VALUATION AND PRICING

MODULE 4: GROWTH AND SUCCESSION GUIDE

INTRODUCTION

Who will buy my practice is a question that is increasingly being asked. With the average age of public practitioners now well over 50, an increasing number are contemplating how they will succession manage their practice. For many the focus is on the capital value of the practice and how they can extract this capital value to assist in their retirement planning. Succession though, isn't always about retirement. There are a whole range of events that can be a catalyst to the sale of a practice.

Currently, there are approximately 9,000 public practice firms in Australia, and of these 83% are represented by sole practitioners and two partner firms. You have a large number of small practices delivering similar services to a similar client base. These firms are typical of small business in Australia. CPA Australia public practice statistics identify that approximately 42% of members may have a succession event for their practice within the next five years.

Where does this place public practitioners looking to plan and implement their succession?

The main options are the sale of a fee parcel, outright sale of the practice, a merger, sell to existing partners, internal succession, the introduction of new partners or the orderly wind up of the practice.

Each of these options, with the exception of the last one, will seek to generate a return of working capital and also a return on your investment in plant and goodwill. The critical factors will be timing, pricing and planning. Your approach to the sale of your firm will vary depending on which sale option you are planning to pursue.

The difference between taking a structured approach to this and a last-minute rush to find a buyer can be many thousands of dollars. Planning the sale of your practice is about maximising the value of your asset and also managing an orderly transfer of your professional obligations in respect of your clients and your team.

Given the expectation of an increasing number of firms and fee parcels coming on to the market, without question we will see buyers gravitate toward value. A clear message is that we should all be planning for the ultimate sale of our firm – irrespective of whether we expect to be in practice for two or 22 years.

Every firm should be developed with view to the ongoing succession and ultimate sale of the business. The great thing about doing this is that you build a strong and profitable business from day one. And when the time comes for you to move on, then you have an asset that is attractive in the market and one for which there should be strong demand.

This guide has been designed to provide you with some of the practical tools that will assist you to plan and position your practice so that it is attractive in the marketplace and to manage your succession. It is particularly focused on small and medium size practices, although the fundamentals hold true for all.

VALUATION AND PRICING

Why value and price may be different

Value and price will not always equal each other. In a perfect market they should, but no sale operates in a perfect market. So, don't expect your valuation and pricing to be the same.

Take a moment to think about the normal valuation introduction. It goes something like this. 'the Fair Market Value is the price that would be negotiated in an open market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller dealing at arm's length within a reasonable time frame.' Whilst true in establishing a fair market value it is not reflective of the typical market in which a transaction takes place. In most cases either the seller or the buyer will be more anxious, willing and knowledgeable and this imbalance will influence the price. For this reason, price normally trades at premium or discount to value.

It is not uncommon to see price at a premium or discount of up to 33% of the valuation.

In determining a likely price for your firm, you would start with a valuation estimate of the firm and then overlay relevant market influences that are likely to push the price in excess of the valuation or alternately that depress the price against the valuation. Included in these factors will be supply and demand. This will not be the same across the entire market, so don't accept generalisations as applying to everyone. Factors such as location, client mix, profitability, staffing and growth rates could all influence this position.

As more practices come on to the market there will be a normal supply/demand pressure. However, it is more likely that what we will see is a polarisation on price rather than a similar effect with all firms. Good practices will continue to command their price while poor performing firms will be more difficult to sell and in some cases be unsaleable. In sale events it is becoming increasingly common to include an element of the purchase price that is contingent on future performance. This serves as some level of protection for the purchaser against clients or work that may leave the practice on departure of the vendor. Typically, this will be limited to the first anniversary of the sale date.

The 'at risk' consideration may be tied to some deferred payment arrangement. Contingent consideration may also be used where the practice is in growth phase and the vendor wants to be rewarded for growth that has been achieved but which, at the time of sale, has not been realised in fees. These types of arrangements are commonly referred to as earn out or claw back clauses. They are often used as a bridge in agreeing price between the vendor and purchaser.

The following should assist you to understand the likely methodologies that will be applied, when they will be applied and factors you should consider in reconciling value and price.

As a starting point you need to consider the purpose of the valuation e.g. is it for an outright sale or the sale of a partnership interest? In the case of the sale of a partnership interest you always need to have regard for any underlying partnership or shareholder constituent documents where a valuation methodology has been agreed and forms part of the partnership or shareholder agreement.

Current practice valuation methodologies

There are numerous methods used in valuing a business. Traditional methods used in valuing a business include:

- capitalisation of future maintainable earnings
- discounted cash flows
- rule of thumb or industry method

- return on investment.

