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HOW TECHNOLOGY ADOPTION IMPACTS THE VALUE OF YOUR ACCOUNTING FIRM

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Introduction

When accounting firms are sold and acquired, sellers are typically prepared for a relatively standard list of due diligence items – historical financial performance, services mix, age of clients (and partners), deferred compensation obligations, noncompetition agreements, and so forth. But are you ready for technology due diligence? An afterthought in times past, where the hallmark of a high-tech accounting firm was to have gone "paperless," the opportunities and demands of technology have rapidly evolved to a point where the firm's technological maturity is at least as important as more conventional due diligence considerations.

Technology impacts the value of the firm along certain broad themes:

➢ **Profitability** – Technology, properly leveraged, enables firms to become more profitable by improving productivity and efficiency.

➢ **Growth** – Technology removes constraints to firm growth by enabling it to scale more easily, reach more potential clients, service clients anywhere in the world, and offer new (and possibly more lucrative) services to clients.

➢ **Risk** – Technology can reduce the incidence of errors and enhance client diversification. Technology is also a must to enable the firm to properly exercise its obligations to protect sensitive client data from theft or misuse.

It is important to calibrate the meaning of value and technical context of (approach to) value to ensure full understanding of a valuation discussion. For the purposes of this exercise, value is defined as "fair value," which, generally, invokes the well-worn framework of a willing and knowledgeable buyer dealing with a willing and knowledgeable seller negotiating the price of the firm to be acquired. Both parties are assumed to be purely financially motivated (i.e. not buying a firm for the purpose of building ego or selling because the key partner suddenly received a grim health diagnosis). The acquisition thesis is not strategic (synergistic) in nature, and there is no explicit adjustment for the fact the accounting firm

is not publicly traded (e.g. a discount for lack of marketability per fair market value).

The technical context of this analysis will be the application of a capitalized earnings approach. Business appraisers typically value capitalized earnings by using the Gordon Growth Model. This model originated in the 1930s but began to accelerate in popularity and prominence after Gordon published "Dividends, Earnings and Stock Prices" in Review of Economics and Statistics in 1959.

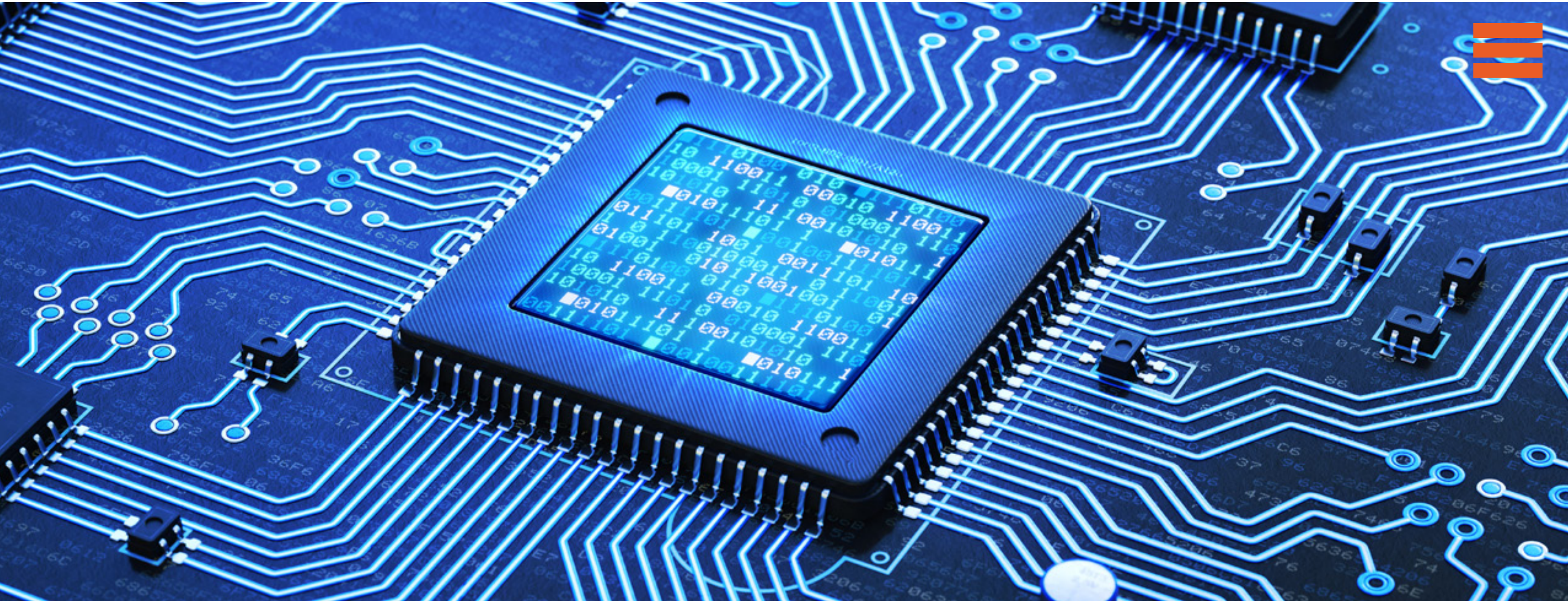
The Gordon Growth Model indicates an enterprise level of value (before consideration of debt) with the following formula:

