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Law Firm Profit Components

Would anyone advise a commercial entity with multiple business lines to operate in an environment in which management does not know the relative profitability of the company`s business lines, product lines, and/or geographic regions? Given the competitiveness in today`s legal profession, managing partners and management committees should consider that same question as it applies to the management of their firms.

Law firms historically have been proficient at analyzing the revenue side of the profit equation. For years, management in most firms has been examining revenue data for strategic purposes and for purposes of assessing the performance of practice groups, offices, and individual partners. Law firms have also been tracking and managing profits, both at the firm level and on an average per-partner basis.

But what if a managing partner wants to know whether a particular client is really profitable to service, given the pricing parameters that the client has imposed? Or what if an executive committee is considering extending an offer to a small group of lateral lawyers in a particular practice and wants to have some sound economic data to support the decision to expand the firm`s existing practice?

To support these types of decisions, management should analyze the firm`s component profitability. The five most common component levels for which profitability is measured and monitored in a law firm are:
individual matters,
clients,
practice groups and departments (collection of groups),
offices, and
individual partners.

DOING THE MATH

To understand component profitability calculations, think of individual matters as the basic building blocks. Profit can be calculated on a matter-by-matter basis, then matters can be grouped together appropriately. For example, to analyze the profitability of work performed for a particular client, all matters for that client in the time period being studied (e.g., calendar year 2011) can be grouped together and the aggregate profit metrics analyzed.

To calculate profit on a matter-by-matter basis, the revenues and costs of each matter are needed. The revenue of a matter is the cash received by the firm for work on the matter -- in most instances, the hours worked simply multiplied by the hourly billing rates of each timekeeper working on the matter, adjusted for write-offs.

Just as hours worked times billing rates is the basic revenue calculation, hours worked multiplied by a timekeeper hourly cost factor is the basic cost calculation. That hourly cost factor has two primary elements: direct costs and indirect costs. The direct costs that go into calculating the hourly cost factor are the salary, benefits, and any other costs the firm wishes to attribute directly to an individual timekeeper (e.g., bar dues, individual marketing expenses, etc.). Partner compensation, though not technically a cost, can be included in the calculations and may be handled in a variety of ways, depending on the complexity of the analysis. The indirect costs are the general overhead expenses allocated among the timekeepers, and these allocations can also be determined in a variety of ways.

After the matter revenue and matter costs have been calculated, and the costs have been subtracted from the revenue, the net result will be the matter profit. As mentioned above, matters can be grouped to analyze profits by partner, client, practice group, and/or office.

GETTING TO ZERO

It is essential to recognize that, if full partner compensation and full overhead allocations are included in the calculations, the total profitability of all matters taken together should net to zero. That is, the total amount of revenue taken in will exactly equal the amount of expenses plus amounts paid to the partners as their share of firm income. For some matters, the profitability calculation will result in a positive number, i.e., a net profit, while for other matters the calculation will result in a negative number, i.e., a net loss, but the aggregate net of all matters would be zero.

When assessing the net profit or net loss number on a matter-by-matter basis, the usual desired result -- if one were theoretically to look at every matter in the period being examined -- is for each matter to result in either a small profit or a small loss. The reasons are obvious as to why one would not want a significant number of outliers on the loss side. But why wouldn`t one want a large number of outliers on the profit side? In order to have a "zero total" with a large number of outlying profitable matters, the firm would also need to have either an inordinately large number of small-loss matters, or a number of large-loss matters, or some combination of the two. Thus, the typical desired profitability results are for each matter to result in either a small profit or a small loss.

Of the other profit metrics to analyze, the most important one is profit margin (profit divided by revenue), because it shows the percentage of each revenue dollar that ends up as profit. Other metrics that are typically measured are profit per partner hour, and profit contribution (or contribution to partner compensation).

Profit contribution is calculated excluding the partner compensation element, and is an important statistic to compare with the revenue-minus-costs calculation that includes partner compensation as a cost. The comparison helps avoid potential confusion between profitability issues and compensation issues. All of these profit metrics should be examined with other profit-related statistics, such as realized rates and realization percentages.

These metrics are of limited value when viewed on an absolute basis, that is, in isolation, rather than in relation to the statistics of other matters, practices, departments, clients, and/or partners. The analysis is most relevant when the profit metrics are examined and compared with statistics at the same component level and at the firm level. For example, how do the profit metrics for Practice X compare with those of Practices Y and Z? How do they compare with firmwide profitability?

An important aspect of the analysis is looking "behind the numbers" to determine what is driving the profitability results. Is there anything that can be changed in order to improve the profitability? For example, maybe particular types of matters are staffed such that they are partner-heavy, driving up the cost and cutting into profitability. Or maybe pricing arrangements are having a larger impact than was envisioned at intake. Maybe relatively low profitability is attributable not to upfront fee arrangements, but to subsequent write-offs. The impact of these various factors can be identified and addressed with appropriate profitability analytical tools.

STRATEGY AND OPERATIONS

Component profitability analysis not only provides support in tweaking profitability at the component levels to improve the firm`s overall economic performance, but also -- more important -- it is critical to sound strategic decision making. The results can be invaluable in making strategic decisions involving, for example:
contemplated changes in the firm`s practice mix, including expansion of existing practices,
possible pricing issues and financial relationships with particular clients, and
office assessments, i.e., whether to grow, maintain status quo in (or even close, in some extreme instances) a particular office, or whether to change the practice mix in a particular office.

Profitability analytics also support operational decision making by providing insight into the efficient staffing of certain types of matters, the assessment of new technology needs, and the expansion of administrative resources to support particular practices. They can also be used as a very effective tool at intake, both in deciding whether to accept a particular matter and how to staff it most economically. An analysis can be run based on similar matters undertaken in the past in order to determine how a matter should be priced and staffed. It is important to recognize, however, that such an analysis is only one input in the decision-making process; there may be other, more important parameters to consider as well.

Many firms use the results of revenue analysis as one factor in partner compensation systems. To give more insight into the economic contribution of a particular partner, these firms should consider profitability data along with revenue data.

SHARING THE NUMBERS

Despite understanding the component profitability concept and the benefits of analyzing results at various levels, many managing partners nevertheless consciously decide either not to institute profitability reporting systems or not to share the resulting reports with a meaningful group. Such decisions are usually based on a desire to avoid divisiveness and defensiveness over the results, and to avoid the potential debate over calculation methodologies.

Obviously, any desire to avoid divisiveness is well-intentioned. Yet in the hyper-competitive environment of today`s legal profession, tough decisions must be made by weighing the benefits of one alternative against the benefits of another. With the competition for both clients and lawyers growing more intense every day, the benefits of instituting a component profitability reporting system surely outweigh the drawbacks. The information obtained is a key ingredient to effective firm management.

Deciding with whom to share the component profitability results depends on the unique management structure and characteristics of each law firm, and should be addressed on a case-by-case basis. We generally recommend that the results be distributed within a controlled group, either just the members of the management or executive committee, or those committee members plus the practice group leaders. Practice group leaders would typically receive only results related to their specific groups, thus matching their span of influence.

Component profitability analysis is an important law firm management tool. When used effectively, the results support strategic and operational decision making, provide insight into profit improvement opportunities, and can be part of the performance assessment apparatus. But for the firm to benefit, the right system must be put in place and the results used and shared appropriately.