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# Legal revolution

The 'future normal' for law firms

## **Flawed finances**

The problems with how law firms measure profitability

## **Strategic resilience**

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# Flawed finances

Jim Hassett outlines six ways that law firms typically measure profitability and the challenges associated with each approach

**H**ow do law firms define profitability? The topic is highly controversial and confusing, resulting in myriad approaches. Some firms rely on 'seat of the pants' methodologies while others base profitability measurements on unsustainable business models. Based on interviews with senior decision-makers at 50 AmLaw 200 firms, there seem to be six approaches that law firms have traditionally taken to measuring profitability, and there are problems with each of them.

## 1. Relying on intuition

Interestingly, about one in four respondents said they do not have any objective measure of profitability, but they know it when they see it.

As one senior executive put it: "We don't calculate profitability by formula. It's really seat of the pants."

The managing partner at another firm said: "Profitability is to some extent in the eye of the beholder. We're still looking for good tools to evaluate what is profitable and what is not."

A senior executive at a third firm pointed to subjective views of certain types of matters. "Lawyers have a visceral association about what kinds of litigation matters or corporate/securities matters would be very profitable, such as an IPO in the corporate sphere or a major, multi-state litigation."

The managing partner at a fourth firm listed some of the factors involved in forming an intuitive impression. "We look at gross revenue. We look at how that compares to standard rates versus discount rates or AFAs. We look at collection problems. We look at staffing. Is it staffed all with partners, or are there staff-staggered billing rates? And then we come up with an impression. But we don't analyse profitability through any software program or formula."

Can you think of any other industry in which firms analyse profitability intuitively?

## 2. Relying on revenues

Gross revenue is often the first factor used in evaluating profitability. As one managing partner pointed out, "law firm partners for a long time equated successful practice with revenue".

Commented a senior executive: "Huge matters are associated with larger revenues and I think attorneys associate larger revenues with larger profitability. We've just started to be able to look beneath the surface on large and small matters to determine how much of these revenues are winding up being profits. But I think that we are a long way away from having that be in the consciousness of the average attorney at the firm. It's just a few people who are looking at that and thinking about those things so far."

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**"There are many problems with PEP figures, not the least of which is that they are unaudited"**

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Similarly, one anonymous reviewer of an early draft of this report commented: "When I was on our firm's executive committee, it was always frustrating to me that gross collections seemed to dazzle my colleagues, even when write-offs were significant. I often reminded them that the partner with the biggest collections could also be the biggest reason for a bad year if he used up too many resources. I think we're better at recognising that now, but the impact of write-offs on

net profits is still given too little weight in compensation decisions."

However, some firms continue to look at revenue as the primary measure of success. One chair said this of his firm's decision to do so: "It's important to give your partners something to aim at. Lawyers are competitive and they respond well to goals. So if you don't set a target, then you're unlikely to get a very disciplined set of behaviours."

One problem with this approach was articulated by a consultant interviewed recently. He described a partner who brought in US\$80m a year to one firm and was highly compensated for it. But, his clients constantly asked for greater discounts, and realisation went down sharply. Meanwhile, the firm had to hire many more lawyers to do all of the new work, which further increased costs and made the \$80m still less profitable for the firm.

It is a mistake, however, to focus on revenues alone. The application of this fallacy to the legal profession was well stated by one managing partner. "I have a \$10m practice. But that could be a disaster for a firm, because it could cost them \$11m to get \$10m, but nobody ever talks about it that way. We need to get partners accommodated to the idea that we don't really care what your revenue is, we care what your profit is."

## 3. Focusing on PEP

When lawyers talk about profit, many think first and foremost about profits per equity partner (PEP), a figure publicised in annual rankings of the top 200 firms. These figures are widely perceived as a sign of financial health and sometimes used to recruit laterals to higher profit firms.

However, there are many problems with these figures, not the least of which is that they are unaudited. Before its collapse,

**FIGURE 1: FIVE DIFFERENT REALISATION RATES FOR A SINGLE SITUATION****The facts:**

A lawyer has a standard billing rate of \$500 per hour and bids on 2,000 hours of work at a discounted rate of \$400 per hour. She works 2,000 hours but, before the bill goes out, writes off 100 hours of inefficient time, so only bills for 1,900 hours at \$400 per hour. The client refuses to pay for 100 hours of this, so the firm is ultimately paid for 1,800 hours at \$400 per hour.

