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Demystifying profitability analysis

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Many clients are asking firms to provide more for less, so when pricing out services, firms tend to hold their breath hoping their best guess is accurate enough to generate some semblance of a profit. However, firms often overlook the fact that data from previously completed engagements is readily available to assist in making a more educated decision about future pricing.

Analyzing rates, staffing models and the time needed to complete a client/matter provides valuable information to improve the ability to price services, determine the cost of acquiring and maintaining a client and decide whether or not this is work that should continue to be performed.

Unfortunately, profitability analysis tends to become overly complex and complicated in an effort to arrive at a precise answer. If the goal is to know where we make our money, what clients contribute most to our overall profitability and what actions can be taken to enhance future profits, precision is not necessary when determining if Client A is relatively more profitable than Client B.

While some could argue that pricing out a client/matter from an administratively intense practice area (i.e., an intellectual property prosecution matter) should include a component of overhead, analyzing the profitability of most client/matters simply by comparing the agreed upon billable hourly rates and hours (working attorney fees) to the direct costs (salaries and benefits) of the timekeepers involved will provide valuable information.

To improve firm profitability and provide supporting data for alternative fee arrangements, many firms perform an ongoing exercise to determine the relative profitability of completed client/matters from differing practice areas. The firm ultimately wants to know the matters and fee arrangements that contributed to firm profits and/or the matters that were performed at a loss, and what characteristics and staffing models differentiated one from the other. It is from this data that strategic decisions can be made about where to allocate firm resources, what work should be sought and at what price, what work should be declined and, in some circumstances, what clients should be dropped.

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Comparing revenue generated from a client/matter with the direct costs required to service that client/matter provides information not only regarding cash flow, but the profit generated. Firms should be cautious not to misinterpret these end results. Client A may have generated more revenue than Client B, but that would be misleading if Client A had a negative net profit or if Client B was completed with greater efficiency.

	Client A		Client B	
Revenue:	$100,000	100%	$40,000	100%
Direct costs:	$90,000	90%	$31,000	78%
Net:	$10,000	10%	$9,000	23%

Generally speaking, leverage, the experience level of the attorney assigned to the client/matter, effective project management and in some cases location of where the work is to be performed (in the case of a firm with multiple offices) all have a direct impact on the profitability of an individual client/matter. For example:

> **Leverage –** It is common for a litigation matter that employs greater leverage to contribute a higher margin to the firm. As a result, firms make a concerted effort to allocate more resources to developing this type of work and actively market the firm in areas where the work can be leveraged down to the least expensive, yet most appropriate timekeeper.

> **Experience level** – Partner expertise yields valuable results; however, partner compensation models often contain some measure of billable hours and careful management is necessary to avoid the disincentive of partners performing work that can adequately be completed by associates. Most firms generally recognize that client/matters serviced primarily by partners are significantly less profitable.

> **Location** – The profit from commodity type legal work (use simple real estate leasing as an example) may vary between geographic locations due to differing local salary structures. As a result, a firm may determine that all future simple real estate work should be assigned to the city with the lowest cost per attorney hour.

With the legal landscape evolving, the analysis of client/matter profitability provides a clear opportunity for a firm to more accurately price its services and to modify its existing business model to improve firm profits. The analysis need not be precise but merely able to discern whether one client contributes relatively more profit to cover firm overhead and improve net income.

About the author

John Niehoff is the firm's partner-in-charge for the professional services practice, leading the firmwide strategy for providing Exceptional Client Service to law firms and other professional service businesses. He has been with the firm for more than 20 years and focuses on financial reporting, tax and operational issues unique to professional service businesses. He has extensive experience assisting law firms with specialized advisory projects tailored to achieve their financial objectives.