Managing risk in a CPA firm merger or acquisition

By Amy Waldron, CPA

More and more CPA firms are up for grabs as Baby Boomers hang up their calculators for good. Merger-and-acquisition activity is high, and this trend is expected to persist. According to the 2012 biannual survey on succession planning conducted by the AICPA Private Companies Practice Section, almost half of multiowner firms had actively discussed mergers, acquisitions, and sales or planned to do so over the next 24 months. The motivations for this activity include revenue growth, expansion into new markets, talent acquisition, and the addition of niche services.

Firm leaders weigh many considerations during the due-diligence, negotiation, and integration phases of a successful merger or acquisition. One of the most important considerations is the professional liability risk that can arise from combining with another firm. This column identifies those risks and recommends how to address them.

**DUE DILIGENCE ON TARGET FIRM**

**Evaluate Skills and Experience**

*Risks*: Professional liability claims often arise from niche services, such as family office and personal financial planning, delivered by personnel of the acquired firm. In many cases, principals of the surviving firm aren’t supervising the activities and lack awareness of shortfalls in the skills of acquired personnel performing these services.

*Recommendations*: Evaluate credentials of the target firm’s personnel. Verify relevant experience, educational backgrounds, required licenses, and professional designations. Inquire about regulatory or disciplinary investigation history. Check state accountancy boards and professional associations to verify good standing. Consider costs associated with the extra resources needed to support this niche practice, including training that would enable your existing personnel to supervise these services during the integration phase.

**Assess Quality Control**

*Risks*: Professional liability claims are more likely if a target firm does not value quality controls. Surviving firms that do not identify quality-control issues of a target firm will miss opportunities to mitigate this risk. Effective quality-control mechanisms are especially important in the early years following an acquisition. The larger the gap in value placed on quality control between your firm and the target, the greater the challenge during the integration period.

*Recommendations*: Read the most recent peer review report. Request a copy of the quality-control manuals. Find out how the target firm’s principals monitor quality control. Focus on policies related to engagement letters, engagement assignments, documentation standards, and supervision and review requirements. Assess adherence to established policies through an inspection of a sample of workpapers. Determine if identified deficiencies in quality control can be managed through the integration process. Recognize a red flag if the firm has little to no quality control or if target principals operate with a high level of autonomy.

**Inquire About Client and Engagement Acceptance and Continuance Policies**

*Risks*: While client and engagement acceptance and continuance is a subset of quality control, it is a critical issue requiring its own careful scrutiny during due diligence. Claims often arise from acquired high-risk clients of target firms where the risk was not properly identified and managed.

*Recommendations*: Examine the target firm’s existing client and engagement acceptance and continuance policies and procedures as well as its client list. Determine the adequacy of these policies and the target’s compliance with them. Identify clients and engagements where risk can be managed through heightened supervision or other mitigating controls. If a client poses too great a risk, the relationship with that client may need to be terminated.

**Evaluate Claim Experience**

*Risks*: The professional liability claim experience of the target firm should be considered from the perspectives of firm culture, practice management, and quality control. Claim experience also affects the availability and cost of insurance coverage.

*Recommendations*: Discuss the target firm’s process for identifying actual and potential claims. Request a 10-year loss run report, which is typically provided by the target’s professional liability insurance carrier. For recent claims, identify the nature of services, responsible personnel, claim investigation results, lessons learned, and actions taken. For resolved matters, determine the disposition and extent of any forgiven fees or settlements paid. For pending matters, determine the amount of asserted damages and the carrier’s
reserves for defense costs and indemnity payments, if available.

NEGOTIATIONS WITH TARGET FIRM

Evaluate Professional Liability Insurance Coverage

Risks: In the event of a claim, differences in coverage can lead to significant disputes between parties if coverage is not addressed during negotiations prior to the merger or acquisition. A thorough examination of insurance coverage will help maintain appropriate protection for the combined firm. Failure to address these issues in detail in the merger or acquisition contract can lead to gaps in insurance coverage and may unexpectedly create uninsured exposure for firm owners.

Recommendations: Obtain a copy of the target firm’s professional liability policy. Review it with your firm’s insurance agent or broker to identify coverage gaps. The merger or acquisition contract should address responsibility for maintaining professional liability insurance coverage for both past and future services by each of the firms, as well as the individuals affected by the transaction. For example, the document should address if and how prior acts of each firm will be insured, the policy limits and deductibles that must be maintained, and who will be responsible for paying the continuing costs of insurance and deductibles in the event of a claim. The contract also should address how these issues would be managed in the event of the death, disability, or retirement of any of the owners, or the dissolution of the combined business entity.

Address Work-in-Process

Risks: Unless responsibility and legal liability for pending engagements are specifically addressed in the agreement, the surviving firm will assume responsibility for the completion of the engagement and issuance of the work product on or after the transaction closes.

Recommendations: Review work-in-process on all audit engagements, significant tax engagements, and other high-risk engagements. This examination should be performed sufficiently in advance of the transaction date to address all relevant issues, including assignment of personnel to supervise and complete the engagement by its due date.

INTEGRATION

Personnel Integration

Risks: In the absence of clear communication and timely training, acquired personnel will continue delivering services in accordance with the former firm’s quality controls and processes. If quality-control gaps were identified during due diligence, this deficiency will create exposure to the surviving firm.

Recommendations: Communicate the effective date of the merger or acquisition to all personnel of the surviving firm. Schedule timely training sessions to train personnel on the quality-control expectations and policies. Monitor adherence to quality control more frequently in the first two years of the integration.

Client Integration

Risks: Similarly, the absence of clear communication with clients can create interruptions or other service issues leading to professional liability claims.

Recommendations: Communicate the effective date of the merger or acquisition to all clients of the surviving firm. The communication will vary depending on the nature of the merger or acquisition. For example, if the name of the newly merged or acquired entity has changed, the firm should indicate the name of the firm that will continue to deliver the professional services. Modify engagement letters as needed. Communicating clearly with clients will also help soothe any anxiety they may experience over how their needs will continue to be met by the surviving firm.

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