

## Definitely Mabey

### You may get paid on revenues but you spend profits



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This month's column addresses the third "P" that today's law firms need to tackle to ensure they are tomorrow's law firms too. The January column *Let's learn about process mapping* addresses the need to have processes that ensure the efficient and effective delivery of legal services without which you could be out of step with clients' needs. February's column *Pricing: too critical to be left to the accountants* deals with the importance of having and sticking to a pricing strategy again without which you could be disengaging clients (unfortunately unknowingly).

This month's column addresses profits.

Jonathan Byrnes, a senior lecturer at MIT, presents a thoughtful and practical approach in his book *Islands of Profit in a Sea of Red Ink*. While focused on the corporate world, the book presents the concepts in such a way that they can be applied to law firms without too much imagination.

It is more effective to increase the profitability of the work you already do for the clients you already have, than spend valuable resources, both time and money, on chasing clients you don't have. STOP! I am not saying to terminate your business development efforts, I am just saying without the combination of a focused business development strategy and a focus on profitability, you could erode your bottom line (partners' income) while growing your top line (revenue).

While there may be different lessons for many firms coming out of the unfortunate demise of Heenan Blaikie (and not all of them financial by any stretch of the imagination), one is you can generate a net income but not have sufficient profits to go around to keep partners engaged.

Some myths which need to be exposed around profitability:

*All client work is profitable.*

The theory is a smaller number of clients contribute more than 100 per cent of a firm's net profits

and the remainder create losses that bring the profits back to 100 per cent. But the profitability of any client's work can be enhanced by having the right people handle it the right way. Not all work should be done by partners in the way they have always done it.

***All revenues are equal.***

Too often if a firm's bottom line is 35 per cent of revenue this ratio is applied to all revenue – wrong! Work priced at \$250 an hour done by a professional costing \$225 an hour does not have the same contribution ratio of work billed at \$225 done by a professional costing \$150 an hour.

***Lower profitability can be made up by volume of work.***

Perhaps in some situations where the unit being demanded is totally homogenized; there is no downward pricing spiral in play; and demand is greater than supply – but not in a professional services environment where we are facing an oversupply and under-demand scenario. Firms appear willing to “grease” each other's slide down the pricing spiral; and services sought can differ (commodity work does exist but not in the magnitude required for most firms).

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***Even if not profitable it's better to have lawyers busy.***

While there is some truth to idle hands do the work of the devil, creating more losses so as to look busy is a unique approach to creating too small a pie (profit) for too many diners (partners). Channeling the available time into business development and client retention efforts focused on the most profitable clients will contribute more to your firm's profits than busy work and you are not expanding your lawyers' time commitment.

The law firms that create income sufficient to keep partners engaged will ensure their resources are focused on and channeled to the most profitable work and prepared to make the tough decisions required to ensure such an approach including:

- Passing on work available from clients and even “firing” some clients;
- Reducing the range of areas of law serviced by a firm;
- Eliminating parts of a firm's cost infrastructure that don't contribute to the profitability of the firm and which are not truly core cultural in nature;
- Favoring process effectiveness over lawyer autonomy, including matter intake governance and embracing risk; and
- Changing mix and reducing level of lawyer complement.

**How does one go about determining profitability?**

There are two sub-questions wrapped in this question:

1. How should firms calculate profitability?
2. What should firms calculate profitability for?

The latter question, while the easier one to answer, is not without its own perils. While the law firms will be of varying degrees of sophistication it really does not have to be a complex exercise. Firms should analyze their profitability at the following levels:

- individual lawyer;
- client;
- type of legal matter;
- practice area; and
- office.

The last one is the highest risk one when it comes to divisiveness and several consultants to the legal industry would recommend against it. In part, the logic being if you address profitability at the first four levels the last one should, in effect, be addressed without creating the “exercise killer” of “we have to close X office because it is unprofitable.”

The purpose of the exercise should be to identify those areas where the firm is leaking profits and work towards finding ways to enhance the profitability to an acceptable level – e.g. change mix of professionals handling work; changes to how services are rendered; etc.

Now for the eyes-glazing-over question: How should firms calculate profitability?

There are a number of costing scenarios ranging from dividing the firm's total cost by the number of hours worked and saying that is their cost per hour to activity-based costing. This approach incorporates the use of “cost drivers.” A cost driver is used to allocate costs based on a common measure of the quantity of the resource used by the service. The cost-driver concept focuses on the activity that drives or causes the consumption of cost. This is in contrast to the concept of allocating costs just because they were incurred.

***Now for the eyes-glazing-over question: How should firms calculate profitability?***

However to avoid killing off the project in its infancy, I would recommend a simple approach that is slightly individualized by timekeeper (note, I would do this for anyone charging time to a file). The steps are as follows:

- Determine the budgeted hours you are going to use for each timekeeper category e.g. 1,600 for associates; 1,700 for partners; 1,200 for paralegals; 1,000 for articulated clerks.
- Take your total annual expenses for the year and subtract the salaries and bonuses you pay to non-partners and divide this number by the total number of hours available (which is calculated by taking each of the categories above and multiplying the number in the category by their budgeted hours – 15 partners @ 1,700 + 10 associates @ 1,600 + five paralegals @ 1,200 hours + two articling students @ 1,000 hours = 49,500 hours).
- For each individual timekeeper you divide their total compensation by the number of budgeted hours to get their compensated cost per hour – for partners it is their total compensation divided by their budgeted hours.

- Add the two numbers together – annual expense per hour plus compensation cost per hour and you have each timekeepers' cost per hour.

If you then take the number of hours billed by a lawyer and multiply it by the combined cost above per hour, you have their cost and you simply compare this against their personal write-up (work credits, billings, etc. – whatever term your firm uses) to determine if the lawyer was profitable or not.

To make a similar calculation at the client level, you would cost out by individual timekeeper based on the hours billed to that client by each timekeeper to come up with the total cost and then compare that to the total billings to the client to see if it's profitable or not.

This is just one simple suggested way of which there are many variations. What is critical is to use an approach your partners have bought into or you will be focused on trees and not the forest.

Until next month, as Bernard Baruch so aptly pointed out,

"Nobody ever lost money taking a profit."

**Comments or Questions?**

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