As private equity investment in CPA firms soars, parties need to be mindful of ethical responsibilities

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The past decade and a half have seen an explosion in the number of private equity (PE) firms investing in CPA firms. Some of the notable deals in 2022 involved big names such as EisnerAmper, Citrin Cooperman and Cherry Bekaert. As these deals proliferate, participants need to make sure that they adhere to their professional responsibilities.

There are many reasons why these transactions can be attractive to the buyer and to the seller.

"Private equity provides access to funds that can be used to invest in technology enhancements, new service lines, geographic expansions or to purchase other firms to fuel growth in revenues," said **Barry C. Melancon**, president and CEO of the American Institute of CPAs (AICPA). "Additionally, private equity deal structure typically allows for a faster payout for partners, which can be attractive—especially for younger partners. PE also provides firms the opportunity to tap into sophisticated boards of directors and financial support teams who provide a great deal of financial acumen and rigor to running the business."

Allan D. Koltin, whose Koltin Consulting Group has worked on more than 140 mergers-and-acquisitions deals, with a total worth topping $3 billion in the past decade, predicted that 2023 will be another big year for the industry. Taking an investment from—or being acquired by—a private equity firm "provides capital to re-create and transform the business," he said.

In an October 2021 interview in the *Journal of Accountancy*, Koltin explained how such private-equity deals work: "A non-CPA firm cannot own an attest firm, so there's what's called the alternative practice structure. Because the buyer, in this case the private-equity firm, cannot purchase the audit practice, they take an ownership interest in the tax and consulting business. Essentially, they're buying a majority of the firm, typically something more than 50 percent but probably not more than 75 percent." He added that the acquiring firm typically holds its ownership stake for four to seven years and then sells it to a larger private-equity group. CPA firm partners receive ownership shares in the new entity. "By not buying the entire business, [the private equity firm is] leaving a lot of equity and upside on the table for younger and maybe, to a lesser degree, older partners to take advantage of."

These are some of the inducements that compelled CPA firm Cherry Bekaert LLP to accept a strategic investment in its business advisory practices from Parthenon Capital in June.

"When [this] started happening in our industry, and we knew this was … a new business model, it was important to us to at least explore what that meant," said Michelle Thompson, the former managing partner of Cherry Bekaert LLP who became CEO of the resulting entity, Cherry Bekaert Advisory LLC. "[As] a different way of running our businesses, we felt [as if] we had to understand it and decide: Is that something we want to compete against or is it something that we … need to follow? So, ultimately, we

felt we owed it to our partners to explore what it means and, ultimately, we decided that it was going to help us accelerate our strategic plan, and we felt like it was the right time and the right move."

Such a transformation was an impetus for EisnerAmper LLP to sell a majority stake to TowerBrook Capital in 2021 and to use the cash to expand its business offerings.

"We thought we could put the capital to good use [and] build on our foundation," said **Charles Weinstein**, CEO of what is now Eisner Advisory Group LLC. "The hindsight proved that we underestimated the opportunity. We have engaged in so many high-quality conversations with firms that have an interest in joining us—far more than we had anticipated."

"We far surpassed what we thought we could accomplish in the first year and a half," he said, adding that the firm has "nearly doubled in size" in fewer than two years and has added services that it did not previously have, such as Service Organization Controls (SOC) reporting and HITRUST, a security and privacy framework that provides information protection, risk management and regulatory compliance.

Benefits of investment

Thompson agreed about the opportunities that investment provides.

"One of the advantages to this business model is the capitalization that comes with it," she said. "So, for us, it's that capitalization that allows us to accelerate investments. One of the things that has been going on in the industry is the switching to paying cash for these acquisitions, as opposed to [a] promise to pay in the future. And that started before the entry of PE into the market."

The new model also means that profits can be more easily reinvested into the business than in a partnership, where earnings are typically distributed to partners in full each year.

"From my perspective, there is tremendous value in having a multidisciplinary firm that offers opportunities for its people to be exposed to attest roles, tax roles and advisory roles," said Melancon. "And I want to emphasize, as private equity owns firms, the importance of their continued support of CPAs in the tax role (and other advisory roles) along with those in the audit role. Of course, they also need to be committed to the ethical requirements on the assurance side as to structure and independence."

