White Paper - Nº13

The Value of Accounting Practices

Covisory

Introduction

For most of us valuation is a bit of a dark art, not quite like witchcraft but close. We ask an expert to determine the value of our home, bach or accounting practice. However, before we do this, we should always think about the fundamentals and market forces which are at play which we are aware of and can sometimes control.

As chartered accountants we are experts in business and commerce so maybe we should start with what's obvious and perhaps treat ourselves as if we were a client. What's the saying about shoemakers' kids?

Let's start by listing some obvious factors:

1. The sale of accounting fee blocks is more attractive to buyers than practices and therefore will attract a higher price. Why? Because the buyer just bolts them into their existing firm infrastructure. No new leases, staff, computer systems or partners.
2. Supply and demand drive the price for accounting fees and practices. At present (September 2021) we continue to have a high demand from existing practitioners who seek to bulk up their fee bases to fund that nirvana of higher profitability from scale.
3. A single sale does not make a market and if you are selling the worst house on the street you cannot expect to get the top dollar for it. Accounting practices are the same. We will discuss this further shortly.
4. The bigger the practice or fee base the smaller the group of buyers that can afford it. Simple common sense. Fee blocks and practices up to $1m can sell quickly as there are a lot of buyers, but those with $2-$3m and more of fees become a lot harder and slower to sell, unless the vendor is happy to see it broken up.
5. The sale of accounting practices and fee blocks are unusual in that the price paid is calculated with reference to the value and number of clients that actually transfer to the purchaser. This clearly de-risks the transaction for the purchaser and should theoretically result in a higher price for the vendor. While such earn outs are not unusual on business sales, they are also not that common.
6. Internal Transfers –in our experience internal transfers of interests in accounting practices transact at a discount to an external sale & purchase, due to the reluctance of younger partners to take on large obligations and retiring shareholders not expecting their fellow shareholders who helped build up the practice to pay the same price as a third-party. Further, the long-term viability of a practice assumes greater importance in an internal transfer than an external transaction – the trade-off for this is terms that make it (long term viability) possible.

Covisory

7 Where the price is determined by the value of fees that transfer to the purchaser (ie contingent), then payment terms usually involve some payment up front and the balance spread. We usually work on 1/3 up front, 1/3 after say 7 months and the final payment after 14 months. Others may use 50% up front and 50% after 14 months but there will be a deferral of a significant part of the payment to protect the purchaser from clients not transferring.

So what does this all mean to you at the coal face when you are looking at buying or selling a practice or fee block? Let's start by understanding how we value a practice. We use all 3 of the following methods for each practice where we can.

1 **Cents per dollar**– this is a valuation of the fees themselves. Goodwill on sale. It is the historically used method and results in differing prices based on the nature of fees, geographic location, and other factors. So what factors do we look at in trying to determine a cents per dollar figure?

a Size;

b Number of returns filed;

c Average charge per return filed – this provides a rough guide and allows the vendor and purchaser to get a quick and dirty comparison;

d Special or non-recurring work. How much and is it similar amounts each year;

e Client churn;

f Age of clients;

g Nature of work – just compliance or trusteeships, directorships, etc;

h Profitability;

i WIP and debtors including ageing;

j Staff costs, age, productivity, and experience. What % of fees do staff costs represent? Also, in a merger situation it is important that the culture of the respective practices is compatible, i.e. that staff get on;

k Lease liability – often vendors seek to sell a practice with a long lease to run;

l Which accounting system is used? It's expensive and time consuming to change systems;

m Location – different areas have different price structures, largely reflecting differing competitor dynamics in different locations.

Why do we look at WIP and debtors I hear you say? You are not selling or buying these. The vendor should bill or write off all WIP and will retain the debtors.

The answer is that the purchaser will have to fund WIP and debtors. If your clients are slow to pay you, after you were slow to bill them, then they will have to fund the same amount until they have taken the time to educate the way staff operate and clients are trained to pay promptly. The purchaser will pay based on what the vendor is doing, not what can be achieved in the future. You don't pay a vendor of a rundown property what it will be worth when it is done up.

In essence it is all about the amount of money the purchaser will have to invest. Naturally as accountants we should follow good business practice and manage WIP

Covisory

and debtors well, but given we are busy practice owners we often don't follow the advice we give to our clients. We should be our own best clients. We also often feel embarrassed to chase up money owed to us, especially if we feel the clients are more like friends.

