How to impact law firm profit:

the vanity, sanity and reality of tomorrow's practice.

BigHand

- by James Kippenberger,
Managing Director - Product Strategy & Innovation

There is a great phrase that is well used (possibly over used), but almost certainly undervalued. It states: Revenue is vanity, profit is sanity and cash is reality.

In fact, it is so widely cited that trying to determine who it should be attributed to is difficult. Google (our default trusted advisor in these matters) interestingly suggests that by adding the word "legal" it's use is less popular. This might well change over the forthcoming years as firms progress their collective journey from "the practice" to "the business" of law.

The simple premise is that firms, management, business owners and investors can (sometimes) become too focused on revenue and, in the end, profit counts for more. The next hypothesis is that profit is also only worth having if it actually generates cash.

Law firms are (to varying degrees) still heavily focused on revenue generation. Their model (historic or present depending on the firm) is based around time and billing hourly rates. It is focused on "utilisation" of lawyers to maximise the revenue the individual (and in turn) the department or firm generates. KPIs are all around time recorded, time spent and time billed. And to date, that model has been (mostly) sound. If you are confident each hour spent is chargeable and that for each hour the client pays you more than it costs you, ensuring utilisation is high – profit will be generated. So far all good.

This then creates a culture of "spend more time equals good".

Where this model does not work superbly is where the customer has grown tired of paying in this way and where other firms have shifted your competitive landscape by agreeing to fixed fee or alternative/capped fee arrangements. Add to this equation new entrants and diminishing spend externally on legal, and the previously de facto model creaks that little bit more.

None of this is to say that there is no interest in profit. In fact, a well quoted metric is "profit per partner". The key point being this is often a measure of remuneration for the owners, rather than to set a commercial culture for running the firm. This is often an annual calculation, rather than something that is continuously tracked at either department, team or matter level.

But is it true that law firms are gazing in the mirror (vanity) and should wake-up (reality)?

Revenue is a relatively easy number to track and monitor. Whether it turns out to be what you expected will be affected by many things, not least write-offs (more of that later).

But when it comes to profit there are two things that law firms now need to know and control; (achieved) Price and Cost.

This simple equation of Profit = (achieved) Price - Cost

If law firms are not aware of the actual cost of delivery of their services and they are not aware of how best to price a matter upfront, logic suggests controlling profit will be tough.

Being able to control anything has to start with visibility.

Visibility of Costs:

In an increasingly fixed fee world, where there is no option to throw more billable hours at a bit of scope creep, the focus on cost (and a more granular view) becomes important. And this means all costs. Historically the key cost was lawyer time spent on work (and that remains key). But as more and more work is delegated towards lower cost resources (paralegals, PAs, document production centres or outsource third party service providers) more detail and insight is needed to establish the "true" cost of a matter.

Do you have something that tells you accurately, by client and matter, who else works on a piece of legal work? If not, you don't have full cost visibility and have one arm behind your back when it comes to controlling it.

Being able to see and control costs already sits (very) high on a firm's CFO's agenda. Of course it does. But this is only one side of the equation. It needs to be viewed in combination with pricing and not in isolation.

Visibility of Price:

Again, the slow decline of the use of billable hours, the increase of fixed fees as well as the competitive environment means there is a new spotlight on pricing. Firms are now investing in pricing consultants, implementing pricing policies, recruiting pricing professionals and rolling out specialist software to bring it all together.

If a partner has to quote a price (and then stick to it!) they need to know how to build up a budget in a simple, but effective way. Using best guess estimates or a well-worn spreadsheet is not sufficient anymore. They need to have access to data on previous similar transactions and they need to know how to build up a budget based on likely resources needed for this new matter.

