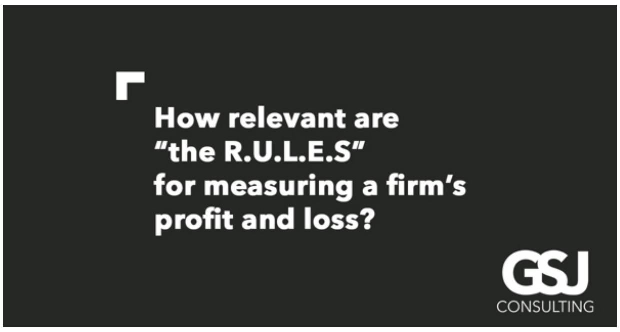

Learning the R.U.L.E.S

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I first came across the concept of “RULES” in the early 2000s. Taken from Robert J Arndt’s relatively short (at 31 pages) 1988 publicationIdentifying profits (or losses) in the law firm,the acronym “RULES” stands for:

Realization – of billing rates

Utilization – of their professional staff

Leverage – of the professionals in their team

Expense – control of (both the fixed and variable kind); and

Speed – of the firm’s billings and collections.

There is absolutely no doubt that the use of “RULES” has been the preferred “go to” metric for professional services firms who are looking to mine their financial information beyond the mere top-level question of whether or not the firm made any money this year.

Indeed, if used properly, use of “RULES” should allow firms to further analyse:

which professionals and partners are making a profit;

- which practice areas are making a profit;
- which matters are more profitable than others; and
- which clients are more profitable than others.

Given the intense nature of professional services firms, and especially among partners looking at their equity points and the divvying up of profits at the end of each year, the RULES seems a fair and equitable profitability measure.

But…

Are the RULES the most appropriate measurement of a professional services firm's profit or loss?

To answer this question, we need to look at each of the components and ask whether or not it applies in the era of the "new normal".

Realization

Realization is generally accepted as being the amount collected (i.e., in the bank) against the effort to produce (i.e. productivity); or, as Altman Weil has defined it: "realization is fees collected divided by the standard value of the time worked".

Consider this scenario on an individual professional's basis:

- You set your professional a standard billable hourly rack rate of [say] $100;
- They charge the client $90 per hour (after write-offs etc) for work done;
- The client pays $85 per hour (after asking for a discount etc) for the work.

In that scenario, the realization rate is 85% [I note that some firms adopt the practice of looking at realization as being the amount paid against the amount billed (94.44% in this example), but this is not the methodology used in RULES].

On the other hand, if the same professional does a fixed fee job for $1,000 and it only takes them 5 hours to do the job (cost of $500), then the realized rate is 200%.

While this may have been a good indicator of individual professional's profitability in the past, in the era of the "new normal", more and more clients will not pay for their professional's time on a fully rack-rated hourly basis. At the same time, professional services firms have been slow to learn how to price their services in any way other than hourly rates (i.e., this job will take me 5 hours times $100 per hour = $500 for the fixed fee).

The combination of these two failings goes some way to explaining why industry trends have seen realization rates declining – from 88% in 2008 to 84.5% in 2010– and, unless professional services firms become much better at pricing their services, this metric will very shortly become meaningless.

Utilization

Utilization is the yardstick by which we determine how busy the professionals in your firm are. To determine this, we look at the annual budget of hours the firm has set each relevant professional against the amount of billable time they have put on their time sheets (daily, weekly, monthly or annually).

There are two principal flaws with this use of utilization:

> The first is that the annual billable hour figure is a moving goalpost. Not too long ago, expected annual number of hours per professional was in the 1,400 to 1,500 range. Today it is not uncommon to see figures of 1,700 to 1,900 hours per year being thrown around.

> The second and more important reason is that utilization sees an hour billed as "king". Indeed, an hour billed to a client while sitting in your office trumps a non-billable hour sitting in your client's office talking about their business – regardless of the fact that others in your firm may actually get 50 hours of billable time because of that hour. Moreover, an hour doing pro-bono work for the good of your community or KM in creating precedents documents is, by use of this system, essentially a wasted hour.

In the era of the "new normal", where clients are looking for, among other things, an understanding of their business (non-billable hours spent attending industry events) and corporate social responsibility, utilization seems an outdated profit-related performance metric.

Leverage

Leverage is the number of professionals you have to partners.

A reading of Maister'sManaging the Professional Service Firm will tell you that leverage is a key component of a firm's profitability. In order for a firm to be more profitable, the maximum amount of work possible must be pushed down the chain to the more junior-ranking professionals.

Unfortunately, this too is problematic in the new normal. Clients today are simply not willing to pay for junior professionals to work on their files in the same way as was previously acceptable. Indeed, it's not uncommon these days to see clients refusing to pay for associates less than 3 years PQE in requests for proposals.

On this point, firms do appear to be taking note. Take a cursory look at any number of firms' websites, and you'll likely see the firm positioning its team as being "partner lead" (as opposed to the old language of "partner supervised").

Expenses

Expenses are both fixed (i.e. rent) and variable (i.e. salaries and bonuses) and are always going to be an important factor in determining a firm's profitability.

The only issue I take with professional services firms' approach to expenses at the moment is the belief that cutting expenses will help to maintain or increase profitability.

While this will have some part to play, studies from the likes of Bain & Company show that an increase of price – if properly managed – is far more successful in increasing profitability than a reduction of costs. But, as reducing your own internal costs is an easier conversation for firms to have, this remains the current preferred method.

Speed

Speed of collection is generally determined as being the time from when you did the work to the time you are paid for that work.

Sometimes known as "lock-up" days, speed of collection will have a massive effect on the firm's profitability.

Not only is this the case because firms have to borrow in order to operate their business during the time the payment remains outstanding, but also because there appears to be a direct correlation between clients who want discounts to the number of outstanding days of payment (with the longer you take to get paid, the higher the chances are that your client is asking you for a discount).
