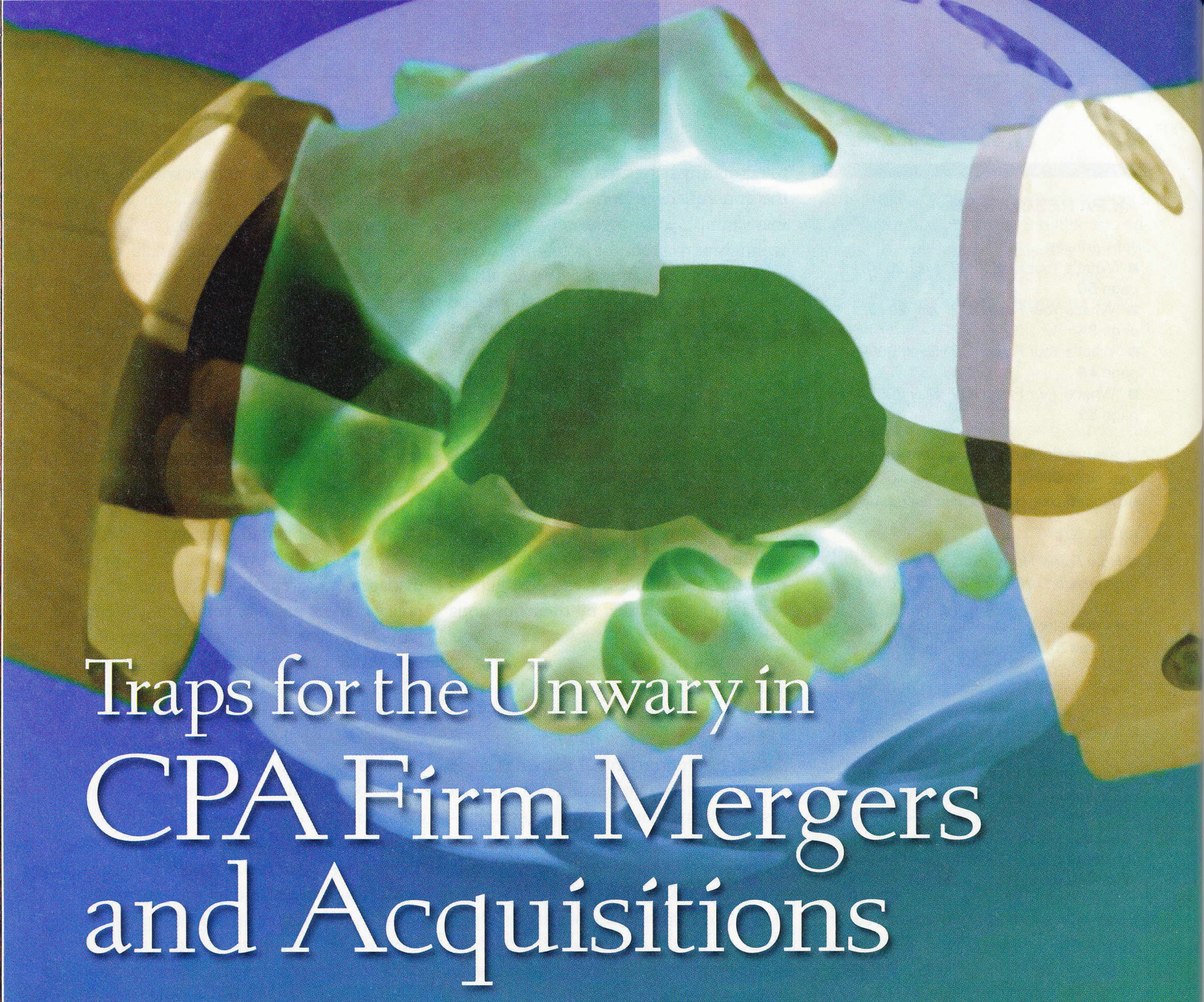

Traps for the Unwary in CPA Firm Mergers and Acquisitions

Allure of a tie-up may vanish if improperly planned or executed.

by John F. Raspante, CPA, and Joseph A. Tarasco, CPA

You can't hold back the demographic tide. In the U.S., another baby boomer turns 60 every eight seconds. This translates into a leadership change in the near future at many CPA firms.