Capitalisation of future maintainable earnings

Capitalisation refers to the return on investment that is expected by an investor. This method forms an opinion on the business value based on the sustainable profits generated by the business relative to the risk return expected. While not precise, it allows an investor to consider possible future returns against other investment options.

This method is the most widely used and accepted methodology in business valuations for small and medium businesses. As such, much of this module concentrates on the workings of this methodology.

This method involves an analysis of the past performance of the business, in order to determine the business's future maintainable earnings and capitalise those earnings for an expected rate of return for the investment.

Download a Valuation working paper (capitalisation method).

The valuation expressed as a formula is:

Value = Future Maintainable Earnings / Capitalisation Rate +/- Net Surplus Assets (if any)

Procedure for valuation under capitalisation of future maintainable earnings

1. Obtain as a minimum the previous three years' financial statements of the business to be valued.
2. Review the financial statements and determine from enquiry and other means whether the financial statements adequately represent the trading of the business.
3. Analyse the Profit & Loss Statements, making appropriate adjustments for either commercial and non-commercial expenses or income included in the accounts.
4. Total the net results for the years reviewed and calculate the average net result. This figure is referred to as the Maintainable Earnings amount.
5. Consider whether any permanent issues that were not necessarily present in the prior periods trading will affect the future year's profits.
6. Determine what would be an appropriate return for an investment, taking account of the risks and other issues applicable to an investor.
7. Divide the maintainable earnings figure calculated in 4 above, by the desired investment return as determined in 6 above.
8. Analyse the latest balance sheet and calculate the value of the net tangible assets of the business assets.
9. Subtract the net tangible assets from the value calculated in 7 above; the net result is the value of the goodwill of the business.

Establishing maintainable earnings

When analysing the Profit & Loss Statements there are a number of factors that should be considered in establishing a future maintainable earnings figure:

- the comparison should be made over a period of at least three years
- an allowance should be made to include a commercial salary for the owners
- adjustment should be made for any above or below market salaries or benefits paid to the owners or their associates
- adjustments should be made to exclude any costs which do not relate specifically to the operation of the business
- depreciation or amortisation charged for prior years should be amended to reflect accounting rates for life of equipment and not tax rates
- interest should be excluded from the calculation, since that reflects a funding decision of the vendor, not the purchaser. Obviously, a purchaser would need to include his own estimates to determine his rate of return
- if real property is included in the sale, a commercial rent should be included in the operating costs and the property valued separately
- the maintainable earnings figure can be calculated on either a pre or post tax basis. However, you must ensure that the applicable capitalisation rate is based on the same tax basis.

Once you have calculated the adjusted earnings for each of the three years (or a greater period being reviewed) you then need to average the earnings to determine a future maintainable position. You may either apply a simple average or alternatively, a weighted average with the higher weighting applying to the more current years. The decision to use a simple average or a weighted average may be influenced by the degree of variability in earnings over the period being assessed.

Where you are valuing a business part way through a year it may be appropriate to include the current year position, particularly if there are clear trends developing through the year. Where you are using a weighted average approach, you will need to consider if some level of discounting is appropriate to reflect the lack of certainty in the final result. In a limited number of cases it can be appropriate to include a future year in your consideration. Such a case could exist where forward income is locked in and there it has a material effect on the result. In this you need to consider the level of certainty around the earnings forecast. This requires an assessment of both the reliability of income and expense forecasts.

Capitalisation rate

Determining a capitalisation rate for the calculation is a subjective decision and requires consideration of a number of factors.

The capitalisation rate effectively relies on the concept of "fair value" and requires the valuer to establish what a willing and informed purchaser would require from that type of investment. In determining the rate, it is necessary to consider a number of factors:

- current "risk free" rate of return, usually the Government Bond rates
- relative bank rates of interest, comparing say cash rates to bank bill rates
- price-earning ratios of publicly listed stocks, comparing differences between:
    - blue chip industrial type shares
    - smaller industrial stocks
    - various same industry stocks
- ability to resell the business – liquidity of the asset
- identify risks particular to the relevant industry
- identify risks specific to the business being considered
- length of time that the business has been operating

- effect of technology on the industry and business - will major investments be continually required?
- is the industry still growing or has it matured or even declining?
- is the business subject to any issues due to its location?
- level of business dependence on key customers, suppliers or staff
- are there any regulation changes likely that will affect the business?

