CHARTERED ACCOUNTANTS
MacKay LLP

1100 – 1177 West Hastings Street
Vancouver, BC V6E 4T5
Tel: (604) 687-4511
Fax: (604) 687-5805
Toll Free: 1-800-351-0426
www.MacKay.ca

Valuation of an Accounting Practice

Succession Planning 101
or
What is my 'exit strategy'?

By Hugh G. Livingstone, BA, CGA, CBV

When it comes to the valuation of an accounting practice, whether you are buying or selling, the issues are the same. However, different practitioners will have different assessments of risk and value. Fair market value can be determined within an acceptable range; however, the price paid for any business will be a function of the purchaser's assessment of risk, relative negotiating strengths, access to information, desire to buy and the ability to obtain synergies with the purchaser's existing business. In this article I will explore the factors to consider in determining the range of fair market value of an accounting practice as well as other factors that will affect price.

Common reasons for selling a practice

The most common reasons for selling a practice, or merging practices, are:

- retirement
- the reluctance to sign a new lease for premises
- moving
- lifestyle changes, including burn out or health problems

The price you obtain for your practice when using a well planned exit strategy (i.e., a plan that looks five years ahead) is likely to be higher than the price you obtain when the purchaser, your staff and your clients are aware of your health problems or an imminent need to retire.

Who will buy your practice?

Your buyer is likely to be an employee, a competitor or a practitioner trying to buy a job or a practitioner moving into the area.

An employee may have difficulty financing the transaction. Your practice may not generate enough income to reward the hard working employee/new owner and at the same time be able to pay you your asking price.

A competitor may be a likely buyer as they can often benefit from economies of scale as the extra volume contributes proportionately more income to the bottom line.

In smaller transactions, the purchaser may be buying a job and this will often attract a premium.

Rules of thumb for valuation purposes

There are rules of thumb as to how much is paid for an accounting practice. Often you will hear of 100 cents on the dollar, i.e., $200,000 of volume would sell for $200,000. However, a range of 80 cents to 120 cents on the dollar, or 80% to 120% of volume, may be more appropriate.

Rules of thumb are merely ballpark estimates and care should be taken when establishing the price you will pay for a given practice. As this article will illustrate, not all practices with $200,000 of volume are worth the same amount.

The steps that I would recommend that a buyer take when performing their due diligence in acquiring a practice are exactly the same steps I would recommend that a seller would have taken two to three years earlier when grooming their practice for sale.

Due diligence steps for the buyer/practice price enhancers for the seller

<u>Analyze the work</u>

- Personal income tax returns

  This type of work is not considered as valuable as it is often price sensitive and there is increasing competition from user-friendly software and Internet filings. This is not relevant if the personal income tax returns are more complicated.

- Bookkeeping

  These engagements are also threatened by improvements in user-friendly software.

- Audits, reviews and compilations

  Generally audits are worth more than reviews and reviews are worth more than compilations. Audits are often required by statute and cannot be downgraded to lesser work. Audits and reviews require disclosure under Generally Accepted Accounting Principles, require more expertise and therefore generate higher fees. Reporting under International Financial Reporting Standards (IFRS) will require additional expertise and command higher fees. Conversely, the learning curve for IFRS may be an incentive to retire/sell early.

- Opportunities in the volume

  Depending on the skill of the vendor, there may be untapped work for specialists in the volume. There may be many unidentified consulting assignments, estate plans or corporate reorganizations. The purchaser may recognize that they can create more volume with the vendor's client base than the vendor has done.

- Pitfalls in the volume

  Again, depending on the skills of the vendor, perhaps the value-added work mentioned above has already been done and some of the volume is non-recurring.

- Analyze the client base

  I would then look at the client base to determine the mix of the clients. Financially healthy clients, clients in growth industries and a diversified client base all add value to the practice. If the firm is recognized as having expertise in a particular industry, the commensurate higher fees indicate a higher value for the practice. On the contrary, an aging client base or a single industry client base would likely reduce the value of the practice. The geographical location of the client base may be a plus or a minus.

  You should consider asking the vendor for a profile of the firm's top ten clients or permission to contact or survey a sample of the client base. If the clients are happy, your chances of client retention are higher than if the clients were already thinking of leaving. Client sophistication and fee sensitivity should also be assessed. Will the target firm's clients be able to handle your firm's billing rates?

<u>Analyze the staff</u>

I have heard it said that 90% of your goodwill goes down the elevator every night. What skill level does the staff have? How effectively are the personnel trained? How happy are they? How are they compensated? How many are expecting a bonus at year-end? How many were promised partnership before you bought the practice? A younger staff can attract younger, longer lasting clients. Will the culture of the target practice merge well with the culture of your current practice? Are expectations regarding overtime the same? Have senior managers in the target practice signed non-competition agreements?