Thousands of partners are at or reaching retirement age now and in the next five years, putting a tremendous strain on even the best succession plans. But age isn't the only factor affecting the profession. Factors such as increased globalization and turmoil in the general economy causing greater competition have been analyzed previously in the *JofA* (see "Accounting Firm M&As: A Market Update," Nov. 2010, page 30). Consider also these forces:

- A significant number of firms have unfunded partner retirement obligations.
- Efforts to retain women in the profession and facilitate their progression to the partner ranks have been largely unsuccessful.
- There is a lack of next-generation "rainmakers."

For many firms, an M&A strategy will

be the solution to these problems. It's a necessary step: A recent CCH survey revealed that managing partners of the top 100 firms in the country spend 20% or more of their time in merger-related areas. A properly planned and implemented M&A strategy can:

- Increase revenues and grow the firm at a faster pace to maintain a competitive edge within the marketplace. Organic growth alone is often insufficient to keep pace with competitors who have grown through M&A.
- Obtain niche and industry experts as the marketplace moves more toward specialists and away from generalists.
- Overcome succession-planning issues by merging in partners who have leadership and practice development skills.
- Expand the firm's geographic market.
- Improve the chances of attracting better quality staff.
- Spread the cost of marketing, human resource and IT professionals over a larger base of partners.

However, improperly planned and implemented mergers and acquisitions can create more problems than they solve. Some of these issues have been explored in a *JofA* two-part overview, "Mergers & Acquisitions of CPA Firms: Understanding the Roadblocks to Successful Deals" (part 1, March 2009, page 58), and "Keeping It Together: Plan the Transition to Retain Staff and Clients" (part 2, April 2009, page 24). Many types of issues and risks can arise in merger transactions. But our experience in advising firms has revealed several specific M&A traps, which are highlighted in this article, that are often overlooked—and that unwary firms can fall into amid time constraints and pressure to finalize a merger.

Trap: Restatement of Previously Issued Financial Statements

The discovery of possible misstatements in financial statements reported on by a predecessor auditor has historically created challenges for the successor auditor. Firm mergers and acquisitions complicate those challenges.

Scenario: Predecessor firm P audited the financial statements of XYZ Corp. and issued an audit report for the year ended Dec. 31, 2009. Successor firm S audits XYZ for the year 2010 and expects to issue an audit report on comparative financial statements for the years ending Dec. 31, 2009, and Dec. 31, 2010. During the audit of XYZ, S becomes aware of information that leads the firm to believe that the financial statements of XYZ issued by P in 2009 require revision.

The P partners disagree with the need to revise the financial statements and object to any restatement. The merger agreement is silent as to which firm's professional judgment governs this dilemma. In addition, the merger agreement includes a one-year de-merger period, which has not elapsed and is creating additional pressure during the discussions on how best to resolve this problem.

A recent survey revealed that managing partners of the top 100 firms spend 20% or more of their time in merger-related areas.

Possible ramifications and considerations for S and P:

- S can resign from the engagement if it is not satisfied with the technical resolution to the potential financial statement revisions. This could be a significant problem, as XYZ is a major client of P and its loss as a client may lead to a de-merger of the firms. A more comprehensive and detailed due diligence—evaluations and inquiries made before a merger or acquisition—may have detected this problem early on and resulted in a simple resolution. Greater due diligence is recommended when merging firms have as clients start-up companies, shell companies, larger companies, companies with liquidity and cash flow problems, and companies in nontraditional industries and other businesses that could be considered high-risk. For example, the due diligence might be extended to review more closely the potential merged firm's workpapers dealing with going concern or other emphasis-of-a-matter disclosures and the engagement team's adherence to AICPA audit guides relating to nontraditional and higher-risk industries, as well as the firm's competency capabilities and realistic basis for completing higher-audit-risk engagements.
- Since the merger agreement doesn't address this issue, S should refer to the AICPA professional standards and use professional judgment regarding the need to restate.
- If S and P agree no restatement is necessary, they could issue comparative financial statements and make reference to P's audit in the auditor's opinion paragraph of S. Alternatively, S could issue comparative financial statements that don't refer to P's audit in the auditor's opinion paragraph.

