

A Persistent Challenge:

Measuring Law Firm Profitability

This article was adapted from the new book Client Value and Law Firm Profitability. For more information, see www.legalbizdev.com or call 800-49-TRAIN.

Based on our confidential interviews with managing partners and other leaders from 50 AmLaw 200 firms, there can be no question that clients are demanding more value than ever before, and that is putting pressure on the bottom line.

There is, however, much less agreement about the best way to measure the bottom line. There are many problems in relying on profits-per-equity-partner, realization, leverage, and other traditional measures. So it may seem obvious that the way out of all this confusion is to move toward the approach used in almost every other business: applying cost accounting to measure profit.

The basic formula looks deceptively simple:

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

Cost accounting establishes rules for defining both revenue and costs, but it's not as simple as non-CPAs might think.

Cost-Plus Model

Before we started working with law firms, my company spent almost 20 years developing training programs for financial services clients and for government agencies. Many of the government contracts we worked under were “cost-plus,” in which an hour of a person's time must be billed at its “true cost”—as defined by many pages of government accounting rules—plus a negotiated fixed fee. (In our experience, the negotiated fixed fee on government contracts was typically between 3 and 5 percent of cost, which seems

laughable by the standards of many law firms.)

So you'd think that, if anyone could identify the true cost of labor, it would be a government contractor.

But we gradually learned that government contractors have a number of options for calculating both the direct cost of what a person is paid per hour and allocating the indirect costs of benefits, rent, general and administrative overhead, and so on, to different groups within the company. There was no single number for the “true cost” of a particular hour of labor, despite all the rules and regulations. The answer depended on a number of assumptions and interpretations.

Still, many law firms see cost accounting measurement of profit as the Holy Grail, with potential benefits to both themselves and their clients. As ACC Value Co-Chair Michael Roster summed it up:

Once a firm or practice group shifts to a true profitability set of measurements, the firm finally has incentives to:

- Keep reducing its cost of production—meaning moving matters to those with appropriate expertise while lowering leverage and hourly rates, where hourly rates are now used to monitor the cost of production, not how to maximize what can be billed
- Measure and deliver better outcomes and be rewarded for that
- Learn how to fix the cost of any given type of work
- Along the way, improve profitability (Michael Roster, *Facing Up to the Challenge: Law Firm Metrics*, Association of Corporate Counsel (2013), www.acc.com/valuechallenge, 7.)

The Law Firm Exception

However, in one leading text on law firm accounting, CPA John Iezzi explained that, in working with law firms, he learned that it's much, much harder than it sounds:

My first article [on law firm profitability was]...written in 1975...after I had recently left public accounting, convinced that one could apply the same cost-accounting techniques to the service profession as one did to any other industry. [However], this was not the case, as I later determined once I began attempting to apply various cost-accounting practices to the legal profession. (John G. Iezzi, *Results-Oriented Financial Management: A Step-by-Step Guide to Law Firm Profitability*, American Bar Association, 2003, 125)

The result for many firms is that, as one managing partner admitted:

We struggle with a standard profitability model, and we don't really have one right now.

Another managing partner pointed out the underlying problem:

There's really more art than science as to what you count as revenue, and similarly what the cost allocations are going to be. Lawyers will debate all day long about those things. So it's important to have uniform or reasonably well-accepted best practices for profitability analysis. I don't think our practice is there yet.

As far as we can tell, neither is anyone else. When I talked to several members of our Research Advisory Board about this issue, Don Ware, chair of Foley Hoag's Intellectual Property Department, said:

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.

It's not for lack of trying. A growing number of software programs are available to handle the calculations. The two long-time leaders in the field, 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 make a series of assumptions, and that's where the trouble starts.

At one recent conference, Jeff Suhr, vice president of products at Data Fusion, noted that his company currently has 91 clients actively using their tools, including 10 of the top 35 AmLaw firms (Jeff Suhr, "Best Practices in Leveraging Profitability Analysis to Better Price, Staff and Manage New Engagements," Presentation at the LMA P3 conference, Chicago, May 13, 2014). Exactly how do these 91 clients calculate profitability? Ninety-one different ways. The fundamentals are the same, but there are important differences in the details that can have significant implications for the way profitability is interpreted and used to motivate changes in behavior.