$$V = \frac{CF \times (1+g)}{k-g}$$

Here, V = value, CF is net cash flow (i.e. profitability), g = long-term growth, and k is the discount rate (required/offered return as a function of the firm's risk). As risk decreases, the discount rate decreases, resulting in an increase in V. As growth or CF increases, the firm's value increases. Generally, the Gordon Growth Model is applicable in cases where a baseline cash flow is reasonably estimable and expected growth is not much greater than 5-6% over the long run. As many accounting firms, other than the very smallest ones, tend to be reasonably stable in terms of financial performance, the Gordon Growth Model is applicable.

Technology impacts value in any one of CF, g, or k; in fact, it often impacts two or even all of those value drivers. The implication is clear – if your firm is behind on technology, you are leaving value on the table. Your firm may be functioning fine, and it may be an attractive acquisition candidate if your technology is lagging or incomplete. But it surely won't attract the top dollar that it could.

There are specific technology fields that command the attention of potential buyers. By ensuring that your firm is current in these technologies, you have the opportunity to make it more valuable to your shareholders and potential buyers.



❶ Systems and Processes

Corporate systems and processes for service delivery and back office operations impact value by requiring less human time to deliver and oversee delivery. Systems and processes also reduce risk by helping to ensure consistency of work product and enforcing observance of policies and procedures (which reduce the risk of costly errors). There are few firms that don't benefit tremendously from enhanced and consistent systems and processes, and accounting firms are no exception.

Technology is available to improve nearly every business system an accounting firm might have, including job scheduling, proposal creation, deliverable production, employee performance tracking, information storage, customer relationship management, call routing, expense management, continuing education management, and so on. Some features of technology-enhanced systems and processes augment human productivity. Others reduce or eliminate the need for human involvement altogether.

