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Time for New Metrics

Over the past two decades a number of metrics have become standard benchmarks of measuring firm and partner performance - Profits per Equity Partner, Revenue per Lawyer, Average Billable Hours, Realization, and others. But as the legal landscape changes, and both clients and firms look to develop new approaches to providing services, offering alternatives to the billable hour pricing model, and rethinking traditional staffing structures, it is becoming increasingly clear that while remaining of certain value there are shortcomings in many of these metrics.

They can be irrelevant, encourage inappropriate behaviors, discourage innovation and, of course, tend to be short term in focus.

We believe that firms need to take a twin-pronged approach to addressing this: first, improve the commonly used current metrics - that are largely concerned with operational management, and second introduce new metrics with a longer term focus and which measure progress on key strategic priorities:

- The key changes required to the current metrics are: first, moving from a focus on revenue generated to a focus on profitability and, second moving from a focus on partner personal performance to one that assesses each partner’s overall contribution.

- In terms of introducing a longer term perspective metrics that measure progress on strategic priorities are important as are those that reflect the demands of today’s market. These include metrics that assess vital strategic issues such as risk, efficiency, quality, reputation and the like.

The approach any firm takes to refining the metrics they use will depend on their particular circumstances but in this Insight we focus on four areas – the first two relating to improving existing metrics and the other two related to introducing new metrics – which we have found applicable to many clients.

1. Matter Profitability

Firms have historically tended to measure matters primarily on their scale, based on the revenue generated. While revenue is important, it is profitability that really matters and the profit generated on two similar value matters can be vastly different.

While matter profitability is not a new metric, it remains a relatively under-used one, in part because of the perceived sensitivity of introducing it and in part because the methodology many firms have historically applied is not appropriate under certain circumstances. Particularly in the context of pricing and margin improvement, matter profitability is most effective when a notional salary is applied to partners to account for the cost of their time as a working lawyer. To include a partner’s full compensation can lead to misleading results. On the flip side, excluding partner compensation entirely is also likely to be inappropriate because it will make a matter largely undertaken by partners look far more profitable than one with a more balanced team. While certain circumstances may warrant calculating matter profitability using a partner’s full compensation (e.g. compensation setting or staffing) the notional salary method offers a more universal and easily understood approach.

There is in our view an urgent requirement for firms to take a more sophisticated approach to evaluating the profit of matters (and clients and business lines) both so that better informed decisions concerning profit management and pricing can be made but also to allow firms to set prices and manage matters more effectively on other than an hourly rate basis.

2. Extended Leverage

Traditional leverage has been measured as the ratio of associates to partners, or non-equity lawyers to equity partners. Such metrics have always been somewhat flawed in that they do not necessarily reflect economic leverage. But as firms operate with business models that are more and more distant from the traditional structure, traditional leverage metrics become even less relevant.

Today firms need to leverage effectively not only their own full-time attorneys, but also contract attorneys, legal assistants, technology, services provided by 3rd parties, and other resources in order to compete effectively. This raises the need to introduce an extended leverage metric. There is a need, and the most appropriate approach will vary from firm to firm, to capture on a monetary basis the ratio of non-partner revenue (or better profit) to partner revenue.

3. Risk Index

Firms, and especially partners, tend to focus on income and profit with an emphasis on the current year. An index that measures the relative risk profile of a firm provides insight into its underlying robustness, resilience and longer term potential. The factors that can be included in a risk index include:

- Change in the net economic value of the firm based on the accrual balance sheet of the firm including off balance sheet liabilities such as the net present value of unfunded retirement obligations.
- Total liabilities as a percent of income. This provides an indication of the firm's obligations compared to annual income.
- For cash basis firms, percent of income attributable to a reduction in work in process and/or accounts receivables balances. This provides a sense of whether profit growth is a result of current activity or a one-time benefit that might be a result of better billing practices or a contraction in the firm's practice.
- Percent of income attributable to recurring clients of the firm. This is a measure of the strength of the firm's client base.
- Dependency on a small number of significant clients. And linked to this the extent to which major clients are institutionalized (clients of the firm) or anchored with individual partners and hence portable.

4. Quality Index

A quality index is perhaps the most difficult to measure, and requires some subjective inputs, but is nonetheless one of the most important metrics that firms should be focusing on. Many consumer facing industries regularly measure quality. The factors that might make up a quality index include:

- The number of new matters opened for existing clients. This provides an indication that clients are satisfied with the firm's services.
- The rate of change in the average size of the firm's top 50 or 100 client relationships. This provides an indication of the growth in the firm's largest relationships.
- The number and levels of the public rankings of the firm.
- The rate of change in the rankings (increase or decrease in ranked practices) is also a factor.
- For firms which conduct regular client interviews or satisfaction surveys, the overall satisfaction with the firm as reported by its clients. And even more importantly an assessment of their loyalty in recognition that loyalty is a far more demanding and valuable achievement than satisfaction.
- For firms who conduct regular internal satisfaction or engagement surveys, the overall satisfaction with the firm.

The old adage "You get what you measure" is largely true in law firms. So as the market and the demands on law firms shift so too must the metrics. Firms need to take a hard look at the metrics they use to measure performance and profitability and ensure that they remain meaningful and support the firm's strategic aims.

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