

## “MEASURING PERFORMANCE: HOW HEALTHY IS YOUR PRACTICE”

### Introduction

We were recently asked by one of our clients, a medium sized Law Practice: “How do I measure the performance of our Law Practice? How do I know if we are in better health now than one year ago?”

The standard performance indicators may show that the Practice has grown in size, that revenue has increased, and that the profit per partner has increased... but do all these indicators mean that your Law Practice is in better health than it was last year?

The financial statements of your practice are a sound starting point. However, prevailing wisdom informs us that financial statements do not tell the whole story as a law practice is the quintessential “knowledge” business; it has few fixed assets and no tangible inventory or stock.

Its critical assets are its intellectual capital which comprises –

(a) Human Capital – fee-earners (including paralegals and legal support staff) and their skills and reputation;

(b) Consumer Capital – Existing Client Relationships and Goodwill

(c) Structural Capital – Best Practice Methodologies, Client and Contact Databases, Precedent Libraries, Knowledge Base and Systems for retrieving or sharing knowledge, Software Applications and Procedures; Mentoring / Training Programmes.

While we easily recognize that a practice’s intellectual capital is critical to an evaluation of the strength of the practice, few of these “assets” will feature at all in the practice’s financial statements.

In this article, we begin by evaluating what the key performance indicators (“KPI”) derived from the financial statements will tell you about your practice.

Extending beyond the narrow constraints of the purely financial perspectives, we will then show you how an examination of the non-financial KPIs using the “Balanced Scorecard” approach (a term coined by Robert Kaplan and David Norton in 1992) will prove more accurate and useful for measuring the health and performance of your practice.

In this process, we examine your practice from the perspective of your clients (how your clients see you) and from an evaluation of your internal business processes (how efficient are you? What use have you put to your intellectual resources? What is the extent of your investment in your intellectual capital?). We believe that only after you have examined your practice from both financial and non-financial perspectives will you “know” your practice and be in a position to make the right decisions devising a sound business strategy to deal with the challenges ahead.

### A. The Financial Perspective

First, what you can derive from your financial KPIs -.

#### The Profit and Loss Statement

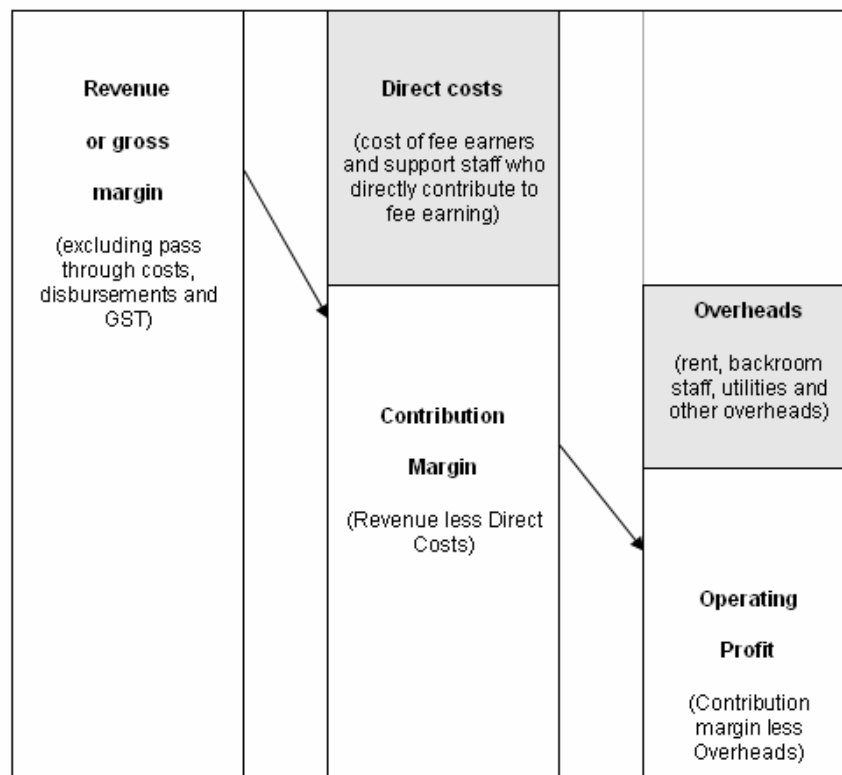
These are the values you would derive from an examination of your practice’s Profit & Loss Statement