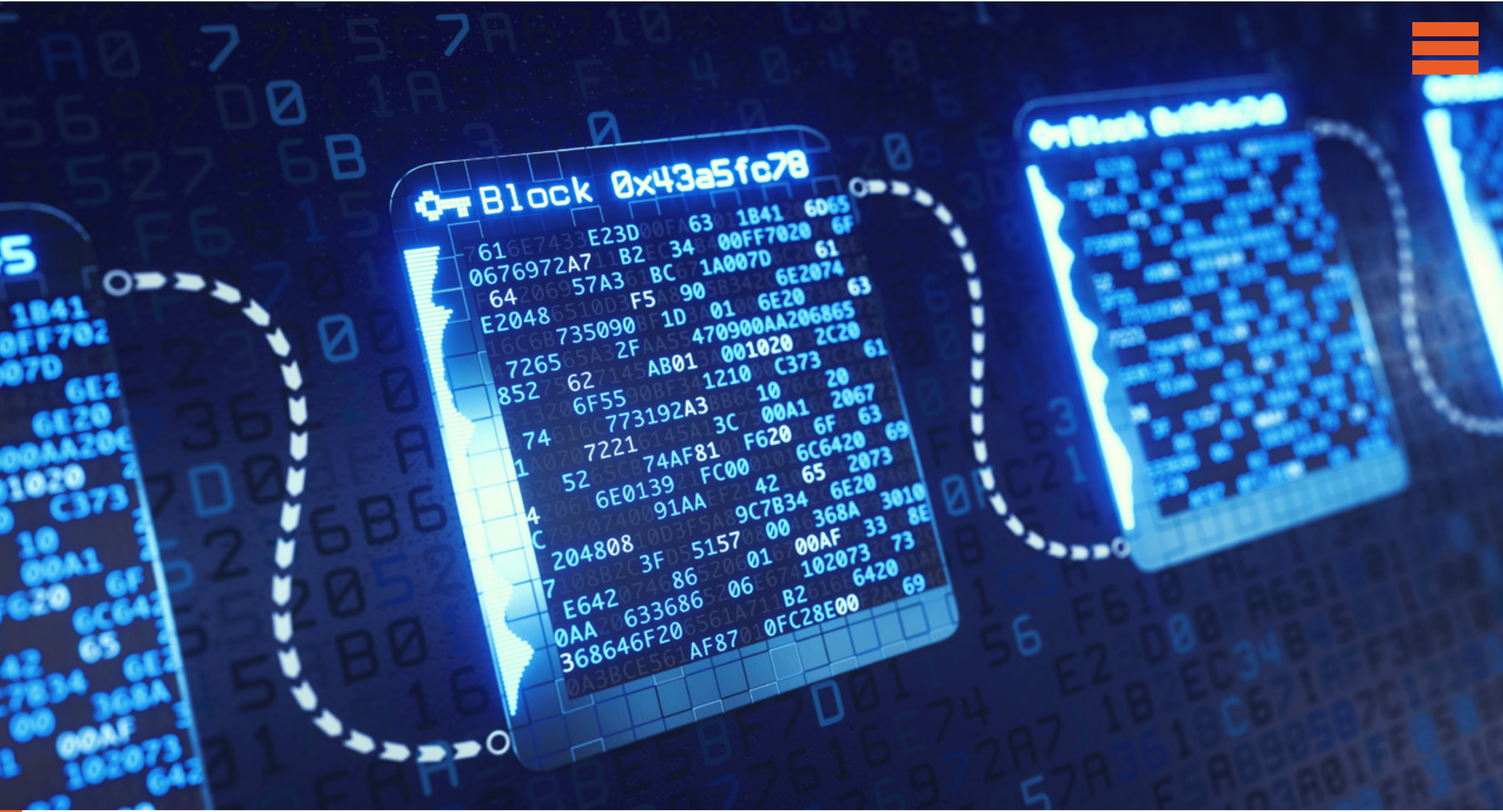
Technology is generally algorithmic in nature – it is a natural tool for enhancing systems and processes. Robust systems and processes can both improve profitability (CF is increased) and reduce risk (k is reduced).

❷ Practice Management

Technology enables firm management to obtain insight into the firm's performance, value drivers, and delivery efficacy. Beyond the depth of insight that practice management provides, technology also offers ownership the capability to view key information in real time. With astute investments and proper implementation, nearly any question that firm ownership wants to ask about performance can be answered with the click of a mouse. With a few clicks more, the right technology can provide firm ownership with insight not only into "what" is happening, but "how" it's happening and, most importantly, "why" it's happening.

Practice management technology enables ownership to understand the sources of revenue and profit generation, manage the sales pipeline, properly reward the firm's strongest contributors, identify the firm's relative strengths and weaknesses as evidenced by profitability, ensure compliance with billing directives and procedures, and manage risk.

Good decision making requires good information. Technology provides leverage so that firm ownership can gain visibility into nearly every aspect of the firm's operations and value creation that it wishes and do so in real time. This same infrastructure enables potential buyers to easily assess the firm's desirability from an acquisition standpoint. All accounting firms understand the value of transparency, and, in this case, practice management technology enables firm ownership to manage and improve profitability (CF is increased), enhance growth (increase in g), and reduce risk (k is reduced).



