INSTITUTE OF PUBLIC ACCOUNTANTS®

Module 9v1.3

Professional Practice Program
Financing Your Practice

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Program completion

The IPA Professional Practice Program has been designed for IPA members in professional practice and for non-practitioners as a refresher Program.

With recognition comes responsibility. The IPA is recognised in legislation as one of the three professional accounting bodies within Australia. This means compliance with the ASIC Act and with regulations and standards set by ATO, TPB, ASIC, APESB, FRC, AASB, AUASB and IFAC.

The regulators, standard setters, government and the public all rely on the professional expertise, competence and ethics of IPA members. Therefore, the IPA has mandated that members moving into professional practice must demonstrate competence in these key areas.

It is compulsory to complete the IPA Professional Practice Program within 6 months of receiving an IPA PPC unless you have completed a Professional Practice Program with Chartered Accountants Australia + New Zealand or CPA Australia within the last 5 years.

The Program consists of self-paced study and a 2 day face-to-face workshop. You should complete the self-paced study before attending the workshop. This will take up to 80 hours, depending on your experience. To successfully complete the Program, you must:

- Attend all sessions of the Program,
- Successfully complete the assessment held at the end of the Program.

The assessment comprises of 30 multiple-choice questions and you are permitted 1 hour to complete the assessment. You may refer to your course materials, but you are not to consult any other person in or outside of the room. There is 1 mark per question and you need to obtain at least 50% to successfully complete the assessment.

If you do not successfully complete the assessment, you will be offered an opportunity to re-sit the assessment. If you are still unsuccessful, you will be required to repeat the 2 day face-to-face workshop and successfully pass the assessment. The IPA reserves the right to cancel a member’s PPC in the event a member does not pass the assessment.

Module 9

Financing Your Practice

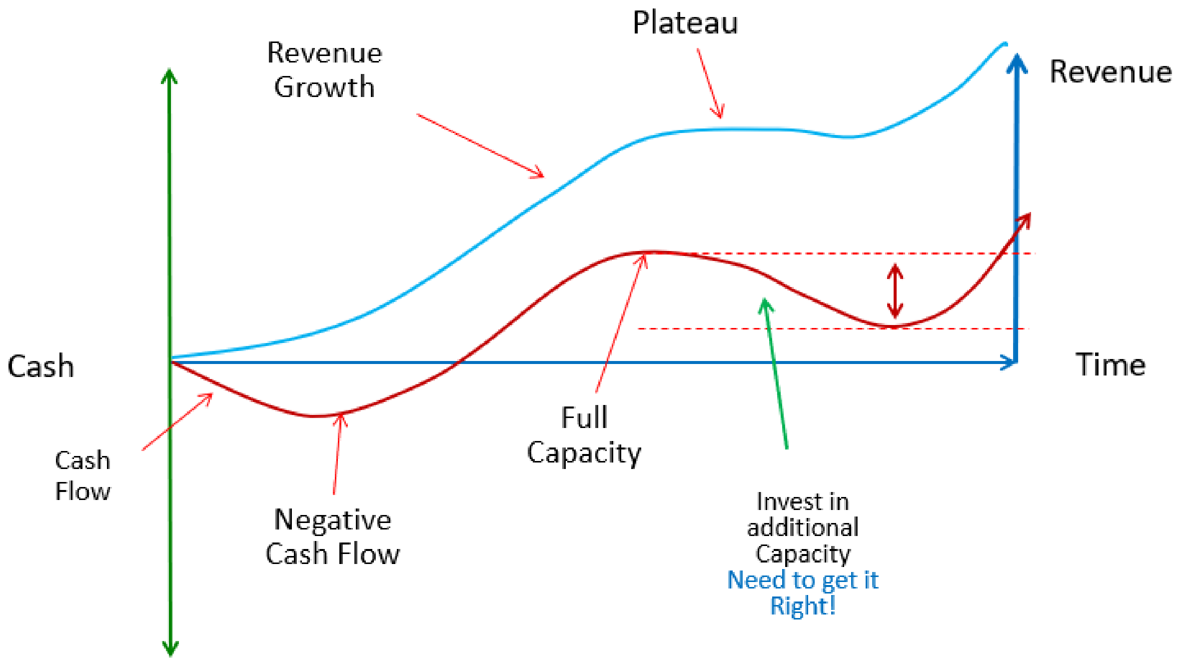
Topic list | **Page**

9.1: Introduction

The decisions you make on your practice financing model will be one of the most critical initial business decisions. All new practitioners have different financial circumstances and life style aspirations. Life style aspirations will vary between each individual. Some practitioners are looking for work life balance, other may be seeking to build a practice empire. There is no one right or wrong answer in regards to personal public practice aspirations, however all new practitioners will need to plan how their new practice will be financed to ensure your success.

In the Strategic Business Plan module we introduced the ***Cash v Time*** chart.

Cash v Time



The purpose of the ***Cash v Time*** chart is to highlight the relationship between resources, time, capacity and cash flow. In a typical single practitioner start up scenario, the practitioner will need to have the financial resources to cover their living expenses while establishing their practice. The financial resources available to you will influence the time you have to gain the appropriate number of clients and exceed the life style break-even point.

In the purpose of this chapter it to provide you with the tools to plan your finances appropriately to ensure your greatest chance of success in the shortest possible time. The chapter we will explore the planning models to assist you with your decision making and estimating the financial resources you require to ensure your greatest chance of success.

9.2: Establishing a new Practice or Purchasing an Existing Practice.

All investment decisions have pros and cons to consider in light of your personal circumstance, professional aspirations, sales and marketing experience, work preferences and life style aspirations. Below is a list of pros and cons for both buying a practice or starting a practice from scratch. You'll need to consider your circumstances, personal preferences and goals to assess the path that is most appropriate for you.