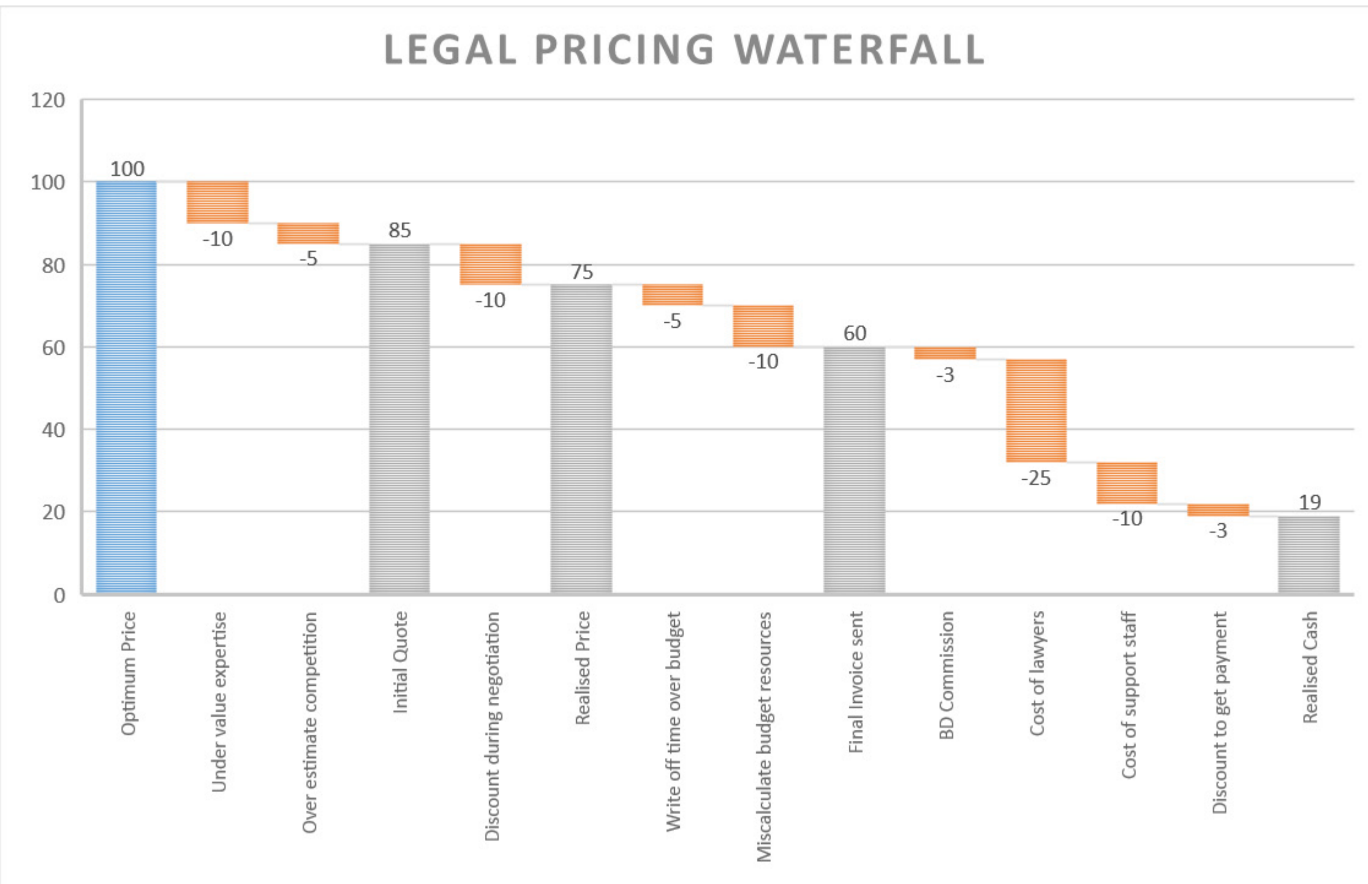
A problem shared is a problem halved

Visibility works two ways as well (and this relates to the cash collection covered later). If you can build up a price based on something credible and real, you can share transparency with your customers (in a way not possible before); this creates "collaborative not combative pricing". If both parties know and agree the price, and what it constitutes in terms of resources required to deliver a piece of legal work (to the expected quality) then you massively decrease the chances of the uncomfortable conversation at the end of the work.

If work turns out to be more expensive (as is often the case without a tight budget) the customer is frustrated, they haven't got budget and/or they don't want to pay. So then, to protect the important client relationship (for which read "to avoid having an uncomfortable conversation"), discounts are promptly offered and more write-offs begin. Pre-empting this conversation could halve the damage and build a closer relationship with your client.

The Pricing Waterfall in legal

Write-offs are just one of multiple rocky ledges on the pricing waterfall as value, then price and then margins get eroded. It is a simple but effective concept for watching how your final cash received declines from what should have been your optimum price point down to the final resulting payment (reality).



Is not worrying about cash actually insanity?

Insanity is not actually the widely held belief of doing the same thing over and over again expecting different results. Its definition is primarily a state of mental ill health, but it has a secondary definition that is; "extreme foolishness". Is not worrying about cash extremely foolish? Have any law firms ceased to exist because they ran out of cash? Yes.

Of course firms do already worry about cash, but the harsh reality is that profit drops to £0 if you don't get paid. The price is irrelevant, the quality is irrelevant and the cost of delivery is irrelevant if you don't get paid.

Obviously there are significant cash outflows in the business that need tight management such as property rents, salaries and partner distributions but a focus on cash inflows is key. There is no faster way to ensure late, part or no payment than if there is a mismatch of expectations with the customer. If there was no budget set, no detailed understanding of what was required to deliver the work there will be awkward conversations with the customer which will ultimately impact payment. Keeping them abreast of the matter as it moves through its phases, tracking progress and managing the budget (project managing the matter) will all work towards better, tighter and ultimately faster cash realisation.

Cash collecting or chasing debts is unlikely to have been a key driver for most lawyers heading to law school, but in a world where being a "commercially minded lawyer" is unavoidably more important, being aware of the dynamic is key. Interestingly, some firms are deliberately freeing up their senior PAs and legal secretaries by reorganising and centralising support staff so they can be more focused on more value adding tasks. Building a relationship with the customer's PA or Finance team and helping collect payment could sit quite high on that list.

Holistic view

To maximise the return from revenues and to maximise the chances of being paid there is likely a needed cultural shift over time to become more commercially minded. This is no easy task and, like most professionals, lawyers might find this sounds unappealing. The reality is though; it needs to happen.

One of the best ways to assist the transition is visibility and control.

If the right people can see the right information, they can do the right thing. Give partners and lawyers access to business intelligence tools to correctly price work, build budgets and track work. Give operational leaders access to solutions to route work to the best resource and to track the genuine full cost of a matter beyond just the lawyers' time.

Bring those two together (price and cost) and your firm will be able to better watch, monitor and control the value flow from revenue to profit to cash. It is one of the sanest things you can be doing as we all head into tomorrow's dynamic market legal environment.