



# The Economics of Law Firms

for  
The Women Leaders Roundtable



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## Overview



- Financial Statement Basics
- Measuring and Improving Profitability at Law Firms
- Building a Better Brand (and Profits)

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## Overview



- **Financial Statement Basics**
- Measuring and Improving Profitability at Law Firms
- Building a Better Brand (and Profits)

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## Personal Backgrounds



- Have you passed the bar exam?
- Do you play a musical instrument?
- Do you speak a foreign language?

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## Personal Backgrounds



- Accounting is a language you can learn
- Accounting misses a lot; it struggles with intangibles
- The hard part of accounting is people

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## All Financial Pictures are Imprecise



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### The Basic Financial Statements

- The Balance Sheet
- The Income Statement
- The Cash Flow Statement
- The Notes

### Using Financial Data in Managing a Practice

### The Reality

### The Balance Sheet

- Most follow Generally Accepted Accounting Principles (GAAP)
- What you own and what you owe (per GAAP)
- Most don't tell the true story for service firms

### A Services Firm's Balance Sheet

| ACCENTURE PLC<br>CONSOLIDATED BALANCE SHEETS                       |                      |                      |
|--|----------------------|----------------------|
| August 31, 2012 and 2011   |                      |                      |
| (In thousands of U.S. dollars, except share and per share amounts) |                      |                      |
|  | August 31, 2012      | August 31, 2011      |
| <b>ASSETS</b>  |                      |                      |
| <b>CURRENT ASSETS:</b>   |                      |                      |
| Cash and cash equivalents  | \$ 6,640,526         | \$ 5,701,078         |
| Short-term investments   | 2,261                | 4,829                |
| Receivables from clients, net                                      | 3,060,877            | 3,236,059            |
| Unbilled services, net   | 1,299,834            | 1,345,733            |
| Deferred income taxes, net   | 685,732              | 556,180              |
| Other current assets   | 778,701              | 587,224              |
| Total current assets   | 12,587,931           | 11,471,103           |
| <b>NON-CURRENT ASSETS:</b>   |                      |                      |
| Unbilled services, net   | 12,151               | 49,192               |
| Investments  | 28,180               | 40,365               |
| Property and equipment, net  | 779,494              | 785,231              |
| Goodwill   | 1,215,363            | 1,231,991            |
| Deferred contract costs  | 537,843              | 559,794              |
| Deferred income taxes, net   | 808,765              | 756,079              |
| Other non-current assets   | 695,568              | 937,875              |
| Total non-current assets   | 4,077,464            | 4,260,527            |
| <b>TOTAL ASSETS</b>  | <b>\$ 16,665,415</b> | <b>\$ 15,731,630</b> |

