

Measuring Practice Group Performance

QUESTION:

As a relatively new managing shareholder I'm attempting to assess the various practice groups we currently have throughout our firm. My question to the group is: What specific metrics do you use and find to be worthwhile in assessing or measuring the performance of your practice groups? And, is there any difference in the metrics that you would use for a practice that is pretty much only in one office versus a more regional or national group?

RESPONSE:

The first question that needs to be asked is, for what purpose do you want to measure the practice groups. We think the question of why you are measuring may be more important than what metrics to use.

It takes a number of measures to approximate the truth of what is going on in any practice group. What you measure and how you do it depends in significant part on what use you want to make of the measurement. In most cases you will want to act on the information and in many cases the fact that you are measuring a group in a particular way, will, in and of itself, affect the group's behavior - akin to the 'observer effect' or the seeming paradox of Schrodinger's cat which is the subject of much scientific commentary. Peter Drucker, the well known business management guru, said it in another but related way - people do what you 'pay' not what you 'say.'

Most law firm measurement systems are a devilish collection of assumptions, definitions, allocations and other details, the manipulation of which is much more accessible to your partners than market success or client rate negotiations or client payment practices. Lawyers being lawyers are inclined to improve results as much by working the system as working the fundamentals, thus the risk of unintended consequences of measurement systems is reasonably high.

Another aspect of deciding what to measure and how to measure it is the fact that data that is not actionable is not useful. This means that you need to know what the levers are in your practices that can be pulled to affect performance. That said, here are some of the most common levers that we see law firms attempting to pull:

I. NON-FINANCIAL METRICS

• Leadership Measures

In many firms, management will actively assess whether the practice group leader is providing any real leadership to the group; for example, whether the leader is investing non-billable hours in providing one-on-one coaching, whether there are regular practice group meetings, whether a robust practice group plan has been developed, and whether there is

evidence that the action elements of the plan are being executed. While the amount of time and effort required may differ by the size of the group and whether it has a local or national focus, this is the most basic non-financial metric to examine.

Some firms also measure the practice group leader's performance through the use of internal and external surveys, to determine (usually on an annual basis) if the practice group has

- a healthy sense of professional morale and teamwork;
- a track record for associate retention;
- good tools, templates and knowledge management systems; and
- a high degree of client satisfaction;

Firms have been known to measure somewhat softer data such as:

- how many associations or industry groups group members actively contribute to;
- how many external seminars and programs group members have spoken at; and
- how many key reporters group members interacted with to generate media attention.

• Market Share and Client Penetration

You may choose to measure the number of new clients originated within the practice group, and / or the number of new matters opened, and / or the average size of the matters, and / or the total penetration of key clients according to set targets. All of these are intended to assess the progress of the practice group in the current year compared to their previous years results and to goals set by the group.

Where a practice group may have more of an industry focus you may want to measure their total penetration (market share) of targeted clients in particular sectors. In other words, if you have a regional health care practice targeting nursing homes, your goals and metrics might be focused on measuring how many of the top 25 nursing homes in the region are now clients.

And of course, we all know that today, in many practice areas, there are published deal lists and league rankings that measure your firm against your competitors by number and volume of matters. There are research reports that can identify whether your firm has a presence in serving investment banks or venture funds and how many of the Fortune 1000 companies consider you a "Go-To" resource in specific practices. These rankings offer another important means of assessing performance.

II. FINANCIAL METRICS

• Internal Calibration

As the current economic downturn intensified last fall, one of our LAB member firms began using a billable hours index over successive trailing four-month periods, just to give them a quick snapshot of how busy they were overall and how busy particular practice groups were. They report that it's been a helpful tool in assessing capacity utilization. It is not intended as a compensation tool or to incentivize groups to produce more hours. It simply tells the management committee where the soft spots are and, by also looking at longer

periods, whether the soft spots are chronic or transitory. It serves as a good short-term management and predictive tool.

You might want to think of performance measurements in terms of ultimate measures and surrogates. Since cash is king in law firm accounting, the ultimate measures are: collections, expenses and net income. The common surrogate for revenue and expenses has been for many years, average billable hours. The logic was that you couldn't get the revenue without the hours and the more hours per fee earner you booked, the lower the average cost of each hour. Maximize both and the net income number comes out just fine, assuming rates and salaries are reasonably aligned. This is still true to a significant degree. From there we all began to look at "realization" in one or another definition as a qualifier to hours and at inventory ratios - as a measure of cash flow differences. All of these are surrogates for real performance but useful indicators.

There are so many variables among practices these days that overall it may now be better to look at

- collected revenues per fee earner and
- costs per fee earner for all fee earners and support staff in the group, including salaries of salaried fee earners.

Costs per billable hour, average billable hours, collections, realization and inventory trends are all useful pieces of data that can point to where you need to take action but do not by themselves tell you how well the group is doing

In the current environment, one could advocate more attention to the 'cost per billable hour' measure, as we are all going to need to focus on reducing costs as revenue growth slows. Tracking net income on a monthly basis is also a good measure, but since in the short term expenses are relatively fixed, the data is not necessarily more actionable than revenues and revenues per fee earner. Periodically looking at 'per capital partner' measures such as revenue and net income will tell you what group performance trends are at that level.

• **Measuring Profitability**

Some firms now use financial dashboards for their practice groups that they've developed in collaboration with vendors of financial analytics to track performance across multiple variables. They are then able to compare the practice group's performance to goals set for certain of these variables.