Purchasing an existing practice

Pros	Cons
Ready-made book of Clients	Relationship building required, client attrition to manage
Established Pipeline of work	Staff utilisations or established rates may be lower than optimal. Alternatively, rates may be appropriate however write off hours may be historically high.
Established Local Brand already tested and proven	Brand positioning, historical client perceptions may need developing and improving.
Established Workforce	Staff may leave with new management and clients may follow
Established Processes, policies and Organisational Culture	Processes may not be documented or need improving. Policies may be outdated or a hinderance to changing billing policies.
Established portfolio of services	Some services may require specialist knowledge held by only one staff member.
Established location	Inheriting rental agreements and potentially aging office equipment, furniture and fixtures.
Obtaining finance for an existing business may be easier than gaining finance for a start-up.	Capital cost of buying an existing business may be higher than financing a start-up.

Establishing a new practice

Pros	Cons
Blank canvass to design and position the business in the market exactly as you envisage	Time and resources required to plan and develop and execute business marketing activity
Ability to set your fees and service portfolio without reservations from historical clients	Can take some time to gain the number of clients to make the business profitable.
Ability to establish processes and policies exactly the way you want them.	Time and cost required to set up processes and policies.
Ability to recruit staff new staff	Time required in the recruitment and onboarding process.
Ability to determine Location office.	If working from home is not an option or not consistent with your planned marketing position the time will be require to search and organise office rental and set up furniture, fixtures and office equipment.
Ability to set up IT infrastructure	Time required to set up and test IT infrastructure or learn new software

9.3 Start-up Factors for Consideration

In planning the start-up of a single practitioner practice there are fundamental factors that you must consider and plan for carefully. The list below provides some of the key factors to consider, however every individual has different needs and you must consider your own circumstance carefully.

9.3.1: Aggregate Cost of Living

Calculate carefully the sum of all personal commitments that you're required to support during the start up phase of your practice. Calendar your commitment by month over the estimated period required for your business to reach a break-even level of billable work. The items that contribute to your cost of living may include:

- Mortgage or Rents
- Insurances (e.g Home, Car, Health)
- Council Rates
- Food
- Utilities (Electricity, Gas, Water, Telephone, Mobile phone)
- Motor Vehicle petrol, servicing and tyres
- Festive presents and gifts (birthdays, religious celebrations, anniversaries)
- Other miscellaneous spend (entertainment, school fees, books, uniforms, excursions, holidays)

9.3.2: Personal Goals

Set clear personal goals for your practice, then create a list of actions. List the timing of the actions in a Gantt chart in the sequential manner required to achieve those goals.

9.3.3: Capacity to Work and Other Commitments

List all your personal commitments and estimate the time the commitments absorb. For example, the commitments may include positions on committees or coaching sporting teams. Consider carefully if you will have the capacity to maintain each commitment during the start-up phase of your new practice.

9.3.4: Support from Family and Friends

The positive support of your closest family and friends can be help full in many ways. Family and friends can provide positive emotional support and encouragement during the start-up of your practice. Family and friends can also be your strongest "word of mouth" marketing advocates and sources of referrals.

9.3.5: Contact List and Potential Early Clients

Create a list of all your business related contacts. The list may begin with your current LinkedIn contacts. Add to the list by collating all the business cards and contact details available to you. The list becomes your initial marketing list that you can notify of your new practice and may be a source of new clients.

9.3.6: Sales and Marketing Experience

Consider your level of sales and marketing experience. Where appropriate enrol in short courses to update your skills appropriately. Consider courses on networking, personal sales, sales copy writing, or the psychology of the sales process. To be familiar with methods for attracting, gaining and maintaining clients can have a significant impact on the time required for your practice to reach break-even position.

9.3.7: Potential Alliances and Marketing Partners

Identify potential sales and marketing partners. Consider joining local business groups and to form referral relationships. Referral relationship may take some time to establish. The key to referral relationships is to be consistent and conscientious in building the business relationships.

9.3.8: Organisational Skills

Your ability to plan your week and follow through on your list of actions are critical factors in the speed of success. Ensure you set aside the appropriate time to follow up on leads, write quotes, proposals and follow through with timely billing of client work. All the actions mentioned will impact on your cash flow. Although the follow ups, quotes and billings sound like basic fundamentals; solo public practitioners can get very busy very quickly in the act of completing billable work and fail to set aside the appropriate time to gain future work the interim. The absence of a consistent balance between completing and gaining work slows the overall growth of the firm.

9.3.9: Access to Funding

Your access to funds in reference with your cost of living will determine the time you have to generated a viable number of clients. Access to funds may be via personal savings, drawing on positive equity on your home or an investment property. Funding models of higher risk include borrowing funds from family or friends, or offering a share in your practice to silent investors. We will consider the element required for loan application later in this module.

9.4 Setting Goals Case Study – Start Right Accountants and Advisors

After 15 years working in various public practice firms, Peter Jackson decided the time was right to start his own practice. Peter assessed his lifestyle requirements and decided an earning goals of $8,000 per month after tax would be a good goal once his practice had matured and is stable.

Peter had to estimate what this average hourly rate would be. To estimate his average hourly rate Peter had to determine his total income before tax goal, and his capacity to complete billable work. Peter took the following considerations to estimate his average hourly rate:

- The annual overhead cost of his practice would be $30,000 per annum;
- 40% of his time will not be billable due to work on sales and marketing and other non-billable administration;
- He would take up to 6 weeks off per year;
- He would work a standard 40 hour week.

