

MANAGEMENT

When firms merge, splitting of profits among fee earners can become a potential can of worms. With the use of a hypothetical scenario, **Eric Laing** illustrates how it can help firms to undergo a detailed income and profits analysis, something that can bring many benefits and smooth out future disputes among partners

Avoiding post-merger blues

This article is about mythical law firms and people. All the events and characters are entirely fictitious. Two years ago, the old, respected 14-partner firm Stable & Reason had merged with the go-ahead firm of May Gamble & Speed with 19 partners. The new firm, Reason & Gamble, offered a good range of services, particularly to the potentially lucrative commercial sector. This was one of the main drivers for the merger.

The merger agreement had stipulated that the profit be split equally between all the partners for the first year following the merger. After that, the agreement allowed for variation by mutual consent. Given the unhappiness of many of the partners with the division of the first year's profits, it was clear that the profit split would have to be renegotiated for future years. The situation was exacerbated by the actual profits falling well below the ebullient, pre-merger predictions.

The problem

The root of the problem was the disparity in the perceived profit each partner generated. Some worked longer hours than others, some generated greater chargeable hours, some introduced more work and some billed more fees. There was no easy way of reconciling these differences. For each argument, a counter-argument was raised. Without time spent marketing, the firm would not grow. Not all chargeable hours worked were actually billed. Some deals were done on fixed prices, and others were charged at 'blended' rates. Several major jobs made use of the services of more than one of the firm's departments. To add to the arguments, two major May Gamble & Speed clients had been lost after the merger.

The new managing partner, Steven Playfair, began to fear for the future. A very messy break-up in which there would be no winners was on the cards. If they could get a credible indication of the actual profit each partner generated, he believed that 80% of the arguments would disappear.

The firm had adopted the systems used by May Gamble & Speed. Everyone, including partners, rigorously recorded their chargeable time, which was coded to job number. Each job number was designated to a department, client and lead partner. However, time spent on marketing, administration and training was not recorded. The system evaluated the chargeable time using hourly chargeable rates and was able to compare the chargeable value this produced with the amounts actually billed to each client.

Following a fortuitous meeting with an old acquaintance, Steven was introduced to a specialist consultant. After an initial meeting, and with the approval of the partnership, the consultant was instructed to analyse the data on the firms' systems and produce the information that Steven needed.

Solving the problem

The first step was to consider what sort of decisions the partners needed to make. This would dictate what information should be gathered. For Playfair there were two main decisions — how to split the firm's profit equitably; and, having identified which jobs, departments or clients were not generating the necessary profit, to decide on appropriate actions.

The analysis was revealing. Reports showing profitability by job, client, department and lead partner were prepared. An example of the report showing profitability by client and department is shown in the table.

'Client profit' was generated by firstly calculating the

profitability of each job. This was achieved by deducting the 'full cost' of the time chargeable to each job, plus the cost of travel from the amount billed. The resulting information on job profitability was then summarised to produce the 'Client Profit' shown in the table.

The 'full cost' of the time chargeable to each job was calculated for each fee earner. It included employment, training and car costs, plus a share of the secretarial and the building costs, based on usage. Notional employment costs were used for the equity partners. The full cost was applied using a rate per hour for each fee earner, which was computed by dividing the 'full costs' for the year for each fee earner by his/her total chargeable hours, plus an estimate of the time he/she spent on marketing and administration. These 'full cost rates per hour' were also used to evaluate the time spent on marketing and administration.

Of the fee earners, only the partners and five senior employees spent time on marketing and administration. Although estimating this time was subjective, by agreeing on the minimum hours that a senior individual or partner should devote to the firm's business and deducting the chargeable hours, a starting point for discussion was established. To avoid endless arguments, it was also agreed that attendance at social and sporting events would be excluded from the estimate of marketing time. Further estimates were made to split the time on marketing and administration between relevant departments and the firm as a whole.

Departmental administration costs were mostly specific library items, some computer software, and time spent on departmental staff issues. The central overhead administration included all reception, general IT and accounting costs, plus the cost of occupying the administration areas of the building.