| Version number | Revenue paid to the firm | Realisation formula                       | Realisation calculation   | Realisation rate |
|----------------|--------------------------|---|---|------------------|
| 1              | \$720,000                | Revenue bid/ Revenue at standard rates    | \$800,000 (2,000 hours at \$400) / \$1,000,000 (2,000 hours at \$500) | 80%              |
| 2              | \$720,000                | Revenue billed/ Revenue at standard rates | \$760,000 (1,900 hours at \$400) / \$1,000,000 (2,000 hours at \$500) | 76%              |
| 3              | \$720,000                | Revenue paid/ Revenue at standard rates   | \$720,000 (1,800 hours at \$400) / \$1,000,000 (2,000 hours at \$500) | 72%              |
| 4              | \$720,000                | Revenue billed/ Revenue at bid rates      | \$760,000 (1,900 hours at \$400) / \$800,000 (2,000 hours at \$400)   | 95%              |
| 5              | \$720,000                | Revenue paid/ Revenue at bid rates        | \$720,000 (1,800 hours at \$400) / \$800,000 (2,000 hours at \$400)   | 90%              |

Dewey LeBoeuf is said to have reported higher profits per partner than those in its audited financial statements.

Dewey was not the only firm to exaggerate. Research by Citi Private Bank Law Firm Group suggests that more than half of the top-50 US law firms had overstated their profits per partner in 2010, with a fifth doing so by more than 20 per cent.<sup>1</sup>

The term 'profit' has led to many misunderstandings. Merriam-Webster's dictionary defines it as "money that is made in a business ... after all the costs and expenses are paid". Unfortunately, the term 'partner profit' is not typically used this way in the legal profession.

Partner profit usually refers to the amount of cash remaining to distribute to equity partners after all other expenses and non-partner salaries are paid. Partner salaries come out of the partner profits pool. In a large firm, if there were no partner profits, partners would be paid nothing for their work. The PEP figure which appears in the league tables might better be called net revenue per equity partner, because that's what it is.

The fact that the term 'profit' is used continues to lead to much confusion among lawyers and their clients. For example, one managing partner said: "As a partnership, everything we make above our cost is profit. I once had a lawyer who stood up and said 'how did we lose money this month?' I said 'we didn't lose money, we just didn't make as much money as we would have liked'. It's very hard for a law firm to lose money, that is, to be in a situation where you're not paying your partners anything."

Even if the PEP figure was not so misleading, it summarises the total profits of

the firm and does not allow management to answer one of the most important questions in a changing marketplace: which matters, practices, partners and offices make money and which don't? In most businesses, companies analyse which product lines and groups are profitable, and they act on that information by fixing or discontinuing unprofitable products or people.

## “Do you know which matters, practices, partners and offices make money and which don't?”

### 4. Measuring realisation

A better approach to profitability starts with realisation, as described by this chair: "We have made a big point to our attorneys that the focus is not revenue, it is profitable revenue. We try to get to realisation. We start with the standard rates on a person's time, and then we can determine, when bills are rendered and receipts are achieved, what percentage of the standard value we collect. It could have been a discount at the beginning. It could have been a write-off along the way. It could have been a billing or payment adjustment, whatever. But we look at the relationship between the standard value and the collection. If you spend \$3m worth of time to produce \$5m worth of revenue, that's a hell of a lot better than spending \$4.5m worth of time to collect \$5m."

But, realisation is a lot more complicated than most lawyers think, because it comes in many flavours and goes by many names, each with their own strengths and weaknesses. As Jim Cotterman has noted,<sup>2</sup> there are seven key components that underlie the various definitions of realisation:

1. timekeeper discounting at the timesheet;
2. write-downs of unbilled time;
3. client adjustments, resulting in write-offs of receivables;
4. pricing variance;
5. efficiency variance;
6. turnover of unbilled time; and
7. turnover of accounts receivable.

One result of the complexity is that a number of different realisation rates could be used to summarise a single situation (See Figure 1). Note that, in all five versions cited, the firm is putting in the same amount of work (2,000 hours by a single lawyer) and bringing in exactly the same amount of revenue (\$720,000). But, the realisation rate could be as low as 72 per cent or as high as 95 per cent, depending on which formula is used. And, there are many other ways that some firms define realisation, so there are far more than five options.

For an extreme example, consider an associate who earns \$400,000 and bills 2,000 hours in a year. Now imagine that, for competitive reasons that have nothing to do with the associate himself, the work was bid and paid at an average of \$175 per hour. This does not cover the associate's cost under any definition. Revenue of \$350,000 (based on 2,000 hours times \$175) does not cover a \$400,000 salary plus benefits,

no matter how you calculate cost. However, under definition four or five in Figure 1, that associate's realisation rate would be 100%.

Law firms' differing definitions of realisation can lead to considerable confusion when trying to compare results across firms and can even derail merger plans. This confusion is one of the reasons that firms are moving away from realisation as the sole measure of profitability. As one chair said, "a lot of times, there is confusion that profit is just realisation".

The definition of realisation that a particular firm chooses can also affect lawyers' behaviour in unintentional and unproductive ways, since firms often measure lawyers' success and award compensation based on realisation. You get what you pay for.