Figure 9.1

Income Required for Personal Lifestyle Goals

In this example Peter has assessed that he needs $8,000 per month to live comfortably in the lifestyle he chooses

Estimated	**96,000**
Tax Payable^	36,414
Cost of Running your business	30,000
Total Income Required	**162,414**

Available Chargeable Hours

Weeks in the year	52
Less number of Weeks public holidays and annual leave	6
Total Working Weeks	46
Number of hours worked per week	40
Total Number of Hours per annum	1,840
Less non Chargeable hours %	40%
Total Non Chageable Hours	736
Total Chargeble Hours	**1,104**
Estimated Average Chargeble Hour	**$ 147.11**

Total Income Required ($162,414 / 1,104)

Based on Peter's assumptions, it is estimated that Peter needs to have an average charge out rate of $147.11 per for his available hours to reach his income life style goals.

^ Tax payable is for illustrative purposes only based on 27.5% of profit before tax where no salary is taken. Each public practitioner will need to consider their own particular circumstance and tax strategies.

9.5 Cash-Flow Planning for the Sole Practitioner Start Up.

Forecasting your business cash flow is a critical planning tool. A cash flow forecast provides a plan for how you are going to use your cash resources over the forecast period. Cash flow forecasting as a management tool is crucial. The tool provides for a plan to manage your cash position through your annual business cycle. Lenders and investors are particularly interested in your projected cash flow to ascertain your ability to service loans and increase the net worth of your company. To project your cash flow you will need to consider carefully the following elements.

9.5.1: Projected Fee Income and Collection

Projecting fee income and collection involves forecasting the volume of sales by month and when you're likely to receive payment for the sales. You will need to take into consideration annual business cycles. For example, December and January tend to be slow months in public practice due to the festive holiday season. Factoring bad debts is another item to consider is the percentage of sales that go unpaid. Fig 8.2 provides an example of a cash collection projection. Line 8.5.1 "Total Sales" provides the total anticipated fee income for a month. The fee income forecast is based on the total units of work completed, multiplied by the average fee per job. Line 8.5.3 "Cash Inflow" applies cash collection assumptions to the completed billable work to estimate the total cash inflow for a projected month

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Cash Collection Assumptions

Receipt Collection

Cash Sales	10%
1 month	50%
2 month	30%
3 month	17%
Bad Debt	3%

9.5.2: Calculation of Overhead Costs

Overhead costs are the direct costs associated with running your office and delivering your products or service. This may include rent, utilities (Gas, Electricity, Water), ongoing marketing costs, insurances, software licenses, equipment leases (multi-function printing machines), training costs, direct labour costs and subcontractors. In the Fig 8.2 example we have estimated the total overhead costs to be $30,000 per annum. To simplify the example, we have applied the overhead costs evenly over 12 months.

9.5.3: Business Initiatives

The third element of cash flow forecasting to incorporate any planned business initiatives. In a typical business scenario, planned initiatives might include the purchase of new equipment, office refurbishment or relocation, any large one off marketing or business development initiatives, putting on additional temporary staff, bonus payments or capital funding expansion plans. In our Fig 9.2 example we allow a budget (8.5.6) for setting up IT equipment and business launch marketing activity. The business launch marketing activity can range from new office signage, initial graphic design consulting, establishing a website and initial marketing brochure ware and stationary

9.5.4: ATO Commitments

A cash flow planning trap for many small business owners is often the exclusion of ATO revenue commitment from their cash flow planning. 8.5.7 "BAS and PAYG" estimates the BAS and PAYG commitments that the new public practitioner must fund.

9.5.5: Cost of Living

Line 8.5.8 "Total cost of living" totals the estimated cost of living for Peter Jackson. Peter estimates that house hold expenses ranging from mortgage repayments to miscellaneous cash spend will total approximately $69,100 per annum.

Fig 8.2 projects Peter Jackson's first 16 months in business. Starting his practice in March Peter uses the last 4 months of the financial year to get his practice ready for the next financial year. By the end of his first full financial year Peter was successful enough to complete 132 individual tax returns, gain 32 company clients and 3 Audits small not for profits. The funding required to sustain Peter's practice and living expenses peaks at negative $66,575 in his 12th month of operation. By the 12th month Peter is begins to make a consistent net positive cash flow of between $3,000 to $7,000 per month after accounting for his living expenses

