

Chapter 9:

Profitability, the concept of Managing on the Edge™, and their importance to a regional law firm

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Introduction

In this article I introduce a basic primer on what I term “micro-profitability”, the ability to measure and compare, with a reasonable degree of accuracy, such indicators as the profit of clients, matters, working attorneys, billing attorneys, practice teams, practice groups, and alternative fee arrangements. I also discuss how our matter profitability program is part of a management concept we have implemented, called Managing on the Edge™, to ensure our firm maintains a strong financial and profitable profile.

Reviewing the many articles written over the last few years on profitability one easily ascertains that the landscape is littered with warnings to tread warily. Quoting from different past articles; “a managing partner pointed out the underlying problem that there’s really more art than science as to what you count as revenue and similarly what the cost allocations are going to be”; and from a another managing partner – “I’ve never heard of a law firm that has a good way to measure matter profitability. Many say they do, but when you push on the details it becomes clear that they really don’t”. One quote that goes to the heart of the issue; “the subject of profitability at the client and matter level is one that is very difficult to grasp for those not fully versed in cost accounting concepts. Whatever methodology is used, it should be agreed to by a consensus of the partners so that the results are accepted once the methodology is applied, and make certain that everyone buys into how the process is going to be done, and more importantly, why it is being done and what decisions will be made from the information once the analysis is completed.” And from a senior manager of a profitability software product; “if I asked fifty law firms how they are measuring and using matter profitability I would get fifty different answers”.

In the “fifty law firms” example however, each firm would likely agree with the importance of measuring profitability to improve firm management. If we asked them; “is your firm taking on clients and matters that are the bad for the bottom line”, and a firm answered “no”, then I think we would all agree that they are either in denial or the only firm in the world that is so “perfect”. There is definitely a move afoot among leading law firms to change the dialog from the traditional “hours and revenue” to “revenue and profit”. We think we are one of those firms.

Managing on the Edge™

In an article I wrote in the 1996 entitled “The Business of Running a Law Firm”, and soon after I had become chief operating officer (COO) of Procopio, I made the statement that such comments by consultants as “lawyers did not know how to run a business” were nonsense. Law firms, managed and run by lawyers, had been making a profit for a long time and, as I saw it, the key factor was that competition in the legal market was weak and as such it did not require sophisticated business acumen to manage law firms and do well financially. Culture and tradition was the name of the game and regardless of whether the law firm’s market was local, regional, or national (there were not many global firms back then) the ability to be financially strong was not that difficult. Matters were priced in an effort to simply get the work done without any real need to develop an understanding of the true cost of the engagement to the firm or its impact on profitability. The vast majority of firms had mastered what I term the “macro-approach” to profitability, the RULES¹ game, and could produce a solid firm profit at the end of the year. This situation continued for the vast majority of law firms up until the 2008 “crash”. Given the changes that have occurred since 2008 and the many changes in the legal industry being forecast for the future, and as firms continue to adapt to an emerging procurement and alternative fee arrangement (AFA) environment in which clients increasingly expect their law firms to shoulder more risk in their engagements, law firm management has to now become a lot smarter if our firms are to survive and be sustainable in the long-term. It is critical that law firms develop the metrics to quantify both the revenue and costs at the client and matter level. Law firms will need to focus more on client and matter profitability, the “micro-approach” versus for example, realization percentages.

Our firm, like many regional firms in the country, plans to stay independent and as such needs to hold its own in the battle for talent against its main competitors – who are not only strong and innovative California

