



IMPROVE MY BOTTOM LINE

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Not too long ago I had a hot line call from a solo practitioner who wanted assistance improving the bottom line. Fair enough. We scheduled a time to talk at length. In preparation “Bob” sent me some requested information about his practice. I admit I was somewhat stunned to find that his net earnings were incredibly low. My immediately thought was, “If only the general public, which believes more than not that lawyers are money hungry individuals who earn too much, could see this P&L, it would dispel a lot of myths.”

During our telephone conference, I individually addressed each of the areas which might reveal opportunities to improve the bottom line. I could tell in short order that Bob was sensitive in a lot of areas, so I had to probe gently. There was a lot of resistance to any change whatsoever. There were reasonings to support every reluctance. In frustration, at one point, I said with humor, “Work with me here, Bob!” He didn’t get it, despite having a well developed sense of humor.

I know Bob was disappointed with the outcome of the call. But the truth is that there are only so many factors which can impact the bottom line in a firm. We explored all of them. I had no bunny left to pull out of the hat. I don’t invent these things folks, I just understand them.

A very long time ago a law firm consultant by the name of David Maister quantified the factors of law firm profitability as follows:

Net Income Per Partner (NIPP) = Leverage x Billing Realization x Productivity x Rates x Margin

That’s it folks. There are essentially five factors which will ultimately impact the bottom line at your firm. These are the links in the profit food chain. Let’s examine each link briefly.

Leverage used to mean simply the ratio of shareholders to associates and paralegals. The more associates and paralegals employed, the greater the leverage, and the greater the profits. Under the old “Rule of Threes”, one third of the billed/collected rate went to cover compensation, one third to cover related overhead, and the remaining third went into the pockets of the partners.

With the expansion boom of the 70's and 80's, firms began making service attorneys (e.g. worker bees), partners in order to hold onto them. It forced firm rainmakers to fill the plates of partners as well as associates and paralegals. That often resulted in a cutback of underutilized associates.

In order to entice and hire top associate talent, a wage war erupted, starting in NYC, and spreading across the nation. Starting associate salaries rose as high as \$125,000 at big name firms. There was a ripple down effect for even the smallest firms.

At the same time, technology started to make major inroads into law firms, and overhead rose considerably. A firm could still increase profit by maximizing the work it had available which it could push down to associates and paralegals. But the old reliable Rule of Threes became distorted, with compensation and overhead eating more than their respective third at many firms. And at the same time, the ratio of partners to associates and paralegals declined at many firms.

Many firms today struggle to reestablish leverage. They just can't produce sufficient work to support a greater mass of associate and paralegal hours. And clients have become resistant to paying for what they perceive as training time for young lawyers. So leverage has become more about using technology and alternative fee arrangements than about the number of bodies.

Realization is the relationship between fees billed and the actual value of those fees. For example, if your hour is normally worth \$100 and you bill it at \$90, you are only getting a 90% realization. Improving realization dramatically affects the bottom line without working any harder. In order to improve realization you need to keep very accurate time records, bill promptly, avoid writing time down before it's recorded (shrinkage), and avoid continual discounting at time of billing.

Let's look at three examples of the impact of improved realization to illustrate the point. In each instance let's assume that the firm accumulates 5600 billable hours in the year at a blended rate of \$180 per hour. That accounts for a potential gross billing of \$1,008,000. At 80% realization, the total billing will be \$806,400. At 85% realization, the total billing increases to \$856,800. At 90% realization the billing increases to \$907,200. More than a \$100,000 increase in billing is the difference between good timekeeping and billing habits, and bad ones.

Productivity is, simply, the billable hours for a timekeeper, and the overall average for the firm for all timekeepers. Any improvement in productivity has an immediate positive impact on the bottom line. Law firms learned this lesson early



on. When law firm profits started to contract, billable hour requirements rose sharply. But eventually a limit is reached, beyond which even the most motivated attorney cannot surpass ethically.

In other words, increasing productivity is a target of limited opportunity. I know firms never appreciate it when my answer to their question about improving the bottom line is, "Work harder!" Yet, at some firms I do find that partners have "retired" without the courtesy of informing their fellow partners or taking a reduction in pay. At some firms the hallways are dark at 5:15 pm with not an associate to be found.