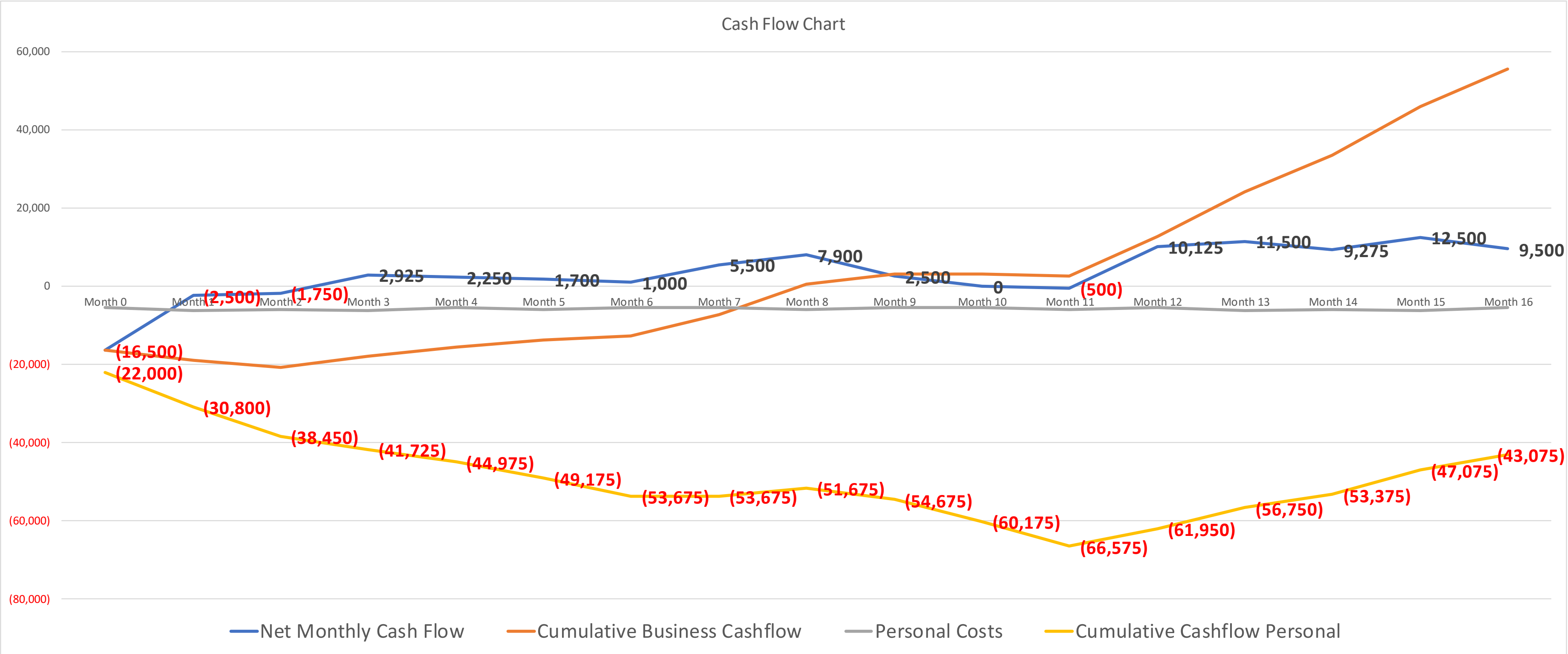
Fig 9.3 provides a graphical representation of Peter's cash projection for his start up public practice. The graph indicates that based on the forecasted assumptions on new business, average fees, overhead and living expenses, Peter needs at least $66,575 of cash funding to ensure this new practice survives the start-up phase.

Fig 9.2

Cash Flow Forecasting		Month 0 Feb	Month 1 Mar	Month 2 Apr	Month 3 May	Month 4 Jun	Month 5 Jul	Month 6 Aug	Month 7 Sep	Month 8 Oct	Month 9 Nov	Month 10 Dec	Month 11 Jan	Month 12 Feb	Month 13 Mar	Month 14 Apr	Month 15 May	Month 16 Jun	Financial Year Total
Units																			
Individual Tax ($250)		0	0	3	4	3	10	14	20	25	12	10	0	3	8	8	12	8	**130**
Company / trust Tax ($2,000)		0	0	0	2	2	1	0	0	1	1	0	1	5	6	6	6	5	**32**
Audit ($3,000)		0	0	0	0	0	0	0	1	1	0	0	0	1	0	0	0	0	**3**
Individual Tax ($250)	250	-	-	750	1,000	750	2,500	3,500	5,000	6,250	3,000	2,500	-	750	2,000	2,000	3,000	2,000	**32,500**
Company / trust Tax ($2,000)	2,000	-	-	-	4,000	4,000	2,000	-	-	2,000	2,000	-	2,000	10,000	12,000	12,000	12,000	10,000	**64,000**
Audit ($3,000)	3,000	-	-	-	-	-	-	-	3,000	3,000	-	-	-	3,000	-	-	-	-	**9,000**
8.5.1) Total Sales			**-**	**750**	**5,000**	**4,750**	**4,500**	**3,500**	**8,000**	**11,250**	**5,000**	**2,500**	**2,000**	**13,750**	**14,000**	**14,000**	**15,000**	**12,000**	**105,500**
8.5.2) Average Hourly Rate	**$142.58**																		
8.5.3) Total Chargeable Hours				5	35	33	32	25	56	79	35	18	14	96	98	98	105	84	740
																			-
Cash Sales			-	75	500	475	450	350	800	1,125	500	250	200	1,375	1,400	1,400	1,500	1,200	10,550
30 Days			-	281	1,875	1,781	1,688	1,313	3,000	4,219	1,875	938	750	5,156	5,250	5,250	5,625	4,500	39,563
60 Days				-	169	1,125	1,069	1,013	788	1,800	2,531	1,125	563	450	3,094	3,150	3,150	3,375	22,106
90 Days					-	96	638	606	574	446	1,020	1,434	638	319	255	1,753	1,785	1,785	11,252
8.5.3 Cash Inflow			**-**	**356**	**2,544**	**3,477**	**3,844**	**3,281**	**5,161**	**7,590**	**5,926**	**3,747**	**2,150**	**7,300**	**9,999**	**11,553**	**12,060**	**10,860**	**83,471**
Bad Debt						-	23	150	143	135	105	240	338	150	75	60	413	420	**2,250**
Office Overheads (Rent, Insurances, Marketing, software licenses etc)		2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500	
8.5.4 Cash Outflow		(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	**(30,000)**
Net Operating Cash Flow		(2,500)	(2,500)	(1,750)	2,500	2,250	2,000	1,000	5,500	8,750	2,500	0	(500)	11,250	11,500	11,500	12,500	9,500	**75,500**
Cumulative Operating Cash Flow		**(2,500)**	**(2,500)**	**(1,750)**	**2,500**	**2,250**	**2,000**	**1,000**	**5,500**	**8,750**	**2,500**	**0**	**(500)**	**11,250**	**11,500**	**11,500**	**12,500**	**9,500**	**75,500**
Business Initiatives																			**0**
New Equipment or Assets IT Set up		4,000																	**0**
Business Set up & Marketing Launch		10,000																	**0**
8.5.6 Total Business Initiatives Cash flow		(14,000)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
8.5.7 BAS & PAYG					425		(300)			(850)				(1,125)		(2,225)			**(4,500)**
Net Monthly Cash Flow		(16,500)	(2,500)	(1,750)	2,925	2,250	1,700	1,000	5,500	7,900	2,500	0	(500)	10,125	11,500	9,275	12,500	9,500	
		(16,500)	**(19,000)**	**(20,750)**	**(17,825)**	**(15,575)**	**(13,875)**	**(12,875)**	**(7,375)**	**525**	**3,025**	**3,025**	**2,525**	**12,650**	**24,150**	**33,425**	**45,925**	**55,425**	**146,550**
Cost of Living																			
Home Loan/Rent		2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	
Food		1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	
Petrol		400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	
Utilities (Electricity, Gas & Telephone)		500	500	500	500	500	500	500	500	500	500	500	500	500	500	500	500	500	
Council Rates				400			400			400			400			400			
Insurances (Car, House, Health)		200	1,000	200	900	200	200	200	200	200	200	200	200	200	1,000	200	900	200	
Cash spending		400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	
Miscellaneous items		500	500	500	500	500	500	500	500	500	500	500	500	500	500	500	500	500	
8.5.8 Total Cost of Living		**5,500**	**6,300**	**5,900**	**6,200**	**5,500**	**5,900**	**5,500**	**5,500**	**5,900**	**5,500**	**5,500**	**5,900**	**5,500**	**6,300**	**5,900**	**6,200**	**5,500**	
8.5.9 Net Total Cash Flow		**(22,000)**	**(8,800)**	**(7,650)**	**(3,275)**	**(3,250)**	**(4,200)**	**(4,500)**	**0**	**2,000**	**(3,000)**	**(5,500)**	**(6,400)**	**4,625**	**5,200**	**3,375**	**6,300**	**4,000**	
8.5.10 Net Cumulative Cash Position		**(22,000)**	**(30,800)**	**(38,450)**	**(41,725)**	**(44,975)**	**(49,175)**	**(53,675)**	**(53,675)**	**(51,675)**	**(54,675)**	**(60,175)**	**(66,575)**	**(61,950)**	**(56,750)**	**(53,375)**	**(47,075)**	**(43,075)**	

