

Profitability Reporting...Just Get to Work

By [Michael D. Short](#) on October 22, 2014

Last month I wrote about the role of client or matter level profitability reporting as [A Common Tool for Basic Innovative Thinking](#). Initial responses and dialogues were positive and I enjoyed the related conversations. Then, something predictable happened. A few naysayers on profitability reporting weighed in. Interestingly, they were not resisting the concept of innovation related to profitability reporting. Their focus was on the overall value of such reports and/or their inability to develop and use the report at all...a timeless theme.

We've been speaking and writing on profitability reporting for many years, and the excuses are as static as the electricity in a carpet in winter time. We were told, long ago *and most recently*, that:

1) "We just don't do it...it's too divisive and not worth the heartache."

Our response: If handled incorrectly, it can absolutely be highly divisive. If handled correctly, however, it can be transformative information that is invaluable to overall firm profitability, strategic decision-making...and innovation.

2) "We can calculate the profitability of just about anything...but we don't do anything with it."

Our response: There is usually an unstated message behind this comment, such as "We lack accountability," "It's not linked to compensation so who cares?" or "Some of our most powerful Partners know they won't look good in the results so we just aren't going to go there!" When we hear this excuse, we know that any progress requires a focus on culture, governance or the partner compensation system...not on the report itself.

3) "We want to do it but we can't agree on a methodology...we can't get started."

Our response: You simply need to figure it out and get to work. Profitability reporting is a highly imperfect blend of accounting, assumptions, and trust – all three in a careful balance. If any one factor is missing, the report will either not be developed or will be cast aside. If you accept and understand that the reports are a tool, rather than a perfect measurement of performance, it becomes a lot easier to adopt an approach.

The accounting aspect of this balance is rarely the problem. Many accounting systems have a profitability module. There are also software packages for sale (and if you go this route, do your homework carefully and ask around for recommendations on both the results and the installation experience). However, if you don't have something in place and you don't have the money available for an external solution, start doing it via Excel spreadsheets. (Let us know if you want some hints on how to do this.)

The assumptions part is the most common point of failure for most firms because perfection is impossible and the pursuit of detailed accuracy often creates a point of diminishing returns/rampant frustration. Key design decisions include:

- Overhead cost allocation – Accept a "rule of thumb" approach, or at least something simple that is universally applied. If you sink to the level of one practice using conference rooms more than others or some Partners drinking more coffee than others then you are deep into the land of diminished returns. A general allocation methodology

would be to apply a weighting ratio of 1.5/1.0/0.5 for Partners/Associates/other timekeepers and move onward. Some firms use 1.25/1.0/0.75. Pick the menu that best suits your practice or design a new one and get to work.

- Treatment of partner compensation – This decision goes hand-in-hand with what are “profits”? What are we ultimately trying to measure? Again, there is no perfect answer here. I’ve seen some firms include Partner draws as “compensation” so the “profits” represent their year-end bonus pool. I have seen some use a notional/average salary for all partners, an average for groups of partners, or an “all-in” number for each Partner. All of these are fine provided that all Partners know what the bottom line result means and how to appropriately use the report and optimize profitability.

Of course, there are *many* other details, but once you are through these two you are at least up and running.

The trust aspect – which speaks to how the report is used – can undo a well-developed report. Partners need to have trust that this information is being used consistently across the partnership and applied in a manner that doesn’t create unhealthy internal competition. I firmly believe that the reports should focus all Partners on client and matter level profitability, which is something that each person can control and directly influence with the shared goal of improving something universally...for example, the profitability of each matter by 2%. Profitability reporting should be supported by ongoing and tailored education and training because many Partners do not truly understand the mechanics of law firm profitability and assume that if they are operating at or above the firm’s average realization rate on their personal billing rates, they must be “profitable”. Most importantly, profitability data should be used in compensation setting only *after* everyone has had a chance to learn it and manage to it...not on day 1. If you rush this aspect then you will experience many unintended consequences that run contrary to your strategic goals.

If you have a profitability report that is sitting idle, blow the dust off of it; (re)sell the concept; put the appropriate goals and rules in place so you can roll it out without causing undue angst, and get to work. If you don’t have a report in place then you are passively giving your competition an additional edge over your firm. Time is wasting and the firms that are using it are increasing their profit margins and using it to innovate...which should further increase their profit margins.