Industry Trends

The Five Life Cycles of CPA Firm Growth

By Allan D. Koltin

In this article, Allan D. Koltin, CPA, CEO of PDI Global, Inc., explores the five life cycles of CPA firm growth and discusses how firms transition from one life cycle to the next.

Q: Let's begin by talking about Life Cycle 1 of a CPA firm, which I assume includes all start-ups to a certain point in size.

A: Yes. For me, Life Cycle 1 (as shown in Exhibit 1) represents any start-up firm, up to approximately $2 million in revenue. For the most part, these firms are run by the one or two partners and, make no mistake about it, they are working partners. They do everything, including bringing in business, servicing clients, having a high number of billable hours, all the way to making the coffee and vacuuming the carpet! For many partners I have talked to, they have told me that this was one of the most exciting and challenging times of their professional career, but also was one of the craziest times of their career. Their strategy is simple—anyone who can pay their bill is a worthy client and, to some degree, they are jacks-of-all-trades.

Q: Is there any big issue or obstacle that firms this size need to deal with if they want to get to the next life cycle of growth?

A: That is an excellent question and a simple one to answer. The big question partners in this life cycle need to ask is whether they want to have a couple of partners who build their book of business as much as they can, or do they want to build an organization that is greater than the founding partners? For most firms, it is the moment of truth—grow the business or "become" the business. There is not a right or wrong answer for this decision, but it surely will define the long-term culture of the firm.

Q: Let's discuss Life Cycle 2, in terms of the typical size of firms, as well as the biggest challenges and opportunities.

A: Life Cycle 2 firms typically have revenue of $2 million to $5 million and grow from one or two partners up to three to six partners. Most of these firms have a compensation system that is strictly formula based, so the more you work, typically the more money you make along the way. At some point, the biggest concern is that of leadership and which partner will essentially evolve as the Managing Partner to "work on" vs. "work in" the business. Clearly, staffing becomes an issue and it becomes apparent to the partner group that not all partners need to be involved in the decisions that need to be made. From a differentiation standpoint, clearly their "pitch" in the marketplace is that if a client hires their firm they will get true, hands-on, working partners vs. the "bait and switch" that larger firms typically use, in which the people selling the work are not necessarily the ones delivering the work.

Q: **Are Life Cycle 2 firms typically boutiques that specialize within an industry/service area or are they more of a general firm?**

A: While there are exceptions to this, most Life Cycle 2 firms are generalists, but begin "dabbling" in one or two industry or functional service areas. It is a tough balance because, once again, they have their day job as a generalist, but are trying to develop an expertise in some very specific area. For the most part, they are doing that in addition to maintaining their existing book of business.

Q: **So if a firm is fortunate and grows beyond Life Cycle 2 to a Life Cycle 3 firm, what might that firm look like and, once again, what might be its issues and challenges?**

A: Life Cycle 3 firms are typically between $5 million and $10 million in revenue size and have gone through the process of electing a Managing Partner. For the most part, these managing partners are more administrative in nature and haven't really immersed themselves in the management (and holding accountable) of individual partners within the firm. Also, unfortunately, management at this level is not valued as highly as client service or bringing in new business, so oftentimes someone will do it just because someone has to be the Managing Partner and will receive a relatively modest stipend for providing this service. For the most part, firms will have anywhere from four to twelve partners. The big awakening for them is that they now are investing partner time in professional management (i.e., nonbillable type things), and I think they realize that at some point they will need to hire true expertise in this area, but are worried about the effect it will have on their bottom line. Simultaneous with this is the continued discussion of specialization, as they can now see a couple of emerging industry/functional niches within the firm, and they begin to talk about a more formalized approach (both marketing and from a service delivery standpoint) to how they will serve clients within these niches.