Fig 9.3

	Month 0	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	Month 13	Month 14	Month 15	Month 16
Net Monthly Cash Flow	(16,500)	(2,500)	(1,750)	2,925	2,250	1,700	1,000	5,500	7,900	2,500	0	(500)	10,125	11,500	9,275	12,500	9,500
Cumulative Business Cashflow	(16,500)	(19,000)	(20,750)	(17,825)	(15,575)	(13,875)	(12,875)	(7,375)	525	3,025	3,025	2,525	12,650	24,150	33,425	45,925	55,425
Personal Costs	(5,500)	(6,300)	(5,900)	(6,200)	(5,500)	(5,900)	(5,500)	(5,500)	(5,900)	(5,500)	(5,500)	(5,900)	(5,500)	(6,300)	(5,900)	(6,200)	(5,500)
Cumulative Cashflow Personal	(22,000)	(30,800)	(38,450)	(41,725)	(44,975)	(49,175)	(53,675)	(53,675)	(51,675)	(54,675)	(60,175)	(66,575)	(61,950)	(56,750)	(53,375)	(47,075)	(43,075)



9.6: Buying a Practice Key Factors to Consider

There are many business valuation methods that you can consider when buying a business. The three most common business valuation methods are;

- Asset-Based Value

Asset based value is calculated by the value of the net assets accounted for in the balance sheets (assets less liabilities). In many circumstances the book value of assets does not accurately reflect the market value of the assets and the opportunity for arbitrage exists. An alternative asset-based approach for valuing a business is through estimating the net cash position of a business where all liabilities were extinguished.

The asset-based approach for valuing a sole proprietorship is difficult as the core assets of the practice that generates future income are intangible items such as client lists, client relationships, brand awareness, community relations and business networks.

- Earning Value

The basis of the earned value approach is derived from the premise that the value of a business is fundamentally linked to the future cash flows that business will derive. The value of a business is estimated to be the sum of the discounted cash flows that the practice is projected to generate over a per-determined time horizon. The determined time horizon may be 3, 5 or 10 years depending on your own goals and requirements for return on investment. The discount rate used in the calculation is calculated based on the assessed risk associated with the going concern.

What is the appropriate discount rate? There are many factors to consider when establishing a discount rate. The list below includes some of the factors to consider:

(1) The Product Portfolio Lifecycle. How quickly is changing technology changing the services currently offered and how the services will be delivered in the future.

(2) Client Relationships. Who holds them and what is the likely hood that the transfer of relationships will be smooth for the new practice owners or partner.

(3) Key personnel and key knowledge holders. Are there specific income streams that only one person has the knowledge to service? Or are they key clients who have a strong relationship with one staff member? How will you ensure knowledge and relationships are transferrable from the staff member/s

(4) The percentage of income derived from the top 10 clients. The higher the percentage of income derived from the top 10 clients the higher the risk of maintaining the income over time.

(5) Staff turnover. The rate of staff turnover can impact transferrable knowledge of client files, staff utilisation rates and billable hours. Consider the number of staff in the practice and the impact of staff turnover in the immediate period after taking over the practice.

A discount rate of 15-20% is not uncommon for a business with strong earnings and that operates in a stable competitive environment or industry. For unproven businesses or businesses that operate in a highly volatile market discount rates of between 25-50% is possible. Your need to assess the risk of your investment and decide on the appropriate discount rate.

