PROFITING WHEN THE WORLD IS FLAT

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FLAT IS THE NEW UP—AT LEAST IN THE LEGAL PROFESSION.

There are many strategies for managing through this flattened market being discussed. Some involve process improvement (but what, how and at what cost?), cost-cutting (a difficult job with few variable costs and our dependence on technology) and spending more marketing dollars to gain a larger share of a declining market (which simply leads to marketing budget escalation among competitors).

Each of these ideas addresses only a piece of the puzzle. Solving the puzzle requires a firm-wide strategy. There is one—but it is being overlooked by many firms, perhaps because of both the mind-set and behavior change that would have to be embraced to achieve it. That strategy is *managing for profitability*. Profitability in a law firm means doing the right work and using the right people in the right way.

First a little background.

THE EVIDENCE

Flattened, you say? Who is making such prognostications? As we move from conjecture to conviction, we share the following evidence from the *2012 Client Advisory* from Hildebrandt Institute and Citi Private Bank:

- "Unfortunately, the economic performance of the industry in 2011 … was not able to redress the significant declines experienced in all key financial indicators during the first three years of economic downturn."
- "Since it is unlikely, based on overall economic conditions, that the demand for legal services will grow robustly for the foreseeable future, the legal industry will be forced to live with uncertainty for some time to come. … That uncertainty will be exacerbated by both constrained growth in revenues and rising expenses."
- "Continued sluggishness in demand growth in much of the world will exacerbate the ongoing struggle in many firms to maintain profitability at acceptable levels. This is particularly true given other economic factors that are also at work in the current market: continuing client resistance to fee increases, growing levels of direct and indirect expenses, and the increasing cost of maintaining leverage."

MANAGING FOR PROFITABILITY MEANS DOING THE RIGHT WORK AND USING THE RIGHT PEOPLE IN THE RIGHT WAY.

And this, from Hildebrandt Institute's *Peer Monitor Index* for the fourth quarter of 2011:

- "Demand turned sharply lower in the fourth quarter, its decline accelerating each month. And after several months of stabilizing, realization rates fell sharply. Both contributed to a weak end to the year, setting up a challenging 2012. In addition, there were clear year-long trends. Demand slowly but steadily declined and finally turned negative in the fourth quarter. Meanwhile, expenses and headcount rose steadily. Rates eked out minor gains, but those were largely offset by a drop in realization late in the year. The clear message the market is signaling is that firms can no longer simply wait for things to get better. Thoughtful market analysis and strategies need to be translated into prompt action to reverse the diverging demand and cost trends."

To successfully generate greater profitability from your existing book of business, there are three main processes that must be in place:

1. You must know what it is costing you to do the work.
2. The work must be delegated to the right members of your complement.
3. You must deliver on your promise of quality.

UNDERSTANDING THE COST OF THE WORK

In navigating the land of alternative fee arrangements, costing is critical. Understand your costs so you can be assured that:

- You are pricing your services appropriately
- The work you are doing is the work you *should* be doing
- The clients you serve are profitable

Activity-based costing (ABC) has been around for a long time

THE OLD SAYING THAT LAW FIRMS ARE LUCKY THAT THEY ONLY HAVE TO COMPETE WITH OTHER LAW FIRMS NO LONGER HOLDS TRUE. FOR LAW FIRMS TO CONTINUE TO BE PROFITABLE IN A FLATTENED FIELD WITH MORE PLAYERS, CHANGE IS CRITICAL AND URGENT.

The metrics on the Lexis Firm Insight site supports the premise that the legal market has experienced a flattening. Some key performance indicators showed:

- Median billed value of time for partners has declined from $531,245 in 2009 to $510,966 in 2011.
- Median billed value of time for associates has declined from $354,411 in 2009 to $338,664 in 2011.
- Median effective hourly rate for partners has declined from $394 in 2009 to $378 in 2011.
- Median effective hourly rate for associates has declined from $243 in 2009 to $235 in 2011.

THE MANAGEMENT IMPERATIVE

The premise for the strategy of managing for profitability is that it is more impactful to increase the profitability of the work you already do for the clients you already serve than trying to grow market share in a declining or flat market.

