WHITE PAPER

To PE or Not to PE

That is The Question

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Smith & Johnson CPAs (fictional name), a respected mid-sized accounting practice in the heart of Chicago, had always prided itself on its independence and client-focused service. Established three decades ago, the firm has weathered economic storms, industry changes, technological evolution, and talent market changes with resilience. But now, after getting closer to their retirement, the founders found themselves in a predicament regarding how they would ensure the firm's future that they had created with so much passion and hard work.

Williams, Brown, and Jones, P.C. (fictional name), a growing accounting firm in Los Angeles, is led by an entrepreneurial leadership team. The firm's business model has a full-service model with advisory and consulting weaved into its services packages.

The firm has seen rapid growth recently, which has rightly flamed its growth ambition. The problem? To grow faster and bigger, the firm needs growth capital and resources.

One sunny afternoon, leading Private Equity (PE) representatives arrived at both firms to present an offer that would solve most of their problems. This financial investment could push Smith & Johnson into its next growth phase with augmented succession. On the other hand, Williams, Brown, and Jones, P.C. would leverage the PE investment to flourish faster. The offers were, however, temptations that were nestled up with a host of new considerations and concerns.

These are just some examples of PE investment cases and related matters that several CPA firms are experiencing today.

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About Hitendra

As the President of Global F&A Services at Datamatics, he drives the company’s Finance & Accounting business vertical. His expertise spans client accounting and advisory services (CAS / CAAS), emerging accounting technologies, and CPA firm success.

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What are PE firms and CPA firm owners thinking?

Over the last few quarters, I have spoken with a few PE firms and several CPA firm owners about the interests of both sides. Not all PE firms or PE-backed firms are the same. PE firms may or may not provide resources and expertise along with capital. Some options will take the firm's independence and culture when merging up to a PE-backed firm. Others may allow independence to flourish.

While the PE firms' objectives and methodologies to identify and evaluate firms to invest in seemed more or less similar, I saw a divide in how CPA firm leaders think about PE investments. For PE firms, firms with a good client mix and revenue levels but those with *"inefficiencies"* in their processes present a quick opportunity. PE firms can trigger enhancement in the profitability of such CPA firms by applying best practices from the portfolio of firms PE firms have invested in, such as pricing changes, technology stack standardization, offshoring/outsourcing, etc. For CPA firms, it is a complex decision - and depends on several factors, including how long the partners want to continue, objectives of the firm partners regarding their plans for the future - e.g., quick flip or going public, whether there is a succession plan in place, the lifecycle stage of the firm, the process and technological maturity of the firm, services, and client-mix focus, etc. A CPA firm owner shared, *"I will operate my firm as if we are ourselves a PE firm,"* - which is somewhat in line with the traditional M&A approach.

Why to PE?

Access to capital for growth and expansion

One of the most compelling reasons for CPA firms to accept PE investment is the significant inflow of capital the investment has in store. This capital can be used to invest in technology, expand service offerings, and enter new markets.

PE investment can make a difference for most firms, especially those that want to grow quickly or remain competitive with larger firms. An infusion of funds can help modernize operations and improve client service to increase profitability. A rising tide lifts all ships.

Strategic guidance and expertise

PE firms bring in not only money but also a lot of strategic expertise. These investors have immense experience scaling a business and optimizing operations while steering their way through substantial market dynamics—often cutthroat and too complex to deal with.

This means an accounting firm can gain access to business acumen, resources, and networks unavailable at any other level. Such strategic advice from PE firms can help the CPA firm make its operation leaner and more efficient through best practices. A coin in hand comes with a guiding hand!

