

Due Diligence Before Buying or Selling an Accounting Practice

By Joel Sinkin

FEBRUARY 2005 - Many think that due diligence is the first step before negotiating the purchase or sale of a professional practice. This is not necessarily correct. The due diligence process reveals significant confidential information, is very time consuming, and increases the risk that employees, and potentially clients, will find out that change is in the works.

Prior to investing time in due diligence, the buyer and the seller should have at least the framework of a deal crafted. The parties should exchange generic (no names of actual clients) but specific, detailed information about their respective businesses. If an agreement can be reached based on this information, it is then appropriate to commence a due diligence review.

Prior to starting the due diligence, both parties should enter into a formal confidentiality agreement. This document should include language that prohibits each firm from contacting the other's clients for a reasonable amount of time, penalties for doing so, and a nondisclosure aspect that prevents either party from sharing confidential information with third parties.

What the Buyer Should Review

The terms of the deal frequently dictate the level of due diligence the buyer should do. If the buyer is required to place significant cash down at the closing, or will be entering into a deal that has little to no retention period for the seller's clients, the buyer will need to perform detailed due diligence. Conversely, should the buyer be acquiring a practice with little to nothing down at the closing, and the balance of the purchase price is based on a contingency relating to client retention and fees collected over the payout period, a less detailed review will be needed.

The following are basic items to be reviewed in a typical deal.

Billings versus collections, age analysis of receivables, and seasonal cash flow. These areas must be compared to expenses, which should include the payments made over time to purchase the practice. These help determine a business' ability to fund acquisition

costs and generate a return on the acquirer's investment of time and money. The buyer should review the amount and frequency of write-downs and any other collection problems. If it is determined that some of the clients are very slow payers, the buyer should consider the following issues:



- Can the buyer afford to carry the practice until the business begins collecting its own receivables? It may be necessary to retain cash from the seller's receivables and work-in-progress and then pay it back separately.
- Does the buyer need to protect its cash flow by reducing down payments, deferring or delaying the first note payments, or making smaller payments initially and larger ones in the future? One method of accomplishing this would be to reduce the down payment but arrange for a balloon payment when the cash flow increases.
- Does the buyer need to provide for the seller's slow-paying clients by sharing receivables? For example, once a client is 30 days late to the buyer on current work and still owes the seller money, future collections could be evenly split between the buyer and the seller until the seller is paid off. The seller would not lose its accounts receivable, but would allow the buyer to participate in revenues while delinquent clients catch up.

Cash flow and profitability. If a business' revenues are highly seasonal (as with a tax practice), the buyer must be aware of the possible need to financially carry the practice if it is bought after the busy season. The buyer may need to adjust the monthly or quarterly payments to the seller to match a seasonal cash flow. Such adjustments are automatic in collection-oriented deals or earn-outs, because the payments made to the seller are actually based on a percentage of collections received from the original clients acquired over a period of time.

Loyalty of the client base. The longer the seller has serviced a client, the greater the existing loyalty. If a transition is done correctly—for example, the sale is promoted not as the loss of the seller but the addition of the buyer—post acquisition retention should be excellent for loyal clients. Clients that have been with the seller for years may be more loyal than newer clients. Why have clients left? An accounting firm that has a recent record of losing clients to a rival firm should make the buyer nervous and indicate a longer retention period.

Who does the work, and where? If the seller physically visits certain clients and works there, the buyer will have a tough time replacing the seller with its own staff. In many clients' minds, the seller's fee may be partially justified based on the time an accountant

is dedicating to the client while in their facility. The buyer should be prepared, at least during the transition, to handle clients the same way the seller had, thereby mitigating the risk of loss.

The seller's billing rates. Billing rates constitute one of the great mysteries of accounting and tax work. If the seller does the work manually and the buyer computerizes it, the billing rate can be doubled without raising the fee. The buyer's focus should be on determining the time, effort, and level of staff that will be needed to complete the work, and the subsequent billing rate and client fees, as compared to the seller's current capabilities.

