# PETER SCOTT CONSULTING

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## Actively manage your people's financial performance – to increase your profitability

To be successful as a law firm today, a law firm has to perform to ever higher levels, and its performance will depend upon the skills, experience and motivation of its people, supported by all the firm's structures, systems and support processes. This will be the case in relation to every aspect of a firm's operations, including how it manages its people to build higher financial performance. However, people's financial performance cannot be left to chance – it needs to be **actively managed.**

Currently many law firms are reporting greater inflows of work. However, will all that work be reflected in increased profitability – or will there be 'profitability leakage' which could be prevented?

To discover how just much more profit can be generated a firm should carry out a **performance audit** to find out how its people, its support systems and structures are performing. The focus of the performance audit should be on those factors which can most strongly improve profitability.

Once the findings from a performance audit have been analysed the next stage should involve a firm helping its people to maximise their potential in relation to their financial management and ensuring that all a firm's structures, systems and support processes are directed at improving their financial performance.

Here are a few areas of people performance you may wish to look at as part of putting in place a plan designed to improve profitability.

### 1. How productive are our people?

Partners and other fee earners may appear to be busy and putting in long hours yet this may not be reflected in their level of financial contribution. How productive are they?

***How are they using their time?***

A performance audit should begin by looking at each partner, fee earner and group in a firm to ascertain the utilisation of their time by comparing their recorded matter-related hours with the hours available to them, in order to identify on what else they are spending their time and whether this is efficient and profitable use of their time.

A firm should review in particular whether partners and other lawyers are spending their time attempting to carry out functions which would be better performed by non – lawyers and at a fraction of the cost. What is the point of having partners spending large amounts of their time on finance, marketing, HR, IT and other functions when other suitably qualified and experienced professionals would most likely perform those functions more cost – effectively?

For most lawyers in a firm, their roles are to primarily carry out client-related work and to fully record the time they take to do so. A review of so – called 'non – billable time' recorded by both partners and other fee earners in relation to things other than client work can provide an indication of the level of profitability leakage and what can be done to stem it. How often do firms analyse their non-billable hours reports and even if they do, what action do they take?

Non-billable time codes often tend to become 'dustbins' for people to make up their hours in the day when, for whatever reasons, they cannot or choose not to record time against client matters. If an audit shows that non-billable time is a substantial proportion of total time (I have seen non-billable time as high as 40% of the total) then a firm's people will be throwing away a great deal of their firm's potential profit.

At a time when firms are experiencing more work coming in (and also seeking to recruit additional legal staff as a result), partners in particular should be refocused on building the business and earning more fees for the firm.

***Is work being carried out at an appropriate level and cost?***

This will involve looking at 'leverage' (the ratio of equity partners to other fee earners) which is a key element in building greater profitability.

Work coming into a law firm will often require a wide range of expertise and experience to be applied to it and ensuring that work is carried out by those with the appropriate level of expertise and at the most appropriate cost level is a key to building higher profitability. To achieve this will require effective delegation and supervision, which in turn will help to build the use of teams and to better manage risks and compliance. A performance audit will identify which partners are doing work which others should be doing more profitably.

Legal work is continuously being 'commoditised', particularly through the use of technology, so that less and less expertise at a higher level is needed to carry out any given task, with a corresponding ability on the part of firms to do work at 'value for money' prices which clients will be prepared to pay.

**2. Are our people fully capturing all their matter-related time?**

Whilst matter-related time should be regarded as only one component in arriving at what is the 'right price' for the a job, it is an important component because apart from anything else, without recorded time and descriptions of the work carried out, a firm may have very little evidence of what work has been carried out on a matter and will be at risk if bills are challenged.

***Are the matter related hours targets we have set across the firm realistic? / too high? / too low?***

How do you set your matter-related hours targets?

If targets are based on what your people have recorded over the past few years when there was less work around, then your targets are likely to be too low relative to current levels of work and so too easy to achieve.

There is also evidence in law firms that for a variety of reasons not everyone fully records the time spent on client work. People are likely to record just enough to meet their targets.

An audit of how much matter-related time is being recorded compared to how long people are in the office each day and how busy people are seen to be on client work is likely to show that there is a gap between the time people are actually spending on client work and the amount of matter-related time recorded. If workloads are increasing then consider raising matter-related hours targets to what you believe to be realistic and achievable levels.

At the same time embark on an education and training programme, explaining to all partners and fee earners **why** they should fully and honestly record such time. Training for your people on how to use your time recording system may also help to capture more time. Combine this approach with close monitoring of recorded time against new higher targets on say, a weekly basis and require those who miss their targets to provide explanations. Low recorded hours can be a symptom of numerous problems which may need to be nipped in the bud if serious consequences are to be avoided.

