



Buying or Selling an Accountancy Practice

In the first of two articles, John McCarthy CPA's recommended Practice Advisor, outlines the factors to consider when buying or selling an accountancy practice.



Introduction

Buying or selling an accountancy practice can be tricky at the best of times and in the current economic climate some would say you are mad to even consider it. If one is trying to grow a firm to reach an economic size, a purchase or a merger can be an excellent stepping stone to reaching that goal. I will deal with mergers of accounting firms in the second article in this two part series.

Why do it?

The purchase of fees provides instant growth which needs to be carefully nurtured. Some practitioners who had up until recently been looking forward to a planned retirement in the next few years or so, have now had to shelve those plans due to the poor performance of their pension funds. Retirement is postponed indefinitely while they plan their exit by another means.

One avenue being explored by some firms is purchasing a block of fees so as to facilitate the introduction of a new partner which can allow the exit of the sole practitioner founder or can help with the retirement of a senior partner. The new partner contributes some cash as part of their buy in and the additional fees from the block just purchased are used to justify their introduction.

The Market

The easiest block of fees to sell is that for fees of up to about €150,000. The demand for larger fee blocks is smaller because there are not as many buyers who can finance such a purchase. Practices with fees up to about €600,000 are certainly saleable. After that point the disposal of equity is more likely to be achieved by either merging or disposing of the practice in smaller blocks.

Valuation

The majority of practices change hands for between 80% and 125% of annual recurring fees. A suggested way of valuing a practice is to list all fees and apply a separate multiple to each client.

Profitable fees (on which full charge-out recovery has been made) and large fees (work which would be difficult to acquire through normal growth) could be multiplied by a figure of up to one and a half. A multiple of one could be applied to fees on which a recovery of 85% to 90% of charge-out rates is made.

On smaller fees (say, under €1,000 where the recovery percentage is less than 85%, the multiple might be as low as half of the annual fee or less. This is because buyers argue they could find this type of work in the normal course of business without buying it. Many practitioners also believe that it is very difficult to achieve recovery on the audit of any limited company if the audit fee is less than €2,000 or on a sole trader if it is less than about €1,500.

Incoming Partners

The value of a practice for the purpose of a total sale and its value for the purposes of disposing of only part of the equity to an incoming partner may be quite different. The limiting factor on the amount paid for goodwill by an incoming partner is very often the amount of money he or she can borrow and repay from the additional income they can generate as a result of becoming a self employed partner.

A sole practitioner with fees of €400,000 could potentially realise €400,000 for the disposal of the entire practice to an outsider. If he/she was to take in a partner on a 50/50 basis the incoming partner's share of profits would be approximately €160,000 to €165,000 per annum and the newcomer would be expected to pay around €200,000 for that half share.

It might be difficult to justify paying €200,000 for that level of hard earned income and a stake in a practice, the eventual realisation of which is by no means certain and is so dependent on the implicit 'approval' of the clients.

If, for instance, in the above example the incoming partner paid €25,000 in respect of goodwill based on a super profits valuation and was to share profits 50/50, the partnership agreement could state that at the date of admission one tenth (€40,000/€400,000) of the goodwill belonged to him and nine tenths belonged to the founding partner. Only increases in the goodwill valuation after the date of admittance would then be shared 50/50.

Payment

There are numerous alternative methods of payment for a block of fees. These are usually the result of compromises between the buyer wishing to finance as much as possible of the purchase price from the cash flow and the seller wanting as much of the money “up front” as possible.

A common method is to spread the payments over 18 months with say one third paid immediately, one third after twelve months and the balance after eighteen months. There is usually a clause in the purchase agreement, which will allow the buyer to deduct from the final payment the price paid for any clients which were in the original list and did not transfer.

Realistically it should be assumed that about one third of the clients will not transfer their business to the new practice.

If the economics of the whole transaction only makes sense to the buyer if one or two major clients transfer, then he may insist that the agreement is subject to the transfers of these specific clients. The buyer should meet all the significant clients as soon as possible and certainly within a week of them being told of the sale by the seller. Meeting the major clients in person can substantially improve the rate of success of the overall transfer.

Pre-disposal steps

In order to minimize the problems caused by trying to value work in progress, it is recommended that before the disposal date, the seller reduces WIP to a minimum and converts as much of the WIP as possible into debtors. It is normal practice for the seller to collect their own debtors.

The payment for WIP is sometimes included in the goodwill valuation. The seller should prepare a schedule of clients with names on one side, which can be excluded when photocopying. This information should show the following in respect of each client:

- Type of business
- Year end of each client business (to establish peaks and valleys)
- Work done (Annual audit, management accounts, PAYE etc.)
- Annual turnover
- Net profit
- This year's fee analysed between recurring and non recurring

- Previous year's fee analysed between recurring and non recurring
- Last accounts prepared/last accounts agreed with Revenue
- Number of years the client has been with the practice
- Age profile of the principals in the client business

Other Considerations for the Buyer

The buyer should consider the level of fees being charged by the seller and whether the buyer can do the work for the same amount. If fees have been historically low then the buyer may need to discount the price paid as it may be difficult to increase the fees to a realistic level due to client resistance.

The buyer should establish the degree of delegation which took place in the seller's practice to ascertain the risk of a member of staff leaving and taking clients with them. If this happened after the eighteen-month claw-back period it could be very painful.

Sellers sometimes insist, as part of the deal, that certain employees be employed by the buying firm out of loyalty to individuals who might otherwise have difficulty in obtaining employment. The purchaser needs to consider this very carefully.

Considerations for Sellers

In general the age profile of the clients in a practice reflects the age of the practitioner. When the age profile is older then the value of the practice will be lower.

The amount which can be realised in a forced sale brought about by age or poor health will be less than in normal circumstances. For these reasons it makes sense for older practitioners to think about the disposal of their practice at least five or six years before they actually wish to retire.

The value of the practice can be maximized by making a gradual transfer of the clients to the purchaser while the seller continues to work for the buyer and, perhaps, appearing as a 'consultant' on the letterhead of the new practice for a pre-agreed time.

Conclusion

The purchase/sale transaction should be the subject of a legal agreement which should not be agreed without the benefit of professional advice.

In my second article I will deal with mergers of accounting firms.

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