

## **CONSOLIDATION AND THE SMALL FIRM**

By William R. Pirollo, CPA.



Much has been made over the past several years about the consolidation of the accounting industry. What started as a whirl wind sweeping through some of the largest firms in the country has mostly fallen from view. With some successes and failures, our industry, and those who would participate in it, still finds themselves working out the major issues of consolidation.

Consolidation is nothing new in our industry. You need only look to the Big Five firms to see the results of an extended period of consolidation. The events of the past several years brought new attention to consolidations as a result of the players involved. The consolidators were for Century Business Services began an aggressive campaign to acquire some of the most well known firms in the country.

During the height of consolidation activity it looked as if there would be no end in sight. You could almost envision the formation of super firms owned by financial giants threatening the very existence of regional and smaller firms. Many, including myself, looked to banks and the insurance industry as future consolidators. Reality has proven to be a different picture.

So is this a post-mortem for consolidation? Hardly. There is still much activity by regional firms who were not initially targets of the consolidators. This activity is producing many exciting opportunities, or threats, depending on your point of view, for small firms.

For purposes of this article we will focus on small and what I will call regional firms. By AICPA standards a small firm is defined as one having fewer than ten professionals. These would include sole practitioners, small multi partner firms as well as larger firms whose reach is generally within a local geographic region. A regional firm may vary in size but for purposes of this article consider them to be in the range of 10 – 50 professionals. These firms generally provide a wide range of services including traditional tax and audit, specialized consulting such as elder care and business valuation, personal financial planning, litigation support, information technology, merger and acquisition and many others. They may typically belong to a national organization of allied firms and their service reach may extend far beyond their own back yard.

The passage of legislation regulating commissions and contingent fees in many states has provided the ability for these firms to expand into commission-based products such as investment management, insurance, mortgage origination and payroll processing. In short these multi-disciplinary practices are attempting to leverage their client base by forming a one-stop financial resource.

The challenge for these firms is to acquire a sufficient critical mass of clients and sell these new products and services to them. In many cases the firm may not have a sufficient internal client base to carry each new department. Their choice is to market for clients one at a time in traditional fashion or to consolidate other firms and leverage the new client base.

What are the options for small firms? In today's market you can choose to embrace the opportunities of consolidation or continue to choose independence. For many the latter option will work fine. I believe the role of the small practitioner is strong and will remain that way for

many years to come. Your geographic location and client demographics may mean that consolidation will never be an issue for you. With that said, however, there is never a time where you can ignore market forces and the demands of your clients. You should always seek to provide quality services and be competitive in your marketplace. Suggestions for those choosing independence appear later in this article.

If you perceive there is opportunity for your firm in consolidation there are many ways to enhance your opportunities.

## **OPTIONS FOR SMALL FIRMS**

### **GET IN THE GAME**

Preparing your firm for consolidation will be a different challenge for every firm. The first step for everyone, however, is to determine who you are and what your strengths and weaknesses are. This means compiling your firm's client and financial demographics. According to consolidators, lack of solid administrative procedures, firm and client demographics is the single biggest reason for deals to fail in getting off the ground. At a minimum you should be prepared with:

- Average firm billing rate
- Firm utilization and realization rates
- Charge hours per professional
- Breakdown of services/fees by category (corporate, personal etc..)
- Analysis of possible specialties or niches.
- Solid client demographics. Size, service, industry.

There are many others. Consult the AICPA MAP handbook for the Texas Survey of firms. You must understand your own firm's financial data. It is critical to anyone who will be analyzing your practice for consolidation.

## **MAKING YOURSELF ATTRACTIVE FOR CONSOLIDATION**

The reality for small firms is that you are a piece of someone else's puzzle. By consolidating your practice, larger firms are trying to build critical mass for their own firm. They may in fact be filling a mandate to grow if they have already themselves been consolidated. They may also be posturing for their firm to be consolidated in which case volume and profitability are the rule.

Keep in mind what the consolidators motivations are. Yes, they are acquiring your firm, but more importantly they are buying direct access to your clients and your staff. The better your clients and the more highly trained your staff, the more attractive your firm will be. Better does not necessarily mean bigger. A good client is one to whom additional services can be sold. Concentrations in particular industries can also be a very valuable commodity to a larger firm trying to fill that hole. It is critical that you

understand who your clients are and why they are valuable to someone else who is not interested in traditional services alone.