### A Services Firm's Balance Sheet

| LIABILITIES AND SHAREHOLDERS' EQUITY  |             |             |
|---|-------------|-------------|
| <b>CURRENT LIABILITIES:</b>   |             |             |
| Current portion of long-term debt and bank borrowings   | \$ 11       | \$ 4,419    |
| Accounts payable  | 903,847     | 948,250     |
| Deferred revenues   | 2,275,032   | 2,219,739   |
| Accrued payroll and related benefits  | 3,428,838   | 3,259,252   |
| Accrued compensation taxes  | 317,422     | 348,340     |
| Income taxes payable  | 125,527     | 124,903     |
| Deferred income taxes, net  | 21,018      | 32,647      |
| Other current liabilities   | 606,392     | 853,208     |
| Total current liabilities   | 6,395,205   | 7,906,518   |
| <b>NON-CURRENT LIABILITIES:</b>   |             |             |
| Long-term debt  | 22          | 35,840      |
| Deferred revenues relating to contract costs  | 553,768     | 555,840     |
| Retention obligation  | 1,532,266   | 995,655     |
| Deferred income taxes, net  | 305,044     | 72,237      |
| Income taxes payable  | 1,297,190   | 1,678,976   |
| Other non-current liabilities   | 322,096     | 235,181     |
| Total non-current liabilities   | 3,811,782   | 3,474,049   |
| <b>SHAREHOLDERS' EQUITY:</b>  |             |             |
| <b>Ordinary shares, par value \$0.000212 per share, 40,000 shares authorized and issued as of August 31, 2012 and August 31, 2011</b>   |             |             |
| Class A ordinary shares, par value \$0.000212 per share, 20,000,000,000 shares authorized, 745,745,177 and 571,793,719 shares issued as of August 31, 2012 and August 31, 2011, respectively              | 87          | 87          |
| Class X ordinary shares, par value \$0.000212 per share, 1,000,000,000 shares authorized, 43,371,364 and 49,340,779 shares issued and outstanding as of August 31, 2012 and August 31, 2011, respectively | 1           | 1           |
| Retained earnings   | 863,714     | 784,217     |
| Additional paid-in capital  | 1,381,876   | 523,017     |
| Treasury shares, at cost - Ordinary, 40,000 shares as of August 31, 2012 and August 31, 2011; Class A ordinary, 112,370,409 and 80,261,763 shares as of August 31, 2012 and August 31, 2011, respectively | (5,283,625) | (5,577,774) |
| Retained earnings   | 7,964,242   | 6,281,517   |
| Accumulated other comprehensive loss  | (478,148)   | (134,585)   |
| Total Accumulated other comprehensive loss  | 4,148,533   | 3,876,551   |
| Noncontrolling interest   | 478,005     | 475,021     |

### The Income Statement at Law Firms

- Typically on a modified cash (modified accrual) basis
- Properly done accrual is a useful tool
- Professor vs. Mies

### An Income Statement

ACCENTURE PLC  
CONSOLIDATED INCOME STATEMENTS  
For the Years Ended August 31, 2012, 2011 and 2010  
(In thousands of U.S. dollars, except share and per share amounts)

|   | 2012          | 2011          | 2010          |
|---|---------------|---------------|---------------|
| <b>REVENUES:</b>  |               |               |               |
| Revenue before reimbursements ("Net revenue")   | \$ 27,862,330 | \$ 25,507,036 | \$ 21,536,568 |
| Reimbursements  | 1,913,655     | 1,843,878     | 1,543,510     |
| Revenue   | 29,775,985    | 27,350,914    | 23,080,078    |
| <b>OPERATING EXPENSES:</b>  |               |               |               |
| Cost of services  | 18,974,629    | 17,263,317    | 14,299,823    |
| Cost of services before reimbursable expenses   | 18,915,615    | 17,204,378    | 14,240,810    |
| Reimbursable expenses   | 59,014        | 59,939        | 58,993        |
| Cost of services  | 20,760,284    | 18,864,195    | 15,843,331    |
| Sales and marketing   | 3,361,479     | 3,094,465     | 2,678,018     |
| General and administrative costs  | 1,910,984     | 1,820,277     | 1,660,286     |
| Reorganization costs, net   | 1,691         | 1,520         | 9,518         |
| Total operating expenses  | 25,966,437    | 23,882,457    | 20,179,213    |
| <b>OPERATING INCOME</b>   | 3,811,548     | 3,468,457     | 2,910,865     |
| Loss on investments, net  | (928)         | (1,086)       | 869           |
| Interest income   | 42,550        | 41,083        | 29,931        |
| Interest expense  | (13,061)      | (15,086)      | (14,877)      |
| Other income (expense), net   | 3,995         | 16,568        | 415,224       |
| <b>INCOME BEFORE INCOME TAXES</b>   | 3,864,154     | 3,512,822     | 2,914,589     |
| Provisions for income taxes   | 1,879,241     | 958,782       | 813,810       |
| <b>NET INCOME</b>   | 2,984,913     | 2,554,040     | 2,100,779     |
| Net income attributable to noncontrolling interests in Accenture SCA and Accenture Canada Holdings Inc. | (217,326)     | (243,375)     | (217,046)     |
| Net income attributable to noncontrolling interests - other   | (13,963)      | (11,988)      | (122,425)     |
| <b>NET INCOME ATTRIBUTABLE TO ACCENTURE PLC</b>   | \$ 2,553,624  | \$ 2,299,677  | \$ 1,761,308  |

