

The Perils of Profitability... and Thoughts on Best Practice

By [Joseph B. Altonji](#) on October 29, 2015

During a meeting last week of twenty or so Managing Partners from around the country, the conversation predictably turned to one of the hotter topics in law firm management today: *How do you best measure the profitability of legal practices, and what role should that play in setting partner compensation?* Given the radical changes in the economic structure of legal practices over the last decade, this topic is both essential and perilous. Firms cannot afford to ignore profitability, but equally importantly, cannot afford to let pure profitability calculations, at least as currently employed in the business of law, drive all decisions.

Fifteen years ago, consultants and others, including myself, argued (to paraphrase) that firms should concentrate the value positions of their practices within a reasonable range, because if they didn't, the management and cultural challenges needed to effectively manage a wide range of economic practice structures would prove overwhelming for most firms, resulting in suboptimal economic performance across all or most practices, and serious cultural challenges (such as needing to pay associates on different compensation scales, provide different promotion opportunities, and the like.) That advice is out of date because the *market* has changed dramatically. Today, the economic structures and relative contributions have diverged dramatically across practices in most law firms. Any firm that tries to hold its practices to a consistent value position is, effectively, choosing to become a boutique, which is fine for a boutique, but not so good for the more general commercial firms! So firms are forced to face the fact that their different practices will have different economic structures, and require different approaches to management, and simply face the challenges posed by this reality.

The corollary for compensation purposes is that not all revenue is created equally, and a dollar of revenue from one practice is not as "profitable" as a dollar from another. It follows, of course, that the compensation of partners producing those dollars cannot simply be revenue driven (as far as the objective factors go) and that relative profitability of practices needs to play a part. The challenge though, is *how* best to do this? It's too simple a conception just to say, "subtract the cost from the revenue and you get the profits." While many would generally agree on what the "revenues" were from whatever client, practice, office or partner you were trying to measure, the "cost" side is somewhat more problematic. What does the work cost? It's not as easy a question to answer as one would like, and even how you answer the question should depend, to some degree, on what issues you are trying to address. The details include answering sub-questions such as "How do you assign the direct costs of a lawyer – based on actual hours or "standard" hours?" "How do you calculate overhead, and how should that be assigned to individual practices?" "How much does a partner 'cost'?" "What does 'profit' mean in the context where the industry defines 'profit' as everything paid to the partners?" "How do you assign management cost, or the value of making rain?" The list goes on.

Given all of these questions, it's fairly easy to get tied in knots over how best to measure profitability, and what to do with it once you get there. Given the ambiguities involved, it is highly unlikely that a single answer is going to satisfy everyone, for all purposes, all the time. Furthermore, the risk of creating serious cultural divisions grows with both the degree of focus placed on profitability as a compensation factor and the degree to which profitability calculations result in specific practices or lawyers becoming the focus of open discussion. Perhaps worse, there appears to be some trend in thinking toward the idea that, if we could just agree on how best to measure profitability, we can use that to set compensation and everything will somehow be better. Nothing could be farther from the truth.

In addition to needing to think carefully about *how* to measure profitability in the first place, some deep thinking is warranted about the appropriate *disposition* of profits in a law firm, assuming you actually have some. Profit, properly measured, is not what the industry defines “profit” to be – everything paid to the partners. Rather, no matter how you measure it, the profit of the firm is what’s left over after you pay all the costs of the firm, *including* paying the partners for the real value their work contributes (not just the client billings directly, but other personal services including rainmaking, management and everything else the partner contributes.) Profit measured that way would be very different than what the industry labels as profit, and for a significant number of firms may actually be negative.

Irrespective of how you define “profit”, the last thing you want to do is finely divide the profits based on who produced them according to some perfectly crafted profitability model. The downsides to doing so would be significant on multiple levels. First, this approach would move your firm to the ultimate “eat what you kill” model where each partner is on his or her own – and the benefits of actual partnership would be minimized. Arguments about credit, already a major issue in many firms, would get much worse. Second, and even more importantly, your ability to build a firm for the future would be destroyed. Years ago (circa 1970), Bruce D. Henderson, the founder and long time leader of the Boston Consulting Group, created the Portfolio Growth-Share Matrix (aka, the “[BCG Matrix](#)”) and along with that the term “cash cow,” generally defined as a business where the company has a high market share in a slow growth area. These businesses require little investment and should be thought of as sources of investment capital to fund the company’s – or the firm’s – future. From the perspective of the law firm, you should be using the profits of practices where the firm has a good position but limited need to invest, and using them to invest in practices which will drive the future growth of the firm. This need is exacerbated by the cash basis accounting practices utilized in US law firms because, on a cash basis, it is almost always true that a rapidly growing, high value practice will be “unprofitable.” You pour back the profits to fund the future of your firm.

While many firms have come to realize they need to consider profitability in compensation setting, few firms have actively focused on the deeper issues of the interrelationships of profitability, investment, and the firm’s strategic growth and development. Partners need to be in alignment on investment philosophy, and in sync on where things are going. In the absence of such alignment, profitability analysis, while important, runs the real risk of creating conversations that start with “I produced \$X in profits, pay me that.” Profitability analysis, carefully done, is a powerful management tool, but like any tool, if used poorly can do more damage than good.