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## **SOME NUMBERS YOU SHOULD KNOW PART 3 — THE LEVERS OF PROFITABILITY**

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Before I dive right into the third article in this series, I want to express my appreciation to the members who have taken time to write and call about my previous two articles. Feedback is so rewarding to an author; to know we are providing valuable information and to know that we have conveyed an important concept in a way that readers can understand.

PBA members who missed the preceding two articles can find them behind the members-only page in the Law Practice Management section of PBA's website. Or members can send me an email request.

My first article in this series talked about my first law firm position and how it has influenced the direction of my career. As I said, “. . . that's when I realized that one of my primary missions at a law firm would be to not only uncover and examine the meaningful data, but to find ways to convey the information such that it would teach them what the numbers really meant. It was the only way to ensure that they could make good business decisions.”

I have said countless times in my 27+ years with PBA—in writing and from the podium—that in the absence of good business data, one cannot make good business decisions. That doesn't mean that lawyers don't get lucky shooting from the hip. The problem is that the reward of luck misleads one to think that continuing to make important business decisions based on instinct alone is a good strategy. Trust me, it's not! But you may never know how dearly it costs you.

In my second article I examined profit margin; the amount of revenue left over to pay owners, once the overhead is paid. I provided concrete examples of the various ways this essential number is useful. I provided benchmarks to get you started on examining the relative health of your firm and I supplied real-world

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examples of how this number matters when approaching of counsel or merger/acquisition opportunities, among others.

Today we'll be examining the levers of profitability. The following formula is accredited to David H. Maister, a former Harvard Business School professor, prolific writer and expert on business management practices and the management of professional service firms:

$$\text{Net Income Per Partner (NIPP)} = \text{Leverage} \times \text{Realization} \times \text{Productivity} \times \text{Rates} \times \text{Margin}$$

Ok, I anticipate that the simple reading of the above formula has caused many of you to experience that glazed-over vision I have seen thousands of times in the eyes of attorneys who have just heard something “mathematical” and are already in a panicked “I will not understand this gibberish” reaction. So let me very quickly translate this into plain English.

What is shown in this formula are the five levers one can manipulate to alter profits in a firm. This is what we have to work with, folks. Neither I nor any other law firm consultant or financial manager can invent other ways to improve profits per partner beyond these five levers. So, they are fundamental to your understanding of why you are where you are, in terms of profit. Understanding them is essential to building a sound strategy to improve your financial position.

**Leverage** is the first lever of profitability. It used to be simply defined as the ratio of shareholders to associates/paralegals. Over time, with the introduction of templates, word processing and document assembly, we have come to understand that technology can provide another method of creating leverage. With the relatively recent introduction of AI, we are seeing yet another method of creating leverage. Although, we are still wrestling with how to translate that into ethical billing practices.

Simply, a shareholder who can generate, delegate and supervise production of work to one or more timekeepers will be more profitable than one who fills only his or her own plate. It sounds so simple. Don't turn work away; push it downward.

However, many aspects of lawyer DNA make this simple concept difficult to implement. Lawyers tend to seek perfection. That morphs into the concept that no one can do it better. Lawyers don't like to delegate – it requires higher trust levels than are comfortable. It requires training and oversight we are often unwilling or incapable of providing. I'd be wealthy if I had a penny for every attorney who stated, “It's easier and faster to just do it myself.” That's true if you're only going to do the same thing once or twice. It's insane if you're going to do it hundreds of times.

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**Realization** is the second lever of profitability. Originally defined simply as fees billed divided by the actual value of those fees—e.g. billing realization— we have come to realize that there are really three distinct types of realization that we should analyze and improve: recording, billing, and collection.

**Recording realization** is the comparison of hours spent at the office to those actually recorded, whether billable or nonbillable. I urge young attorneys to record all their time, whether billable or not, and to compare it each day to the total hours at the office.

If you can't account for at least 70 – 80% of your time at the office, something is wrong. Either you're frittering away time or your method of capturing and recording time is deficient. Learning to capture time effectively is a skill most lawyers will need forever. It takes attention and practice to become second nature.

Later, solo attorneys can analyze nonbillable time to make wise decisions about whether and when to hire staff, determine exactly what type of assistance is needed and how much. Billable time will reveal when it is time to hire a full-time or fractional attorney or paralegal.