### Another Income Statement

FTI Consulting, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income (Loss)  
(in thousands, except per share data)



|  | Year Ended December 31 |              |              |
|--|------------------------|--------------|--------------|
|  | 2012                   | 2011         | 2010         |
| Revenues                                     | \$ 1,251,871           | \$ 1,566,768 | \$ 1,401,461 |
| Operating expenses                           |                        |              |              |
| Direct cost of revenues                      | 980,532                | 956,908      | 825,590      |
| Selling, general and administrative expense  | 378,016                | 373,295      | 341,239      |
| Special charges                              | 28,957                 | 15,212       | 51,131       |
| Acquisition-related contingent consideration | (3,064)                | (8,465)      | 1,190        |
| Amortization of other intangible assets      | 22,407                 | 22,371       | 23,910       |
| Goodwill impairment charge                   | 110,387                | -            | -            |
|  | 1,217,835              | 1,361,321    | 1,243,069    |
| Operating income                             | 59,036                 | 205,447      | 158,392      |
| Other income (expense)                       |                        |              |              |
| Interest income and other                    | 5,659                  | 6,304        | 4,423        |
| Interest expense                             | (56,731)               | (56,024)     | (56,263)     |
| Loss on early extinguishment of debt         | (4,870)                | -            | (5,141)      |
|  | (55,922)               | (55,720)     | (56,981)     |
| Income before income tax provision           | 3,114                  | 151,127      | 101,411      |
| Income tax provision                         | 40,180                 | 40,224       | 41,407       |
| Net income (loss)                            | \$ (36,966)            | \$ 101,903   | \$ 59,904    |

### Cash Flow Statement (Cash Basis Income Statement)


- The lawyer's best friend
- The law firm manager's best friend
- Doesn't suffer from assumptions (you can't fake cash flow)

### The Notes/Narrative

- The music that goes with the words
- May be more useful than the numbers in managing the firm

### Hiding in Plain Sight



## Focus on Law Firms



- Financial Statement Basics
- **Measuring and Improving Profitability at Law Firms**
- Building a Better Brand (and Profits)

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## Standard Productivity and Profitability Measures



- Hours billed
- Realization (collected ÷ charged)
- Gross Margin = (Revenue – Direct Costs) ÷ Revenues
- Days Sales Outstanding
- Line of credit
- Equity and stress tests

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## Measuring Contribution—The Entire Firm



- All Revenues
- Less: All Expenses
- Equals: Net Income
- Includes *Reasonable* Accruals, Allowances, and Reserves
- Are Payments to Owners Compensation (for work) or Distributions (of profits)?

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## Measuring Income—By Practice Area/Group



- Allocated Revenues by Group
- Allocated Costs by Group
- Equals: Group Contribution/Profitability
- Cash or Accrual Basis (keep the yardstick consistent)

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## Measuring Contribution—By Office



- Allocating Revenues by Geography or Office
- Allocating Costs by Location
- Do the offices consume resources at different rates?
- Allocating by “the law” or “equity”

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## Measuring Contribution—By Project



- Revenue Should be Clear
- How Much Overhead Allocated to a Specific Project?
- Will the Project Consume More Resources (people, space, etc.)?

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## Measuring Contribution—By Professional



- Incremental or “New” Revenue
- Direct Costs (“Fully Loaded”)
- Support/Allocable Costs
- Profit/contribution by Partner is the Excess of *All* Revenues over *All* Costs

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## Measuring Contribution—The Hard Part



- Allocating Revenues
- Allocating Costs
- Now It Gets Interesting
- The “Art” of Accounting

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## Measuring Contribution—An Overview



- Direct Costs
- Indirect Costs
- Allocating Costs: Art, Science, or Cruel and Unusual Punishment?
- The Inevitable Disputes  
(Is *everyone* a timekeeper? “I don’t use that much of \_\_\_\_\_.” )