The lawyer in Figure 1 could be rewarded for high realisation if it was calculated at 95 per cent (version 4) or penalised if it was considered 72 per cent (version 3), despite the fact that both versions have exactly the same impact on the bottom line from a business point of view.

These problems can be especially challenging for firms that use standard rates as their base for computing realisation. In that case, to improve your realisation, all you need to do is lower your standard rate, as the following senior partner implied.

"When you look at those realisation rates and you compare them to the actual profit margins based on standard hourly rates of the underlying timekeepers, it's all over the board. There is no consistent profit margin in those rates anymore and hasn't been for years, because nobody's gone back and sunsetted them and started them all over again. So what's happened over time is, as rates have been adjusted, some up, some down, you've lost that connectivity. So realisation really is no longer an effective measure of profitability."

If partners are rewarded for realisation rates based on what is billed rather than what is collected, it will drive them to put in more hours, even when that produces no revenue for the firm.

A firm can get into problems when using realisation as a measure of profitability, as one reviewer demonstrated. "I had one huge litigation where realisation was not great, probably 80 per cent. But, all the associates worked long hours on the case, including nights and weekends. Effectively they were working overtime, at no additional cost to

the firm. Also, the client had a policy that you could not bill for travel time, and there was a lot of it. I felt, in fairness, that they should record all their travel time and I would just write it off as billing lawyer. Other partners would have told them not to write it down at all, so their realisation would have looked better, although profitability would have been exactly the same."

Some firms are starting to look for more sophisticated measures of profitability. Commented one senior executive: "I think we've been much too focused on realisation and that partners have a skewed view of what's really profitable. They assume low realisation means not profitable and high realisation means profitable, and we're just starting to get them to come around to the idea that that's not always the case. I think we can go a lot farther down the road of getting partners to understand the impact of leverage on profitability."

### **"The definition of realisation that a particular firm chooses can affect lawyers' behaviour in unintentional and unproductive ways"**

#### **5. Gaming leverage**

Leverage can be defined as the percentage of partner time worked per matter or per client, according to Toby Brown and Vincent Cordo. "The basic economic concept of leverage is that the more [non-equity] workers work, the more owners (partners) benefit. Workers generate the profits that pay partners. Therefore, the more work is pushed down to them, the better leverage you have and the more profit is generated."<sup>3</sup>

Software programs that are designed to help lawyers to bid in a way that maximises profitability often do so by encouraging partners to push more work down to associates. This concept is tied to the 'old normal' pyramid model of profit, in which it was assumed that clients would have all of their work performed on an hourly basis and would generally pay all of their bills. These assumptions are often incorrect today.

For example, in a fixed-price environment, efficiency is king and leverage can lead to higher costs and more unbilled time. Suppose a \$1,000-per-hour senior partner can solve a problem in one hour, but a \$300-per-hour associate will require 10 hours to come to the same solution. If the firm is paid the same fixed fee regardless of who does the work, it is obvious that solving the problem at the unleveraged partner 'cost' of \$1,000 is more profitable than at the leveraged associate cost of \$3,000. (Of course, billable rates are a very approximate indicator of cost, but they are used here to keep this example simple.)

Some critics have long questioned the value of leverage. In 1993, Bartlit Beck was founded on a totally different model. "Experienced lawyers can clearly do a task more efficiently than untrained rookies. So, why not choose a model based on low turnover, where only a very few high potential lawyers were well trained and mentored in order to dramatically increase experience levels?" said Fred Bartlit.

"Our philosophy has turned the typical law firm structure upside down. Most large firms have few true partners and a large number of inexperienced associates. A typical ratio is 3.5 associates to each partner. Our experience metric is dramatically different: instead of the usual 3.5 associates/partner, we have 3.5 partners for each associate. This reversal of the typical large firm partner/associate ratio gives us a major competitive advantage in experience."<sup>4</sup>

The result has been an award winning and highly profitable organisation that does billion-dollar litigation for *Fortune 100* firms and is never compensated based on the hours expended.

One research advisor believes that leverage is "a goofy concept" sold by management and consultants. "Ultimately, except maybe for some of the elite New York firms, high leverage will fail. There's a reason Bartlit Beck operates with 3.5 partners per associate and Munger Tolles operates with slightly more partners than associates. Leverage and turnover have always been a disaster, except for the 'golden era' (1980 to 2005) when clients weren't paying attention, and thus it looked like a great business model for law firms to be inefficient, with high leverage and high turnover."

The role of leverage in profitability depends on the client and the fee arrangement. For clients on a fixed-fee



basis or for hourly clients who refuse to pay portions of their bills due to inefficiency, greater leverage may decrease profits. If you have hourly clients who don't question their bills and pay in full, greater leverage will still produce more profits. But it seems reasonable to ask how long this will continue.