Valuation of a sole proprietorship projected earnings can be difficult. Client loyalty in a sole proprietorship is directly linked to the business owner. The incumbent business owner may have a particular operating style, method or process that is difficult to replicate. Whether the business involves electrical services or business advisory, customers inherently expect that a new owner will deliver the same degree of service, pricing and professionalism.

The valuation of a service oriented sole practitioner practice needs to consider the percentage of business that might be forgone under a change of ownership. Note that the risk can be mitigated in cases when a trusted family member or a long-term staff member who the clients are already familiar with, takes over the business.

- Market Value

The market value approach to business valuation attempts to establish a value by comparing similar recent transactions in the market. The challenges with the market valuation method is often there are very few comparable examples in the local geographical area and the information on the operating circumstances of the business sold may also be limited. For example, the efficiency of internal processes, the systems and software they used and were proficient at, the industry mix of their client portfolio and the percentage split of the service fee income are unknown.

Defining the value of a sole proprietorship based on market value can be difficult. Gaining information on prior sales of like businesses may not be an easy task.

The Earning Value Approach is the most popular business valuation method. Using a combination of business valuation methods is often considered when setting a selling price.

Additional considerations:

- Ensure you are across any contingent liabilities associated with your business as a going concern.

Many small to medium sized business do not have all liabilities accounted for. Be aware that as a potential buyer you may use the absence of items including and not limited to; annual and long service leave provisions, unpaid super contributions, any continuing or pending work cover claims and make good provisions on property or equipment.

- Ensure the accounts are clear and discernible for your prospective buyer.

It is imperative that when you as the prospective buyer conducts the due diligence, you can understand and identify the cost structures of the practice. Understanding the cost structures will allow you to identify synergies and costs savings. The potential synergies and costs savings increases the value of the practice to you as the buyer. It is important that you as the buyer understand the potential synergies but do not include the projected gains in the valuation, as the valuation is based on the current going concern not the improvements that you'll be making to the business. Having a clear and discernible general ledger aligned to the operational structure will give you the buyer confidence in your business as a going concern, as a result lower the risk to you the buyer.

- Dominate a niche or market segment in your industry.

Does the practice have a cohort of clients in a particular industry and do you have experience in that industry? A practice that dominates position in a market niche or segment that you have experience in, is of higher value to you. The knowledge of the market niche benefits is not something you would share with the prospective seller when negotiating the price of your business. However, buying a client base in which you have expertise is an advantage when it comes to retaining clients and maintaining business momentum.

- Non-Competition and Market exclusion clauses

When purchasing a public practice ensure that you include non-competition clauses in agreement for the sale of a business. One of the largest risks you will face as a public practitioner purchasing a public practice is your ability to retain the clients. The payment of goodwill often forms a significant part of a public practice valuation. In purchasing a professional services business, a major assumption is that current customers will continue to seek the services of the business. Imperatively, the assumption is made that the previous owner will not immediately join a competing firm or open a competing practice. However, to mitigate the risk of losing recurring income including a non-competition clause in the agreement of sale is recommended.

Non-competition clauses typically contain restriction such as:

- Forbidding the seller from commencing a competing business or working in the industry and offering competing services for a predefined period. A five-year exclusion for non-competition is not uncommon clause in the contract of sale.
- Non-competition clauses can be contentious and can be the subject of court cases between buyers and sellers after a business is sold. Non-competition clauses can also be referred to as restraint of trade clauses. The law courts will consider cases from the perspective of how clearly defined the clause is. To be enforceable the restrictions placed in a non-competition clause must be considered 'reasonable'. Non-competition clauses may include sub clauses defining non-solicitation of clients, non-poaching or recruitment of current staff and client confidentiality.
- Non-competition clauses can be nullified by the courts if it is judged that the enforcement of the clause is excessively broad and/or provides unreasonable restrictions in reference to the seller's ability to continue his/her trade and earn a living. Each sales of practice transaction may have specific circumstances that need to be considered. It is recommended that non-competition clauses are reviewed by the legal representatives of the seller and buyer prior to agreeing on the purchase of the practice.

9.7: Earned Value Practice Valuation Method

There are many methods of extrapolating the current earnings of a practice to estimate the practices overall worth when negotiate a sale price. Multiples of annual earnings and net present value of projected future cash flows are two examples of common approaches.

Ultimately the agreed price for a practice needs to meet your personal risk and return criteria and the specific circumstances of the practice considering factors such as the client mix, geographical location, surrounding demographics, the presentation state of the office and fixtures and fittings, signage, the assistance or future plans of the current proprietor.

Fig 9.4 provides an example of using a discounted cash flow approach to determine the net present value of a public practice.

In the example below, Year 0 refers to the last year run by the previous practitioner. In year 0 the practice generated $350,000 of fee income, and had expenditure of $133,000 on staff costs excluding the practice owner. Administration and overhead costs totalled $65,000. The total Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) generated by the practice in year 0 was $152,000. Depreciation totalled $8,050 providing for a taxable income of $143,950. Applying the prevailing tax rate of 27.5% amounts to a tax liability of $39,586. Net cash flow in Year 0 based on the circumstances outlined is $112,414 calculated by subtracting the tax liability from total taxable income then adding back the non-cash item of depreciation.

Year 1 – Year 5

From the base defined by Year 0 the flowing assumptions are applied for illustration purposes. Note you need to consider your particular circumstances appropriately if you choose to use a similar approach.

i) Fee Income: Client attrition is estimated to be 7% per annum

ii) Direct Costs, Wages, Marketing and Other are estimated to grow by 2.5% per annum.

iii) Depreciation for capital purchases and asset write offs is estimated to be approximately 2.3% of turnover

iv) Taxes remain at 27.5% for the foreseeable future

v) Working capital requirements are $20,000 for year one then diminish over time as the practice becomes established with new proprietors.