firms, but also national and global firms. We need to be able to hire the best talent and compensate them such they are not tempted to move to our competition. This especially applies to our equity partners, who are the main rainmakers of the firm. We have to date been very successful in this endeavor in the main because several years ago we embraced a management philosophy we term Managing on the Edge™. As stated above, and like most successful firms, we have mastered the overall profitability of firm management that comes with understanding RULES, however to ensure revenue and profits are sustainable and grow year-over-year Managing on the Edge™ makes us focus on those activities “on the margin” that bring small positive incremental changes. These incremental changes, when added together, can make a substantial difference to the “bottom line”. These incremental activities are mostly economic and directly affect the financials of the firm, for example a one percent increase in revenue, an “incremental” change, can result in a three to five percent increase in the net income. Such activities have included use of software to track all client “touches” in a day whether a document, a telephone call, or via an e-mail; use of automatically generated e-mails that contact clients when their invoices reach forty-five days past due; electronically generated paperless invoice proformas viewable anywhere in the world at any time on our virtual desktop system; a laser-like focus on improving standard to matter realization rates; reducing write-downs; and being smarter at AFA implementation. Other activities, like allowing clients a secure window into our business intelligence data or our collaborations with the Ritz Carlton Leadership Center to improve client service, have an indirect but long-term effect on our bottom line. Our recent focus on client and matter profitability, the “micro” approach to profitability, is the latest and potentially our most important Managing on the Edge™ incremental activity.

The macro-approach to profitability

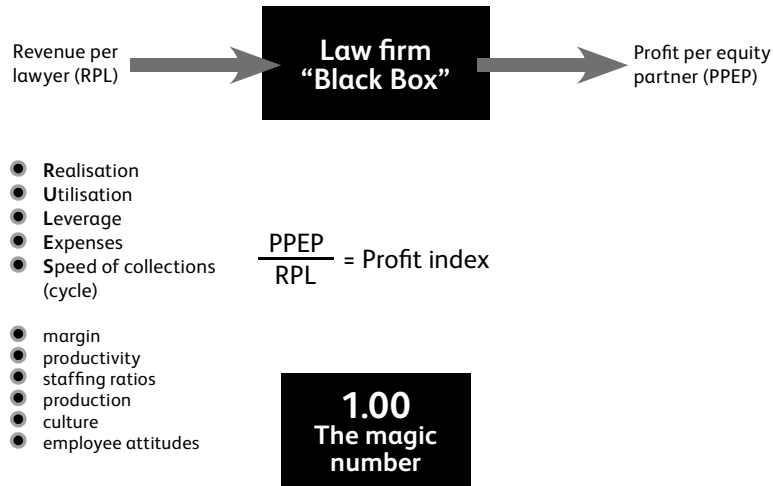
Before we discuss the micro-approach to profitability, it is useful to say a few words about the historical macro-approach. The RULES approach for professional service firms appeared in the early '90's in the accounting world and was soon adopted by the law firm consultants. It has become the easiest way to focus on the management of law firm finances and profit. The “R” in RULES stands for realization, which is the percentage of work ultimately collected compared to the value of the work actually performed either at standard rates or at matter rates. A myth is that realization is the same as profitability, which is not true and

can be very misleading if believed. Realization has been used incorrectly as a surrogate for profitability over the years, but as our own five years' analysis of the 15 percent of clients who give us 80 percent of our revenues shows, the correlation between realization and profitability, while a rough indicator, is not high. The "U" in RULES refers to utilization. The principle of utilization is to ask the question "how busy are you?" The firm has to set its standard for "full capacity". The "L" refers to leverage, which is simply the ratio of the number of lawyers who are not equity partners to the number of equity partners. Usually the calculation is based on the annual full time equivalent (FTE) number of partners and attorneys. The "E" in RULES refers to expenses and expense control, and the "S" serves as reminder that "speed of collections" is critical. When it comes to expense control, we are believers in "zero-based budgeting" techniques, a process that takes place at our firm every year. We assume no operating expense should continue year to year without being solidly vetted. Expense control also means that the firm should have a very solid understanding of the concept of fixed and variable costs and the differences between fixed/variable and direct/indirect costs. This understanding is essential to move from the macro-approach to the micro-approach of profitability.

Over the last twenty years or so, successful firms have learned to balance and manage the above RULES factors such that they maintained an acceptable level of profit (revenue less expenses). Other traditional financial indicators for law firms are revenue per lawyer (RPL) and profits per equity partner (PPEP) and, as shown in Figure 1, these two numbers can usually give a good indicator of a firm's ability to optimize all the RULES above. PPEP divided by RPL, called the Profitability Index (PI) should be equal to or greater than 1.0 (what I term the Magic Number). In many of the firms I have consulted with over the years, one of my first reviews is to determine their PI number, and if it is well below 1.0 then I know there is certainly room for major improvement in their profitability!

