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Financial Management Tools and Information for the CMO

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Today, chief marketing officers (CMOs) need to understand law firm finance and economics. Likewise, I'm sure you would agree that law firm chief financial officers (CFOs) need a better understanding and appreciation of marketing strategies. The success of your firm will depend on how well these two disciplines work together. Marketing decisions affect whether the firm will obtain new business or increase business from existing clients. Profit needs to be returned to the firm as a result of these activities. Accordingly, the test of marketing decisions ultimately comes from its financial results.

This article will familiarize you with two strategic but basic tenets of law firm finance and economics — matter profitability and return on investment (ROI). Along the way, you should look to answer the continuing question asked by most managing partners (first attributed to Macy's founder, John Wanamaker) when weighing the contribution of marketing expenditures: "Half the money I spend on advertising is wasted; the trouble is I don't know which half."

Client/Matter Profitability

Why is determining the profitability of client matters important to you? Because ultimately, this is the most important metric in determining the success of your firm. This analysis also provides the foundation for determining practice group or industry segment profitability. Armed with such information, law firm leaders have useful information for:

- Strategic planning purposes
- Investment decisions, including the allocation of limited firm resources
- Improving profitability of existing clients or areas by:
  - Increasing knowledge levels in order to reject unprofitable work
  - Understanding the impact on matter staffing patterns
- Making pricing decisions:
  - Possibility of increasing profitability through alternative pricing
  - Careful use of discounts
- Holding attorneys accountable for matter management

As this list suggests, law firm are using profitability analysis as a management tool. Determining the cost of services sold is an absolute necessity, so do not be swayed by some partners who argue that only the traditional determining factors of hours, billings and collections are the correct measure of overall profitability.

Cost Allocations — Art vs. Science

Businesses in this country are expected to abide by generally accepted accounting principles (GAAP). However, some firms have their own principles, which are referred to as PCAP (politically correct accounting principles). What this means is that there is no one correct way to determine cost allocations, and this is why some art is needed in determining the methodology for cost allocations. Any method will be subject to debate, so the key is to obtain the approval of firm management on the assumptions and then proceed.

For purposes of determining matter profitability, all or most costs must be allocated, and such costs are normally tracked by the hours invested in the matter. The end result of the allocation is that each fee earner will have a cost number associated with his or her billable hours. These costs are further defined as "direct" (such as fee earner salaries and benefits) and "indirect" (overhead). You do not need a mastery of numbers to get through this exercise, and your firm's CFO can easily walk you through the process. Law firm management guru Scott Adams offers this simple advice: "Remind people that profit is the difference between revenue and expense. This makes you look smart." 'At least in front of the partners anyway.

Ongoing Review and Reporting

One thing to keep in mind is that ultimate matter profitability is not determined until the matter is closed. However, monthly or periodic reporting will assist management by keeping track of the financial progress of each matter. For example, on fixed-fee engagements, management can monitor the investment of billable time compared to the fixed fee in addition to monitoring costs on the file. Sophisticated financial systems incorporate “push reporting” to signal certain financial events, such as fee budget warnings.

The timing and frequency of these reports will depend on the ability of the firm’s financial system and the CFO’s team to generate the reports. Some firms will be able to use data warehouses to generate reports with relative ease, and some firms may be able to utilize executive inquiry systems. Executive inquiry systems are available from your desktop with easy-to-follow screen inquiries.

Return on Investment

You are probably already aware of the concept and some practical applications of ROI based on personal experience. Some examples include the amount of equity buildup in your home as a percentage of original cost and the returns (or lack thereof) from your personal savings and investments in the stock market. Businesses can use ROI as a very broad measure, such as dividing the company’s annual net income by the company’s total assets on the balance sheet. On a more micro level, CFOs and management will use ROI to judge specific requests for capital outlays, marketing initiatives and the like. In the real world, requests are normally approved for those projects offering the highest returns.

Some law firms may have difficulty in assessing ROI data since the results of many marketing strategies and activities do not find their way on to new matter intake forms. Firms cannot begin to accurately measure ROI related to marketing activities if sources and reasons are not tracked at the intake stage. Examples of source activity include:

- Seminars
- Advertising in the legal or trade press
- Legal and other directories
- Referrals
- Personal relationships
- Information from the firm’s Web site
- Client newsletters or other news articles
- Press releases
- Corporate department big-hitters golf tournaments

Forecasting ROI

The use of ROI in determining actual results from marketing campaigns is relatively clear based on historical information. However, ROI should also be used to forecast returns on future activities. Forecasting requires that we have good historical information or judgment on activities that have resulted in new clients or new matters from existing clients. For example, assume you want to sponsor a seminar related to nanotechnology, and you want to demonstrate the return to the CFO and firm management. To do so, you would need the following data from historical information (or professional judgment):

- How many responses will we receive from the invitation
- How many will actually attend the seminar
- The number of attendees that will become “leads”
- The number of leads that will result in new business

Determining the Investment and the Return

What should be included as costs in the investment determination? Some of that depends on the firm’s tracking systems. It would be easy to track the costs for the nanotechnology seminar (printing, facility, catering, etc.). Should you include other expenses, such as an allocation of marketing department salaries, for this activity? How about the time invested by the firm’s attorneys in preparing for and attending the event? I would suggest that you include this information only if the data is readily available. We don’t want to have everyone suffer from analysis paralysis. Start from some meaningful point.

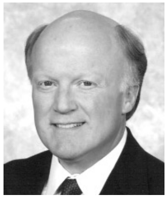
The return is normally the profit that the marketing campaign or initiative provided — not simply the fee revenue that was derived. Earlier, we explored matter profitability, so it is possible for you to determine or make a conservative estimate on resulting profits.

Last, how do we interpret the results? What is an acceptable ROI —10, 20, 50 percent? The main purpose of the measurement is to interpret the result relative to the ROI of other investment opportunities. For example, if you determined that the ROI from the nanotechnology seminar was 35 percent and that the ROI from the Corporate Department Big-Hitters’ Golf Tourney was two percent, you would hopefully focus your future resources on similar seminars or events. Time also plays an important role since you need to allow the marketing initiative to run its course for an acceptable period — the amount of time it takes to generate a new client or matter from a lead that originated from the event.

Benchmarking is another use of ROI. If the nanotechnology seminar yielded 35 percent in year one, our minimum results expectation for a similar seminar in year two should be 35 percent or higher. If you have no basis for comparison, you are left to judge each set of results on its own merits.

Moving Forward

ROI is a powerful tool, and measuring ROI for marketing activities is a must. Marketing professionals have the ability to effect positive contributions to the revenue cycle and, ultimately, the bottom line. To accomplish this, you need to understand the concepts and measurements of ROI and matter profitability. Armed with this information, you can help your firm identify specific clients and types of matters that are more profitable than others. Matter profitability is the beginning point for reviewing the profitability of partners, practice groups, industry segments, and ultimately, the success of the firm.



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