❸ Blockchain

Few new technologies have gained as much attention in the accounting world as blockchain. This is a distributed and practically foolproof journaling system that instantly, dynamically, and irrevocably records financial transactions.

Blockchain adoption is not yet an imperative for most small to medium-sized U.S.-based accounting firms. Europe has been much faster to adopt it. However, few dispute the idea that blockchain is coming to the U.S. and will permanently change the landscape of the American accounting industry.

Firms that demonstrate command of blockchain and perhaps are even assisting clients wishing or acting to leverage blockchain will be attractive acquisition candidates, as expertise in blockchain is seen as a form of future-proofing the firm. Accordingly, blockchain impacts value by offering growth potential (increase in g), often at the expense of other firms that have failed to develop such expertise.

❹ Customer Relationship Management

CRM technology captures, stores, and processes data about a firm's customers. CRM has opened unprecedented opportunities for firms to better understand their current and potential customers. This information allows a firm to target its offerings more effectively, to prospect more efficiently, and to understand its own identity in the marketplace at a very high level of detail.

Thanks to the advent of CRM, accounting firms can produce more predictable sales and profits. Whereas standard marketing and sales practices for accounting firms generally are founded upon the principles of raising awareness of the firm's capabilities, features, and achievements, such practices are, ultimately, passive in nature. A sales opportunity typically only presents itself when a potential client calls. However, if a firm adopts and leverages CRM, it can proactively identify opportunities to add value. Firms can intelligently, actively probe clients and prospects for potential needs. Often, those needs are so acute clients are less sensitive to fees than they are to those for straight compliance engagements. And, because the need is proactively sourced, there is typically little or no competition to meet it. Finally, CRM, used in this way, strengthens the relationship with the client in that it communicates that the firm truly does care about the client's well-being and business outcomes.

Firms that successfully implement and leverage CRM enjoy higher closure rates, are able to capitalize better on up- and cross-selling opportunities, and have higher client retention rates. The latter is particularly important, as one of the most important risk factors a potential acquirer considers is the ability to transition the target firm's customers to itself. CRM has the potential to positively impact profitability (CF), growth (g), and reduce risk (k), all of which contribute to increasing the firm's value.

5 Security

All companies bear an increasingly complex, weighty, and important responsibility to product their clients' data. There are many potential parties desirous of acquiring sensitive financial data, including individual and cyber-criminals and organized crime syndicates. In some cases, even foreign governments may wish to access your clients' data. Accounting firms, by definition, are stewards of their clients' most sensitive data – tax returns, Social Security numbers, bank records, employer identification numbers, and personal balance sheets. As such, they are prime targets for attacks.

The responsibility to protect data is paramount. A data breach can give rise to liabilities including, but not necessarily limited to, legal damages, remedy costs, and fines. Data breaches can also lead to a potentially fatal loss of trust in the firm. The larger the size of the firm, the greater the potential exposure. Large firms are potentially more attractive targets, since their clients' information is likely to be more valuable than those of smaller firms. Larger firms also simply have more information. They also have more clients, and their clients' accounting needs are likely more complex.

Data security is a material risk for any company and is perhaps more acute for accounting firms for the reasons previously described. Thus, it is certain to be a significant due diligence item for any acquirer. Further, identifying weaknesses in data security (especially if a potential breach is identified) of a potential acquisition target could trigger a material adverse change ("MAC") clause in a letter of intent. The triggering of the MAC could result in an adjustment of the pricing and terms of a deal (for example, to pay for the investment required to bring the target firm's data security systems up to a level the acquire deems acceptable) or may disintegrate a deal altogether. Information security represents multiple avenues of exposure to the accounting firm, which impacts risk (k).

6 Marketing Automation

The most valuable accounting firms (or any professional services firm, for that matter) are actively leveraging technology in order to raise firm awareness in the market as well as to stay connected with current clients, referral sources, and prospects. Automated marketing is efficient from a labor perspective and helps the firm shift its value from the personal goodwill of the owners to corporate goodwill, the latter of which is much easier to transfer to an acquirer.

