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Maximize proceeds in accounting firm sales

Common misconceptions can cost CPAs dearly when they sell a public practice. Fortunately, better options are available.

By Harry L. Olson, CPA

The largest asset for many CPAs is their ownership interest in an accounting firm. Unfortunately, CPAs often agree to sell their practices completely unaware that they may have misconceptions about the firm's potential market value and the optimal deal structure from a seller's perspective.

These misconceptions can cost CPAs significant amounts of money—both at the closing table and over the course of the deal. It's a painful scenario, especially for CPAs who are counting on the sale proceeds to fund their retirement.

Fortunately, CPAs have alternatives to deal structures and price-determination methods that favor the buyer. This article, which is based on lessons learned negotiating hundreds of CPA practice sales on behalf of sole practitioners, partnerships, and larger firms, rebuts many of the myths about such deals and examines options that can result in sellers' receiving substantially more money.

ADDRESSING CPA FIRM SALE MISCONCEPTIONS

Misconception: A CPA firm's purchase-price valuation should be based on a multiple of 100% of the practice's recent historical annual billings. Several approaches can be used to determine a business's sale price. However, selling an accounting practice based solely on a 100% multiple of revenue ignores the wide range of differences in profitability from firm to firm.

In most other industries, middle-market businesses are often valued at a price calculated as a multiple of earnings (net income or loss) before interest, taxes, depreciation, and amortization (EBITDA). In addition, small businesses are often valued and sold at a price that equates to a multiple of the seller's discretionary earnings (SDE), which can be defined as EBITDA plus owner's compensation and benefits and other discretionary expenses, or "add-backs." SDE attempts to define the recent historical annual pretax benefit that a seller has derived from the practice on a cash basis.

Single-owner CPA practices and small partnerships are most often classified as small businesses based on the typical level of annual billings for those firms. CPA firms with high SDE as a percentage of revenue are inherently more desirable to buyers than firms with low SDE, assuming all other variables are essentially equal.

Buyers' preference for high-SDE firms can best be explained by the following example. Imagine that two hypothetical single-owner CPA firms with $750,000 in annual collected billings perform similar services in relatively the same geographic location. One firm has low billing rates, is managed poorly, and produces annual cash-basis SDE to the owner of approximately $75,000 (a scenario I have seen). The other firm has high billing rates, is managed exceptionally well, and produces annual cash-basis SDE to the owner of approximately $350,000 (a scenario I have seen).

A rational buyer would likely choose to purchase the firm with the higher SDE, assuming all other variables between the two firms are equal. As a result, high-SDE firms generate significantly greater demand. The greater intrinsic demand for high-SDE firms can often produce sale prices significantly higher than 100% of billings for those practices. I have seen the SDE approach result in hundreds of sales at 100% to 150% of billings and numerous others at 150% to 200% of billings, including in the past 12 months.

Be aware that SDE is not the only variable to consider when evaluating a CPA practice. Other considerations include, but are far from limited to, the location, the type of work performed, the

number of hours the seller works, staffing, and industry and/or client concentrations. Still, SDE is often a much better predictor of CPA firm price than annual billings, due to large variations in profitability from firm to firm.

An owner of a CPA practice with low SDE should consider using whatever ethical means he or she has to enhance the firm's SDE in the two to three years before selling the practice. An owner of a CPA practice with high SDE should consider using SDE as the primary basis for an asking price.

Misconception: Lending for CPA practice acquisitions is unavailable or difficult to obtain. Thus, most sellers should accept a down payment in the neighborhood of 10% to 20% and owner financing for the balance of the purchase price.
In reality, lending is readily available for CPA practice acquisitions. It is also relatively easy to obtain if the buyer is adequately qualified. The lending program most often used for the purchase of CPA practices is the U.S. Small Business Administration's (SBA's) 7(a) program, which offers a maximum loan amount of $5 million. The SBA has streamlined the program in recent years, no longer requiring that it directly approve the deal as long as the prospective borrower submits terms that conform to the SBA Preferred Lenders Program (PLP). Under this program, the SBA delegates the final credit decision to carefully selected "preferred lenders."