The rate can be determined by a number of approaches. One such approach could include:

1. Start with a risk-free rate or the industry adjusted P/E multiple
2. List the issues identified affecting the investment decision against a scale applying a percentage multiple to either increase or decrease the rate
3. Tally the scores to either add or reduce the initial figure.

The valuer may then, even after adopting such a methodical approach to weight the different issues, simply adjust that for their own experience of similar businesses operating in that industry. The majority of accounting firms, where the risk profile is assessed as normal to industry, will command a multiple in the range of 3.4 to 4.2 times earnings.

Finally, the rate also needs to be determined on a consistent tax basis to how maintainable earnings was calculated, that is on either a pre or post tax basis.

Calculating the value

Based on the formula set out previously, the valuation is then simply determined by dividing the maintainable earnings, by the capitalisation rate. Where the capitalisation rate is expressed as a multiple you would apply this multiple to the assessed future maintainable earnings.

When providing an amount, we suggest you establish a range as opposed to simply quoting a spot price. This can be achieved by using an upper and lower capitalisation rate for the calculation. Similarly, you may choose to establish an upper and lower earnings estimate.

Remember, the calculation made is for the gross value of the business. To the extent that any assets exist within the business that are surplus to the requirements of the business, then the value assessed would be increased to allow for these surplus assets. You should always consider and comment on the existence of surplus assets.

Rule of thumb or industry multiplier method

This approach adopts the value of the business as relative to an “industry standard”. Generally, the multiplier would be applied to either the profit of the business or its turnover. For example:

- accounting practices may apply so many cents in the dollar of gross fees

The most common rate occurring in the current market is in the range of 80 cents in the dollar to dollar in the dollar of maintainable fees. There are examples of transactions falling both above and below this range. It all depends on the fundamentals of the practice. Practices exhibiting high profitability, good quality clients and strong growth features are the ones most likely to command strong pricing. Location will also have an impact on this. Areas where there are a large number of firms and where there is continuing demand for accounting firms will command the best rates. Some isolated locations may trade at a discount.

Where a practice has a financial planning revenue stream within the practice it would be normal for this to be valued separately. This assumes that the revenue stream is material. This normally occurs where revenues exceed $100K.

The problem with adopting these industry standards is that they are really only applicable to those businesses that operate to an industry average. The multipliers offer no benefit or discount for those businesses that are either above or below the standard. Where you are using this method and providing a professional opinion you should consider and where appropriate comment on this.

Also, in applying a standard industry method, the price should be compared to an alternative methodology to ensure the merits of the business investment. For a purchaser, it may be necessary to borrow or invest funds, and accordingly essential that profits can be earned, and the investment is capable of being recouped.

Download a Valuation workpaper (cents in dollar method).

Other methods – return on investment (ROI)

This method considers the return that will be achieved by the investment. It measures the maintainable revenues of the business against the investment required. Unless you have threshold levels below which you would not invest in a business this method provides a comparative rather than an absolute valuation.

It is not unusual to use ROI as a secondary valuation method. Whilst there are no absolutes you would normally expect the ROI to be in the range of 20-50%. A return less than 20% would normally not warrant the risk of an investment in a private business. This method requires an analysis of the risk /return model of any business.

Also, in applying a standard industry method, the price should be compared to an alternative methodology to ensure the merits of the business investment. For a purchaser, it may be necessary to borrow or invest funds, and accordingly essential that profits can be earned, and the investment is capable of being recouped.

Valuation segmentation

There is a reasonably clear segmentation of valuation methodologies that is based on the fee level of the practice. Like any segmentation it is not absolute and will blur somewhat when you approach the dividing lines. As such the following should be taken as an indicator rather than as an absolute.

The annual fee levels across the accounting profession can be divided into the following natural segments:

Less than $500k	In the majority of cases practices or fee parcels of this size will be negotiated on a cents-in-the-dollar of maintainable revenues. Currently there is a reasonable demand for practices of this type. If the practice is a good quality one and exhibits reasonable levels of profitability it will command pricing at the upper end of the price range.
$500k - $1m	In the majority of cases price will still be negotiated on a cents-in-the-dollar of maintainable revenues. The closer the fees to the $1 million range the greater the focus will be on the profitability of the practice. Your buyer will be more concerned about the rate of profit after allowance for principal or partner salaries. In some cases, at the upper end of this fee range you may find buyers who want to employ more traditional valuation methodologies to establish pricing such as a capitalisation of future maintainable earnings.
$1m - $2m	As the size of your practice moves above annual fees of $1 million it is far more likely that the practice will be valued for pricing purposes using a traditional valuation methodology. The most common valuation method currently employed is a Capitalisation of Future Maintainable Earnings. This requires establishing a maintainable earnings level for the firm. The earnings will