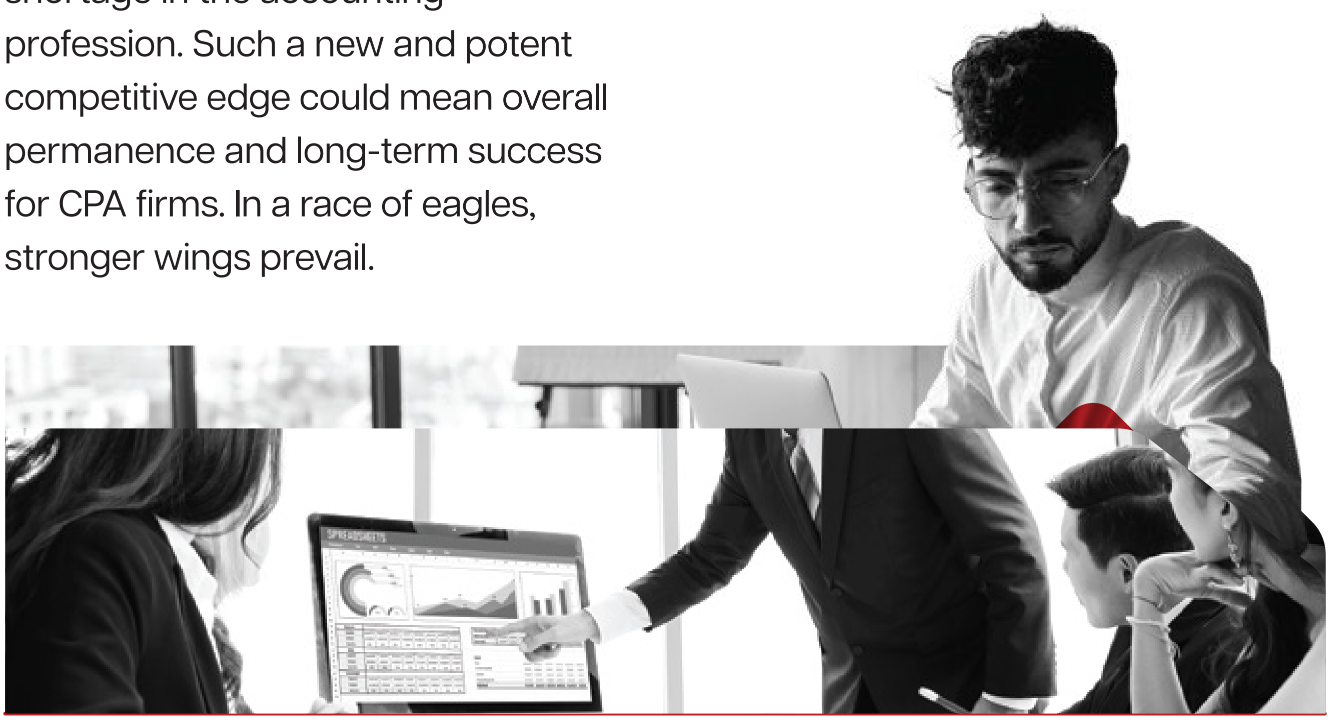
Enhanced competitive edge

PE investment can be the factor that gives a competitive edge to CPA firms. The additional resources and strategic insights boost the firm's capacity to innovate and compete differently in the saturated competitive environment.

Whether it is advanced technology, superior customer service, or vast expansion of service offerings, PE-backed firms find themselves in a much better position when it comes to attracting and retaining customers – and talent – which is a massive advantage in the era of epic staffing shortage in the accounting profession. Such a new and potent competitive edge could mean overall permanence and long-term success for CPA firms. In a race of eagles, stronger wings prevail.

Attract and retain talent

It is quite possible that with PE investment, talented people who have yet to reach partner levels can also stand to gain Equity much earlier in their careers, and likely with smaller or even without investments. And with the inevitable perception that PE-backed firms become more efficient and modern, driven by growth focus, it can also help attract new talent to the firm—where opportunity knocks, ambition answers.



Why not to PE?