It should be noted that similar risks apply to compilation and review engagements. The firms must balance the client's needs, professional standards and the ultimate success of the merger.

Trap: Post-Transition Engagement Letters

Scenario: P merges with S after P has issued and received signed engagement letters from its clients. S now must decide if and how it should issue updated or initial engagement letters to P's clients.

Possible ramifications and considerations for S and P:

- One option might be to do nothing and wait until the next year to obtain new signed engagement letters. This may appear to be a practical solution, but it's risky. If a client of P's believes S subsequently performed unauthorized or unexpected work beyond the scope agreed upon, there could be a breach-of-contract claim, particularly if P failed to make the client aware of the merger.
- They might instead issue new engagement letters to every client under the name S. For large firms, this could involve sending out hundreds or thousands of letters, which can be costly and time-consuming to oversee.
- Perhaps the most satisfactory outcome is if P had the foresight to include successor-and-assigns language in its engagement letters. This language allows S to service acquired clients with reduced fear of liability or contractual breaches. The required language varies by state, but the general content usually contains language such as, "Any rights which inure to the benefit of [the predecessor firm] pursuant to this engagement letter shall inure to its committed successors an interest by way of merger, acquisition or otherwise in their committed assigns." Inserting this language in engagement letters in contemplation of a merger makes the transition smoother for S and P and their clients.

Trap: Breaches of Client Confidentiality

Scenario: Your firm is considering merging with or being acquired by another firm, which will conduct a due-diligence process of your firm's financials, agreements and other records. State accountancy boards, regulatory agencies and professional membership organizations have detailed rules regarding protecting clients' confidential information. How can you avoid violating those rules if the merger transaction is not finalized?

Rule 301-3 of the AICPA's Code of Professional Conduct, "Confidential information and the purchase, sale, or merger of a practice," provides guidance in these circumstances:

> Rule 301 prohibits a member in public practice from disclosing any confidential client information without the specific consent of the client. The rule provides that it shall not be construed to prohibit the review of a member's professional practice under AICPA or state CPA society authorization.
>
> For purposes of rule 301, a review of a member's professional practice is hereby authorized to include a review in conjunction with a prospective purchase, sale, or merger of all or part of a member's practice. The member must take appropriate precautions (for example, through a written confidentiality agreement) so that the prospective purchaser does not disclose any information obtained in the course of the review, since such information is deemed to be confidential client information.
>
> Members reviewing a practice in connection with a prospective purchase or merger shall not use to their advantage nor disclose any member's confidential client information that comes to their attention.

Possible solution for S and P:

- Require potential buyers or merger candidates to sign a separate confidentiality agreement that protects each party from client infringement and use of client information outside the due diligence process.

EXECUTIVE SUMMARY

- **Besides the well-publicized succession problem facing CPA firms,** a number of other demographic and economic forces have increased pressure on firms to combine. Firm mergers and acquisitions (M&As) are fraught with hazards, including some less-apparent traps that are often overlooked.
- **When evidence suggests a prior audit** by a predecessor firm may require revision of financial statements, a disagreement over whether a revision is necessary can scuttle a planned merger and/or lead to the loss of the client. The merger parties should be prepared to explore all possible alternatives to restatement while duly considering applicable professional standards and the client's needs.
- **A predecessor firm's engagement letters might need to be updated** by the successor firm or the engagements renegotiated, especially if the predecessor did not include successor-and-assigns language in the letters.
- **Although the AICPA Code of Professional Conduct** addresses client confidentiality during the due diligence process preceding an M&A, the parties may wish to execute a confidentiality agreement further protecting them from client infringement and improper use of client information.
- **Pre-existing "clawback" or other agreements with partners** or other employees should be particularly sought out during due diligence.
- **Noncompetition agreements and fair withdrawal terms for partners** can lessen the possibility of disgruntled partners leaving and taking clients with them.
- **Make sure professional liability insurance** continues to cover work done by the predecessor firm for the applicable statute of limitation period.