Planning is the key. It is impossible to change yourself quickly and old habits are hard to break; but you need to start. Consider the following.

- Prune the tree, eliminate marginal clients
- Phase out low end services
- Adjust your rates upward over a period of time
- Concentrate on your utilization and realization rates
- Practice efficiently to enhance profits
- Expand upon any niches or specialties you may have
- Develop solid administrative procedures
- Make your firm more visible in the accounting community
- Keep current of trends both nationally and in your marketplace
- Consider non-traditional services to enhance value
- Consider mergers or acquisitions to build volume
- Keep staff well trained, promote future leaders
- Join an association

Your goal is to make yourself as attractive as possible to a consolidator. Even if you never consolidate your firm taking action can only make your firm more profitable to you. Once you have “dressed up” your practice you will need to understand what to expect from any consolidation.

### **VALUE**

Expect less. Your firm will not be worth what you expect unless it is highly profitable or has some major client or industry attraction. If your firm’s annual gross billings are one million dollars and your consolidator’s are ten million dollars, you are not worth 10% of their value. Their average partner compensation and billings per partner may very well be twice yours and as such they value your gross less than theirs. Actual numbers are elusive but in conversations with larger firms who are currently consolidating smaller firms, you may be hard pressed to realize one times annual gross. The trade off is long term security and an attractive compensation package.

Keep in mind that this is not a retirement purchase. It assumes continued effort on your part. Adjust your expectations and remain open minded. The total package is probably more than if you were not proactive and simply sold a less than attractive practice.

### **PERFORMANCE**

Your role will change. You will be expected to leverage your clients with the new products and services available to you. In short, you will be expected to sell to your clients and actively produce non-traditional revenue for your new firm. This may be new and even uncomfortable. At the heart of the process is providing the client with a wider range of quality products and services from their most trusted advisor, you.

Assuming a solid upstream consolidation, you most likely will not participate at the top level of firm management. Many practitioners view this as a distinct advantage. Eliminating management and administrative responsibilities allows the practitioner to become more efficient.

## **STRUCTURE OF THE DEAL**

The current market place is providing for a variety of options.

- Straight purchase  
Payments based upon traditional valuation methods payable as deferred compensation based upon client retention. May include short-term employment contract to aid in transition. Not a true consolidation.
- Equity merger  
Your firm is valued as a part of the whole. You will become a stakeholder in the consolidating firm. Assumes long term commitment with employment contract.
- Combination  
Provides for both cash and equity. Long term commitment.

The better postured your firm is the more negotiating power you have. Take a big picture approach and be willing to be flexible.

## **ALL DRESSED UP WITH NO WHERE TO GO**

Finding the right firm consolidation partner is critical. Your new partner must share your philosophy towards performance and client service. Firm culture is a key component and proves to be a major stumbling block. Unhappy staff and clients will not make for a smooth transition so the culture of their new home is important. How do you find the right fit?

- Make your firm visible in the accounting community
- Spend time with all partners of the consolidating firm
- Get involved with your industry on a State and National level
- Be proactive. Meet with major firms in your area and sell yourself
- Consider a strategic alliance first, it is the courtship before the marriage

## **CHOOSING INDEPENDENCE**

One common trait of small firms is fierce independence. Many practitioners began their careers at larger firms and are not anxious to return to that culture.

While the future of independent firms is strong, what is up for debate is what the firm of the future will look like. It is clear that clients have more options available for basic tax and accounting services. Tax preparation, with advice, is now available for free on the Internet. Programs such as Quick Books have also changed the landscape. Clients still rely on CPAs as their primary source of financial advice but we need to adapt to their needs. The client of

tomorrow will be more sophisticated and continue to challenge our profession to provide different and innovative services.

As an independent, you will face competition in the future from the new firms being molded today. Just as firms who are looking to be consolidated, you will need to examine your firm and be prepared to adapt. The previous suggestions can help a firm both prepare for consolidation and defend from it. Additionally, consider some of the following:

- Develop a niche
- Consider new services, investment counseling, college planning....
- Develop a strong network with other independents
- Form a practice group
- Form a strategic alliance with another firm
- Develop a practice continuation plan
- Seek independent review of your firm practices
- Focus, focus, focus

## **SUMMARY**

While consolidation has faded from national attention it is still alive and well. Small firm practitioners are uniquely positioned to capitalize on the trend towards developing multi-disciplinary practices by larger firms. Whether you choose consolidation or independence, the future of your firm and our industry has never been brighter.

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