Loss of control and increased involvement

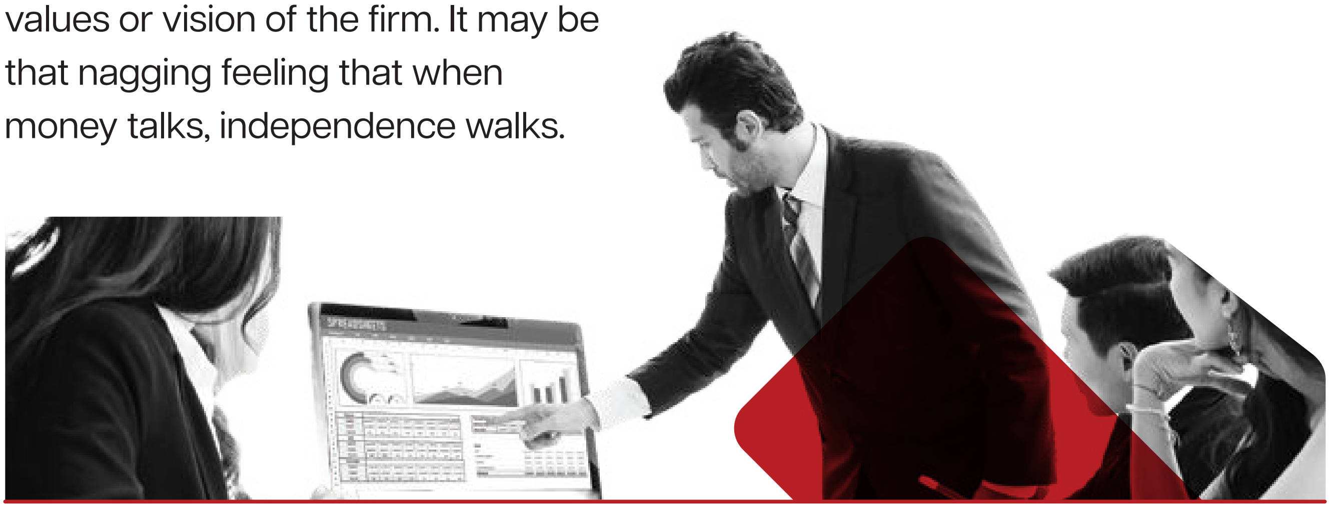
One of the significant issues facing accounting firms when it comes to accepting PE investment is the fear of loss of control and independence. When you sell the cow, you sell the milk too. PE investors will want investment returns and may have active managerial involvement and motive.

This is a tough pill for most independent accounting firms that have been around for a long time. Some of the biggest deterrents to this move are fear of the loss of independence and being railroaded into decisions inconsistent with the values or vision of the firm. It may be that nagging feeling that when money talks, independence walks.

Pressure to achieve short-term financial goals

PE firms mainly operate with a relatively short horizon in delivering high returns to their investors. It creates an environment in which there is pressure on CPA firms to focus on short-term financial results at the expense of long-term stability or client relationships.

Immediate changes could involve restructuring, altering business models, and cultural transformations that differ from or might bode against the best interests of either clients or employees of the firm. The possibility of such radical change causes anxiety among many firm leaders.



Cultural misalignment risk

The culture of the CPA firm is usually deeply and profoundly rooted in its history, values, and style of providing services to clients. The addition of the PE firm can bring about cultural differences. New hands may not always fit the old gloves.

The PE investors may try to implement measures that are not in line with the management of the CPA firm, causing discomfort among employees and clientele. Maintaining the careful balance between seizing new opportunities and preserving the firm's uniqueness can be challenging, presenting much risk for cultural misalignment.

What do you do if you get a PE offer?

The decision to accept PE investment is rich with opportunity and fraught with vulnerabilities. For a firm like Smith & Johnson, the promise of faster growth and modernization must be balanced against the potential loss of control and cultural disruption. For a firm like Williams, Brown, and Jones, the cost of servicing the additional capital must be balanced with strengthening its own Equity in the longer term. Firms need to deeply understand which PE firms they are dealing with and look for patterns in their potential PE partner's previous experiences in the space. It is the decision of each firm, determined by its circumstances, goals, and values. It is not a one-size-fits-all proposition. It may not just be about gaining strength but about choosing which facets of your defining identity you're willing to dilute or give up.

The question of "To PE or Not To PE" has to be weighed in the context of a comprehensive assessment of the potential benefits and downsides, viewed clearly through the eyes of whether a PE partnership aligns with the vision of the firm's future. For some independence-minded firms, all that glitters is not growth.

Ultimately, the right choice will depend on the firm's readiness to navigate changes and challenges that come with PE investment while at the same time seizing all the opportunities that come with it. In the PE-backed accounting world, it may sound like he who pays the piper calls the tune, but sometimes the tune is not your own, and the hand that feeds also steers.

It all reminds me of a proverb that, adjusted to PE in accounting, would be this:

"If you want to go fast, go PE.
If you want to go alone, no PE."

Do you think differently about PE? We'd love to hear your thoughts.

The PE Playbook of Investment in Accounting Firms

So, what do PE firms do when they invest in an accounting firm?

1. Raise prices. (You can do this yourself without PE investment!)
2. Create SOPs (standardize). (You can do this yourself without PE investment!)
3. Invest in technology to enhance those SOPs. (You can do this yourself without PE investment!)
4. *Offshore the work.* (You can do this yourself without PE investment! We can help you get this done quickly, reliably, and profitably.)
5. Acquire additional firms and do the same above. (You can do this with or without PE investment).

To learn more about how you can leverage our exclusively-for-accountants-outsourcing, **click here to book a 15-minute** no-strings meeting with one of our experts.

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