Suhr distinguished between the relatively straightforward science of calculating profitability and the art of determining the exact methods that best fit the needs of each firm. He also discussed the different challenges of "macro strategies" for analyzing profits for a firm, an office, or a practice group, versus "micro strategies" for analyzing a book of business or a particular matter. Different assumptions and different approaches are sometimes required.

For starters, you would think it would be easy to measure the revenue associated with a matter, but it's not. Iezzi's text notes that:

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. (Iezzi, *Financial Management*, 132)

The first two numbers reflect theoretical revenue. After client write-offs and write-downs, a significant amount of this revenue 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.

Dumping Ground

It 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.” Not to mention that in many firms attorneys get paid more if they bill more hours, whether the client ever writes a check for the hours or not.

In the *LegalBizDev Survey of Alternative Fees* (118), one AmLaw 100 decisionmaker told us that:

It often happens that alternative fee matters, particularly large ones, end up being a dumping ground for individuals who may not be fully employed because you are reportable to the client for the result, not the cost. When lawyers work unnecessarily on a project your profitability looks bad, so in order to really determine the profitability, we need to deal with that issue.

As one chair in this research 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.

That is why 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 the future, or postponed until the end of a case, which could take years to resolve. And this can lead to arguments and gamesmanship.

One senior executive at a firm that bases compensation partly on accrual-based profitability highlighted one such problem:

We use dashboard tools including Redwood Analytics and Intellistat to track key metrics and responsibilities for each attorney as a working, billing, and originating attorney. This information is directly used in each person’s annual review and compensation setting, along with qualitative and subjective elements. They have visibility to this key information every day, and it begets a whole different sense of responsibility and accountability.

Determining Cost

Determining cost 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 labor of performing the work, and what indirect overhead costs (such as rent, clerical staff, etc.) 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 rain-maker partner was paid \$1 million last year, how much of that was his or her direct cost for working on legal matters versus origination fees, payment for time spent on management, profit distribution, and other factors?

A number of different systems of “notional compensation” are used to split compensation

between the amount allocated to billable activity and the amount allocated to everything else. The how-to details could easily go on for many pages but, in this context, the most important fact is that 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. Further, 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.

If you think that, since associates are on salary, it's easier to calculate their direct costs, you'd be right. But even there, important decisions must be made. For example, suppose two mid-level associates earn the same \$300,000 salary, but Associate A billed 2,000 hours last year and Associate B billed 1,500 hours. To keep this example relatively simple, we will ignore the cost of their health insurance and other benefits and focus strictly on salary.

Some firms say that the direct cost of Associate A is \$150 per hour (\$300,000 divided by the 2,000 hours billed), while Associate B is more expensive at \$200 per hour (\$300,000 divided by 1,500 billable hours).

Now suppose that relationship partners are rewarded for managing matters more profitably. Of course, they will try to assign more work to the busy \$150 per hour associate than to the \$200 per hour associate who has more time available. In this case, the attempt to measure profitability to develop a more efficient system rewards behavior that is actually likely to reduce efficiency by overworking the busiest associates.

Devils in Details

Discussions of other aspects of overhead can also get into heated debates about such details as:

- If one practice group heavily uses the services of the marketing department and

another doesn't, should the first group pay more marketing expenses through higher overhead?

- If one lawyer has office space in a high-cost city like New York and another has an office in a lower-cost city like Cincinnati, do they have different overhead rates?
- If one lawyer in New York has a 600-square-foot office and another has a 300-square-foot office, should that be reflected in different overhead rates?
- If one lawyer's assistant makes more than another's, should that be reflected in their personal overhead?

