



PRACTICE MANAGEMENT/M&A

WHAT WILL A BAD ECONOMY MEAN FOR CPA FIRM M&A?

Every news story reinforces the idea that we are in economically challenging times. How will these turbulent times affect the mergers and acquisitions market among CPA firms? What other practice management considerations could it raise? While no one knows with certainty what will happen down the road, a look at the past sometimes can give you a sneak peek into the future.

Learning from the Past

In early 1990s, a tough economy made it difficult for most of my clients (accounting firms in the New York metropolitan area) to collect their own fees, let alone grow. Client attrition was hurting gross volume at a pace that ran well ahead of new client development. An ad in the *New York Times* for a junior accountant brought letters from hundreds of seniors applying for the junior's job. The reason was a steep decline in the real estate market, in new construction and in retail sales, especially in garments and textiles. There are clearly some comparisons to our own situation today. So what did we see during that time that we may see again?

Until very recently, CPA firms were having a great deal of trouble finding staff. In recent months, though, the top 10 accounting firms have laid off a lot of employees, as have many financial service and other companies. My regional firm clients have suddenly begun filling positions that have been tough to fill for the last two years. While this windfall has not trickled down to the small practitioners yet, there is reason to believe that staffing issues may improve soon. While this is a good thing for many accounting firms, we do have to wonder if we will need the labor if demand for services shrinks.

Over the past few years, the value of accounting firms has dropped in most parts of the country. This has been primarily due to three factors:

- The aging of the baby boomers, which increases the supply of firms on the market.
- The shrinking labor force, leaving fewer firms with excess capacity to buy, which lowers the supply of buyers.
- The good economy, which has made it possible for so many firms to grow organically that there was less interest in acquisitions and therefore lower demand.

Anticipating Near-term Change

How will this change in a recession, if at all?

One possibility may be a return of what I saw in the early 90s: A huge demand for accounting firm acquisitions.

Acquisition was one of the few ways to grow and offset the loss of business from clients in financial trouble.

If acquisitions do become popular again, the economic climate will likely work against all-cash sales of firms. I have never been a proponent of any cash/no retention deal for an accounting firm, and uncertainty about client retention during a recession will likely mean that most sales within the profession will be based on future collections and client retention. This protects the buyer against client losses. The seller, too, may benefit from a higher value. That's because buyers will be anxious about buying a firm and losing clients that go out of business and less likely to engage in fixed-cash deals. Add in the challenge of finding financing for an all-cash deal, and you can see that the attraction—and value—of these deals will probably decline.

But there's better news for the seller who is willing to share the risk. This seller offers the buyer an opportunity for an immediate influx of clients and the chance to pay only for those who are retained. As a result, don't be surprised if the seller who wants little to no retention period has a hard time finding a buyer or a good value, while the seller who makes a deal based on retention is well rewarded for his or her years of sweat equity.

Niches Become Popular

Another notable development in the early 1990s was the addition of niches at CPA firms. How many readers have added a new service area (financial services, information technology consulting, business valuation, general consulting, etc.) that you never had before the early 1990s? This is partially a practice development strategy when demand for traditional services declines.

In recent years, many firms may have been reluctant to venture into a new niche or may not have felt it was necessary. Will that change? Are we about to see an influx of new niches catering to individual and business needs that reflect the current economy? For example, consulting on bankruptcy and debt problems may become lucrative niches. It's easy to imagine them adding significantly to a firm's bottom line.



Mergers for Overhead

In the early 1990s, many firms decided it would be a great idea to reduce rent, software, labor and other costs by merging. One valuable lesson to be learned from that period: Don't merge for this reason! Many of us spend more waking time with our partners than with our significant others. Being a partner is about more than sharing space. There are many good reasons to merge, including but not limited to adding depth of talent, niches, services, succession, marketplace, cross selling and more. However, if the only point of merging is overhead dumping, live together (share space), but don't get married!

What to Expect

How will the CPA firm M&A market change? While no one knows for sure, expect to see values stop sliding and even potential increases in price for sellers of smaller firms in densely populated areas of the country who are open to appropriate retention periods that adjust the balance the seller is owed from the buyer

based on future client retention. New niches will become popular and some old ones, such as bankruptcy consulting, will strengthen in the current economy. The staffing shortage will ease as more people are let go.

Mergers will remain a powerful solution for mitigating client losses, adding niches, cross selling and, when coupled with these benefits, reducing overhead for both parties.

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