Fig 9.4

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal Value	Total Projected Cash Flow
Fee Income	350,000	325,500	302,715	281,525	261,818	243,491		
Direct Costs - Wages (Excluding directors ^^)	133,000	136,325	139,733	143,226	146,807	150,477		
Admin & Marketing	15,000	15,375	15,759	16,153	16,557	16,971		
Other	50,000	51,250	52,531	53,845	55,191	56,570		
EBITDA Result	152,000	122,550	94,691	68,301	43,263	19,472		
Depreciation	(8,050)	(7,487)	(6,962)	(6,475)	(6,022)	(5,600)		
EBIT	143,950	115,064	87,729	61,826	37,241	13,872		
Taxes (27.5%)	(39,586)	(31,642)	(24,125)	(17,002)	(10,241)	(3,815)		
Earnings After Tax	104,364	83,421	63,603	44,824	27,000	10,057		
+ Depreciation	8,050	7,487	6,962	6,475	6,022	5,600		
+ Changes in Working Capital		(20,000)	(10,000)	(5,000)	(5,000)	(5,000)		
Net Free Cash flow	112,414	70,908	60,566	46,299	28,022	10,657		

Where

C_0= initial cash outlay will be the value of the investment. To estimate the value of the investment, C_0 is equal to 0

Net Present Value of Investment = NPV of forecasted cashflows + Terminal Value

$$NPV = \sum_{t=1}^{n} \frac{Ct}{(1+k)^t} - C_0 + \quad Terminal\ Value\ T_0 = \frac{D_0(1+g)}{k-g}$$

	1	2	3	4	5	Terminal Value	Total Projected Cash Flow
$t = time$	1	2	3	4	5		
$k = 20\%$ $(Required\ Rate\ of\ Return)$	20%	20%	20%	20%	20%		
Cash Flow Generated at t	C_1	C_2	C_3	C_4	C_5		
Net Cash Flow Generated	$=\frac{70{,}908}{(1+.2)^1}$	$=\frac{60{,}566}{(1+.2)^2}$	$=\frac{46{,}299}{(1+.2)^3}$	$=\frac{28{,}022}{(1+.2)^4}$	$=\frac{10{,}657}{(1+.2)^5}$		
	$=\frac{70{,}908}{1.2}$	$=\frac{70{,}908}{1.44}$	$=\frac{70{,}908}{1.44}$	$=\frac{28{,}022}{2.07}$	$=\frac{10{,}657}{2.49}$		
Terminal Value						$=\frac{10{,}657\ (1+0)}{0.2\ -0}$ $=\frac{10{,}657}{0.2}$	
Net Cash flow Generated	$ 59,090	$ 42,060	$ 26,793	$ 13,537	$ 4,280	$ 53,285	**$ 199,045**

In this example we assume growth is generated by you the new proprietor therefor not factored into the price paid to the old proprietor therefor g = 0

Net present value is the total estimated value of future cash flows generated by the target practice in today's money allowing for the impact of inflation and risk. Inflation and risk is accounted for in the discount rate use. In the NPV and terminal value calculation the discount rate is represented by the value of k.

$$NPV = \sum_{t=1}^{n} \frac{Ct}{(1+k)^t} - C_0$$

where C_0 = initial Cash outlay

C_t = net cash flow generated by the investment at time t

n = the life of the investment

k = the required return (discount rate)

Add $$Terminal\ Value\ T_0 = \frac{D_0(1+g)}{k-g}$$

D_0 = net cash flow generated by the investment at time t

g = Growth Rate

k = the required return (discount rate)

Fig 4 provides an example of how to break down the NPV and terminal value calculation.

Based on the assumptions outlined above the net present value of the target practice is estimated to be **$199,045**.

The discount factor used to estimate risk for the cost of capital in the example is 20%. You need to consider your risk appetite appropriately and apply the appropriate rate for your circumstances. The net present value provides a calculated value from which to negotiate the sale price of the practice.

Items to subtract from the sale price include and is not limited to;

- Unfunded liabilities, such as superannuation liability of leave liability unaccrued in the balance sheet
- Make good costs associated with the office lease agreement
- Cost associated with updating the furniture fixtures or IT infrastructure
- Contingent liabilities, any claims against the practice

9.8: Due Diligence Check List

The following list due diligence check list is a high-level list of due diligence items to consider and check when negotiating the purchase of a practice. The list is an illustrative example. You'll need to consider your circumstance carefully. It is highly recommended that you seek third party advice on any business purchase to mitigate all identified and foreseeable risks. Ensure you have comprehensively reviewed the circumstances of the sale appropriately.

9.8.1: Financial Information

i) Copies of financial statements and taxation returns for the past 3 years

ii) Copies of monthly interim financial statements

iii) Break down of Fee income for the last 12 months by:

- a. Service Type
- b. Customer
- c. Industry

iv) Summary of current debtors and creditors reports

v) List of customers including major customers

vi) Arrangements with customers for payment, standard trading terms and any exceptions allowed

vii) List of all problems/disputes with its clients / competitors / associates of marketing partners.

9.8.2: Company Documents

i). Perform company search of the company for any pertinent company information in the public domain

ii). Certificate of incorporation and any certificates of incorporation on change of name

iii). Review of filed documents of the company including ASIC files and minutes of key filing meetings the last three years

9.8.3: Plant and Equipment of Business

i). List of plant and equipment of assets and any liabilities associated with the acquisition of company.