	normally be adjusted for any abnormal items and in particular salaries for principals and partners will be adjusted to market levels. The earnings level being established is after reasonable principals and partners remuneration. This methodology has a very strong focus around the levels of profit being generated by the firm. Once the maintainable earnings level has been established it is then necessary to determine an appropriate capitalisation rate for the firm. Where the firm has quite different types of revenue streams such as business services, financial planning and insolvency then the firm will not be valued on a single revenue stream basis. Different revenue streams characteristics will be valued separately.
> $2m	Practices of this size will almost certainly be valued for pricing purposes using a traditional valuation methodology. The most common valuation method currently employed is a Capitalisation of Future Maintainable Earnings. This requires establishing a maintainable earnings level for the firm. The earnings will normally be adjusted for any abnormal items and in particular salaries for principals and partners will be adjusted to market levels. The earnings level being established is after reasonable principals and partners remuneration. This methodology has a very strong focus around the levels of profit being generated by the firm. Once the maintainable earnings level has been established it is then necessary to determine an appropriate capitalisation rate for the firm. Where the firm has quite different types of revenue streams such as business services, financial planning and insolvency then the firm will not be valued on a single revenue stream basis. Different revenue streams characteristics will be valued separately. It should be noted that some large firms do not recognise goodwill as this is seen as an impediment to the progression of younger partners where a large goodwill payment may be difficult. Firms of this type require incoming partners to make a contribution toward working capital and when they leave their payout is only for working capital. Sales to such firms could lead to different views in relation to goodwill recognition. Such cases would be in the minority.

Example:

ABC Accounting is a CBD partnership operated by two CPAs. The firm has grown recently with fee levels of:

- 2013 - $820,000
- 2014 - $910,000
- 2015 - $1,080,000
- 2016 - $1,260,000

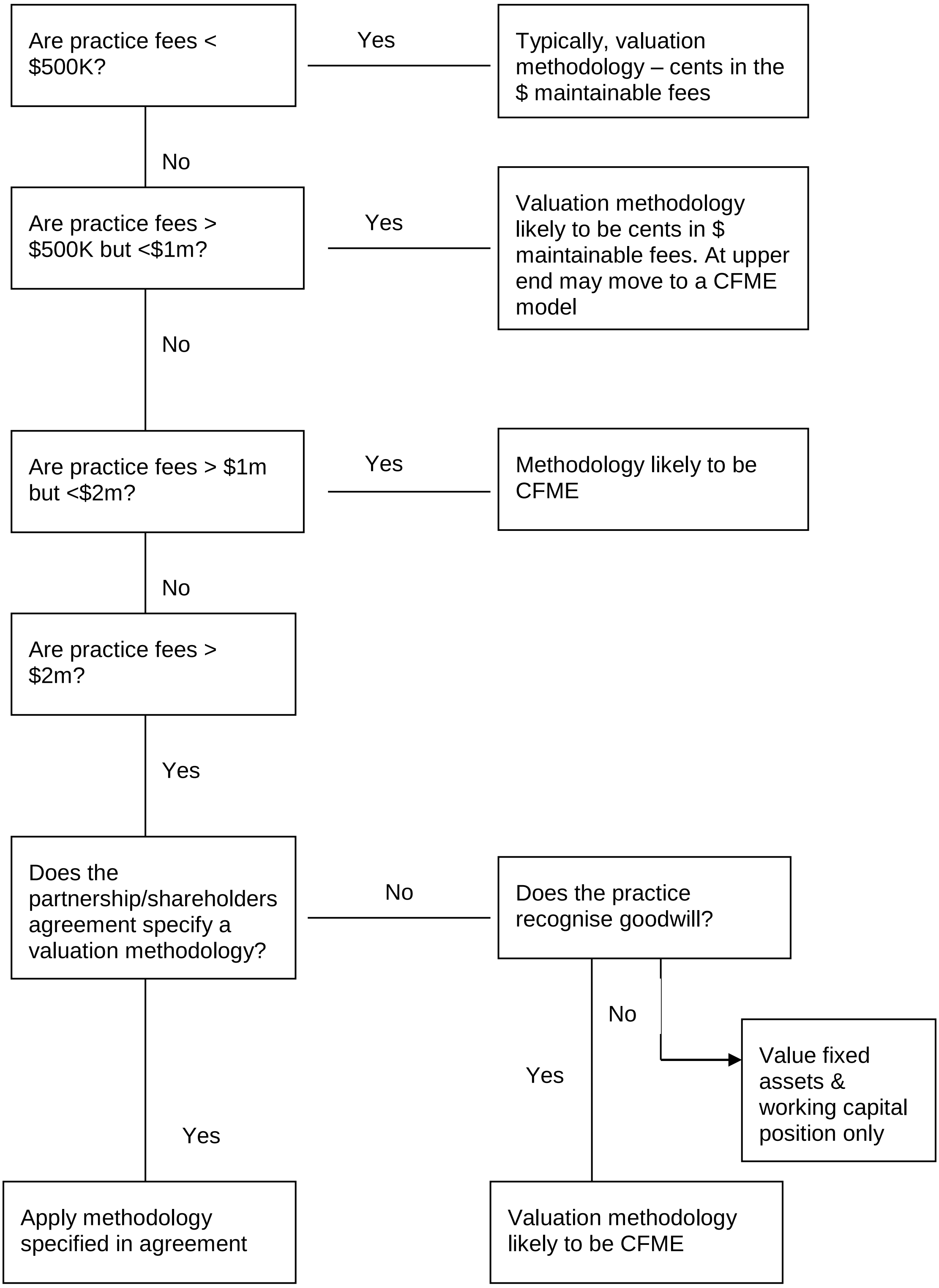
The partners want to complete a valuation of the firm as part of a broader succession planning exercise. There is some discussion around the appropriate way to value the firm. For two of the last three years revenue has been less than $1 million. However, the immediate past year and the forecast year both have revenue in excess of $1 million. Average revenue over the last three years is also less than $1 million.

