



PROFIT CENTER ACCOUNTING

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LPM Hotline question: *Ellen, we're about to bring in a semi-retired lawyer as of counsel to our firm. We want to pay him a fair return on the work he does, as well as the work he passes to us. But we don't want to be overly generous and lose money. How do we know what to pay him?*

LPM Hotline question: *Ellen, my partner and I have been together over 30 years. I'm still working at full speed, but he wants to scale back significantly. We always just split profits 50/50. How do we figure out what's fair under the new arrangement?*

LPM Hotline question: *Ellen, we have a partner here who is a big revenue producer. But there is a lot of grumbling because he is a resource hog. He has two secretaries, whereas the rest of us share. He has his own associate and paralegal, but he dumps work on ours, which are shared and already at capacity, as well. As managing partner I need to do an analysis of some sort in order to address the issue. But I'm not sure where to start. Suggestions?*

LPM Hotline question: *Ellen, I want to start charging for some types of work on a flat-fee basis. But I don't want to lose my shirt. Where do I start?*

The questions above, or variations thereof, arrive frequently and reliably at the Law Practice Management (LPM) Hotline every year. Obtaining answers involves performing profit center analysis /accounting. It is a way to calculate the contributions to the firm's bottom line of departments, areas of practice, offices or individual attorneys. The first step is to identify what you want to measure.

Let me preface the following overview with a serious warning. Undertaking this type of accounting analysis **can be** a divisive exercise for a law firm. While it can allocate and measure objective numbers, it does not measure total contribution to the firm. It can create ill will and misunderstanding. For this reason I usually say that the results of this analysis should be for the eyes of the managing partner or executive committee only. Exceptions can be made only at firms where there is a very high level of trust, equality and respect among partners.

Additionally, there are some aspects of the allocation process used that are subjective. That require reasonable assumptions. And those assumptions can be questioned. So keep everything simple, straightforward, and consistent from one analysis to the next.

Remember, the purpose is not to start counting and allocating precisely down to the “paper clip” level. Typically, when this type of analysis creates discord, it is caused by an overzealous attempt to place every penny in someone’s “column” and/or by resistance/denial from individuals who fear their numbers probably won’t pass muster. Low trust and/or low respect cultures should probably hire an outside accountant or consultant to perform the analysis, and provide the firm with the spreadsheet and explanations to repeat the analysis on their own in the future.

Step 1: Revenue allocation

Revenues received by the firm are usually allocated to the various partners on an originating attorney basis. It is OK to split origination credit among more than one attorney if there is general agreement to do so.

Likewise, it is permissible to have "firm" clients where revenues are not credited to a particular originating attorney. This can occur when clients are passed down from retired or deceased former partners and the firm does not wish to attribute continuing credit to a particular attorney. In this case the revenues could be allocated evenly among partners. Or allocated based on who is performing the actual work.

Generally speaking, revenues can follow origination or the timekeeper(s) who does the actual work. These numbers are readily available from most practice (case) management or time & billing software. Just make sure that whichever decision you make, you allocate the expenses similarly.

Step 2: Allocation of direct costs

Direct expenses, otherwise known as variable expenses, are those which can be clearly attributed to the profit center being analyzed. Examples of direct expenses for an attorney profit center are dues, CLE, pension contribution, direct client entertainment and so forth. (Compensation of partners is *not* in this category.) Compensation costs of staff dedicated to the attorney are also direct expenses.

Some expense categories include both direct expenses and indirect shared operating expenses. For example, staff payroll will include both. Staff members like bookkeepers, receptionists, administrators and so forth should have their



corresponding expense shared equally among the partners. In the case where staff members are shared, be careful not to get caught in “resistance” traps regarding minor changes in percent usage from one partner to another. (e.g. we share a secretary but he uses her more, so I only want to be charged for 40% of her time instead of 50%.)

If paralegals can all be defined under direct expense that is preferable. If it is too difficult to determine for whom the paralegals each work, they should be left under shared resources and allocated evenly to all partners within the practice area(s) they service. Keep in mind that the “who they work for” is determined by the ultimate bucket the revenues go into. For example, if a paralegal or associate works for several attorneys, but all the fees generated by those hours wind up in the revenue column of a particular partner, then the paralegal works for that partner for the purposes of expense allocation.

Step 3: Allocation of indirect / shared costs

Next comes allocation of shared, otherwise known as indirect expenses. Examples of what falls into this category include rent, utilities, liability and malpractice insurance, website and other firm marketing expenses, telephone, technology and so forth.

These shared general operating expenses are normally equally divided among the partners for analysis purposes. Here is an area where nit pickers and those afraid of the results have a field day. Here is where they try to allocate down to the paper clip. By doing so, they can completely undermine the process and purpose of the analysis. So you must draw the line in the sand as to what is fair and reasonable.

Over the years, I have heard objections such as, “I shouldn’t be charge for *any* computer usage because I don’t touch one” or “I shouldn’t be allotted any charge for the website because I wasn’t in favor of it and don’t ever mention it to clients.” At one firm they even had me allocate rent based on size of attorney offices, despite my best efforts to resist. Why? Too complex. In a law firm the structure is such that whether you agree with every particular detail of operation or not, you bear your share of the costs, and that must be reflected in the analysis.

Step 4: The bottom line

After all direct and shared expenses are allocated, the sum of the column totals for each profit center being analyzed should equal the total expenses for the firm. By deducting the total direct and shared expenses from revenue in each column, you will arrive at the gross profit for the firm and for each individual profit center.



If your profit center is an attorney or department, by subtracting the actual draw/compensation of the partner(s) from the profit available for them to draw following Step 2, you will see whether each attorney or department is operating at a profit or loss at their current rate of compensation.

Step 5: The cost of your billable hour

Another byproduct of doing this analysis is the ability to determine the cost of a billable hour on an attorney basis. This is particularly helpful if the firm wants to begin quoting flat fees for projects.

Take the sum total of direct and shared expenses for the partner and divide it by the total hours worked in the same time frame. That will give you the cost to produce each hour. Depending on how efficient attorneys are, the production cost per hour can vary greatly from attorney to attorney.

This article is a condensation of my actual resource that includes a total of eight steps, plus a corresponding Excel spreadsheet to help you do your own analysis. PBA members can get the more detailed explanation and spreadsheet by sending an email request for “Profit Centered Accounting” to lawpractice@pabar.org. Please include your member number and county in the request.

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