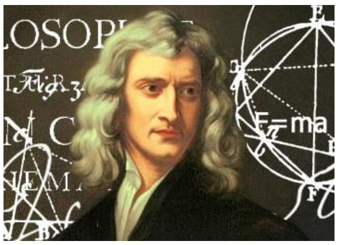
NewGate Law
Lawyers Serving Accountants

Legal Ledger

Briefing for Accounting Firm Clients **May 2018**

The Physics of Accounting Firm Mergers



Sir Isaac Newton was truly a genius for the ages. He lived 85 years, worked his way through Cambridge, invented calculus, had a seat in Parliament, was knighted by Queen Mary, and now rests quietly in a prominent Westminster Abbey crypt. While best known for the unsubstantiated tale about a falling apple that led to his theory of gravity, Newton's three laws of motion have withstood the test of time. These principles are remarkably applicable to modern day accounting firm mergers.

Law Number One: The Law of Inertia

"A body at rest tends to stay at rest unless an external force is applied to it." All of us who work closely with accounting firms are keenly aware of the succession crisis which has beset the profession in recent years. What is the underpinning of this phenomena? In a word, ***inertia.*** Namely, complacency with the status quo and inaction by accounting firm owners to plan for their future until they are on the edge of retirement, and then the panic force is applied - often too late to execute the optimal exit strategy. As a result, there are limited buyers available; and the earn-out terms are likely to be less attractive, as client transition is a frequent concern. Even the fairest acquirer cannot resist taking at least a little advantage of a nearly desperate seller.

Shortly, the effect of inertia is likely to become even stronger. According to the AICPA PCPS 2016 CPA Firm Succession Management Report, 35% of the ownership of CPA firms is likely to transfer in the next five years. This predicts an overabundance of sellers, and a more selective buyer pool. In other words, inert sellers will be rushing to market, and buyers will have the latitude to be more discriminating and dictate more lucrative terms. A word of guidance for sellers - delay no longer and begin to develop and execute a succession strategy.

The corollary to the law of inertia is *"a body in motion tends to stay in motion."* Many larger firms appear to have a nearly insatiable appetite to grow and diversify through acquisitions. While exuberance is more positive than inertia, simultaneously pursuing multiple transactions may be ill-advised. Deals simply require time to successfully plan, negotiate, close and integrate. There is a natural maturing cycle which needs to occur, and it should not be forced.

Law Number Two: F=MA

"Force (F) =Mass (M) x Acceleration (A)". Layperson's translation: the more an object weighs, the more force required to get it moving and gain momentum. Transactions between smaller firms and significantly larger firms typically take more time. It's likely the larger firm is working on multiple initiatives, has a complex and deliberate decision making process, is evaluating or refining its strategic direction, and is managing other significant firm-wide matters. In addition, larger firms may require greater due diligence, utilize comprehensive legal documents, follow a rigorous integration planning process, demonstrate less flexibility, be slower to react, and be more difficult to understand and navigate. In a word, it often takes extra energy to initiate, negotiate and close a deal with a bigger firm. Sellers should strive to appreciate the internal dynamics of merging into larger firms, and look forward to the resulting rewards.

The interplay between the law of inertia and F=MA cannot go unnoticed. As the owners of CPA firms age, they accumulate greater acquisition challenges (i.e. "mass"); and the force required to overcome their inertia increases nonlinearly. In a word, succession planning becomes harder over time, so start early.

A corollary to F=MA is "*deal fatigue.*" When the cycle to start and complete a transaction grows long and heavy, the parties often run out of the energy and enthusiasm necessary to bring a deal to completion. Here are a few potential repercussions. Buyer and seller simply give up and cease negotiating. They lose their ability to creatively resolve issues, or effectively compromise to make a deal work. Hard feelings develop that seriously impede a successful relationship. Trust and energy are lost, and the process of integration becomes suboptimal. Out of frustration, the parties declare that they just want the deal done; leading to poor judgment, and concessions on terms that impact success and are regretted later.

Law Number Three: Action = Reaction

"For every action, there is an equal and opposite reaction." While perhaps the subtlest of Sir Isaac's laws, the "law of balance" is no less applicable to accounting firm mergers; and appears most prominently in transaction structure, integration and execution.

Transactions between buyer and seller need to be structured in a way that is fair and reasonable for both sides of the equation – a balanced give and take - an even push and pull. Objectives and energies must be harmonized; otherwise deals simply do not come together or the results are less than expected. In addition, a buyer's conqueror frame of mind can produce a reaction that leads to alienation, lack of productivity and loss of personnel. Eventually, the equalization of actions and reactions will undoubtedly and naturally occur, usually to the detriment of both parties. Simply put, transactions should be structured so that the actions and reactions are additive rather than having a cancelling effect.

The importance and demands of integration are often underestimated. There is a natural resistance to change (i.e. inertia) that needs to be understood and acknowledged. The most common reactions to the merger action include loss of morale, productivity and opportunity. The negative reactive effect to integration can be minimized by developing an integration plan that accommodates differences, engages personnel and fosters collaboration, communicates credibly and frequently, is metered while embracing change, and provides support and encourages feedback.

Most of us believe that birds fly simply by moving their wings - that's only half of the story. While the wings of a bird push air downwards, the air also pushes the bird upwards with equal force. Similarly, successful mergers result from the synergistic, coordinated and equal movements of buyer and seller; which includes identifying and leveraging strengths and skills, regardless of where they originate. This requires a combining and optimization of cultures, and a commitment of the necessary time and resources. Otherwise, the merger is unlikely to soar.

Accounting Physics Class Dismissed

So, what have we learned from this high school physics refresher? Inertia is a powerful force – perhaps the strongest in the universe – that must be overcome if mature firms are to execute a succession plan based on a merger. Heavier firms, whether gauged by their size or the age of their partners, are harder to move. Understanding and patience, coupled with a sense of purpose and urgency, are critical. Finally, balancing the forces on both sides of the equation produces the most positive results.

Some principles are just universal and timeless - whether they be applied in physics or the business of public accounting.

This briefing first appeared in Accounting Today. *The Physics of Accounting Firm Mergers*

NewGate Law provides a broad range of legal and risk management services exclusively to the accounting industry. Learn more about NewGate Law by visiting our website at newgatelaw.com or by contacting R. Peter Fontaine, founder and managing partner, at pfontaine@newgatelaw.com or (312) 626-2791.