The questions go on and on, and they raise the kind of awkward issues that sew resentments and dissension. As one partner interviewed for Michael Roster's article noted:

Many of us have long believed that the non-attorney costs of the various practice groups are wildly different. At most firms, no one wants to hear that, probably because it might open Pandora's Box. (Roster, *Law Firm Metrics*)

Some experts believe that this box should be opened, and when it is, it will reveal that different practice groups can afford to charge different rates. One expert we consulted, who preferred to remain anonymous, put it this way:

Cost accounting should be kept very simple lest the lawyers argue about it forever more. That said, it should not be the same for the higher cost of production groups that need a lot of work rooms, support services, etc. (such as litigation) versus the very low cost of production groups that can work in a cubicle and only occasionally might need a conference room (such as trusts and estates). GM charges a lot less for a Chevrolet than for a Cadillac, and yet the overall Chevrolet division may be far more profitable than the overall Cadillac division.

Others disagree and feel that analyses that compare relative costs will become divisive by focusing lawyers on their short-term individual interests rather than the long-term benefits of working together. The labor and employment group may come to question the wisdom of belonging to the same firm as the M&A group that needs more expensive space. Lawyers from the Cincinnati office may begin to ask whether it is really worth having a New York office with much higher overhead.

Better Than Lip Service

To explore the real-world solutions that law firms are using most often, we interviewed two of the leading consultants in the field: Suhr at Data Fusion Technologies/Intellistat and Russ Haskin, director of consulting services at Aderant Redwood Analytics. (These interviews were conducted by Jonathan Groner, a lawyer and freelance writer who has been my co-author on a number of articles.)

According to Haskin:

If a firm has hired a pricing director but does not look carefully at profitability in a sophisticated way, it is doomed to fail.

Haskin said that very few large firms do more than pay lip service to the concept of profit margin, but those that do are far ahead of the game. Among other things, they are ready to respond to AFA proposals in a way that will be profitable for them. A firm that looks at profitability in the “old” way by examining gross revenue rather than profit margin as seen at the client or engagement level is simply not equipped to respond intelligently to an AFA request.

Both consultants agreed that the key to success is to simplify assumptions, and one way to do that is to look at gross margin (revenue minus direct costs). Suhr argued that, at the matter level, gross margin is a better measure than any that includes overhead because

issues like office space can't be controlled at the matter level.

Haskin suggested that to simplify the cost analysis, the firm should allocate a standard cost rate to each lawyer or group of lawyers, for all clients, like the senior partner we interviewed who said:

We have a model that takes into account cost not based upon actual draws or salary, but it takes into account junior associate, mid-level associate, senior associate, junior partner, partner, and senior partner typical costs.

Grassroots Support

At the end of the day, there is a reason why Data Fusion's 91 clients use 91 somewhat different methods to measure profitability. Companies like Data Fusion and Aderant Redwood work with each client to come up with a consistent approach that has grassroots support within each firm.

As John Iezzi summed it up at the end of his chapter on cost accounting:

The subject of profitability at [the 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.... 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. (Iezzi, *Financial Management*, 145)

Jeff Suhr made a similar point more succinctly:

The right way to measure profitability is one that is accepted in your firm. The

art is to measure it in a way that keeps everybody happy.

And, as one managing partner in this study summed it up:

You can argue all day about what the right profitability metrics are or what you'd include. We argue about it a lot.

Many participants, like this senior executive, think that the cure is worse than the disease and that firms should stick to more traditional measures:

We've used realization as a surrogate for profitability to this point. True profitability has been reserved for senior management analysis. We haven't wanted lawyers arguing about indirect allocations and whether

they only use 10 percent of a legal administrative assistant's time versus 33 percent.

The profession may never find the perfect solution that some lawyers seem to want, but less than perfect estimates are absolutely essential in helping firms adapt to a rapidly changing world. ■

—Jim Hassett

Jim Hassett founded LegalBizDev (www.legalbizdev.com) to help law firms increase client satisfaction and profitability by improving project management and business development. He has written 13 books, including the Legal Project Management Quick Reference Guide and the Legal Business Development Quick Reference Guide. Reach him at jhassett@legalbizdev.com or 800-49-TRAIN.