Q: **That takes us to Life Cycle 4, which I sense is a life cycle that a majority of the firms within the CPA profession never reaches. Can you tell us more about this type of firm and what percentage of the firms actually gets to this level?**

A: Well first, I should make an overall comment that the size of a firm is not the end-all to its success. There are many, many successful firms in Life Cycles 1, 2, and 3 that couldn't care less about growing and simply want to continue to deliver excellent service to their clients and maintain a fair level of profitability. Having said that, I will tell you that over 98 percent of firms that start never get to Life Cycle 4, which is evidenced by the fact that the 500th largest CPA firm in the country is approximately $12.5 million in revenue. From a size standpoint, these firms are typically in the $10 million to $30 million range and have an even wider approach to the number of partners in the firm. It could range from a low of eight up to a high of 40, depending of course on the size of the firm, as well as whether it is a one- or two-tiered (income and equity) partnership. Interestingly, one would think that, when you get to Life Cycle 4 in the accounting profession, this would be a very safe place to be. The reality is that Life Cycle 4 firms today are absolute "tweeners" and have the continual challenge of being too big to be small and too small to be big. There are only about 400 such firms in the profession today and, when you compare that to the fact that there are over 45,000 CPA firms nationally, one can see how challenging this level can be. From a compensation standpoint, we clearly begin to see a broader range between the highest and lowest earners and we begin to take much more seriously the issues of retirement, deferred compensation, and firm governance. Here, the firm has typically made the Managing Partner function a full-time job and has also put teeth into the positions of department heads and niche leadership. One of the biggest issues facing these firms is whether they should stay independent or merge up (or at least merge with equal-size firms). When we look at these firms under a microscope, clearly a strong indicator of future success is what the next generation of talent looks like in terms of future leaders. Having said that, many firms this size are finding they can stay independent and get to the next level of growth, while others are finding a safer path by merging with somebody larger that already has greater depth and resources and a broader array of products and services.

Q: **I guess that gets us to Life Cycle 5 firms, which I sense there probably are not too many of, based on our discussion thus far.**

A: You are absolutely right in your assessment. A Life Cycle 5 firm is typically $30 million in size or greater. Based on the most recent industry statistics, there are only approximately 100 of these firms in the country. What is interesting is that there is a mix among them, with a healthy number of first-generation firms, but clearly the majority of these firms are second- or multi-generation firms. Make no mistake about it, these firms are run by very sophisticated leaders who excel in leadership and management. It is not strange to find that a handful of them serve in a management capacity on a full-time basis. This applies not only to the CEO and COO, but also to the heads of various service lines of the business segments and the internal management of the firm. At this level, the number of partners really does not matter. What does matter is the revenue per equity partner, which typically will be in excess of $1 million and approaching $1.5 million. You would think that, when a firm gets to this size, many of its worries would go away. But in a recent survey I conducted of what were the Top 60 CPA firms in 1993, it is of particular interest to note that, 18 years later, 30 of them (or 50 percent) are gone and the other 30 have dramatically reinvented their firm and bear only a slight resemblance to what they looked like back in 1993. I guess it is safe to say that, if a firm is a Life Cycle 5 firm and the majority of the partners are resistant to change, there will be some major crossroads that they will need to tackle. From a strategic standpoint, it is all about expanding geography, whether it is through organic growth, mergers and acquisitions, or the addition of new products or services. In as little as 10 years, we have seen a major transformation take place among Life Cycle 5 firms. In 2000, the 100th largest firm was well under $10 million in fees, and only 10 years later the 100th largest firm is approximately $32.5 million in fees. Clearly this group has been the busiest over the past decade in terms of the firms growing way beyond their original size. I sense that there is a continued drive within the majority of these firms to possibly even double again in size over the next five to ten years.

Q: Any closing comments or thoughts on life cycles of CPA firms?

A: Once again, I would stress that size does not really dictate success. What matters is that the partners continue to be on the same page in terms of what their individual strategic goals are vs. those of the firm. It is also critical for firms, no matter what life cycle they are in, to have a strong leader that the partners respect and trust. Finally, at the risk of stating the obvious, there is an old adage that if you do not grow you die, and I believe that successful firms truly embrace this concept along the way. After all, if a firm does not grow, what future opportunities exist for superstar talent to entice them to stay with the firm?

Editor's note: If you have any questions about this article or any other issues facing your firm, please feel free to contact Allan D. Koltin, CPA, CEO of PDI Global, Inc. and a founding member of The Advisory Board at *AKoltin@pdiglobal.com* or 312-245-1930. We welcome your input and ideas and we hope you will continue to look to CPA PRACTICE MANAGEMENT FORUM for guidance and best practices.