***Do you have a bonus scheme related to your people achieving their recorded hours targets?***

Many firms have bonus schemes for fee earners who are not partners, designed to try to ensure full capture of time which should properly be billed to clients. Reward is a motivator for many people in law firms and what gets rewarded tends to get repeated. The key is to pitch the target to earn a bonus just right – not too low a figure so that everyone receives the bonus without being incentivised to fully record all their time, and not too high that it demotivates some people who are unlikely to ever meet the target.

The important thing is to have all the matter-related hours recorded which those who are managing fee earners can then decide to bill or not bill. Billing and writing off of time should really be decisions for those who are managing, not for individual fee earners or indeed some partners.

Capturing more matter–related time, even by just a few minutes per day per person will feed through to the bottom line, provided of course that such hours are then recovered at the point of billing (see later).

A useful exercise to carry out to persuade partners to really put their backs into better managing their people to fully record time is to find out how much more profit a firm would make if every partner and fee earner recorded just an additional 15 or 30 minutes per day of matter-related time and this time was fully recovered. I suspect that probably most people ‘lose’ at least 15 minutes per day of matter-related time for a variety of reasons. If you apply the simple calculation in the example below to your firm, the result may surprise you.

15 minutes per day per person X 220 days (the number of working days in a year) = 55 hours per person p.a.

55 hours per person p.a. X each person’s charge out rate = [£ ]

[£ ] X number of fee earners in the firm = [£ ] of additional profit

Carrying out an audit of your people's use of their time can also have other advantages – you will gather vital information as to your possible future manpower and space requirements.

### 3. How much time which should properly have been billed to our clients was written off last year by our people?

The action which can have one of the greatest positive impacts on profitability and which requires the least work and effort is to improve the rate at which you recover (or realise) work in progress when a matter is billed. Of course, a firm will not be able to accurately calculate its true recovery / realisation rate unless there has first been full capture of matter-related time.

Carry out an exercise to find out the total amounts of work in progress your firm wrote off last year -

- as a total for the whole firm; and
- How much each partner / fee earner wrote off

The results may surprise you.

For some firms, succeeding in doing this is likely to be the single most important factor to improving profitability. Several years ago I worked with a firm which in its previous financial year had recorded £45M of work in progress but had only billed £40M. When this was pointed out to the partners they were shocked and immediately agreed to take steps to put in controls to reduce write-offs to no more than half of the previous level.

Bringing home to partners the amount of potential profit they may be losing by their not adequately managing the recovery / realisation rate can often have the desired effect by persuading them to take more seriously the billing process in order to arrive at the 'right price' for the work and without throwing away their profits.

Who is authorised to write off time in your firm?

What is usually required is a write off policy 'with teeth' to control the unjustified writing off of recorded time which should properly be billed to clients.

### 4. Do our people know how to profitably price work?

Actively managing people's performance in a firm to provide clients with what *they* want on a **'value for money basis'** is what will place a firm ahead of its rivals.

Clients are increasingly knowledgeable and sophisticated nowadays when buying legal services and understand the value or 'worth' to them of their lawyers' services as well as being knowledgeable about the cost bases of law firms. Accordingly they require those services to be priced on a basis which is in their eyes 'value for money' relative to the results a firm achieves for them; and they will require their chosen law firm to do this ‘better’ than its competitor law firms.

In addition to helping to build a firm’s competitive edge, accurately pricing legal services is a major dynamic of law firm profitability. However it’s importance is sometimes overlooked - more emphasis often being given to other factors which can impact on profit. This is, I suspect, due in part to several factors –

- the straight-jacket lawyers have created for themselves by becoming slaves to what are perceived as market rates (when they often have no clear idea whether those rates will make them a profit or a loss);

- lack of knowledge as to what is involved in carrying out work for a client and its cost to a firm; and

- in the case of many lawyers, an acknowledgment that they are embarrassed to ‘talk about money’ with clients.

***How does your firm price its work and what would a performance audit in relation to pricing reveal?***

Do you just quote hourly rates and provide an estimate based on those rates? If so, it begs the question – *‘How do arrive at your hourly rates and your estimates?’*

Or, do you consciously think about the profit you want to make on a job and then price that job with a view to achieving that desired profit margin?

Do you exercise any controls over how your people price their work or are they free to agree whatever price they want to agree with clients?

Consider in particular your people’s prime objectives when quoting for a job. Are those objectives –

- just to keep busy?;
- to meet their billing targets? (which measure only turnover rather than profit, but may be a basis for reward); or
- to build your firm’s profitability by achieving a given margin in doing the work?