The final item under central overheads, described as 'reconciling items', represented, primarily, the dif-

ference between the valuation of work-in-progress in the firm's accounts and the more specific valuation used in the profitability analysis exercise. Being able to reconcile the reports to the firm's accounts significantly improved their credibility.

By sorting the information shown in the table in a different way, the consultant also produced a report showing the split of profit by lead partner. He then generated a further report, which allocated the profit on a job between the relevant partners where more than one was involved. This allocation was based on the chargeable hours in their respective departments.

The outcome

At first, some partners were sceptical. However, after some adjournments to obtain detailed, supporting evidence, the reports were broadly accepted. Once all the partners accepted that actions needed to be taken, the discussions became increasingly constructive.

Three major areas caused concern: the loss made on certain clients; the loss incurred by the property department; and the split of profit among partners.

Loss-making clients

Much to everyone's surprise, the analysis showed that Client B, a major commercial client, was actually costing the firm money. Most of the work for this client was on fixed prices. It was decided that the fixed prices for certain types of the work could be increased, and that a firmer line could be taken in the negotiations on other fixed price work, without serious danger of losing the client. Similarly, although the employment work carried out for Client E was profitable, the property work was not and needed to be addressed.

It was clear that some of the old Stable & Reason clients were not charged the full fee for the work done. The four partners involved agreed not to discount their

charges in future. It was accepted that a few of these clients may be lost. However, the time thereby freed up could be profitably used for marketing and training.

Loss-making department

From the analysis, it was apparent that the loss made by the property department was primarily due to the volume of private house conveyancing done at competitive, but low, prices. The partners decided that the firm should concentrate on commercial conveyancing and significantly reduce the amount of private work. This raised the question as to what two of the partners involved in the property department would then do.

It had long been felt by the commercial partners that being able to offer expertise on patents and trademarks would be a significant asset to the corporate and commercial department. One of the property partners was delighted to take the opportunity of re-training and setting up this section. The other property partner, who was extremely good at networking, was persuaded to reduce the time he spent fee earning and increase the time he spent marketing the firm's services.

Splitting the profits

The contribution made by all partners was reviewed in the light of the analysis. Although the weight to be given to, for example, direct fee earning, profit generated as lead partner, and marketing was necessarily subjective, the clear information as to the profitability of individual clients, departments and lead partners proved very helpful in the discussions and a formula for dividing the profits was produced and accepted. The following year profits increased, and Playfair found himself a most popular managing partner.

Eric Laing is an independent consultant who has specialised in profitability analysis for more than 15 years.

Reason & Gamble — Profit Analysis by client and department for period 1 April, '03 to 31 March, '04

	DEPARTMENTS					PROFITS			
	Property	Corporate & Commercial	Litigation	Employment	Wills & Probate	Total profit	% of tot profit	Total billed	Total profit % of total billed
CLIENT PROFIT									
Client A	x		x		x	x	%	x	%
Client B	(x)			(x)		(x)	(%)	x	%
Client C		x		x	x	x	%	x	%
Client D	x	x	x			x	%	x	%
Client E	(x)			x		(x)	%	x	%
Client F	x		x	x		x	(%)	x	%
Total client profit	x	x	x	x	x	x	%	x	%
DEPARTMENTAL COSTS									
Marketing costs	(x)	(x)	(x)	(x)	(x)	(x)	(%)		
Recruitment costs		(x)	(x)			(x)	(%)		
Admin costs	(x)	(x)	(x)	(x)	(x)	(x)	(%)		
Total departmental costs	(x)	(x)	(x)	(x)	(x)	(x)	(%)		
Total departmental profit	(x)	x	x	x	x	x	%		
CENTRAL OVERHEADS									
Marketing costs						(x)	(%)		
Recruitment costs						(x)	(%)		
Administration costs						(x)	(%)		
Reconciling items						(x)	(%)		
PROFIT PER ACCOUNTS						x	100%		