Interestingly, research has also found that leverage has an inverted U-shaped relationship with performance in diversified law firms. "It is positively associated with performance up to a point, but increasing leverage beyond that point leads to a decline in organisational performance," Amit Karna, Ansgar Richter and Monika Schommer have noted.<sup>5</sup>

## 6. Applying cost accounting

The obvious way out of all this confusion is to move toward the approach used in almost every other business: applying cost accounting to measure profitability. The basic formula looks deceptively simple:

$$\text{Profit} = \text{Revenue} - \text{Cost}$$

Many law firms see cost accounting as the Holy Grail, with potential benefits to both themselves and their clients.

However, it is much harder to calculate matter profitability than it sounds, let alone what counts as a revenues and costs on a firmwide and industry basis. As John Iezzi has noted, "there are three different revenue numbers you can use. One is the accrual basis revenue number, which is hours worked multiplied by hourly rate. The second is the bills rendered number. And third is the cash receipts number."<sup>6</sup>

The first two numbers reflect theoretical revenue. After client write-offs and write-downs, a significant amount of this may never be received. So, a profitability system based on either accrual or bills rendered rewards lawyers for putting in more hours, even if they produce no revenue.

This is particularly troublesome with fixed fees and other AFAs, where lawyers with too little to do may pile on the hours since "it costs nothing and could help the client relationship". In addition, in many firms, lawyers get paid more if they bill more hours, regardless of whether the client ever writes a cheque for the hours.

A culture change is clearly needed. As one chair put it: "What you're trying to do internally is change the mindset of the

attorney who is used to billing hours. In the past, if you billed 2,000 hours, you were better than somebody who billed 1,200 hours. But with an AFA, you have to be more efficient and more concerned with delivering the value to the client in a way that makes this a productive relationship".

## **"In a fixed-price environment, efficiency is king and leverage can lead to higher costs and more unbilled time"**

The best measures of profitability must ultimately be tied to cash received. But, there's no way of knowing that figure until a matter is completed and the bills are paid. In a large firm with tens of thousands of simultaneous matters, each on their own schedule, comparisons between matters must be based on a long list of assumptions about what will happen in future, or postponed until the end of a case, which could take years to resolve. And this can lead to arguments and gamesmanship.

Determining costs is even harder. In order to truly determine the cost of delivering services for a particular matter, one must answer two basic questions: what was the cost of the direct labour of performing the work, and what overhead indirect costs should be allocated to that particular matter?

The problems start with how to estimate the cost of each hour of a partner's time. If a rainmaker partner was paid \$1m last year, how much of that was her direct cost for working on legal matters vs. origination fees, payment for time spent on management, profit distribution and other factors? Equally, how much of her overhead indirect costs are based on the firm resources she actually used and the office she occupied?


Every single system includes arguable assumptions. And, if there is one thing that lawyers do well, it is argue, especially if a calculation affects the way their financial results are perceived. If matter profitability is tied to compensation and perhaps even to job stability, the debates on how to calculate these figures will rapidly get louder and more passionate.

## Rethinking profitability

Given these challenges, what should law firms do to measure profitability?

Two long-time leaders in profitability software – Intellistat Analytics from Data Fusion and Redwood Analytics from Aderant – have been providing sophisticated tools to quantify law firm profitability for several decades. But, to use these tools, one must again make a series of assumptions.

Data Fusion currently has 91 clients actively using its tools (including 10 of the top 35 AmLaw firms), each of which calculates profitability in a different way. The fundamentals are the same, but there are important differences in the details, which can have significant implications for the way profitability is interpreted and used to motivate changes in lawyers' behaviour.

In short, there is no single approach to profitability that will meet every law firm's needs. But, it is clear that firms which want to survive and prosper in the current environment must find an answer that fits their culture and allows them to clearly distinguish between the matters that make them money and those that don't. 

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## Endnotes

1. See 'Law Firms' Profits Called Inflated', Vanessa O'Connell, *Wall Street Journal*, August 2011
2. See *Issues in Realization*, James D. Cotterman, Altman Weil, 2012
3. See *Law Firm Pricing: Strategies, Roles, and Responsibilities*, Toby Brown and Vince Cordo, Managing Partner, 2013
4. See 'The Competitive Analysis Underlying Bartlit Beck', Fred Bartlit, *ABA Journal*, May 2012
5. See 'Seesaw staffing' Amit Karna, Ansgar Richter and Monika Schommer, *Managing Partner*, November 2014, Vol. 17 Issue 3
6. See *Results-Oriented Financial Management: A Step-by-Step Guide to Law Firm Profitability*, John G. Iezzi, American Bar Association, 2003