<u>Analyze the firm's management practices</u>

The firm's management practices can have a tremendous impact on value. The financial health of the firm will depend on what charge out rates are used, the chargeable hours worked per person (utilization), what billing variances exist and its bad debt experience. Areas to look at would include aged work in process reports, aged accounts receivable listings and billing and collection practices. Do invoices go out with the finished product?

We acquired a practice that did not keep time sheets. We had to estimate the number of hours put into a file and impute a charge out rate. We had to satisfy ourselves that we could earn an acceptable return on the files. You would not want to buy a practice where the vendor works a lot of hours for free.

You would also want to assess technology. Have capital investments been deferred? Is all software validly licensed? Is the information technology out-sourced?

<u>Other important considerations</u>

- review the lease for premises
- review equipment leases
- ask the vendor for a copy of the Peer Review
- review a sample of files and income tax returns

- review professional insurance; ask about the claims history; determine who is responsible for insuring prior acts post-merger
- assess the local competition

How much can you expect for your practice?

Not all clients and not all types of work are worth the same amount. It may be useful to rank the clients as A, B, C and D clients. An 'A' client could be defined as an interesting client that pays their fees on a timely basis and refers other clients to you. A 'B' client could be a client with lots of interesting tax issues; however, they are slow payers. A 'C' client could be in a stagnant industry, not require many services and have difficulty paying fees. A 'D' could be a client who is in a declining industry, is difficult with your staff, looks for a discount on every bill and is slow paying. Unless 'D' is your brother-in-law, you should probably fire him as a client. Perhaps you should fire him anyways.

The general assumption that audits are worth more than compilations is merely a rule of thumb. Further analysis may reveal that some compilations are 'A' clients while some audits are 'C' clients. I prefer a client-by-client analysis rather than rules of thumb applied to the total volume.

The following schedule shows how this could work:

Type of Client	Practice Volume		Practice Value
A clients	$ 50,000	1.20	$ 60,000
B clients	40,000	0.80	32,000
C clients	50,000	0.60	30,000
D clients	30,000	0.10	3,000
Non-recurring work	10,000	0.00	0
T1s	20,000	0.40	8,000
	$ 200,000		133,000
Premium for untapped specialty work we can do			20,000
Discount for technology obsolescence			(10,000)
Estimated fair market value of the practice			$ 143,000

What terms can you expect?

Client retention is always a concern. The best way for the vendor and the buyer to share the risk is to use an 'earn-out' approach for payment. The payments can be spread over three years based on client retention. This gives the vendor an incentive to ensure a smooth transition and the buyer does not pay for what he does not receive. Will the amount paid be calculated by client or in aggregate? Will there be a ceiling as to how much you will pay? What will the impact of the purchaser's higher charge out rates be on price? The timing and quantum of the payments will be a function of the relative negotiating strengths of the two parties.

Conclusion

My recommendation is to do your homework. The care and upkeep of each practice will not be the same. Every practitioner has a different style. Accordingly, $200,000 of volume acquired from practitioner A will likely yield different rewards and headaches than $200,000 of volume acquired from practitioner B. The differences may be significant. It follows then, the fair market value of both practices may be significantly different.

Why did I become a Chartered Business Valuator and why should you choose one?

The Canadian Institute of Chartered Business Valuators is the only recognized professional valuation organization in Canada. With the changing role of the traditional public practitioner, I saw an opportunity to provide an expansion of services to existing and new clients and therefore pursued getting my professional qualifications in this field.

Chartered Business Valuators (CBV) are fully qualified to serve as independent, expert witnesses when valuation matters arise before courts, security commissions or other regulatory bodies. CBVs are also accepted as experts in valuation disputes with the Canada Revenue Agency and are employed in their internal valuation department. When managing risk, whether your firm's or your client's, you should consider seeking the appropriate professional assistance when needed.

Hugh G. Livingstone, BA, CGA, CBV
Principal, Valuation Services
MacKay LLP

Hugh G. Livingstone is a principal in the Vancouver office of MacKay LLP, Chartered Accountants and has recently been elected CEO of the firm. As a valuator, he has given testimony as an expert witness on valuation issues in the Supreme Court of British Columbia.

Hugh is also a Vice-president of Blair MacKay Mynett Valuations Inc., a valuation boutique in Vancouver.

Hugh works closely with a wide range of clients and legal firms and currently consults to other CGA public practitioners on valuation assignments for their clients.

For more information visit MacKay LLP's Website at www.mackayllp.ca or Blair Mackay Mynett Valuation Inc. at www.bmmvaluations.com or contact Hugh G. Livingstone at (604) 687-4511 or at hughlivingstone@van.mackay.ca

This article originally appeared in the January 2003 issue of the Special Mailing, one of CGA-BC's former publications for CGA-BC public practitioners. This 2009 updated version has been included in CGA-BC's Practice Management Seminar.