The micro approach to profitability

When one moves into the world of matter profitability one is entering into the world of cost accounting. The field of accounting has generally been divided into main parts, (1) financial accounting, and (2) managerial (cost) accounting. Financial accounting is primarily concerned with how accounting can serve *external* decision makers, banks, creditors, auditors etc., while managerial accounting is concerned primarily



Profit index is the firm's ability to convert dollars coming in the door to dollars in partners' pockets

Figure 1: The law firm managerial accounting "Black Box"

with how accounting can serve *internal* decision makers, like the firm's management. This distinction is important because while there are "rules" for both types of accounting the internal ones are very flexible and allow more interpretation and assumptions, assumptions that are often decided by the management of the firm. Cost accounting is generally indistinguishable from so-called management accounting, or managerial accounting, and its fundamental aim is to assist management to make better decisions across a wide range of business operations. Thus law firm matter profitability needs to be understood in the context of the two very important drivers above: (i) it uses assumptions that are often decided by the management of the firm; and (ii) the aim is to assist management to make better decisions about firm operations.

Costs (expenses) are usually classified as either fixed and variable, or direct and indirect. While costs can be put into more than just two categories, it is sensible to focus on these two groups, as we can usually explain all that we need to with just these categories. Definitions of fixed and variable costs can vary from firm to firm, industry to industry, but for our internal purposes we classify fixed costs as ones that cannot be changed easily, if at all, in less than 12 months, whereas variable costs can be increased or decreased in a shorter period of time. Another way

to view the difference is to say that costs that remain unchanged for a given time period despite wide fluctuations in activity are fixed, costs that change in proportion to changes in activity are variable. Examples of fixed costs in a law firm are rent, equipment leases, capital expenditures, and depreciation. Examples of variable costs are salaries, travel costs, and entertainment expenses. Fixed costs plus variable costs equal total costs, and revenue less total costs equal profit. Thus one can deduce that revenue less variable costs, what accountants often call contribution, is equal to fixed costs plus profit. When revenue exceeds variable costs, we have a positive contribution which first goes to cover fixed expenses and then it *contributes* to profit. This simple equation shows the importance of revenue, in that after it has covered all variable costs it first goes to cover fixed costs before any profit can be made. As law firm consultants all rush us to embrace matter profitability and profits, we must remember that revenue comes before profit, and revenue is extremely important and must not be forgotten. A client with a large revenue stream but with a lower profitability than the firm normal has an important role to play in the overall financial stability of the firm.

In professional service firms, just like other industries, there are also direct and indirect costs. Direct costs are usually always associated with variable costs and indirect costs to some form of overhead calculation or burden. However it is not true to say that all indirect costs are fixed or all direct costs are variable, as it depends on the costing model used by the law firm. In the macro model of law firm profitability it is usual to think of total costs rather than unit costs. Thinking in terms of unit costs however is required in a more granular analysis of profitability. In all cost accounting, regardless of what industry or profession is involved, unit costs are averages and must be interpreted cautiously. This cannot be emphasized enough. Analysis at the matter level of profitability is essential for firm management to understand the dynamics of cash flow and operations so that sensible ongoing business decisions can be made, however interpretation of the data developed can be misleading if the basics of the unit cost formulae are not understood. Different cost objectives can be used as units, for differing purposes, all of which can be very valid. Generally, unit costs are expressed in terms most meaningful to the people who are responsible for incurring the costs. In law firms or other professional partnerships acceptance of the overall unit cost model must occur with the shareholders/equity partners if the decisions that emanate from the model are to be implemented successfully. The partners must be “aligned” and accepting of the business model. The

usual cost units that are cited in law firm profitability models and the ones that make most sense are (i) the individual, the lawyer; and (ii) the billable hour.

