HOW TO NEGOTIATE A CPA FIRM MERGER

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INTRODUCTION

With the aging of baby boomer partners, and a voracious appetite for mergers by the vast majority of firms with $2 million or more in annual fees, a very active market for CPA firm mergers has been created. This monograph is designed to assist firms of all sizes in negotiating a merger, regardless of the merger type:

- Smaller firm merging into a larger firm (upward merger)
- Larger firm merging in a smaller firm (downward merger)
- Mergers of equals or close to equals:
  - Two firms close in size merging together (sideways merger or merger of equals)
  - Two firms of different sizes merging together, but the gap in size is small enough that the smaller firm is able to negotiate terms.

This monograph is organized into sections based on the three scenarios above. However, readers should understand that there is material in each section that often applies to the other scenarios.

The term "negotiation"

The word "negotiation" can take on two different meanings in the realm of CPA firm mergers:

1. "Negotiation" as understood in the true sense of the word: Most or many of the aspects of the merger are open for discussion. Neither
firm enters the negotiations with the intent to impose or force the other firm to "do it their way."

Examples:

a. Name of the firm.

b. Partner income allocation method.

c. Partner agreement including partner buyout plan.

d. How the firm will be managed.

2. "Negotiation" where the smaller firm knows it won’t have much influence on the terms: The partners of the smaller firm are under no illusion that they will convince the larger firm to change its policies and practices on issues such as those listed above. Instead, the smaller firm goes through a process of learning what the larger firm's practices are and assesses whether they can with them. It's possible that a few, minor items could be compromised on.

HOW TO USE THIS BOOK

Since no two mergers are alike, yet many of the same issues have to be addressed regardless, this book approaches some topics more than once, from the views of different merger types and firm sizes/roles. To get an overall sense of CPA firm merger issues, you might benefit from reading the entire book. However, once you begin to familiarize yourself with the key questions and factors, the table of contents can direct you to specific lists relevant to your merger situation.
SECTION 1: THE BASICS OF MERGING ACCOUNTING FIRMS

THE MERGER PROCESS—STEP BY STEP

This monograph focuses almost entirely on the negotiation phase of mergers. However, it's important to understand the flow of the entire process.

Every merger has its unique aspects. It's impossible to choreograph, from A to Z, exactly how the process for all mergers will work. The steps in the process listed below appear in the order of how they commonly occur. But again, because all mergers are different, it is quite possible that the flow of the steps might vary from merger to merger.

1. Decide how you want to search for candidates:
   a. Passive—word of mouth.
   b. Hire consultant to canvas his or her contacts.
   c. Do a mailing: firm can do or consultant can do.
   d. Place an ad.
   e. Join a roundtable group and target member firms who seem qualified.

2. Decide what parameters of a firm are important to you:
   a. Size (fees, # people)
   b. Age of partners (looking for a true merger or a retirement-minded owner group?)
   c. What is your attitude toward taking partners who are nearing retirement?
   d. Staff adequacy
   e. Profitability
   f. Location
   g. Type of work they do and fit with your clients
   h. Specialties and/or niches you are looking for
   i. Billing rates
j. Work ethic  
k. Office lease situation  
l. Software systems compatibility

3. Decide if a consultant will be engaged.

4. Decide what the **deal breakers** and **non-negotiables** will be.

5. Initiate the merger search.

6. Telephone-screen candidates who respond.

7. Hold an initial "get-to-know-you" meeting with short-list candidates. During meetings, each firm:
   a. Describes itself: bio on partners, # people, services, specialties, brief firm histories.  
   b. Shares why they are interested in merging; what they want.  
   c. Describes how they are managed.  
   d. Explains what their timetable might be for proceeding.

8. Have each firm sign confidentiality and non-disclosure agreement.  
   (see Appendix I)

9. Decide on, and begin negotiations with, one firm.

10. Issue a letter of intent and have candidate firm sign and return it. A letter of intent is not common in a sideways merger.