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TRAP: OVERLOOKED PARTNERSHIP AND EMPLOYMENT AGREEMENTS

Scenario: As the merger documents are about to be finalized, a retired partner from the firm being acquired unveils an agreement stating he is entitled to receive an accelerated retirement payout when the merger is consummated due to a "claw-back agreement" he has signed.

The potential exposure for overlooked written and verbal supplementary agreements extends to current partners and employees, as well. In many of these cases, the arrangement may have been made years before the deal discussions, and everyone except the partner or employee affected was ignorant of the agreement or its terms.

Possible solution:

- Pre-M&A due diligence is the best defense against unexpected problems with overlooked agreements. Ask current and retired partners if they are aware of any additional partner-level agreements or if any agreements have been made with nonequity partners or staff.

TRAP: DISGRUNTLED PARTNER LEAVES WITH CLIENTS

Scenario: A partner in the acquired firm decides she doesn't like the merger deal terms and leaves the firm, taking clients with her.

There's always a chance that one or more partners—equity or contract—will be dissatisfied with the M&A terms. If that partner or partners leave during the negotiations and take a significant amount of business, it could change the value of the deal and potentially kill it.

Possible solutions:

- Include an enforceable noncompete provision in an amendment to your partnership agreement prior to the M&A negotiations. State laws on noncompete agreements vary, so check to make sure the terms are enforceable.
- Meet with disgruntled partners early in the M&A discussions to negotiate fair withdrawal terms that will avoid the necessity of killing the deal months after negotiations commence.

TRAP: POST-ACQUISITION LIABILITY EXPOSURE FOR PRIOR WORK

Scenario: Your firm merges or acquires another firm. You inform your carrier about the acquisition and cancel the acquired firm's professional liability insurance because the combined successor firm doesn't need two policies.

Consequently, P has no coverage for past work. Statutes of limitation against CPA firms for general negligence and breach of contract vary among states—New York's is three years and New Jersey's is six years, for example. Failing to consider P's potential liabilities for past work creates a major exposure for S.

Possible solutions:

- Have P obtain the longest tail policy available. Tail insurance, formally known as extended reporting period, continues your ability to defend claims after the claims-made policy is out of force. This covers the risk of a claim made against the acquired firm for work before the acquisition and is the preferred solution. Tail policies typically cover three to five years. The coverage is expensive because the policy's full cost is due upfront, but consider getting three-year coverage for maximum protection.
- If the same insurance company covers both parties to the merger, ask the insurer to use the earlier of the two firms' retroactive ("retro") dates. For example, if the acquiring firm has a retro date of 2005 and the acquired firm's retro date is 2000, ask the insurer to approve a retro date for the acquiring firm of 2000. This eliminates the need for a tail policy, but it has a drawback: The acquiring firm's liability limit now applies to claims against both firms. It creates a potentially unlimited exposure for claims above the acquiring firm's policy limit, particularly if the combined firms encounter multiple claims.

A LIFE PRESERVER

The accounting profession is facing its own perfect storm of demographic and market forces combining to influence the future of many CPA firms. How can accounting firms survive and prosper in this changing environment? An M&A could be the life preserver in the right circumstances, provided the participating firms take the proper precautions before consummating the deal. ❖

AICPA RESOURCES

JofA articles

- "Accounting Firm M&As: A Market Update," Nov. 2010, page 30
- "Mergers & Acquisitions of CPA Firms," March 2009, page 58, and "Keeping It Together," April 2009, page 24 (two-part article)

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