The Rosenberg Survey: Capitalization issues & business shift may shake up accounting industry in coming year

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In the most recent Rosenberg Survey, a yearly study of the CPA industry, we see how major seismic factors involving firms' limited access to capital and the ongoing shift to advisory services may remake the US accounting industry in 2023

The accounting industry is facing macro-sized challenges going forward, including a lack of capitalization that could leave many accounting firms reeling or looking for merger partners, even as the industry as a whole continues to push toward a dramatic shift in its service model, from compliance-based piecemeal work to a more holistic advisory-based partnership with clients, according to a recent industry survey.

The **latest iteration of the Rosenberg Survey**, an annual study of the CPA industry in the U.S. that's published by consulting firm **The Growth Partnership**, took a look at the changing complexion of accounting firm ownership — driven by a need for capital that has raised interest among private equity firms — and the profession's long-anticipated move toward more advisory work. (The latest survey, released in late-September 2022, relies mostly on data from the year previous.)

We spoke to Allan D. Koltin, CEO of Koltin Consulting, who contributed his insight to the report, in order to better understand these larger challenges that the accounting industry must begin to address in the coming year.

Thomson Reuters Institute: ***In the report, you spoke about the changing face of accounting firm ownership with the acceleration of private equity involvement and mergers & acquisitions. How do you think this will all shake out?***

Allan Koltin: Clearly, this kind of change is happening in the industry, in the sense of how a larger number of accounting firms are willing to approach the market and look at strategies, such as mergers or combining with private equity firms.

It's crazy — two years ago, I didn't have one private equity client. Today I have more than 40, and every single one wants to enter the accounting profession. I was warned about this, as the saying goes: If one breaks the code, everyone else will want in.

Of that group, one-third only want to talk to the top 25 accounting firms (those with annual revenue of $300 million or more) — these are the heavyweights. The middleweights, they're interested in accounting firms with revenue between $100 million and $300 million; and the welterweights are looking at firms with revenue between $10 million and $100 million. When you look at this picture and assume deals are going to happen with firms of all sizes, you will have a completely transformed profession within the next two years.

Unlike the consolidators of the late-1990s that only talked to the largest firms, today's private equity firms appear to be talking to everyone — with one caveat: The targeted accounting firm has to be *uber*-profitable. The harsh reality that many accounting firms are finding out is that if you are not profitable, you won't "qualify for the loan" because the model that private equity firms are using today requires a give-back of partner compensation, and if the firm doesn't have excess profitability, your ultimate enterprise won't be that high.

In the late-1990s, public companies like CBIZ, H&R Block and American Express entered the accounting industry as CPA acquirors, of those only CBIZ made a lasting go of it. What the other big consolidators ultimately found out was that their program was great for the old guard, who could immediately monetize their goodwill, but for the younger professionals there wasn't much stickiness keeping them with the organization.

Enter today's private equity firms, which came in saying, What can we do to make this work for the younger partners? They also put something new on the table, a new type of currency called *rollover equity*, which became a game-changer for those younger partners.

Thomson Reuters Institute: *How does that work?*

Allan Koltin: The way that works is that the younger you are, the more rollover equity you're going to get. So, the older group gets cash, and the younger group gets some cash but more rollover equity.

It's a new generation today. When I talk to a 35-year-old partner, they said that under the old deal, they'd have to stay until they're 65 to unlock the first $1 of deferred compensation, and then get small payments for 10 years after that — and that money would then be taxed as ordinary income. And if you look at the present value of that number today, they add, it's "not even lunch money" — and that's assuming both the firm and the profession are still around in 35 years.

Under today's private equity deal, they would likely to get a substantial check with capital gains treatment right away, and then get another in three to five years, provided the firm hits some basic EBIDA performance goals. Then, in years five to seven, when the private equity group sells its investment, these partners would get a third bite of the apple by deciding whether to sell as well. In fact, their rollover equity would be *pari passu*, giving them the same rights and opportunities as the private equity group itself.

That means, at the young age of 40-something, these partners can have money in the bank and then decide if they want to cash out further or rollover their investment into the next private equity fund.

Thomson Reuters Institute: ***As we discussed in the first part of our interview, the report called technology the linchpin of almost every other discussion point in the report. But you said it may be difficult to address the technology question without first addressing the capitalization question. In short, where is the money for tech investment going to come from? Is this what is driving the push toward merger and private equity solutions?***

Allan D. Koltin

Allan Koltin: Exactly, this is a big reason why a private equity firm is in these discussions today. The need for tech investment and digitization at many accounting firms — what I call the fourth industrial revolution — is hitting the accounting profession right between the eyes. Compliance-only shops won't survive this because technology is replacing them. Further, this comes at a time when the younger generation of accountants is pushing back on performing the mundane work that they are often required to perform, making technology even more of a must-have.

That has firms realizing that they will need more capital to operate — so they're looking for that capital. And that leaves them wondering if they should use their own capital and accept lower partner compensation, go to the bank and add debt to the balance sheet, or seek an investment from a private equity firm.

Every firm should engage in a simple strategic planning exercise to assess their capital needs and the vision of what they want to build. Do they want to build a firm of the future? Or just milk the firm they have until they can no longer do that. Look at your talent, look at the changes happening in your part of the industry, and figure it out.

Once you conduct this exercise, you may be open to the idea of combining with somebody bigger, which could be private equity firm or a larger CPA firm, *if* they are culturally and strategically aligned with your firm *and* are built to last, meaning they are profitable and have built out the suite of consulting or advisory services that clients want and need. It also means that they have deep pockets to continue to invest in the talent, technology, and transformation needed to be successful in today's market.

Thomson Reuters Institute: ***Speaking of that, the report also noted that the long-anticipated move toward more advisory work, rather than just compliance work, was quickening. In your opinion, is it moving fast enough? If not, what can firm leadership do to accelerate it?***

Allan Koltin: There's an expression I use, *The operation was successful, but the patient died* — and I think that's what's going on in the accounting profession.

At the base of it, tax & accounting firms create two products — audits and tax returns — that clients, if you think about it, don't necessarily want but surely need. What's happened now, however, is there is some separation in the marketplace because a lot of firms are investing deeply in creating the firm of the future, one versed in consulting & advisory and outsource-related services.

Firms should ask their clients what they *want* — clients don't care about tax returns, they want real and meaningful tax planning, whether we call that estate planning, wealth preservation, personal financial planning, or anything else in that suite of related services.

Too many accountants and their firms are still stuck in the old way of grinding out compliance products. But eventually, this work will be commoditized, and the hours spent doing it will begin to evaporate. Still, too many are blind to the situation at hand, in part because the feeding at the trough right now is really good, and many firms have had back-to-back years of profitability. (Although most partners will confess that they're wearing themselves out with working hours because they can't find the talent to help with the work.)

Yet despite the good times, if your firm is not investing deeply in talent, technology, and the transformation of your business, then in a couple of years you're going to have a big problem.