Problems start with how to estimate the cost of each hour of a lawyer's time, especially for an equity partner/shareholder's time. If a rainmaking partner is paid \$1 million annually, how much of that was his or her direct cost for actually working on legal matters versus origination fees, payment for time spent on management, profit distribution, and other factors? Firms have tried a number of different systems of "notional compensation" to attempt to split compensation (and thus an important direct cost) between the amount allocated to billable activity and the amount for rainmaking and everything else. While not easy, a working attorney direct cost per hour must be calculated for equity partners/shareholders if a matter profitability model is to make sense. Even calculating associates (or other predominately non-rainmaking lawyers) direct costs is not easy. For example, suppose two mid level associates in the same practice team earn the same \$180,000 annual salary, but Associate A has 1,800 billable hours and Associate B has 1,500 billable hours. Assume all other benefits etc. are the same and for this simple example are ignored. Some firms might say that the direct cost of Associate A is \$100 per hour ($\$180,000 / 1,800$) while Associate B is more expensive at \$120 per hour ($\$180,000 / 1,500$). Now suppose the partners managing the relationship are rewarded on profitability, would they not try and assign work to Associate A rather than Associate B so as to increase matter profitability? And would not Associate A become even busier while Associate B gets further behind on billable hours? And so on, and so on until Associate A's direct cost becomes appreciably lower relative to Associate B and the overall system of allocating work sensibly and fairly to associates breaks down. The rule of unintended consequences looms large in the world of cost accounting for law firms.

Establishing a basic profitability model

Procopio uses profitability software by one of the leading law firm analytics service providers, DFTech. The first step in setting up a business model for profitability is to calculate for all timekeepers and staff the direct and indirect costs (overhead) that will be used in the model over the number of past years that the firm is planning to use in its calculations. We have defined costs from 2012 onwards. We also like using three year averages and three year data for much of our analysis, thus we now have in place costs for the 2012–2014 periods as well as

for 2013–2015. By the end of January 2017 we will have the 2014–2016 data ready for review.

All timekeepers at Procopio are assigned to a specific practice team and each of those timekeepers have direct costs calculated from (i) their base compensation in the calendar year; (ii) their benefits paid in the calendar year; (iii) any bonuses paid in the calendar year; and (iv) an allocation for their professional liability insurance premium. Depending on the individual, there might be some other direct costs but we do not allocate as direct costs to individuals travel expense, marketing expense, office costs due to size, etc. We believe doing detailed personal allocations to try and differentiate such direct costs can be destructive and demoralizing and in fact the amounts are relatively unimportant in relation to final costs. We do however account for all these costs in an overhead that is weighted slightly differently depending on timekeeper category. For example, partners have a different weighting to associates, paralegals, etc. As stated above we have never subscribed to the policy of allocating every expense item to individual lawyers, timekeepers. And because of our overall approach using “bands” (see below), where we are not trying to differentiate between very small percentage differences in profitability, we know that these smaller expense amounts make little difference in the “big picture”.

Once the total direct cost per individual timekeeper has been determined we can calculate the direct cost per hour for each. Herein is one of the major business model assumptions that have to be made in profitability at the matter level. What is the denominator in the per hour calculation? Is it actual billable hours worked, a “standard” number of expected billable hours per lawyer category, total hours expected to be worked in the year? As most time tracking and billing systems in law firms are based on the billable hour we selected, as a standard measure, a fixed billable hours quota for each lawyer category. So for example our “standard cost” unit per associate timekeeper is calculated by taking their direct cost and dividing by 1,850 hours. For partners we use 1,700 hours. Thus we develop a standard cost business model. With the DFtech software we can also easily perform, at the push of a button, calculations using the actual billable hours per year per individual timekeeper. This allows us to easily look at the “variance” from standard for every timekeeper or client, however in our view this analysis has limited value due to some of the anomalies already described above and the subsequent unintended consequences.

Indirect costs are all other expenses and costs not included in the direct costs above. One should note that in our business model the indirect costs also include each lawyer's objective bonus portions that are due to originations or for acquiring new business. How one measures and uses the bonus or other base compensation due to a lawyer's "book of businesses" or "new client credits" is worthy of another chapter in this booklet, but suffice to say for now that we include it as an "other" aspect of overhead. These indirect costs are allocated among all FTE timekeepers; lawyers, patent agents, paralegals, etc. From studies of the uses of resources by the various timekeeper categories, we have developed weighting ratios specific to each category for allocating the indirect costs (overhead). Partners are weighted slightly more than associates and associates are weighted more than paralegals. Thus, just as with direct costs, we can calculate an indirect cost per hour for all timekeepers. The direct cost per hour and indirect cost per hour are then added together to produce the total cost per hour for each timekeepers in our profitability model. Obviously the same timekeeper will usually have different costs per hour in different years. The individual cost per hour is then applied to every hour, or part hour, worked by the individual on every matter so we can develop the total cost for every client, every billing attorney, and every working attorney in any time period.