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 set in the corporate world, the book presents the concepts in such a way that they can be applied to law firms without too much imagination.

but has been used predominantly in manufacturing environments. ABC incorporates the use of "cost drivers" into its methodology. 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. Cost driver methodology allows firms to clarify the reasons for performing cost allocations, including performance evaluation and pricing, by using cause-effect relationships.

For example, many professional services firms charge all nonlabor costs to a single pool and then allocate to specific engagements, usually as a percentage of billable hours. This charge for overhead will distort the total cost of the engagement if the various services offered result in costs being incurred that are not in proportion to the number of hours worked.

If the firm arbitrarily allocates costs to a job rather than allocating costs that reflect the actual activities, the firm will not be competitive when pricing its services and will likely be measuring performance incorrectly.

Professional services firms can use a modified version of cost drivers by collecting costs by various functions (such as marketing, professional development, administration or business development) and allocating them based on activities that cause the costs to vary, such as the costs to set up an extranet on a client engagement. These categories could be expanded upon, depending on the type of firm and what cost categories or cost pools are relevant. Firms using the ABC approach will need to be rigorous in determining the cost drivers that best reflect cause and effect of activities and costs incurred.

Once a firm has the tools in hand, it can apply ABC to both existing client billings as well as pricing of future work. The former is important in the flattened legal market for the following reasons:

1. To ensure the current work is being handled in the most cost-effective manner
2. To ensure that any limited resources are focused on and channeled to the most profitable work (not limited to just fee revenue but also incorporating cost of providing the services)
3. That business development and client retention efforts are focused on the most profitable clients

GETTING THE WORK TO THE RIGHT DESK

Effective delegation of work is an issue that has challenged law firms for decades. Unlike the accounting firms that have departments or people responsible for assigning work on a measured basis with the best interest of the firm as the primary decision metric, much of the work in law firms is assigned because we like the particular lawyer, their hourly rate is low, they work long hours, etc. In a flattened market, effective delegation is another key driver of managing for profitability.

There are generally three main obstacles to delegating work on files in law firms:

1. The need to keep the work to satisfy criteria valued by a compensation system
2. The need to be in control
3. Ego—no one can do it better or lack of confidence that someone else can

For firms to not just survive but thrive in a flattened market, effective delegation is critical. Just as you cannot cut costs to long-term profitability, you cannot micromanage your way there, either. Effective delegation is a skill, and as such can be learned if both an able teacher and a willingness to learn are present.

Ronda Muir, in a blog post titled "Practical Practice Management Skills: The Delegating Dilemma," put forth a simple but effective approach that, if mastered by lawyers, would lead to effective delegation. The approach basically had the delegator identify the following four categories of decisions for a file and communicate them to the assigned lawyer:

1. Decisions that only the lawyer doing the delegation can make
2. Decisions that the lawyer doing the delegation must make while looking for recommendations from the lawyer assigned to do the work or file
3. Decisions that the assigned lawyer can make but the lawyer doing the delegation should be apprised of on a timely basis
4. Decisions that can be made by the assigned lawyer and don't have to be specifically reported back to the lawyer delegating the work or file

The level of decisions found in each category will vary from lawyer to lawyer, the size and complexity of the file, the sensitivity of the matter to the client and the importance of the client to the firm. However, if you implement a standard process or practice an approach in your firm, the chances of achieving effective delegation and resulting increased profitability are increased.

GETTING THE WORK DONE RIGHT

Quality control is the third key driver of profitability in a flattened market. For the most part, formal quality control procedures are trumped by autonomy. Alternative service providers, such as legal process outsourcers (LPOs), have been able to make significant inroads with clients because they have embraced and enforce formal quality management systems.

The quality control processes that some firms and most of the established LPOs include the following:

- Formal work intake and allocation procedures
- Evolving knowledge management systems utilized by all
- Internal spot checks for compliance and adherence to work methodologies and standards
- Formal quality audits
- Dealing with complement issues in a direct and timely manner
- Formal review process before work is delivered to clients
- Project management as it relates to budgets and timelines for work undertaken
- Timely progress and end-of-file reporting and feedback procedures

HOPE ON THE HORIZON

The legal profession is experiencing a flattened market for demand and a resulting revenue squeeze. But there are measures that firms can take to manage increased profitability in flat revenue periods. For these measures to be effective, firms will have to embrace both a change in mindset—manage for profitability—as well as adopt new processes in the key areas of costing, delegation and quality control. LP

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