a deal-killer, it would be helpful to offer these people a clear path to equity within a reasonable time and to compensate them for the value of their equity in their prior firm.

PROCESS ROADBLOCKS

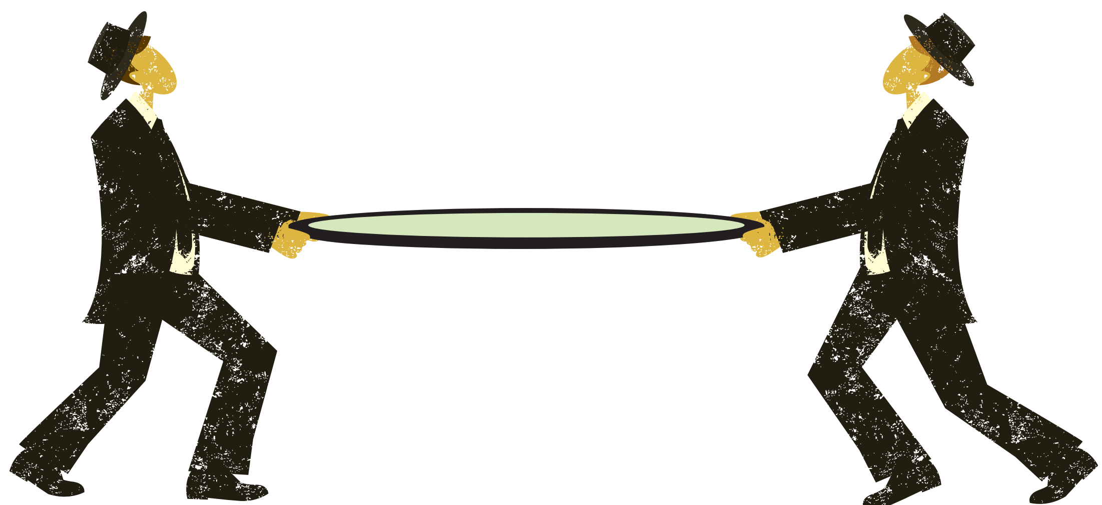
Unnecessary and avoidable delays

As you likely have heard before, delays will derail a deal. But why is this true?

- **Adversarial nature of the deal.** When two firms start the process, they are usually focused on achieving a win-win outcome. However, the longer the parties negotiate, the more likely it is that their individual goals will drive the process.
- **Unintended messages.** When the process becomes protracted, it is invariably because one or both of the parties are not being responsive or are stalling. The authors often hear from firms seeking to be acquired that the other side's delays are probably an indication that this deal must not be a priority, or it's a red flag that the prospective buyer will not have the capacity to take on the selling firm's clients. Buyer firms usually conclude that delays by the seller indicate their offer isn't good enough and that the seller doesn't have the courtesy to just say so. Unintended messages unfortunately often result in a terse note indicating the deal is off. Provide the other side a clear and valid reason for any necessary delays, and make sure you state and meet a deadline for the next step. If you are delaying because you can't make up your mind whether to proceed, it is likely because either you are not properly prepared to do this deal or it isn't the right deal for you.
- **Loss of confidentiality.** The accounting community you operate in is much smaller than you realize. The longer you are in negotiations, the more likely:
  - Staff will find out and perhaps leave out of fear of what a merger might mean for them.
  - Clients will hear about it and start wondering how a merger will affect them.
  - Word will reach your competition, and they start muddying the waters with your clients and staff.

Painfully inefficient piecemeal negotiations

Many times the authors have been brought in to consult on a deal only to find that critical issues have not been addressed. It is important when making offers not to negotiate in pieces but to present all the parts to the puzzle upfront. For example, how can you negotiate the pricing in a sale without addressing the payout and retention periods, tax treatment, and treatment of accounts receivable/work in process?



Think of deal terms sitting on a balance scale. Each variable changes the balance. If you negotiate one variable at a time, the process is likely to become drawn out, and the other side starts wondering if it will ever end. An offer needs to be complete, or you may face the likelihood of constant tweaking, which leads to the deal's eventual death.

Inappropriate term demands during final contract draft negotiations

Issues will arise during the drafting of the final contract. The more significant the problems, the more important it is to discuss them and not just surprise the other side with modifications to the agreements. Sending newly proposed terms not previously discussed can generate bad will and lack of trust. A contract is a tool to memorialize what was agreed to, not to alter the deal. You can avoid this problem by making sure the parties have agreed to a detailed term sheet or letter of intent so that all terms in the offer are the only terms in the contract.

Insensitivity to emotional factors

Particularly for a selling firm, the decision to sell or merge up can be very emotional. It is crucial to keep in mind at all times how these emotions can flare up. This is another reason to be timely and complete with your responses and offers. Be sensitive to the fact that this decision is made based on far more than just a spreadsheet analysis.

SUGGESTED TIMELINE FOR THE M&A PROCESS

The size of the firms involved in a deal will affect the time required to go through the process. Reasonable delays are usually tolerated if necessary to coordinate the schedules of key people who need to be involved in the process. It is harder to justify a delay based on one party's failure to decide how to proceed. Certain types of deals take longer to accomplish. For example, a straight sale typically takes less time to finalize than a large firm merger. Once the parties have decided they want to pursue a deal, they should establish a timeline for the major steps that need to be accomplished (see "Sample Timeline for Accounting Firm M&A" for examples).

With proper planning and forethought of the merger's goals, you can assess how the other party can help you achieve your objectives. This is a key to making the timeline attainable. ■

About the authors

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

AICPA RESOURCES

JofA articles

"Do's and Don'ts of Due Diligence," June 2014, page 26

"The Culture Test," May 2014, page 30

"Managing Owner Transition Through an Owners' Agreement," March 2014, page 42

"Seven Steps to Closing a Succession Sale," Dec. 2013, page 48

"A Two-Stage Solution to Succession Procrastination," Oct. 2013, page 40

"How to Select a Successor," Sept. 2013, page 40

Go to journalofaccountancy.com to find past articles.

Publications

CPA Firm Mergers & Acquisitions: How to Buy a Firm, How to Sell a Firm, and How to Make the Best Deal (#PPM1304P, paperback; #PPM1304E, ebook)

Navigating Mergers & Acquisitions: Guidance for Small and Mid-Sized Organizations (#PGN1302P, paperback; #PGN1302E, ebook)

Securing the Future (#PPM1307HI, volume 1 & 2 set, paperback; #PPM1305P, volume 1, paperback; #PPM1305E, volume 1, ebook; #PPM1306P, volume 2, paperback; #PPM1306D, volume 2, PDF, online access)

CPE self-study

CGMA Learning Program: Strategic Management Accounting (#165350, one-year online access)

Financial and Strategic Implications of Mergers and Acquisitions (#165325, one-year online access)

Succession Planning: Developing Tomorrow's Leaders Today (#BLI165040, one-year online access)

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

Websites

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

PCPS Succession Readiness Assessment (new), tinyurl.com/pvkqgua

PCPS Succession Timing Calculator (new), tinyurl.com/ne73zm7

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. The Succession Planning Resource Center is available at tinyurl.com/SuccessionCenter.