1. **Revenue:** generally refer to “billing” but excludes (i) “pass through costs” such as services which are purchased from a third party as part of the total service rendered to a client which may be captured in the invoice to the client as a disbursement or as professional fees (eg, searches, offshore incorporations, fees payable for professional services rendered by third parties such as a private investigator, accountant etc); and (ii) GST;
2. **Direct Costs:** refer to the cost of hiring your knowledge workers – ie, fee earners, paralegals and other legal support staff who directly contribute to the fee earning activity of your practice. Direct Costs which comprise salaries and CPF contributions generally make up the largest cost item in a Law Practice;

3. **Net Revenue (Contribution Margin):** is the Revenue less Direct Costs. This measures the Law Practice's ability to control and leverage off Direct Costs;
4. **Overheads:** refer to expenses not directly related to fee-earning activity such as office rentals, office utilities and the cost of administrative support services (eg, operating an accounts department, mailroom and dispatch, receptionist, office manager etc);
5. **Operating Profit:** is the Net Revenue (Contribution Margin) less Overheads. This measures the Law Practice's ability to control and leverage off its Overheads.

The ability of a Law Practice to convert Revenue to Net Revenue to Operating Profit determines its profit per partner or profit per share. The relationship between these items can be reduced to a simple diagrammatical representation as shown in **Figure 1**

**Figure 1:** Ability to convert Revenue to Operating Profit determines Profitability



From these numbers we are able to derive ratios that measure your Practice's ability to convert Revenue to Net Revenue to Operating Profit compared to the previous year (or any preceding period):

1. Growth in Revenue per Partner / Share
2. Growth in Operating Profit per Partner / Share
3. Net Revenue per Partner / Share
4. Direct Cost per Partner
5. Direct Costs to Revenue;
6. Overheads to Revenue ;
7. Operating Profit to Revenue ;

At this point, we must emphasize that an improvement in the absolute profit ratios or an increase in Profit per Partner does not necessarily mean that your Practice is performing better now than it did the

year before. **Better profit margins are not a definitive indication of long term health of your Practice.**

The clearest example of this is what happens when you lose a key fee earner - the initial and, by logical deduction, short term outcome of your fee-earner's departure is an increase in profit (as a result of the reduction in salaries) and an increase in profit per Partner (as a result of the reduction in the number of Partners). The fact that your practice has now lost that key fee earner's ability to generate revenue, and (maybe) the goodwill of the clients he brought to the practice predicates an adverse long term prognosis which is not reflected in your financial statements .

At this point, we should highlight another glaring omission when relying on purely the financial KPIs to paint you a picture of the health of your practice - the financials do not reference the time you have spent to generate that fee. Hence, they do not really show how 'profitable' the type of work undertaken. In the section on "Time Based Profitability", we show you how using metrics that measure the time undertaken to earn your fee, you will receive a more accurate picture of the profitability of your practice.

### **The Balance Sheet**

Like all other knowledge businesses, your practice's key assets will comprise your clients, your employees and their tacit legal skills, expertise and experience, your knowledge base (eg, precedent documents, opinions and research) and your internal business processes. These comprise your "intellectual capital" yet none of these will be featured in your balance sheet.

What your balance sheet does contain is information relating to the cash management of your practice. In our experience, most Law Practices do not leverage off long term debt obligations and have relatively low capital investment. Instead you are most likely to be funding the operation of your practice through retained earnings and working capital.