The detail above is actually a small part of setting up the business model for profitability and if you choose to do this with a vendor who has a good profitability model they will be able to take you through the myriad of steps required. However what I want to get across to the reader is that even the above initial "simple steps" of calculating direct and indirect costs per hour involves many assumptions. Different firms could well make different assumptions and thus the adopted profitability models, while they will have the same general accounting underpinnings, could well have different absolute results when applied to the same data set. However they will all probably reveal the same "relative" comparisons. Those clients whose profitability are above the firm average will show up in that same position in all analyses, the most profitable billing partner will appear at the top of all the business models, even though the actual calculated profit and profit margin might differ from model to model. A good profitability model will lead to analysis that is agnostic with regard to any firm's specific business model. At Procopio we have tried several profitability business models to prove out this theory, and in all the differing models, the most profitable stay the most profitable and the least profitable stay the least profitable.

It should be noted that when the final assumptions and business model is set, the final firm “average-normal” profitability in dollars and the profit margin percentage will be different from the firm’s actual financials as shown on the accountant’s and firm’s internal statements. However for the business model to be credible one must be able to reconcile how the business model “ties in” with the actual firm financials. In our business model, and I suspect many others, the main difference comes from (i) the variance of actual overall firm annual billable hours versus the annual standards used; (ii) the fact that the business model uses a direct cost for equity partners whereas the financial income statement of a partnership does not record the equity partners as an expense; and (iii) time period differences especially when one has to consider the accrual aspect of work-in-process (WIP) and accounts receivable.

Using the profitability model

A sophisticated profitability software product based on a viable and credible profitability business model that spans several years’ history is a very powerful analytical tool, and in addition has produced results that have been very enlightening. The results have dispelled some of the myths among the partnership that this client, or that client, was/was not very profitable, that this partner or that partner did/did not have a very profitable portfolio of clients. The actual results did not always follow the assumptions! The analysis also revealed that we had very few unprofitable clients or partners, that is, with profits of less than zero dollars or profit margins at or below zero percent. What the analysis did show however were the clients and the partners who had profitability well below the firm average and also highlighted those who were well above the firm average. We also believe it is more sensible to look at the relative position of clients and partners than to try and use an absolute profit number. We have thus developed the concept of “banding” or “grouping” the data around a norm. For example we have used a simple “band” model with five “bands” for profit margin analysis as shown in Figure 2. Such a simple graph can show profitability versus the annual fee collections by client, by partner. This is just one approach we have taken and obviously firms can have as many different types of analysis. The key, however, is to always remember that profitability analysis does a very good job of showing the relative positions of clients and partners as opposed to the absolute numbers. Because a cost accounting model in professional services firm has many assumptions we must be careful in trying to interpret and differentiate between a 25.7 percent and a 27.5

percent profit margin, but rather focus on whether the client or partner is above or below the firm norm by, 5 percent, 10 percent, 20 percent, or more.