For the CPA firm that aspires to attract private equity investment, there are, as with anything else, hurdles. To start with, there is financing.

"To do PE, you have to be profitable," said Koltin, also noting the importance of earnings before interest, taxes, depreciation and amortization (EBITDA). "If you're not profitable, you don't get the loan—and 90 percent of CPA firms don't qualify for PE." There is a psychological aspect to all of this, too, he said: "CPAs hate change."

Compatibility is vital, too. Weinstein said that he chose TowerBrook from a pool of three potential suitors because it "got the value of what an accounting firm brings to [its] clients [and] understood what would be important to the partners. … From the perspective of aligned vision, TowerBrook was the private equity firm whose vision aligned really well with ours."

Koltin noted that technological factors can also compel CPA firms to seek out new ways of conducting business and remaining profitable.

CPAs "have been providing compliance services … for 100 years, and technology and lack of talent is compressing that service," he said. "Therefore, firms are offshoring what used to take 200 hours and can now be done by bot."

The "evaporation of capital by technology," such as blockchain, which provides daily reporting, and the "war for talent" mean that "every year, there are 10 percent fewer accountants coming into the field," he added. "The best and the brightest don't want to do mundane work, or they will be going elsewhere."

Technology is "a big reason why a private equity firm is in these discussions today," Koltin said in an interview with the Thomson Reuters Institute in February. "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." He added, "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."

Given the declining numbers of people entering the accounting profession, and the reasons for it, taking younger professionals and their compensation needs into account plays a large role in contemplating such transactions.

"When I talk to firms, the first [comment] that they [have] before we have deep and in-depth conversations is, 'I'm worried that this isn't going to be good for my younger partners,'" said Thompson. "Actually, it's much better for younger partners because they're taking risk off the table every few years, and they don't have to wait till they're 65. And you can have more people invested in the business. We've extended ownership privileges to below partner so that we could create alignment and connectivity. We just believe it's just a much more appealing model for younger people."

Independence issues

But, there are other important considerations, as well. "The implications of private equity investments in CPA firms affect both elements of independence: independence in fact and independence in appearance," said Melancon, pointing to the AICPA Code of Professional Conduct as a guide.

"The two main areas of focus within [the code] relevant to private equity investments in accounting firms are the 'form of organization' of the structure after the transaction and [the] 'independence' of individuals and entities within the structure," he said. "The form and organization of a private equity alternative practice structure, which includes an attest firm, is the first hurdle of the transaction, from an ethical standpoint. According to the code, the CPA firm providing attest services must be a separate entity and majority owned by CPAs."

"Additionally, the CPAs who own the attest firm must remain financially responsible for the firm's attest work. In a private equity structure, the CPAs who own the attest firm are generally leased from the professional services company (the private equity fund investment)," he said. "The CPA firm maintaining its separate form and organization in both fact and appearance is critical to mitigate and/or eliminate any pressure or conflict with the public interest principle. It is also important to note that some state boards may have guidance that differs, regarding ownership of the attest firm."

Melancon emphasized that "[t]he public interest principle is a distinguishing mark of the accounting profession. The public consists of clients, creditors, governments, employers, investors, business and financial communities, and others who rely on the objectivity and integrity of CPAs to maintain the orderly functioning of commerce. … The potential for pressure or the appearance of pressure from individuals and entities such as the general partner(s) or the professional services company on CPAs in the attest firm could create conflicts with the public interest principle."

He added, "Determination of who is subject to the independence requirements is a challenge of the private equity structure. In addition to covered members, the Independence Rule extends to direct superiors of covered members and the entities over which those direct superiors can exercise significant influence. Financial relationships where an individual or an entity has significant influence over the attest client also have indepen-

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dence implications. Identifying these individuals, entities and relationships is essential for compliance with the Independence Rule."

The issue of independence is one that has concerned **Victoria L. Pitkin**, the longtime chair of the NYSSCPA's Professional Ethics Committee.

"What safeguards are firms putting into place so they are not servicing clients not owned by their PE clients?" she asked. "There are all kinds of landmines out there, and I hope that firms that are taking advantage of this fast money are putting safeguards into action so they stay on the right side of the rules."