Assuming that you have not yet invested in this sophisticated software, there are a number of metrics, which in the aggregate, give a pretty true measure of the group's profitability performance. For example, you might take a look at:

- average billable, and billed hours for all partners, all associates; all attorneys (produces 6 metrics);
- the per attorney cost of each group (in many instances the actual costs can be obtained--e.g. salaries, marketing expenditures, etc.);
- overhead (can be done on an estimated basis);
- average and total partner compensation for each group;
- average revenue per attorney, and per partner; and
- average origination per partner.

With these numbers, you can produce the "profitability" of each group by subtracting total costs, plus total partner compensation, from total revenue. All of the numbers should factor in the extent to which activities were devoted to matters accounted for in other groups (e.g., it would be inappropriate to attribute an associate's cost to a particular group if half the associate's work is for matters generated in another group).

You can then create a 'stop light chart' in which to compare all of the numbers in each group with firm wide (or office wide) numbers, with "signals" at various levels of under and over performance. This will produce a very good indication of the performance of each group, although care should be taken for anomalies in any particular short term. But in the long term, the total picture is very reliable.

You may also want to measure what is called the "export / import" numbers. This is a metric of the work originated by one practice group and done in another - and an indicator of whether there is any active cross-selling happening between your groups. You can do this for offices as well. It is not so much a matter of whether there was a "balance of trade," but whether work is moving back and forth.

III. CAUTIONS

Measuring group profitability is helpful but ignores the other value that members of the group bring to the firm. Most importantly, the data are the beginning of the assessment of performance, not the end. It is always important to understand the reasons for any extremes in the numbers and not just take them at face value. The numbers often raise more questions than they answer, and it behooves you, as the law firm leader, to rely on performance data as diagnostic tools. Whether the numbers you generate are bad or really good numbers, they should prompt you to ask questions and find answers.

It is also important not to just use a snapshot of any one metric, but to look at trends over time. By doing this it helps you take into account difference in the business models of practice groups. For example, some practices require more leverage to be profitable than others. It is more important to look at how such a practice is doing over time against a particular metric, than to compare the practice group to others with different staffing models.

And, it is important to keep in mind the long-term picture. The work required in any particular area of law can change from year to year. That is the advantage of both practice area and geographical diversification. You need to remember that the fortunes of most practice groups tend to ebb and flow over time. You have to protect your bankruptcy practice during strong economies and your transactional practices during downturns.

The information you might wish to share with partners should be the information they can act on: their own, and group revenue, productivity - in hours or revenue, realization and inventory trends. Each of these items can be affected by individual partner behavior and peer pressure at a reasonable level. You should also aggregate firm data for a variety of reasons you can easily understand.

We would not be inclined to share, across the firm, comparative group and office data. It is not actionable by individual partners and plays to the worst instincts of many - to complain about others rather than focusing on improving their own performance. It also tends to promote internal competition among groups or offices. Each practice group leader may

receive the results for her / his practice group, and perhaps even the firm averages to have something to measure against, but no others. The data can then provide practice leaders with the opportunity to gauge their performance over time and to observe improvement or deterioration.

One needs to be very careful not to promote unhealthy inter-group competition. Apart from the cultural damage that can do, we all know that it is critical that work be done by the lawyers best able to do it – and if we incentivize a group to do work it should not be doing (for example, a securities lawyer doing anti-trust work), rather than making sure it ends up being done by the right person in another group, we are asking for trouble.

If you wish you can calculate net income from the group and then you can deduct actual partner compensation for group members from the net income (adjusting if you must for other factors affecting partner compensation) to see how, comparatively, the groups performed.

This approach is built on a working attorney model for calculating profitability- all worked and collected time is credited as revenue to the group that did the work. In fact, we expect practice groups to contribute to firm revenue in two ways - doing the work and bringing it in. If the group and its partners are well integrated and focused on the success of the whole firm, it will generate work for other groups as well as for itself. To provide an incentive to do just that, some firms calculate group revenue based on not only the work done but the work brought in. This calculation, which requires some arbitrary allocations, gives credit for work brought in to the firm, but done by other groups, and deducts from working attorney credits a portion of the revenue derived from work brought to the group by other groups in the firm. In simple terms, if a group brings in \$100 of work and does it all itself and the firm gets paid for it, the group is credited with \$100 of revenue. If it does the same amount of work, but that work was brought in by another group, a portion of the revenue is credited to the originating group. If the group brings in work but does not do any of it, some portion of the revenue is credited to it (and deducted from the working attorney credits to the group that did the work). The allocation can be thought of as an incentive for obtaining work for other groups in the firm, a kind of "commission."

The question then becomes: what percentage of revenue should be credited for bringing in the work? Firms that use this method of calculating group revenues generally allocate 10-15% of revenue to the originating group. A few go higher. Remember that firm profit margins on revenue - what is left to pay partners after everyone else is paid - is usually in the 30-40% range (less for highly leveraged firms) so a 10% sales charge is actually 25-30% of net income. Also remember that the allocation percentage is purely arbitrary. There is no purely rational way to determine what it should be - and therefore it is grist-for-the-mill of partner opinion and argument. This approach does, however, emphasize two important points - generating revenue has real value and generating revenue for others in the firm is important to the firm's success.

This profitability approach is most useful annually as timing factors during an operating year can significantly affect results. Some models even take into account changes in inventory from year to year as a way of measure results more from "current operations." In any event the comparisons are more meaningful on a multi-year basis.

You need to constantly be weeding and pruning, investing and growing, in good times and bad times alike. But economic metrics are just the starting point. The caveat here is that

what you do with the data can affect how your firm performs. In our view, while this may be an essential measurement for management, if distributed and commented on too widely, it can promote unhealthy internal competition and strife. Used too forcefully in managing group performance, it can promote silo behaviors and cut against teamwork.

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