In this regard, the key metrics which can be taken into account in measuring the "health" of your practice are:

1. Invoice Write offs
2. Unbilled Work in Progress ("WIP")
3. Unbilled Disbursements
4. Aged Debtor Invoices
5. Aged Creditor Invoices

A negative net current assets position between the year before and the current year indicates likely working capital problems for the immediate future. Growing accumulation of unbilled WIP, unbilled disbursements and uncollected debt (aged debtor invoices) indicates poor cash management.

## **B. Beyond the Financials**

While the financial statements are useful for measuring short-term profitability and cash flow, it is equally important to recognize its limitations in terms of addressing the key drivers of your practice and will directly impact on the business decisions you make and in planning its future directions.

The "key drivers" of your practice will include an evaluation of your intangible assets such as -

1. The quality of your client base and client relationships;
2. The quality of your "knowledge workers"; and
3. The quality of your internal business processes .

The import of each of these "intangible assets" and how they can be objectively measured is addressed here:

### **1. Your Clients**

Since your client base is a core component of your practice's assets, any "health check" must, by necessity, take into account your current and ongoing ability to retain existing clients and acquire new ones .

We would like to suggest the following KPIs to help you in your assessment -

1. The revenue generated by each of your top 50 clients;
2. The number of matters per client;
3. The average revenue generated on all matters per client;
4. The number of times that any client refers another client to you;
5. The number of clients referring work to another department
6. The number of unsolicited commendations;
7. The number and nature of complaints / lost clients;
8. The number of new clients and how come to use your services

The above analysis should be undertaken at a firm, department and fee earner level; and will help you improve client care and make sound strategic marketing decisions.

## **2. Your Knowledge Workers**

As Peter Druckner sagely pointed out, Karl Marx's prophecy has ironically come true in a pure knowledge business: "Workers at last own the means of production because the means of production is in their heads".

It is not difficult to see how your practice's ability to retain good knowledge workers and to attract new knowledge workers is vital to its continuing performance and success. Where practices have attracted and invested in lawyers of high standing and caliber instantly builds up an impressive client base; the converse has also proven true in many cases where well regarded law practices suddenly fall into the second-rate category when a "star" fee earner departs from its ranks.

A high turnover of your knowledge workers is a symptom of "ill-health" that should not be lightly dismissed, no matter how much goodwill the Law Practice has amassed in the past.

The KPIs that you can use to measure the health of your practice in this respect includes metrics which reveal the level of employee motivation and morale. Such indicators can be obtained through employee appraisals, and more informally, through feedback sessions and partners meetings.

Some examples of KPIs you are –

1. The rate of turnover and reasons for leaving
2. The number of and reason for employee absences ;
3. The responses to your recruitment drive and ease of hiring new knowledge workers;
4. The size of investment and degree of involvement in continued legal education and training;
5. The size of your investment in staff welfare benefits.

## **3. Internal Business Processes**

Internal business processes, also known as "structural capital" refers to the systems, processes, know-how and methodology established by your practice. Structural capital confer considerable performance advantages: in the form of risk management, increased efficiency, accuracy and productivity, lower costs, improved service levels and increased client satisfaction.

The recognition that professional services companies including law practices can be subject to the rigors of quality control and "standards" assessments comes decades after the lead taken by process-driven businesses to measure the quality of their processes such as TQM, Process Re-engineering, Balance Scorecards and the like.

The Law Society of Singapore has launched its practice management quality mark "PrimeLaw" on 11 December 2003 with the aim of giving recognition to law firms who have achieved standards of excellence in the areas of practice management, risk management and client care.

The following are some examples of structural capital in the context of a Law Practice:

1. Documenting and implementing "Best Practices" methodologies ;

2. Capturing key client and matter information in a searchable index (database);
3. Automating administrative functions such as bookkeeping, financial management and payroll;
4. Automating file management processes such as time keeping, invoicing, document production;
5. Using an Intranet within the organization to keep your members informed of past and current projects, standard operating procedures, legal updates, business and management decisions ;
6. Establishing a "Knowledge Base" or library of precedent documents, legal research, advice and opinions, case histories etc to facilitate knowledge sharing within the practice;
7. Building Client Extranets or "Deal Rooms" comprising a virtual workspace shared by both client and lawyers to enable access to correspondence and the documents relating to their case;
8. Implementing a Document Management System to capture and facilitate the re-use of knowledge in the practice
9. Technology infrastructure and systems; including equipment and software applications that facilitate the delivery of legal services as well as backroom processes .

