Buying and Selling a Practice

by Tom Murray

The need to value an accountancy practice can arise for reasons including a sale or merger, the admission or departure of a partner, the incorporation of a sole practice or partnership to a limited company, amongst other reasons.

Combining a sole practice or partnership into a larger accounting practice is commonplace. Advantages include a means for rapid expansion, pooling of overheads, efficiencies of cost, improving the age profile of the partners, accessing new (and hopefully profitable work). Disadvantages, however, are also numerous: relative expense (versus organic growth), loss of independence for partners, failure due to lack of integration or compatibility, loss of key staff members.

The benefits of buying a practice or buying into a practice may be clear; these include the immediate acquisition of goodwill. However, the how-to and how-to-value may be less evident.

Valuation

Valuing a practice is unlikely to be straightforward and is vastly different to that of valuing shares in a limited company. The approach requires the valuer to put a value on the "goodwill", as well as the tangible assets of the practice. Goodwill is widely considered as client loyalty and the likelihood of repeat business built up by way of the reputation of the practice.

A vendor is likely to consider his practice very valuable; the purchaser will not have the same view. The vendor may rely on the value of his or her practice or part thereof in retirement; the purchaser may be restricted by the level that he or she can borrow and repay from partner income when buying or buying in. A balance will be struck between a willing vendor and purchaser which all parties will hope reflects fair value.

Valuing a professional practice is about proving the core maintainable earnings of the business. Methods of valuation include the consideration of gross recurring fees, weighted average maintainable earnings, weighted average gross income, as well as the client profile. An average of the four methods used, plus assets less liabilities will give a solid valuation of the practice.

Under the Gross Recurring Fee method, the value of the goodwill is based on a multiple of its recurring gross fee income and excludes one-off or non-recurring fees. The multiple can vary from 0.75 to 1.25 depending on the quantum and quality of fees.

In general terms, the traditional method based on Weighted Average Maintainable Earnings seeks to determine a capital value for the expected future maintainable earnings of the practice and again a suitable multiple is applied.

The level of adjusted maintainable earnings or profits can be defined as the level of profits the practice can reasonably expect to generate in the future. The valuer will look at the earnings before interest, tax, depreciation and amortisation ("EBITDA") for the past, say 5, financial years and will adjust same to reflect any non-recurring income or expenditure items that would not be borne by the practice if they were acquired by a third party and operated on an arm's length basis. A weighting is usually applied to the maintainable earnings calculated for the past 5 financial years with the largest weighting attributed to the most recent results.

Similarly, to the above method, using the traditional method based on Weighted Average Gross Income, the appropriate weighting is applied to gross income for the last, say 5, financial years. It is generally accepted that a willing buyer would purchase a well-established practice for approximately €0.75 to €1.25 per €1 of the Weighted Average Gross Income.

Finally, the valuer will drill into the client book in an effort to determine the quality and value of same. Taking the Client by Client approach, gross recurring fees are further classified as Audit and Non-Audit clients, annual fee income listed and appropriate factors applied. Non-audit fees may attract a factor from zero to 4, while audit fees may attract a factor from zero to 2.

The profile of each recurring client is also a key consideration for the purchaser who should also have regard to other matters including

client's sector, percentage fee recovery, relationship with staff and location.

Payment

Payment is often spread over 18 to 24 months depending on capacity. This may be the most contentious of terms and should be set out as part of a legal agreement so that all parties know what is to be expected. Payment is usually made in tranches with vendors preferring a larger upfront recovery and purchasers preferring to fund the purchase from cash flow post-acquisition.

Affording a minimum payment period means that the purchaser can quantify the amount of clients who have successfully transferred to the new proprietor. He or she may look to deduct a sum from the final payment to compensate him or her for those clients who did not transfer as expected.

Practical Considerations

There are a number of factors to consider by vendors and purchasers which include:

1. **Risk of loss of clients following acquisition:** Is the purchaser going to find that clients for whom he or she has paid will migrate to another firm? What is the clients' perception of the merger? Might an incumbent staff member set up alone bring with him or her a bank of clients?

2. **Level of fees:** In the case of a merger, the purchaser should consider the fees charged to existing clients and compare charge-out rates to his or her own. Will existing clients tolerate increased fees? Or will the purchaser continue to apply uneconomic fees?

3. **Clawback:** What recourse has the purchaser where clients do not transfer? As stated above, a suitable agreement will include a claw-back clause providing that the purchaser deduct from the last payment, compensation for those clients who did not transfer after, say one year. Vendors are likely to underestimate client fall-off and actual retention will depend on the smoothness of the transition (amongst other factors).

4. **Staff profile:** A buyer should consider the cost and length of service of existing staff members and whether they are to be retained. A long-term staff member may well be a liability rather than an asset in terms of future redundancy costs and pension considerations.

5. **Integration:** The purchaser should also consider the systems and procedures which are in place, the potentially conflicting styles of the firms, the client relationships and how best to select same going forward.

Conclusion

Both the vendor and the vendee have work to do before entering a transaction. The vendor will prepare the practice for sale, ensuring that information is transparent and available for probing. The buyer will carry out his or her due diligence and attempt to mitigate risk.

The review of existing and formulation of new Partnership Agreements are also key to avoiding the pitfalls of buying a practice and buying into a practice. Legal advice is also required by both parties.

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