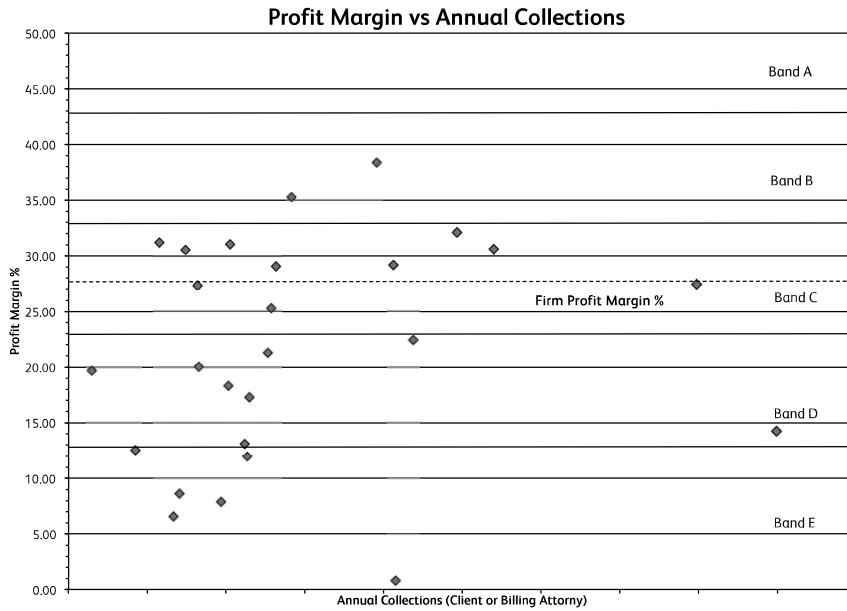


Figure 2. The “band” approach to using a profitability business model.

We have used the bands approach to compare the profitability by total dollars and by profit margin percentage for our practice teams, our clients, our attorneys as working attorneys and billing attorneys. We have done detailed profitability analysis on our various types of AFAs and the profitability of different groups of clients by their fees paid to Procopio. We also discovered that the overall profitability of clients in different revenue groupings is not that much different, and that the smaller revenue groups are as profitable as the larger ones. The ability to do sensitivity analysis on profitability, that is, change one or two parameters easily and see what effect the changes have on profitability, allows us to work with all attorneys on a one-on-one basis to improve the profitability of the clients they are responsible for, and to help them manage the mix of attorneys and other time-keepers they use on their client portfolio. This is especially important for those attorneys with the larger “books of business”. It thus allows the partners to better manage their client portfolio and the non-partner

and non-lawyer timekeeper staff that are under their control. We use the profit models and their results to help educate the attorneys on the “cost” of human resources, and it also helps them to budget more accurately on large litigation or transactional matters and to develop project scopes more efficiently. Knowing the historical profitability of clients when we open new matters for them will also help us develop more appropriate matter plans.

We have started to review how we will use our bands approach to profitability in compensation decisions. I suspect like all law firms that are grappling with the same issue we are treating it cautiously. While law firm consultants have preached for several years that compensation should contain an important profitability component,³ and on the face of it that makes perfect sense, Procopio is probably like 99 percent of other law firms in that the key to compensation is revenue, not profitability.

Conclusion

We have no doubt that the implementation of a cost accounting profitability program at the matter level will allow us to continue to deliver quality legal services in an improved, efficient, cost effective, and profitable way. Profitability modeling is not a panacea and it does not substitute for great lawyers, solid policies and procedures, top-notch ethics, and all the good traditions of a top law firm. It is however a very important new component in our Managing on the Edge™ program that we hope will allow us to remain independent and super competitive with our regional, national, and global law firm friends. Hopefully it helps our ongoing efforts to keep our best talent and attracts others. So in conclusion a reminder of some key points from our experiences:

- Cost accounting is a very good “relative” comparison method, a not so good absolute measure;
- Unit costs used in cost accounting are mostly averages and must be interpreted cautiously;
- Be careful of timing issues. Measuring profitability has to be within a set time period so remember that you are trying to calculate the fees collected on the work done in that time period, so at the end of the time period both work-in-process and accounts receivable will probably play apart and have to be included. Also an accrual approach can be taken;

- If during the time period being reviewed the client(s) were new and growing then the profitability measured might not reflect correctly, especially if for some reason the client(s) have long work-in-process periods, as we experience in our patent prosecution work;
- The profitability business model(s) you use must be able to be reconciled back to your actual accounting financials in the time periods being considered; and
- Before jumping to make decisions with the profitability results make sure that whether you are considering clients or attorneys there are no extraneous factors at work, and if there are that you understand their effects.

And remember, the business model for micro-profitability should be decided by firm management, so don't be afraid to develop several different ones before deciding on the right one for your firm. Then make sure you align your partners with how the model works and how it is intended to be used, before you use the data for serious decision making. And a final word of caution. There are challenges present in measuring and managing "profit" in a law firm such that firm's management should explore how they best navigate their cultural landscape before plunging forward!

References

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