All PLP lenders must conform to the program's rules. However, PLP lenders' internal credit policies can differ greatly with respect to the credit score required, down payment, necessity of outside collateral, working capital requirements, and maximum dollar amount of a PLP loan. Many PLP lenders will not consider a loan significantly larger than $1 million without substantial additional collateral. However, some PLP lenders will fund much larger loans with minimal additional collateral requirements. It should also be noted that conventional (non-SBA) financing is available in the marketplace for the purchase and sale of many CPA practices. The recommended best approach is to talk with a number of lenders to obtain a loan structure that meets the buyer's and seller's specific needs.

Misconception: A seller should accept an earnout contingency sale structure based solely on the buyer's collections from the seller's clients for a three- to five-year period after closing.
In an earnout deal, the seller often receives 20% or less of the purchase price at closing with no real financial commitment from the buyer other than a percentage paid to the seller of what the buyer collects from the seller's client list. An 80% contingency could give the buyer an incentive not to perform if the buyer is inadequately staffed or underestimates the work to be performed. I have occasionally seen this deal structure result in a good transition between the seller and buyer. However, there are also instances when a buyer "cherry-picks" the top 20% to 30% of the seller's client list and does not pursue the remaining clients. Sellers should market their accounting practice to many more buyers before selling the firm strictly on an earnout basis.

All-cash deals are more common than many might expect, but buyers often seek to pay lower purchase prices because of the increased risk they incur. The best balance for maximizing the sale price of a CPA practice, as well as buyer and seller

IN BRIEF

- CPAs looking to sell an accounting practice have alternatives to popular deal structures and terms that favor buyers.
- Sellers of an accounting firm can often determine a proper sale price via a methodology that uses seller's discretionary earnings (SDE), which takes into account firm profitability—an approach sometimes viewed as more accurate than basing the price on a 100% multiple of annual revenue.
- CPAs selling their practice often don't have to accept small down payments with earnout contingencies and long payout periods. Through the U.S. Small Business Administration's 7(a) program, prospective buyers can find a range of loan options. This means that sellers can seek deals with down payments of as much as 70% to 80% of the total purchase price.
- Sellers don't have to provide free labor to, or accept deferred compensation arrangements from, the buyer. If the buyer needs the seller to perform billable work after the sale, the buyer should pay the seller accordingly. Also, sellers should be careful to structure a deal that achieves the most beneficial tax treatment possible.

To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

performance, is a healthy amount of cash at closing with a small, seller-financed note. Most of the hundreds of deals my firm has negotiated used bank financing that allowed the seller to receive 70% to 80% of the purchase price at closing with the buyer owing a note for 20% to 30% of the purchase price to the seller. The note incentivizes the seller's performance during the transition. The cash paid at closing incentivizes the buyer's performance.

The few deals my firm has done with a large earnout contingency usually were structured that way because of underlying problems with the selling firm that precluded bank financing or made the firm significantly less desirable in the marketplace. A seller who is forced by circumstances beyond his or her control to accept a large earnout contingency should obtain legal counsel to protect his or her interests. The seller should also request references from other sellers whose firms the buyer previously purchased, to make sure the buyer does not have a history of cherry-picking the top accounts. In addition, the seller should absolutely verify that the buyer has the capacity to take on all (not just some) of the seller's clients.

Misconception: The seller should provide free labor in the buyer's employ for as long as a year or two after the sale closes.

The buyer typically requires transition time from the seller for client meetings, introductions, and other matters. This transition time is often included as part of the sale price. The time limit for transitional help in the sale is usually short unless the needs of the practice necessitate a longer transition. The deal's terms should clearly spell out the details of the transitional help. Is the help in person or via phone consultation? How many hours per day or week will the seller work? Will the work take place during normal business hours? What exactly will the buyer do? Leaving these matters to chance invites trouble.