Response:

The segmentation of methodology by revenue levels is not a hard and fast measure. It is likely in this example that the firm would be valued using both approaches with the outcomes compared. The more the firm exceeds the $1 million fee level the greater the relevance that would be placed on an earnings-based valuation. A focus on top line growth, in isolation, can be disadvantageous for a firm.

Download a [Working paper to assess price against valuation](#).

Flow chart to selecting a valuation model



Checklist of pricing considerations

Issue	Completed / Comments
All assets included in the price have been identified	
Price has been apportioned across asset classes, with appropriate recognition of work in progress where it exists	
Prices for comparable sales have been identified and assessed	
Whether any of the price is contingency based has been identified	
Whether the price includes any allowance for transition assistance has been identified	

Pricing goodwill, plant & equipment and working capital

Once you have established a final sale price it is important to consider the apportionment of the sale price. Typically, the focus at the time of the sale is on achieving the sale and the global price for all of the assets. It is not uncommon to see sale agreements where the sale price is not apportioned. This can lead to later problems and outcomes that you may not have expected. In particular, you need to consider how your sales proceeds will be treated for tax purposes. You may see your sale as primarily being the sale of a capital asset, and whilst this may be true it is likely that there may be a mix of capital and revenue assets being sold. The area likely to cause the most impact is the position on work in progress.

Where the consideration or part of the consideration is deemed to be a payment in respect of unbilled work in progress then this amount will be on revenue account and assessable under s. 15-50 ITAA 1997. A number of cases have been decided on this point in relation to professional practices, including Crommelin v FCT (1998) and Stapelton v FCT (1989). Where the contract has no apportionment or where the apportionment does not recognise the position of work in progress then the Commissioner has the ability to reconstruct the apportionment of the consideration.

Where the consideration is on capital account and is in respect of the disposal of capital assets being an interest in the partnership assets, the consideration will be subject to the capital gains tax provisions. Section 106-5 deals with partnerships, and the acquisition or disposal of a partnership interest. The Commissioner further states his view on this in IT2540. In brief, the Commissioner adopts a fractional approach to partnership interests. This accommodates not only individual partner shares in a single asset or assets but also accommodates situations where a partner may acquire interests in the partnership at different times.

All of this highlights the importance of some forward planning and identifying the likely tax impacts flowing from a sale of your practice or an interest in the practice.

FURTHER RESOURCES

- Unplanned succession (PDF)
- Succession options (PDF)
- Succession implementation (PDF)
- Succession planning
- Roadmap to practice growth and succession (PDF)
- Growing your business

About the author
Greg Hayes, Director, Hayes Knight (NSW) Pty Ltd, has broad experience and knowledge in the area of public practice succession. With over 20 years experience as a public practitioner, Greg's focus is on business consulting and taxation. He specializes in strategic planning techniques and is well known in the areas of practice management and business development, having been an active commentator in this area for over 15 years.

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