11. Exchange financial statements and production statistics.

12. Partners from each firm meet each other to get acquainted and assess the potential for a culture and personality fit. This is the most important factor for the success of a merger.
13. Commence negotiations. Two or more meetings may be needed to address the following (i.e., it takes too much time to address all of these issues in one sitting):

   a. Major concerns of each firm, and critical and sensitive issues such as the name of the firm, how the firm will be managed, how partner compensation and retirement will be determined, etc.

   b. Important, but less critical issues such as what systems will be used, what policies will be adopted by the combined firm, what the roles of individual partners will be in the new firm, and other partner agreement issues.

   c. Operational issues such as salaries of the staff, benefits, core office hours.

   d. Merger implementation issues (moves, training in software, change-over of telephone numbers, vendors, web sites, etc.)

14. Due diligence conducted by both buyer and seller including work paper review, compatibility of work standards and financial statement formats.

15. Prepare an "English-language" letter that is approved by both firms. This letter merely states in writing everything the two firms have agreed to during the various negotiation sessions. This letter is then given to attorneys to draft a proper, legally binding, merger agreement.

16. Attorneys prepare the merger agreement, which is signed by both firms.

17. Make internal announcements.

18. Send out external announcements.

19. Close the deal.

20. Implement the merger.
WHAT MAKES A FIRM MOST ATTRACTIVE TO A MERGER PARTNER

These apply to all types of mergers.

Pluses

- Reasonable profitability
- Talented people; stars
- Partners who leverage and delegate
- Industry and/or service specialties
- Clients that will stay; age of clients
- Partners who will work for several years and not retire immediately after the merger.
- An urban (vs. rural) location
- Special expertise that your firm could use
- A client base that is more business-oriented than 1040-focused
- A client base with potential to purchase diverse services of a larger firm
- Heavy audit, review, compilation and corporate tax business (vs. bookkeeping and write-up)
- Firms use the same software
- Growth
- Low volume and high fees structure (rather than high volume, low fees)
- Willingness to accept a leader relocating from the parent
Minuses

- Partners who are set in their ways and are control-freaks
- Incompatibility of work ethic
- Over-partnered situation
- Unproductive/weak partners
- One firm's work standards far below other's; this raises questions concerning the true profitability of the work
- Poor or non-existent timekeeping
- Partners looking to sell out & leave without proper transition time
- Sloppy practice; office a mess, work goes out late, high WIP & A/R
- Low realization (under 80%)
- Sacred cows
- Lack of staff non-solicitations agreements
- Poor malpractice history/exposure
- Technologically behind the times— in attitude toward technology as well as the current hardware/software being used
- Lots of debt
- Smaller firm partners have unrealistic buyout expectations
- Ridiculous perks; excessive personal expenses
- Dependence upon one huge client
KEYS TO A SUCCESSFUL MERGER

1. Cultural and personality fit; multiple meetings over the course of many months. Avoid "love at first sight."

2. Valid reasons for the merger: each firm’s merger objectives are realistic.

3. Sound firm management to ensure merger goals are actually realized.

4. Ability to resolve sensitive issues such as:
   - Partner compensation
   - Partner retirement
   - Name of the firm
   - How the firm will be managed
   - Do all the partners of the two firms become partners of the combined firm?

5. Ability of certain partners to survive a dangerous operation: an "ego-ectomy."

6. Agreement on the vision for the new firm.

7. Agreement on what each firm expects from the other and what each partner expects of the others. This includes financial issues, how services will be provided to clients, and what individual partner’s roles will be.

8. A pro-forma income statement that represents what both firms expect to see.

9. Congruity of values (management style, teamwork vs. solo efforts, delegation, accountability, low vs. high billing rates, degree of firm specialization, growth objectives, appetite for risk, traditional vs. non-traditional services)
10. Examination of firm compatibility issues and agreement on how to resolve differences:

- Management style
- Billing rates
- Billable hour expectations
- Billing practices
- Technical work standards
- Service quality standards
- Staff compensation and benefits
- Office policies

11. Due diligence: work papers, internal operations and merger economics.

12. Avoid taking on someone else's problems.

13. Taking sufficient time; asking all the right questions