"Structural Capital" referred to above generally will not appear in the balance sheet of a Law Practice. However, as it is becoming increasingly a key driver of any practice's success, we believe that practices who have invested money, time and effort in establishing and maintaining its structural capital are in a better position to reap substantial benefits over the long term.

The KPIs associated with the above will depend on the specific type of investment and its purpose.

Some examples are given here -

For effective Knowledge Management, you will want to measure –

1. The number and type of documents captured ;
2. The ease of use of the knowledge management systems and the frequency of access to information stored in the knowledge base;
3. The organizational structure of the knowledge base and indexes
4. The frequency and range of new contributions to the knowledge base;
5. The type and frequency of your skills development / training programme.

For effective Practice Management, you will want to measure –

1. How long and how much resource does it take to carry out different administrative functions in the practice? (eg, how long to open a file? issue an invoice? check on balances in the client account?)
2. How long and how much resource does it take to generate a standard report on matters / clients / financial statement
3. What is the average debtor cycle? How much resource does it take to implement your bills collection policies?
4. What happens to closed matters and how do you access information relating to closed matters?

For effective Risk Management, you will want to evaluate –

1. How many client complaints and nature of complaint
2. What is the claims record of your practice?
3. What is the procedure for recording and monitoring key dates?
4. What is the process for conducting a conflict of interest search?
5. What system is in place for supervision and mentoring?

Suitable commonsensical metrics can be formulated to measure the value of that item of structural capital to your Practice (how much it has contributed to / hindered your practice's success) and provide you with a more accurate picture of your practice's strengths and weaknesses.

## **C. Time Based KPIs**

### **Time Based Profitability**

The profit and loss statement reveals the overall profitability of your practice. However, profit and loss statements are limited in that they do not reveal which clients, what type of work and which departments are truly profitable. And even if your general ledger takes into account the expenses of each department, this will not reveal the profitability of that department, unless all the costs of production, including, in particular, the time spent by the fee earners in that department to generate the fees billed and collected.

Thankfully, this can be easily achieved through the implementation of a sound, enterprise-wide Practice Management System to facilitate the process of gathering and computing time records against revenue and enforcing a strict discipline of time recording by your fee-earners (not merely for the purpose of charging the client for legal services delivered but also for measuring the cost of production).

A Practice Management System will facilitate the process of (i) recording time against matters; (ii) analysing how much of that time was billed to the client or written off; (iii) computing the cost of the fee earner's time taken to deliver the service.

By capturing and analyzing this data electronically, you will be able to measure true profitability by work type, by department, by client, by matter, by department and by fee-earner. Only when you have an accurate picture of profitability (hence, the "quality") of your clients and fee earners, will you be in a position to make sound business decisions that will serve you well into the future.

### **Conclusion**

In this article, we have explained the importance of taking a holistic approach when measuring the "health" or "performance" of your practice that takes into account not just your profit and loss statements but also an evaluation of your intellectual assets comprising your client base, your tacit knowledge in the skills and reputation of your fee earners, and your systems.

The Balanced Scorecard approach which we have adopted suggests that non-financial perspectives of the business are critical to formulating a complete picture of the state of your practice. More importantly, you need make management decisions by "gut feel" because we have shown you how non-financial metrics are capable of measurement.

We hope this article provides a useful starting point from which you can proceed to translate your objectives and goals into a comprehensive set of performance measures that provide a framework for devising and implementing a sound business strategy for achieving these goals.

---

Serena Lim & Corinna Lim are lead consultants with Bizibody Technology Pte Ltd who provide business process and practice management consulting for the legal industry in Singapore and Malaysia. Bizibody's consulting team has been appointed by the Law Society of Singapore as consultants to formulate the PRIMELAW standards.