Previous attempts at these types of investments—as chronicled in *Accountancy Daily*, *The Wall Street Journal* and two H&R Block press releases—illustrated her point.

In the 1990s, American Express bought up about 130 CPA practices, but sold the division— which it branded as American Express Tax & Business Services—to H&R Block in 2005 due to disappointing returns. H&R Block, for its part, went on its own spree in 1998–2000, investing about $2 billion in acquisitions, including mortgage services, discount broking, financial planning and, to a lesser extent, CPA acquisitions.

H&R Block acquired McGladrey & Pullen's nonaudit business for $290 million in 1999. This became a separate group—RSM McGladrey Business Services—within H&R Block, which sold the firm back to McGladrey in 2011 for $610 million.

"These were the first times this alternative practice model was attempted," said Pitkin. "It failed. Some would say horribly. I'm not sure I hold out great hopes for this new attempt with [venture capital] money. VCs want to make money on their investment. I worry what firms will be expected to do to make that increase in value."

"You can't have public companies owing audit firms," she said. "These firms spun them off. The partners made a ton of money but, from a managerial perspective, it did not work, and it was a massive failure. As a result, they don't own their firms in the New York area anymore."

A key concern of hers is perception. "Are you, in fact, independent?" she asked. "[Would] an outsider looking at the situation from the outside conclude that you are independent?"

That independence issue has also been addressed by the Securities and Exchange Commission (SEC).

In a statement last year, SEC Chief Accountant Paul Munter wrote that accounting firms that receive investments from private equity must exercise great caution. "[C]omplex transactions with investors that are not traditional accounting firms and have not previously been subject to the same independence and ethical responsibilities," he wrote, "elevate the risk to an auditor's independence."

"In these complex practice structures and divestitures," he wrote, "it is paramount that the accounting firm fully understands its responsibility for maintaining auditor independence and it discloses such requirements to the non-accounting firm investors involved in the transaction so that the accounting firm can obtain the information necessary to fulfill its responsibilities. … When an accounting firm is considering obtaining an investment from a private equity or other investment structure, each entity within such structure would need to be carefully evaluated to determine if the entity is an 'associated entity' and is therefore part of the accounting firm for purposes of assessing potential impacts on, among other things, compliance with the Commission's auditor independence requirements."

"In some cases, an accounting firm may contemplate the divestiture of a portion of its business or other form of restructuring where its intent is that the divested entity no longer is part of the accounting firm post-transaction," he added. In such cases, he wrote, the split has to be complete, meaning that there should be no revenue or profit-sharing between the accounting firm and the divested entity, as well as no sharing of marketing, advertising or branding.

"Although there are differences, the SEC, state boards, and the code seem to be striving to meet similar objectives of serving the public's best interest and maintaining the CPAs independence and objectivity when performing attest services," Melancon noted. "The AICPA Professional Ethics Executive Committee (PEEC) currently has a task force studying private equity investment in accounting firms, which may result in additional guidance."

Considerations before making the big move

With all of the elements that need to be taken into account before embarking on a possible acquisition or investment, firms should know what they are getting into, Cherry Bekaert's Thompson noted.

"You have to evaluate … what's happening in the market, how that's going to impact your ability to continue to operate the way you're operating. You need to fully understand how the funding, how that investment from a PE, works in the first funding, but really how it works in the subsequent ones because that's where the value creation is," she said. "So invest to understand before and [then] decide if you're in."

That may just be the beginning, according to Weinstein, who said that "while there's a lot of heavy lifting to find the right PE partner [and] negotiate a transaction, the hard work really starts after you find the right PE firm."

"Accounting firms are generally run as partnerships," he continued. "When you have a private equity sponsor, you have outside investors in the advisory practice, and you have a responsibility for all of your shareholders. And that's different. So you have responsibility for your partners and now you have new shareholders as well. So when it comes to how you execute, you have to keep in mind all of your constituencies, and you need an open mindset to be able to adapt to that."

"The absolute most important aspect to this is to pick the right private equity partners," Weinstein said. In his firm's case, "We spent over a year with TowerBrook, designing our organization structure, designing the appropriate transaction structure … and really vetting all the fine points around making sure that we had a partner that valued the CPA relationships in a really big way, and it served us really well."

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