In terms of cents per dollar, in Auckland the range is from 60 cents to close to $1.20 at present.

Naturally if it's a deceased estate or similar where the purchaser is paying without any adjustment for what clients do not come across to them there will always be a discount.

2 **EBITDA Multiples** - Traditional business valuation methods are increasingly being applied to the sale of accounting practices. Future maintainable earnings and PE multipliers are becoming increasingly common in discussions.

So, what affects firstly the earnings, then the multiplier and finally the real value?

a Profit will normally be averaged over 2-3 years, especially relevant given COVID;

b Remove personal, abnormal or one off costs;

c Adjust shareholders remuneration to perhaps that of a senior manager or associate. This is what a purchaser could pay someone to run it, and what the purchaser will likely pay the vendor for the typical one-year hand over period;

d Again, age of clients and level of profitability will affect the multiplier;

e Systems compatibility may also see a discount if vendor and purchaser are not aligned;

f PE multipliers we see in the market range from 2.2 to 4.0;

g From the result of PE x Future Maintainable Earnings you deduct fixed assets and the vendor lockup (WIP and Debtors), even if it's not being sold. Again, the reason is that the purchaser has to fund this until they retain the clients and change the vendor's practices. So, the goodwill or fee sale component is net of the lock up. Getting your own practice in order and financially tidy before going to market therefore can increase the price you will get. Don't underestimate the amount of work to do this.

3 **Pay Back Period** – Especially if the purchaser is buying a fee block, they are buying a future or trail income stream. They are buying only those clients, however long they will need the purchasers services for. Clients have a finite life.

We always look to see what the payback period is on a fee block or practice sale. The more profitable it is naturally the higher the price but none the less the payback period to pay off the purchase price and debt (excluding WIP and debtors) should be ideally no more than 5 years. Any longer than that and you are paying to find replacement clients.

You may argue that the sale of a practice is a business sale and that the purchaser buys a business capable of attracting new clients. While that argument has currency perhaps for a big 4 accounting firm, for a 1-3 partner local CA firm is it the firm's goodwill or the personal goodwill of the partners that attracts clients? Typically, it's personal goodwill and the vendor won't be buying that.

We do allow for tax, interest, and the market salary for managing the fees or practice in our workings.

We can assure you that buyers do look at this.

Covisory

4 **Market Observations** – At present as noted demand is strong. We have far more buyers than vendors. This has driven the price up, with many vendors now expecting $1 for $1 of fees when actually they will be lucky to ever get that. Good practices are selling quickly and easily.

However, we are also seeing more "corporate" buyers appearing in the market. These are not the listed accounting firm owners of the past, nor are they private equity firms. Owning and operating accounting firms is attractive as a business proposition. However, they look at how much capital they need to invest and what the return will be. WIP and debtors increases the amount of funds they will have to invest and as a result you will be punished for having excessive lockup.

Finally, most buyers will expect the vendor to hang around for one year only. It is therefore critical that the parties strike up a relationship, i.e. they can work together. The purchaser is usually prepared to pay the vendor what they would pay a senior manager or associate. They will view this as additional goodwill, even if it is deductible. Purchasers will not want the vendor(s) to hang around beyond that as it adversely affects their profitability.

Trusteeships can also be problematic. Will the vendors continue to act as trustees and in effect retain that work? If not, who will pay the cost of changing the trustees, including changing titles to properties that may require lawyers to convey or change the titles? This is real third-party costs.

So, there is a lot to think about. The market is active and just like selling your home, you will get a better price as a vendor if you take time to prepare your home and stage it properly. The same is true for accounting practices. Feel free to contact us to discuss any aspect of this further.

Nigel Smith

Nigel@covisory.com

021 377 280

Mike Bradley

mike@covisory.com

021 678 442

About Covisory

The Covisory Group specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, The Covisory Group has grown from one business to four with a diversity of clients. Covisory clients are owners of family businesses, operating both in New Zealand and globally. Our team of specialists work either one-on-one or alongside our clients' team of professional advisers to develop appropriate short- and long-term solutions.

We build strong relationships with our clients based around trust, accessibility, and responsiveness. There is no 'one size fits all' about our services. Our solutions are bespoke to each client, drawing on our up-to-date specialist knowledge and our years of experience. providing one-on-one expert advice.

Covisory

Contact details

TELEPHONE: +64 9 307 1777 EMAIL: enquiries@covisory.com
POST : PO Box 137215 Parnell, Auckland 1151