**Billing realization** is determined by dividing the fees billed by the dollar value of those fees. In plain English, it means determining how much time is written down or off during the billing process. If an attorney records 5 hours at a billable rate of \$200/hour, then the total value is \$1,000. If the client is billed \$1,000, the billing realization is 100%. Awesome. But very often attorneys must weigh "value" provided to the client against the cost. In the real world, we often lower the cost to provide a better balance between value and cost.

In the example above, let's say the attorney decides to bill only \$750. That's a 25% discount to the client, leaving a realization of 75%. Over time these discounts can really get out of hand. The smallest improvement in realization goes right to the profit line.

I advise attorneys to do two things before making a knee-jerk decision to discount the bill. First, ask yourself whether there is a real disparity in the marketplace between potential cost and value in the client's eyes. Do you any objective data or feedback that informs your decision? Or is it that little "I'm not worthy" voice inside your head, spurred on by imposter syndrome? Second, if you decide to write anything down when you bill, be sure it is "visible" to the client. In other words, provide no unseen discounts. Clients should be fully aware that you are constantly watching their legal spend, and making sure they receive value commensurate with your cost.

**Collection realization** is determined by dividing the fees received by the dollar value of the fees billed. It's tracking how successfully you're collecting what

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you bill. According to most data, the national write-off or “shrinkage” of receivables is about 7%. There are many best practices attached to receivable management, which can greatly influence whether your firm gets anywhere near to a potential 93% collection realization. I will share that I frequently deal with firms that achieve a wholly lackluster 50% to 70% collection realization.

Let me put that difference into a clearer perspective. In a firm that bills \$1M in annual revenue, the difference between 93% collection realization and 60% collection realization equals \$330,000 more in the bank at the end of the year!

**Productivity**, otherwise referred to as **utilization**, is the third lever of profitability. Quite simply, it's just how much billable time a timekeeper produces, and the average of billable hours for all timekeepers. I think that this is the simplest lever for all attorneys to understand. The harder one works, the more billable hours one records, the greater the potential profit to the firm. Law firms have continued to move the billable hour goal upwards over the years. In response, many have rebelled and established solo practices or “lifestyle” firms with more tolerable expectations and higher quality of life.

**Billing Rate** is the fourth lever of profitability. Another straight-forward metric. Increasing the billing rate is the easiest way to impact income, provided the marketplace will support the rate increase. Fortunately, there are benchmark surveys that can reveal a range of rates in practice areas. We can ask corporate clients what they pay their other counsel. We can ask job candidates about their current firm's rate for their work.

Attorneys are usually reluctant to raise rates. I have had to do quite a bit of arm-twisting with clients over the years. This is an area where boutique or niche practices have an advantage. Their competitors at larger firms enable them to charge comparable rates with much lower overhead, resulting in greater profit.

Remember that 80% of law firm work is repetitive, and there is greater pressure to charge a competitive rate for this work. Those who can focus more on the 20% of work that is high-value creative work can charge premium rates.

I advise firms to know the “conversion” rate of prospects to clients. Note that the conversion rate can vary based on who the rainmaker is; some attorneys are much better at landing new clients than others. Conversion rate can vary widely based on practice area; family law prospects, for example, shop around more.

The more information you have on your conversion rate(s) at the firm, the safer you will feel implementing a rate increase. A rate increase should have no or a minor effect on your conversion rate. If you have gone too far, it will take little time for you to see that reflected in your conversion rate.

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My last word of advice concerning rates is straightforward. Anytime you consistently have more work on your plate than you can handle -- if you are turning work away because you cannot handle the additional load -- means it's time for a rate increase.

**Margin** is the last lever of profitability. The last article was devoted to this lever, so I will not repeat myself here.

Any changes you can make at your firm to move any of these levers in the right direction will increase your profit. In my experience, attorneys are very change resistant. I have worked with hundreds of attorneys who insist that there is not a single lever they can alter in any way, shape or form. I am then asked, "What else can I do, my profits are dwindling and I'm barely making a living?" My answer is like the end of a Looney Tunes cartoon: "Sorry, that's all folks!"

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