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## Measuring Contribution—Some Basics



- Costs Should be Allocated by Consumption/Use/Benefit
  - By space (occupancy)
  - By headcount (training)
  - By usage (tech support)
- Not All Costs Can Be Reasonably Allocated (there is some *true* overhead)
- There are Recognized Methods (the least worst alternatives)

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## Measuring Contribution—Expanding or Contracting



- Measuring profitability
- Growing or contracting
- Evaluating new hires/new practices/new offices
- Incremental and absolute impact
- **It all comes back to cash flow**

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## Measuring Contribution—Specific Issues



- Less than FTE
- Working at Home
- Who gets what information?
- Make or Buy Decision

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## Other Accounting Issues



- Capitalize vs. Expense
- Measuring Realization: collected compared to billed or charged?

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## Other Issues: "Bonus Out" the Available Income as Compensation?



- Why?
  - simplicity
- Why not?
  - can distort true measures if shareholder and firm are later evaluated in a transaction, a divorce, or an estate issue

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## Components of Value Creation



$$\bullet \text{ PPP} = (1+L) \times (U) \times [(R) \times (BR)] \times (M)$$

PPP = Profit (net Income) per Partner

U = Utilization, total number of billable hours worked and recorded by the partners, associates or paralegals in the firm.

R = Realization, the efficiency at which a firm converts billable time into fees *collected*, stated as a percentage.

BR = The billing rate of the individual or the blended rate of a group.

M = Margin, the firm's income, stated as a percentage of the revenues.

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## Components of Value—Variations on a Theme



$$\text{PPP} = \text{Margin} \times \text{Realization} \times \text{Utilization} \times \text{Leverage}$$

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## Components of Value—Variations on a Theme



$$\text{PPP} = \text{Margin} \times \text{Realization} \times \text{Utilization} \times \text{Leverage}$$

To Improve Profits, You Have to Change One or More of the Variables

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## Some Practical Suggestions



- Copy best practices; do what works.
- Prepare a mission statement or business plan. It focuses your actions.
- What do your clients want? (Or, what do the clients you *want* want?)
- Alan Dershowitz was wrong.

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## Some Additional Suggestions



- Automate or outsource routine tasks.
- Zero-based budgets are better.
- We're all Billy Beane now.
- Affiliate and revenue sharing models

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## Some Practical Suggestions



- The CFO works for you. Take him to lunch every so often.
- People respond to incentives (even small ones)
- Match your spending to your strategy
- Consider alternate fee arrangements

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## The Goodwill Asset



- Probably the firm's most important (valuable) asset
- Your financial statements don't capture it
- The difference between personal and "corporate" goodwill
- Protecting and growing it

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## The Goodwill Asset: In the Firm



- Over \$50 million in revenue
- Over 50 partners
- Multiple practice areas/offices
- Multigenerational



## The Goodwill Asset: In the Individual(s)



- Less than \$30 million in revenue
- Less than 20 partners
- Founder is still alive (and practicing)
- Feels like alter ego



## The Goodwill Asset: Somewhere In Between



- One partner generates more than 10% of revenue
- Few full equity partners
- Clients are attached to the practitioner(s) more than the firm



**The Firm's Most Valuable Asset** **FSG**  
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- Financial Statement Basics
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**Some Fail** **FSG**  
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- **Howrey, Dewey & LeBouef, Heller, et al.**
- **Andersen, Laventhol, LECG, et al.**

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**Some Prosper** **FSG**  
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- **Wachtel Lipton, Quinn Emmanuel, Gibson Dunn, et al.**
- **Accenture, McKenzie, et al.**

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**Branding Basics** **FSG**  
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**Top Brands - Brand Value as a % of Market Cap**

| Company               | Brand Value as a % of Market Cap |
|-----------------------|----------------------------------|
| Tiffany & Co.         | ~75%                             |
| The Coca-Cola Company | ~60%                             |
| McDonald's Corp.      | ~55%                             |
| Kellogg Company       | ~45%                             |
| Harley-Davidson, Inc. | ~40%                             |
| Walt Disney Co.       | ~35%                             |