There are many marketing automation tools available. Inbound inquiries can be routed automatically, without the need for an intervening conversation with an administrative assistant. The result is usually much faster response times as well as an opportunity to collect and capture prospect data. Chatbots can respond to certain questions without human involvement, creating a satisfying experience for potential clients. Search engine optimization (SEO) of the firm's web presence almost certainly makes a material difference to the firm by attracting more potential traffic to its website. Email funnel marketing engages with audiences and collects valuable data on potential clients. Social media publishing tools enable firms to build a larger footprint online than if social media activities were completely manual in nature.

Increasingly, accounting firms are finding that traditional marketing techniques (lunches, happy hours, networking, golf outings, trade shows, and conferences) are less effective than they once were. Such techniques are very time consuming and generally cannot scale because they are limited by personnel marketing time and simple geography. In addition, as Baby Boomer clients retire and are replaced by Millennials, the market is increasingly receptive to automated marketing techniques. Acquirers will see firms that have embraced marketing automation as having a higher and more forgiving threshold for growth, which means an increase in the "g" term.

❼ Data Analytics

Accounting firms are processors of data. If an accounting firm has been in operation for any meaningful length of time, it has accumulated large quantities of detailed financial data about its clients. This data is a potential gold mine of client and firm value that is waiting to be exploited. However, having the data is only part of the path to value creation. Many, if not most, companies of size have more client data than they can process and use. If an accounting firm is able to make the commitment to capitalize on the data it already has and usefully capture new data as it is produced, it represents an outsized growth opportunity that will be attractive to astute acquirers.

Client data can be leveraged to great use by the accounting firm. Data analysis may reveal opportunities to sell clients new services and may enable the firm to provide benchmarking so that its clients know how they are performing relative to peers. Data analytics may offer understanding of why some firms are more successful than others and may reveal which clients are at greatest risk of defecting. Data also opens opportunities for a firm to accumulate and share deep subject matter expertise through empirical analysis.

Maximizing the opportunities offered by data analytics requires technology to collect and organize data, help spot opportunities, and develop strategic insights and actionable intelligence. The benefits of data analytics can also be amplified with data visualization technology and techniques. Exploiting data analytics also requires personnel who are comfortable with data analysis tools. Like any piece of technology, the value of said technology ultimately is as high as the operator can take it. Data analytics technology and capabilities open new (and often more profitable) services to clients and can be a competitive advantage over other firms. Accordingly, data analytics technology impacts the (g) term in the valuation formula as it offers new opportunities for growth – often where there is little competition.

The foregoing is summarized with the following table, matching technology area with their respective value levers:

Technology Area	Value Impact	Value Lever		
		Cash Flow	Growth	Risk
Systems and Processes	Improves efficiency, reduces errors	✓		✓
Practice Management	Improves decision-making, improves responsiveness	✓	✓	✓
Blockchain	Is a long-term growth area of expertise		✓	
Customer Relationship Management	Improves capture of sales, customer retention, inside sales	✓	✓	✓
Security	Reduces risk of a damaging information breach			✓
Marketing Automation	Amplifies marketing activities		✓	
Data Analytics	Enables deep understanding of clients and prospects.		✓	

Technology is an important part of the accounting firm's value formula. The firm's technology posture is pervasive, impacting systems and processes, practice management, blockchain, customer relationship management, security, marketing automation, and data analytics. These seven facets impact the firms' value by affecting its profitability, growth, and risk. No firm, not even one of the Big 4, is perfect across the entire spectrum of technology practice support. However, in order to maximize value, the accounting firm's management should examine its technology assets and practice integration and identify cost-effective opportunities for investment prior to a sale.

About the Author

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He specializes in the valuation of intellectual property-driven firms, such as software firms, aerospace firms and professional services firms, most frequently in the capacity as a transaction advisor, helping clients obtain great outcomes from complex transaction opportunities. Mike is also a specialist in the appraisal of intellectual properties as stand-alone assets, such as software, trade secrets, and patents.

He has been a full-time business appraiser for 13 years with public accounting firms, boutique business appraisal firms, and an owner of his own firm. Prior to that, he spent 8 years in venture capital and investment banking, including transactions in the U.S., Israel, Russia, Ukraine, and Belarus.

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