The deal terms also should establish a dividing line between transition time provided by the seller and billable work. The seller should not accept a deal that requires him or her to perform billable work for free. In CPA firm sales, the buyer typically buys the practice's fixed assets and intangible assets, not the seller's free billable labor. If the buyer needs the seller to perform billable work after the sale, the buyer should pay the seller based on an agreed-upon percentage of the billed and collected work performed by the seller after the sale, or an agreed-upon hourly rate. The amount to be paid to the seller for billable work should be in addition to the purchase price for the CPA firm.

All-cash deals are more common than many might expect, but buyers often seek to pay lower purchase prices because of the increased risk they incur.

Misconception: The seller should accept a deferred compensation arrangement from the buyer.

For most accounting practices, a sale is structured as an asset sale rather than a stock sale. However, some buyers propose deferred compensation arrangements as a means to achieve a current tax deduction for the portion of the sale that would otherwise be classified as the purchase of intangible assets. In this arrangement, the seller receives payments related to the purchase of the accounting firm that are characterized as either payroll or contract labor. The buyer is allowed the deduction either way—but with a significant difference in the deduction's timing.

The seller's tax treatment depends on the selling firm's entity structure as well as the deal's structure. In many instances, the seller could receive capital gains treatment for the sale of intangible assets without potential double taxation. On the other hand, the seller would typically incur significantly higher taxes if a deferred compensation arrangement is part of the purchase-and-sale agreement. This permanent tax difference occurs because the payroll or contract labor is treated as ordinary income to the seller rather than capital gains—at least as to the amount of the sale price that could have otherwise been treated as the sale of intangible assets. In addition, the seller incurs Federal Insurance Contributions Act (FICA) taxes or self-employment taxes on payments classified as payroll or contract labor. The seller does not owe FICA or self-employment taxes related to the sale of intangible assets. Thus, the tax difference to the seller related to this issue can be substantial.

It is rarely advisable for sellers to reclassify the sale of intangible assets to deferred compensation. This type of deal structure usually produces less-than-optimal tax consequences for the seller, particularly since it's highly likely that many other potential buyers would not assert this

requirement. Only a few of the sales my firm has negotiated have included even a partial deferred compensation arrangement. A seller should attempt to secure offers from other potential purchasers before accepting this type of arrangement.

Misconception: The buyer's qualifications do not matter as long as a seller receives a high sale price and significant cash at closing.

The most important aspect of any deal from a seller's perspective should be whether the buyer has the qualifications, ability, capacity, desire, and incen-tive to provide quality service to the seller's soon-to-be former clients. By making this the primary concern, a seller can mitigate myriad potential legal and other problems that could occur after a sale to an otherwise unqualified buyer.

In most CPA practice sales, buyers perform extensive due diligence on the seller and the practice. A seller must not overlook performing extensive due diligence on the experience and reputation of a potential buyer.

Misconception: The purchase price of a CPA practice should include the seller's cash, accounts receivable, and work-in-process.

The purchase price should rarely include the seller's accounts receivable or work-in-process unless an additional price is negotiated for those items. The seller's cash is almost never included as part of a sale. However, my firm has seen a few deals where the seller agreed to provide the buyer a certain amount of cash as working capital or as a loan when the firm being sold did not qualify for bank financing.

CONCLUSION

No single methodology is used in the purchase and sale of accounting practices. Each potential purchaser in the marketplace has different needs and desires that often drive myriad deal structures. Purchase offers for the same CPA practice often differ greatly with respect to both price and terms.

Keeping this fact in mind, a seller should never enter into a deal without speaking to a number of potential buyers. Sellers also should give serious consideration to putting together a team of specialists to help in the selling, negotiating, and deal-structuring processes.

Sellers should recognize that many buyers do not adhere to the misconceptions described in this article. If an otherwise well-qualified buyer insists on a price or structure based on one or more of these misconceptions, the seller should be prepared to counter with the options outlined here. The seller should also immediately engage additional qualified buyers.

In any negotiation, more options—in terms of potential buyers and deal structures—give the seller the negotiating leverage to achieve full market value with favorable terms. ■

About the author

Harry L. Olson is president of Accounting Broker Acquisition Group Inc. (accountingbroker.com).

The following extremely important information is highly relevant to any seller who wishes to obtain maximum value for their accounting practice sale and was not part of the original JOA article.

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