9.8.4: Human Resources

i) Employee details

- a). Name of employee and statutory details for processing Taxes
- b). Description of position and key accountabilities
- c). Employment contract
- d). Remuneration details including hourly rate and hours required to work per week and any agreed special circumstances or allowances

ii). Details of staff entitlement including annual leave, sick leave and long service if applicable.

iii). Any bonus schemes in place and are there any accrued bonuses that are yet to be paid?

iv). Certificate of currency for WorkCover in place and details of any claims.

9.8.5: Insurance

i). Review current insurances in place and the history of insurance payments to clarity the period the practice is covered for including and not limited to:

- a). Public indemnities
- b). Comprehensive general liability including property damage
- c). Workers compensation

9.8.6: List all Intangible Assets and Legal Claims over the Assets

i). Obtain list of any registered trademarks, copyrights, designs, company names, business names of the company/practice.

ii). Any licences or rights associated with the practice.

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9.8.7: Marketing

i). Review current marketing activity and marketing plans.

ii). Identify the person/s responsible for executing marketing activity.

9.8.8: Computer Systems and Technology

Identify all significant IT systems associated with accounting function and operational processes. This includes hardware server infrastructure if applicable, software, passwords, licenses and software renewal dates, list of passwords and access to all practice related social media accounts including and not limited to, Facebook, Instagram, Twitter, Pinterest and the Practice LinkedIn pages.

9.9: A Business Plan for Raising Finance.

Putting together a business plan can be a daunting task. Where do you start? You have all the ideas in your head; you can visualize a success story and your face in an edition of the BRW. The challenge for the business owner is to communicate what you visualize and why to the lender or investor, in particular why they should provide the funds to help you grow your business. The old adage applies, you can talk the leg off a chair but if you can't put it in writing and communicate it effectively to others, you risk giving potential lenders or investors the perception you're just blowing hot air.

A business plan is essentially your business proposition. The purpose of the document is to outline what you intend to do. The document specifies the market you will service and how you plan to successfully market your products and services. The plan identifies the size of the market, your competitors, your competitive advantage, how you intend to operate and your projected sales and profitability. All the elements outlined above need to be presented in a format that provides lenders and investors confidence that the stated business goals are achievable and you have the skills and experience required to make it happen.

9.9.1: Elements of a Business Plan.

1. **THE EXECUTIVE SUMMARY "THE BUSINESS"** A short description of the business and your reasons for being in the business. What the market is and the potential for your business.
2. **BUSINESS STRATEGY AND OBJECTIVES** A description of your business strategy and objectives. Define the mission and vision and its competitive advantages and differentiation. Identify the business goals, targets and measures for its overall performance.
3. **PRODUCT OR SERVICE PROFILE** A description of products and services. How it is differentiated from competitors. What is your competitive advantage? A survey of direct competitors. How new products will be developed. The current product life cycle. What new products may emerge?
4. **A MARKET OVERVIEW and PROMOTIONAL PLAN** What is the size, trends and outlook for the market sector? The directions for growth and identifiable, marketable advantages over competitors. What will be the selling platforms, methods, for example, internet, direct mail, advertising and intermediaries? What will be the promotional plan and market touch points?
5. **MANAGEMENT, OPERATIONS and ORGANISATIONAL PLAN** Details of your past employment - identify achievements and experience. If there are some obvious weaknesses, how do you intend to deal with them. Outline your management structure with accountabilities and responsibilities. Outline the function of staff in the business and who they will be accountable to.
6. **FINANCIAL ANAYSIS** Detailed forecasts of Cash Flow, Profit and Loss and Balance Sheet - short term (1 year) and long term (3 years). Provide assumptions behind forecasts. Where available, provide historical financial performance.
DOES YOUR BUSINESS PLAN SUPPORT A LOAN APPLICATION? Present your plan to an accountant or business advisor to review on your behalf. A detailed review for presentation, logic, completeness and objectivity by a professional is a must. A key element of success is your ability to communicate your proposal effectively.

9.9.2: Your Business Knowledge.

A key point in the documents is the business plan should highlight is HOW WELL YOU UNDERSTAND YOUR BUSINESS ENVIRONMENT.

- Highlight your experience and its relevance to your industry;
- Provide historical financial reports and prepare a Budget and Cash Flow forecast;
- Value the business goodwill, stock where appropriate and all other assets;
- Provide comparatives to other businesses in the industry.

Providing a solid description of your industry and communicating that you have a complete understanding of your business environment is essential. Have a clear picture of whether your industry is expanding or contracting and what the critical success factors are. Use third party research from reputable sources such as known market research companies, government department reports, Australian Bureau of Statistics or local council publications on demographics if it is relevant in forming your case for investment or loan. Invest the time and effort in making it known to the potential lender or investor that you are equipped with all the knowledge required to make your business proposition a success.

Consider carefully: What are your points of difference and competitive advantage?

- Is your product or service better, why?
- Will you be competing on price?
- Does your location provide a competitive advantage?
- Will you be competing on superior service?
- Do you have access to better distribution channels?
- Is your success relying on your capacity for hard work, energy and enthusiasm?

Your capacity for hard work, energy and enthusiasm are essential but alone are not sufficient for success. If you do not possess a tangible competitive advantage, long term survival will be difficult.

When borrowing money, a business owners' equity is an important consideration as the lender will expect you to contribute to the total amount required.

Other considerations include:

- Inherent risk in the industry;
- The capacity of the business to service the loan;
- The financial record of the loan applicants.

Your business plan will need to consider the cost of servicing the loan (repaying) based on the interest rate and the level of borrowing. Your ability to service the loan will be based on the positive cash flows the business generates.

Lender and investors want a clear understanding of your businesses capability of providing a surplus, service loans and ultimately contribute to your capital growth.

Providing Security

You may need to offer security (lien on personal assets) as a means of raising the borrowings. As a process of managing risk, lenders are likely to make a conservative valuation on the assets offered.