according to the Harvard Business Review the failure rate exceeds 70%. Why? Because companies, including CPA firms, "...that focus on what they are going to get from an ...

Nov. 01, 2018

"When two firms merge, it's one of the most significant liability exposure events they will face." ~ Ken Mackunis, President, Aon Insurance Services.

Although corporate mergers and acquisition activity continues to set new records,

Always glad to help a client, I told the staff members at the acquired firm the following true story.[2]

Lack of Oversight Results in Multimillion Dollar Lawsuit

A large accounting firm with a long history of providing traditional accounting services decided they wanted to develop a concierge business for wealthy and famous clients. They figured it would give their firm more marketing appeal and attract additional business. So, they acquired a single person CPA firm whose primary client was a world-famous entertainer.

The acquired firm performed a wide variety of services for the entertainer, including tax and accounting work, along with travel arrangements while on tour. Two years after the acquisition, the client sued the firm for $10 million, alleging tax filing errors, negligent investment advice, mismanagement of tour merchandise revenues and travel arrangements (resulting in a missed tour date), and theft. At trial, the client won a multimillion dollar verdict.

What went wrong? For one, the acquiring firm did not review documentation of the prior work the CPA performed for the client as part of their due diligence. Even worse, following the acquisition, there was no oversight of the work being performed. They were only interested in one thing: bringing in new clients who were rich, famous, and lucrative. The CPA brought in significant revenue, so the firm left her alone. No one integrated her into the firm culture nor reviewed her work or billings.

The firm had no idea that the CPA sent out monthly bills for thousands of dollars without itemization. They also did not know that most of her communications with the client were via text and social media platforms. As such, there was inadequate documentation to defend her actions, even though the client consistently failed to

Their lack of oversight cost the partners a sizeable self-insured retention, and their insurance company, millions. Worst of all, their sterling reputation got dragged through the mud by the press, which took great interest in the case due to the client's celebrity status.

After providing this classic fable about the perils of mergers and acquisitions, I ended my presentation by asking the staff, "Do you want to be the one who puts the entire firm at risk due to your failure to comply with existing quality control procedures, or to bring such problems to the attention of firm management?" Of course, no one did.

Pre-Transaction Due Diligence: Asking the Hard Questions

"When CPA firms consider acquiring a firm, they are primarily looking at two things: the people and the clients," said Joe Wolfe, a risk management consultant for Aon Insurance Services. "They'll look really hard at the things they're interested in and forget to investigate services and industries the firm dabbles in, because they pay well or keep staff busy during slow times of the year. Firms also usually do a good job of evaluating quality control in an audit practice, but don't devote enough time to tax practice, which generates about two thirds of all malpractice claims. Lastly, they need to evaluate the firm's privacy and security practices. These are where some of the hidden risks may lie."

You need to do extensive due diligence when looking at a firm you're planning to acquire or merge. To avoid potential land mines, you need to ask the hard questions and conduct sufficient investigation to satisfy yourself about the responses provided.

Questions Regarding Clients

- What kind of industries and engagements does the target firm primarily focus on?

want?

o Do they require engagement letters to be signed before the work starts? Or do they "paper the file" with the engagement letter later?

- How do the partners supervise and manage workflow and billings? Do they require itemized billings that align with the scope of the services described in the engagement letter, or is block billing allowed?
- Did you look at their most recent peer review report?
- Did you examine a cross section of the firm's working papers in all areas of practice? Does staff adhere to their existing quality control standards when compiling their notes?
- Do they have a required process for client acceptance and continuance? How does it work in application?
- Are they able to identify their riskier clients? If so, what kind of work is being done for them? Can the risks be mitigated sufficiently to continue them as clients?
- How do they manage accounts receivable? Is there a required escalation process for a client in arrears or in financial trouble? Do they pursue clients for unpaid fees?
- Do they have any clients that have or plan to go through private or public offerings?
- Is the target firm currently completing any complex or high-risk engagements?
- Are there any current or potential claims under any of their insurance policies? If yes, what is the status of each matter?
- What is their procedure for identifying and escalating notice of potential or actual claims?
- Are there any pending employee complaints either to human resources personnel or the EEOC?
- Are there any pending regulatory compliance investigations involving current or former clients?

Questions Regarding Personnel

place, and how do they monitor compliance with same?
- How does the firm vet the degrees and certifications of new hires?

Post-Transaction Integration Playbook

"One of the bigger risks in the first year is that some of your best people may quit," said Wolfe. "There's going to be changes, but you need to create a positive work environment while instituting required controls."

People are going to be doing some things differently than they did before. Provide plenty of explanation about new requirements, and plenty of time for training and oversight.

"For a smooth transition, it helps to have experienced managers from the existing firm involved initially in the day-to-day management of a newly acquired office," Wolfe said. "And if you're physically merging two locations, the faster you accomplish this, the faster you reduce the risk of problems festering."

In addition to transitioning personnel, consider the clients of the acquired firm. Managing the transition of clients will require extra effort. Poor communication can result in missed details, mistakes, billing disputes, loss of clients, and even malpractice claims.

"Firms that experience increased client or personnel turnover associated with a merger or acquisition are more likely to have professional liability claims," said Wolfe. "The training and supervision falters when people are constantly leaving. The end result is that work quality suffers, and the firm suffers as well."

When it comes to boutique practices, don't get blinded by the knowledge, experience, certifications and client lists of senior personnel, and overlook the most important thing; what oversight has there been of their work? They may be making a lot of

A successful merger or acquisition can create new and unique opportunities for your firm. Approach it with your eyes open and be prepared to deal with the unexpected.

========

Resource:

Merger & Acquisition Checklist, Aon Insurance Services, March 2018.

[1]Roger L. Martin, "M&A: The One Thing You Need to Get Right," *Harvard Business Review*, June 2016.

[2]Though based on a true story, the details have been changed to protect the identity of the defendant CPA firm.

Stan Sterna, JD, is a vice president of risk management at Aon Insurance Services, the administrators of the AICPA Professional Liability Insurance Program since 1967. Prior to working at Aon, Stan served as the Director of Claims at CNA Insurance. For more information contact stan.sterna@aon.com or visit cpai.com.

Firm Management