At some firms the shrinkage is so apparent you can almost see the hours falling through the cracks in the floors. For example, one partner admitted to working routinely 10 hours a day, 6 days a week, but his billable hours barely reflected half that. Now that is something more easily fixed, because you're not asking the attorney to work harder, just use better tools to more accurately capture his time.

Are any of you out there unsure what a rate is or how increasing your rate will be the easiest way to positively impact your income? Firms used to work "backward" when setting rates. Compute the budget for the year. Add in the profit the partners wanted to take home. Divide the total by the number of hours that would be produced, and you had your necessary blended hourly rate. And if you wanted more money, the rate just had to edge up a little more.

Annual rate increases used to be a given. Not any more. Clients are very resistant to rate increases nowadays. I hear it across the state. If your firm is not actively working to differentiate itself from the competition in meaningful ways, chances are you cannot charge more than your competitors can. Now that being said, I have to tell you that I find that many solo and small firm attorneys dramatically undercharge. Their perception of what the market will bear, and what it will actually bear, are often far apart. But there is a methodology to raising rates successfully. That's the subject for another article.

Margin is the last factor in the NIPP formula. Very simply, margin is the percentage of revenues not spent on expenses. While expenses should always be monitored for areas to save, even the most effective cost savings initiatives will not impact the bottom line as significantly as manipulating any of the revenue factors noted above. In other words, you can only find so much fat to cut. Beyond that you are cutting muscle, and the ability to properly service clients. As someone once said to me, "Avoid the urge to step over dollars to pick up pennies."



If you want to know how to properly cut costs, see my article entitled “The Art of Cutting Costs” which appeared in the July/August issue of *The Pennsylvania Lawyer*. But keep in mind that you should invest the majority of your time in developing strategies to increase revenues, not lowering overhead. Benchmark data is particularly helpful in determining if your margin is in a “healthy” range. If your margin is 55% or greater, you’re doing fine.

Ok, back to Bob. Bob had an amazing margin of 70%. I can’t remember the last time I saw a firm with such low overhead. Obviously, there was no room for improvement there. We talked about Bob’s rates at length. We didn’t agree here. I felt Bob could easily increase his rates, but Bob was afraid of losing business. I gave Bob some tips on how to properly monitor this, but I could tell Bob was not a fan of the rate increase strategy.

Bob was already working hard, and didn’t feel that he could put in many more hours. That eliminated productivity as a factor to work on. Bob was very detail oriented and precise. He kept accurate time records, and billed promptly. He rarely discounted. So Bob’s billing realization was not going to provide much opportunity for improvement.

As a solo practitioner, Bob did not have “people” leverage. However, to his credit Bob had become a very proficient computer user, and had automated so much of his work product that he was able to bill on a flat fee basis for a lot of his work, and that helped to increase his profit margin. But Bob had gone about as far as he could in that arena. So we mutually concluded that further improvement in the leverage factor would not be possible.

Well, folks, that was about it. We had explored each of the five factors which ultimately determine the net income for Bob. Leverage and margin were definitely not going to yield any improvements. There is no magic here. All that is left is realization, productivity, and rate. That’s what we had to work with.

Here were some of my suggested strategies, which admittedly did not thrill Bob:

- § work harder
- § develop a marketing strategy to begin to differentiate the firm from its competitors in order to support higher rates
- § implement a rate increase strategy for incoming clients



- § fire poor pay clients or those who continually ask for discounts, and replace them with a better quality client who is less resistant to paying for top service (hint: get the new client(s) first; then fire accordingly)
- § consider transitioning to another practice area which supports higher rates

Ultimately, the problem for Bob is on the revenue side. And that's where the solutions must be found. I don't care how large or small your firm is; there are only so many factors to take into account when trying to improve net income per partner. There are a tremendous number of strategies one can employ on the revenue enhancement side. It takes some creativity, willingness to change, and yes, even some willingness to take risk, and maybe even a commitment to work harder.

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