Made to measure

*In your financial reporting, do you focus on fees and hours? If so, you're missing a trick, according to **Andrew Otterburn**. Focusing on gross profit can help you with everything from gearing to pricing, and productivity to teamwork*

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My recent survey for the *Law Society Gazette* (tinyurl.com/zv5pedt) indicated that maintaining or increasing profitability is a key issue for many firms, yet a surprising number of firms are missing basic and easy techniques that would assist.

To run a successful law firm, you need:

- effective leadership
- a plan – that all the partners are signed up to
- good people
- to be responsive to change
- to be perceived as being different by your clients
- to be open with your staff and to share information that will help achieve your goals.

You also need to have a good grasp of the figures, and to present them in a way that enables everyone – partners and other fee-earners – to understand how they are doing. Some, even relatively large, firms simply present the figures, rather than using key ratios and measures to assess and compare them.

A classic example is debtors. If all a firm does is report the figure each month, it is difficult to assess whether that figure is good or bad. Debtors may be high because fees have been good, or because cash collection has been poor. The basic figure does not indicate which of these is the case; it is only by calculating a ratio – debtor days – that it is possible to indicate whether the level of debtors is good or a cause for concern.

Firms need to design a set of reports that highlights how they are doing against a very small number of key metrics. There are a couple of important principles to bear in mind.

First, you get what you measure. This means that:

- if you focus on chargeable hours, you get chargeable hours – although they will not necessarily be billed and paid
- if you focus on fees (as many firms do), you get fees – although that may not translate into profits
- if you focus on profitability, especially team or departmental profitability, you get profit – and that is, at the end of the day, what most partners want.

The key measure for law firms should be departmental profitability. You do still need to look at other areas like hours and fees, but make your main focus departmental profitability or gross margin.

Second, what is measured gets done, so if you measure the wrong things, the wrong things can happen and the wrong behaviours can emerge. For example, many firms measure and place great emphasis on individual fees, and they may even pay a bonus to the fee-earner based on their fees – with the unintended consequence of making it much more difficult to get people working on a team basis. Many firms also focus, quite correctly, on chargeable hours, but do not measure or report on other areas that they want the fee-earners to do, such as marketing – with the result that those areas get neglected. The thing that is valued is chargeable time, and everything else will be secondary.

WHY YOU SHOULD FOCUS ON GROSS PROFIT

The power of gross profit is that it shifts the focus away from looking purely at fees, and towards looking at the profitability

Table 1: Sample profitability report

12 months actual - £'000	Property	Private client	Commercial	Total
Fees	1,700	2,200	1,200	5,100
Less opening WIP	-250	-450	-225	-925
Add closing WIP	350	250	200	800
Income	1,800	2,000	1,175	4,975
Dept salaries (inc NIC etc)	650	710	347	1,707
Equity partner (say £100k each)	100	400	200	700
Direct expenses	25	50	40	115
	775	1,160	587	2,522
Gross profit	1,025	840	588	2,453
Gross profit %	57%	42%	50%	49% (mean)

of those fees. It is calculated by taking a department's fees, as adjusted for its opening and closing work in progress (WIP), less:

- the salaries of the people working in the department – fee-earners and support staff
- a notional salary for any equity partners working in the department
- any direct overheads of the department, such as disbursements written off, bad debts, costs draftsman fees, significant marketing – in particular in personal injury.

A focus at this level and on this figure shifts the spotlight away from the total level of fees, to:

- the level of fee-earner doing the work
- the productivity of the fee-earners
- how good we are at pricing
- our use of technology and our systems
- how good we are at working in a team
- the quality of the work itself and our ability to attract higher quality work.

For most firms, 60 per cent is a good level of departmental gross margin.

Table 1 illustrates what an analysis of profitability might look like for a firm with three departments. Combined with other information you know about the departments, you can learn a lot from something this straightforward, such as the following.

- Property is doing well – the department has been really busy, and has almost hit a gross profit of 60 per cent.
- Private client is struggling. The goal needs to be to try to improve its profitability over the next three years. Part of the problem is that work is being done at too senior a level – there are three partners in the department – but there are also issues around pricing and systems.
- Commercial is also doing relatively poorly. Given the quality of the client base, its figures should be better.

HOW TO REPORT ON GROSS PROFIT

1. Keep it simple. Make sure everyone in the business understands how to read and interpret the figures.
2. If a fee-earner straddles departments, don't start splitting their fees and salary costs between departments – allocate them all to one place.
3. In setting a notional partner salary, charge a realistic level. Don't use a figure that is too low. You could take the salary of the highest paid employed fee-earner (who may be a salaried partner) and add, say, 20 per cent to reflect the greater contribution expected from an equity partner.
4. Avoid allocating too many overhead items to the departments, as in reality there are a relatively small number that are significant. The main items that can be significant generally relate to personal injury in respect of the cost of obtaining work or cases the firm has lost.
5. Report quarterly and year-to-date. Monthly is a bit too short, annual too long.

I find that if a firm focuses on gross profit, it helps it ask the right questions, and over time, the figures improve. And any such improvement normally goes straight to the bottom line.