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**Branding Basics** **FSG**  
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**Who Does Your Taxes?** **FSG**  
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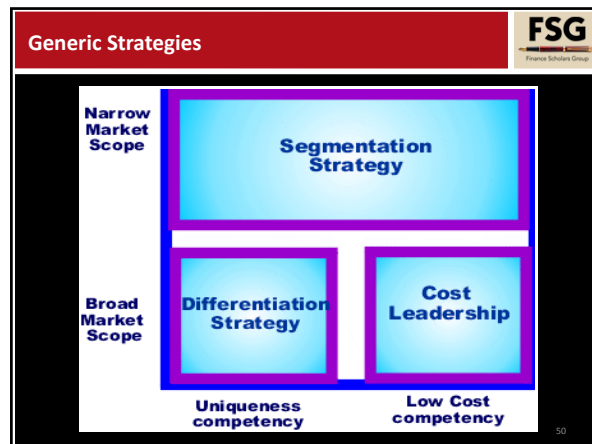
48



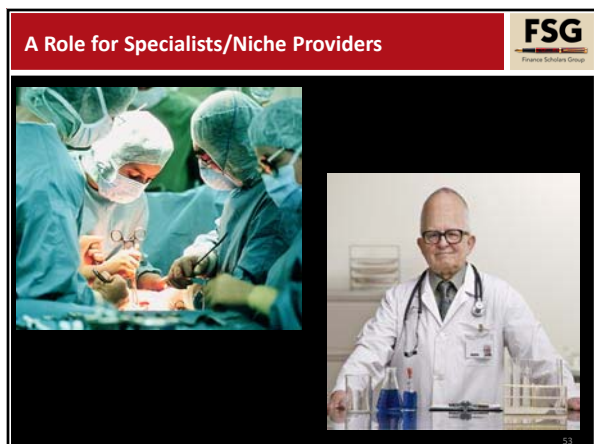
### Branding at the High End

**PATEK PHILIPPE**  
The watch industry is a family business. The watch industry is a family business. The watch industry is a family business.

**LOUIS VUITTON**  
THE QUALITY WITH WHICH THESE WATCHES ARE MADE.




- ### Examples
- High end/premium: Transactional
  - Niche (“boutique”): Employer defense
  - Low cost: insurance defense, title work



- ### Professional Services: Individuals and Firms
- It’s called a service firm for a reason
  - Creating and maintaining trust
  - Solving and preventing problems

**Case Study: Money Management** **FSG**  
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**Hard to beat the averages,  
but service can make a difference  
in counseling (“hand holding”), portfolio  
allocation, etc.**

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**Where Do You Fit In?** **FSG**  
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**Old Model:  
“Finders, Minders, and Grinders”**


**New Model:**

|                       |                    |
|-----------------------|--------------------|
| Internal Relationship | Internal Expertise |
| External Relationship | External Expertise |

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**What is *Your* Competitive Advantage?** **FSG**  
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- Play to *your* strength; back to strategy: what do you do better/different than others?
- What *could* you do better than others? Or what do *others* think you do better than others?
- Everyone has at least one gift/talent/superpower; what is yours?



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**In the End, It's Execution** **FSG**  
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**In the End, It's Execution** **FSG**  
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**Sometimes It's Simple** **FSG**  
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**Sometimes It's Simple** 

- “The conditions of conquest are always easy. We have but to toil awhile, endure awhile, believe always, and never turn back.” *Marcus Annaeus Seneca*
- “Without ambition one starts nothing. Without work one finishes nothing. The prize will not be sent to you.” *Ralph Waldo Emerson*

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**Enthusiasm Counts for a Lot** 


- **Enthusiasm:**  
  
From the Greek *enthousiasmos*, to be “inspired, or possessed by a god.”

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**Jon Stewart's “Biggest Break”** 



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**Summary and Conclusion** 

Q&A

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