Workpapers. The buyer in any deal must review the seller's workpapers in order to do the following:

- Learn what services have been provided, what new services can be added, and if a significant amount of time needs to be invested in order to improve the records.
- Estimate the time, effort, and staff needed to complete unfinished work and confirm profitability.
- Review potential liability and malpractice issues.
- Confirm that the seller is not taking unacceptable accounting or tax risks.

Profitability. The buyer should review the seller's profitability, but the focus should be on the likely profitability after the acquisition is complete. The seller's profit should be a starting point, not an end in itself. Due diligence should focus on both revenues and expenses. An acquisition that enables the buyer to take over a practice with little incremental increase in overhead can be tremendously profitable.`

Equipment and software. What, if any, of the seller's equipment and software is being purchased in the deal? What condition are they in? What does the buyer need to handle new clients? Are there any leases or liens on this equipment?

Staff. What staff does the seller have? What is the role of the staff in the firm, and how much contact do they have with clients? Do they have employment agreements that include noncompete language? If some of the seller's employees are part of the acquisition, the buyer should examine compensation and benefits, as well as the staff's strengths and weaknesses. How does all this compare with the buyer's staff?

Services provided (and not provided). The buyer should have the skills, technology, licenses, and time to handle the services currently provided to the seller's clients. In a business environment of growing niche services, the buyer should determine what services the seller does not provide now but the buyer could profitably add after the acquisition.

Office facilities. The seller's clients and staff are generally accustomed to their current location. If the buyer is not taking over the lease, adequate space to house the practice

and keep clients comfortable will have to be provided. If the buyer is taking over the space, a due diligence review of the current lease should be performed.

Stability of the client base. Are the seller's clients, especially the larger ones, in good financial shape? Are some of them aging and thus likely to be lost to sales, relocations, or retirements?

Fieldwork. What portion of the work is done at the office, and how much is done at clients' offices? How are billing rates applied? If the seller drives two hours total round trip and spends two hours at a client, are two or four hours billed? The more clients visit the office, the more sensitive they are to where the practice is located.

What the Seller Should Review

The seller should also cover a number of issues during due diligence. The following are some of the basic areas to be reviewed.

Serving clients. Do the partners of the successor firm have the capacity to service the seller's clients? The seller's hours—billable and nonbillable—and commitment to the practice should be reviewed. The relative time put in by staff versus principals should also be considered. Can the buyer replace those hours and roles? If the seller has niche practices, is the buyer capable of performing such work?

Size of the successor. Bigger is not always better: Small firms are frequently more attentive to a client's needs. But there are exceptions. Other sellers have clients that are accustomed to dealing with large firms and need that environment to retain clients.

Billing rates. The seller should make sure the successor firm will not have to dramatically change the fees charged to clients and risk possible retention problems. Many practices have clients that are sensitive to the fee they are paying, rather than the billing rate.

Location. To retain clients, many practices cannot be relocated beyond a certain distance without suffering client losses.

Financial strength. The seller should run a credit report on the buyer and make sure the buyer's firm is financially secure before going through with the deal.

Stability. It is typically more risky to affiliate with a buyer whose partners have never been partners before or have only been partners together for a short period of time. While no guarantees exist that partners will stay together, the longer a firm has been together, the less likely a surprise dissolution is.

Firm culture. In some firms, linguistic, ethnic, or cultural issues play a significant role in why clients choose the firm. Should this be the case in the seller's practice, the buyer must be within the appropriate parameters for client retention.

More broadly, clients become accustomed to the style in which they receive service: how phones are answered, how clients are billed, how fees are collected. These and other items can have a dramatic affect on retention.

Retention and strategy. If the buyer cannot retain its clients, it is unlikely to retain the seller's clients in an acquisition.

In addition, the seller should be sure the buyer has a plan for where the business is going. The seller should know the buyer's plan and how it relates to clients.

Restrictive covenants on staff and partners. If current partners or staff members leave the firm, they should be prevented from taking clients with them. If there are no such restrictions, the seller will need to include additional language in the buyout contract protecting the firm from such fallout.

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