If we look at some of the typical problem areas in law firms today which are causing reduced profitability, it can be seen that they can all impact on the pricing of work. For example –

- A poor understanding of clients’ needs
- Insufficient or a lack of work scoping – possibly one of the most serious

financial and risk management shortcomings in many firms today

- A lack of knowledge as to the ‘costs of production’
- A lack of knowledge of how to accurately budget for work
- A lack of understanding by partners about the ‘drivers’ of law firm profitability
- A desire to ‘win work’ on any basis
- A lack of communication with clients ‘about money’
- Inefficient management of work to an agreed or indicated price

Any one of the above can result in substantially reduced profitability, increased risk and damage to client relationships. A performance audit of people’s capabilities in relation to the above is likely to show that a process of education and training for a firm’s people is needed in order to develop techniques –

- to profitably price and win the work
- to negotiate prices with clients
- to strengthen client relationships
- to manage work to an agreed price

**5. Do we have the best financial support people?**

At the same time as a firm takes a hard look at the financial performance of its lawyers there is also the need to audit the performance of the people who comprise the finance function.

To enhance its profitability, a firm will need to analyse whether it has the best people on board in terms of professional financial resource and then put that resource to work in the most effective manner. For example:

*Do we currently have the right calibre of finance professionals to help us to optimise profitability?*

*What should our FD be doing –*

- *better?*
- *more of?*
- *less of?*
- *differently?*

Paying for a high quality finance professional is likely to make far more financial sense than having a partner 'play at' being a finance partner. Instead, a firm should employ a finance professional who understands what is needed to be done to get a firm into financial shape and who can command sufficient trust and respect of partners to enable him or her to get the job done.

**6. Are we using our systems to measure and report on 'what matters' to enhance profitability?**

Financial performance needs to be capable of being accurately measured, assessed and reported on if it is to be improved.

***Are we measuring what matters?***

The purpose of financial measurement and reporting should be to obtain clear and accurate knowledge of what is happening / will happen in a business and to then provide clear information to those involved in managing the business as to what ***actions*** they will need to take to maximise performance, including financial performance. Without accurate measurement no valid analysis will be possible and without such analysis, appropriate solutions cannot be devised and / or remedial action taken. Decisions should only be taken based upon known facts and not on assumptions. For example:

*Do we / can we measure the profitability of each part of our firm? If not, how should we go about it?*

*Will this part of our firm ever be capable of being profitable? If not, then why do we keep it?*

*How profitable / loss making are some of our clients?*

Such financial measurement is likely to reveal a picture of a firm which may surprise and concern some partners. The next step is to decide to do something about it and to then implement solutions. However, if a firm does not have the internal capability to measure and analyse its financial performance in this way and to find solutions, then that firm will need to recruit such capability or to look for external help.

***Is our financial reporting adequate?***

*"Information is a source of learning. But unless it is organised, processed and available to the right people in a format for decision making, it is a burden, not a benefit."* - William Pollard

Financial reports are a vital part of having effective systems and controls in place to help drive financial performance, but many firms still continue to produce over complicated financial reports, which contain ‘raw data’, as opposed to providing good quality financial information which can be understood and acted upon. Such reports come to be regarded by partners as useless, are ignored and are often ‘binned’.

‘Financial information overload’ is a hurdle to improving profitability. Instead, firms should keep financial reporting as simple as possible and focus on producing clear and accurate reports which indicate what needs to be done to achieve higher profit margins.

A firm can test the effectiveness of each of its financial reports by asking questions such as:

*Does this report tell us what we need to know about what is happening / is likely to happen to the profitability of our business and indicate what actions we should take?*

*If not, then why do we produce this report?*

*Which financial reports which should be vital to building our profitability do we not currently produce?*

*Is our financial reporting preventing us from building our profitability?*

**7. Are we supporting the development of our people with financial education and training?**

Just throwing financial reports at people (even clear and informative reports) is unlikely to be an effective way of improving financial performance and profitability if there is no explanation of what the reports mean or what people are supposed to do with them. Recently a fee earner in a firm said to me

*“I don’t have a clue about the financial reports I receive!”*

Individuals need to see financial and other training as important to help them reap the rewards of higher performance and to progress their careers.

There is often a lack of knowledge within firms about the basic factors which contribute to building high profitability, with the result that the profitability of many firms is worse than it should be. How much better off would firms be if partners and other fee earners were taught financial skills to enable them to better evaluate financial reports and enhance their financial performance?

If law firms are to enhance their profitability, there should be more emphasis placed on financial education, training and support for people at all levels in firms. And as part of achieving buy-in to a financial education programme, a business case will need to be made showing the benefits which will accrue to a firm from improving the financial performance of its people and as a consequence the overall financial performance of the firm.

Ensuring that a firm’s people are highly trained and motivated is critical to building performance leading to higher profitability. However they will also need to know –

- The key areas in which their performance will be measured;

- Their performance goals pertaining to each area; and

- How their performance rates in relation to those goals.

Supporting a firm’s people to help them achieve higher performance in financial management should be just one part of an on-going performance management programme designed to be an investment in the long term future of a firm and to make continuous improvement to establish a firm’s competitive edge.