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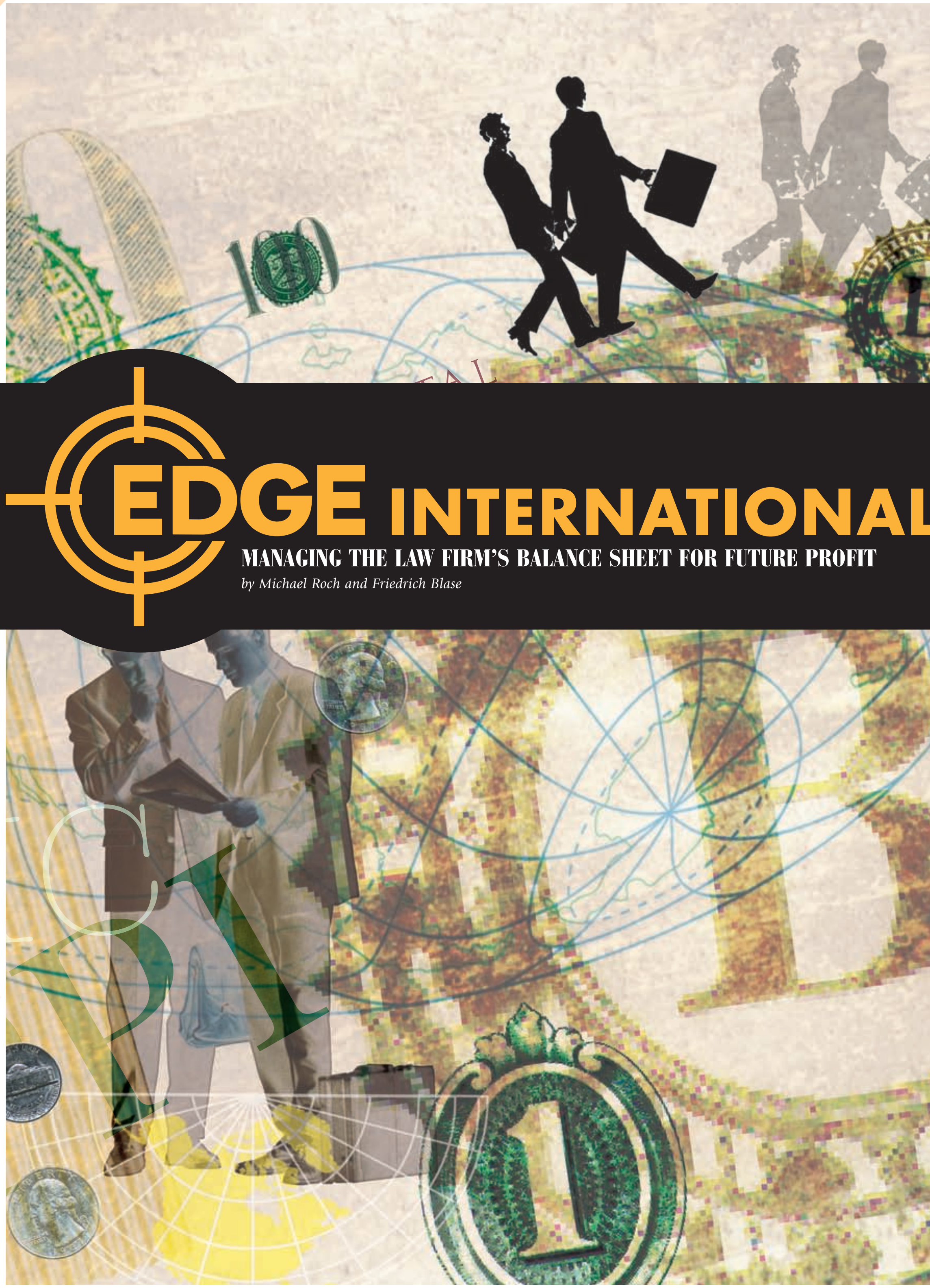

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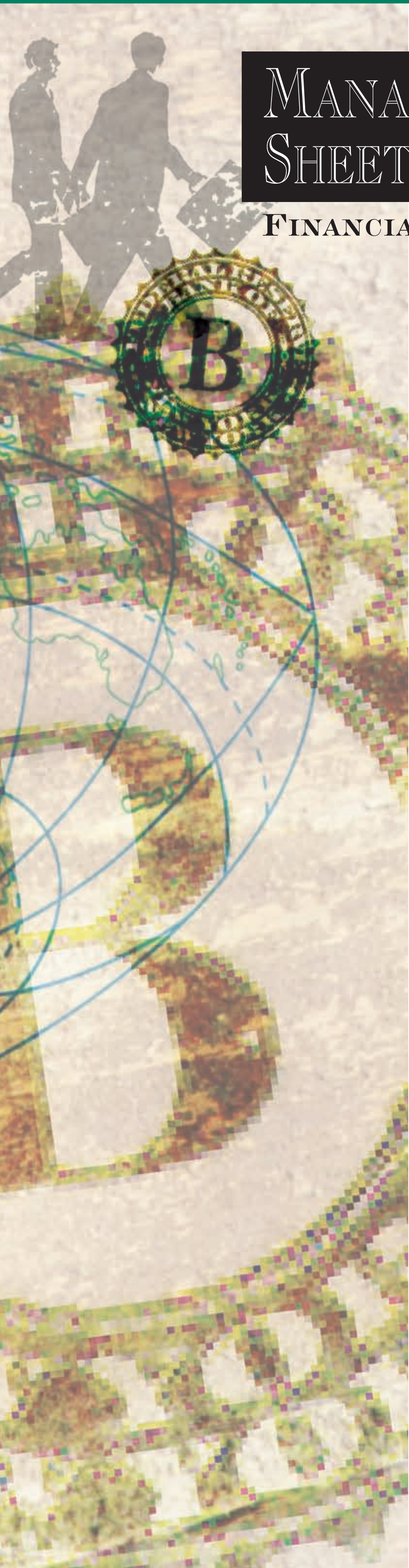
INTELLECTUAL CAPITAL
IC



by Michael Roch and Friedrich Blase, EDGE INTERNATIONAL

MANAGING THE LAW FIRM'S BALANCE SHEET FOR FUTURE PROFIT:

FINANCIAL MANAGEMENT AND INTELLECTUAL CAPITAL

MOST LAW FIRMS ARE RUN BY THE NUMBERS: THIS YEAR'S NUMBERS. AFTER ALL, "AT THE END OF THE YEAR, MY PPP MUST BE BIGGER THAN YOUR PPP." WHILE THIS MEASURE IS FINE FOR REPORTING TO THE LEGAL PRESS, CURRENT YEAR PROFIT PER PARTNER IS A POOR MANAGEMENT TOOL. THIS IS BECAUSE PPP IS NO INDICATION OF WHETHER THE FIRM CAN SUSTAIN ITS PROFITS LONG-TERM, JUST AS CURRENT YEAR EARNINGS PER SHARE ARE NO INDICATION OF FUTURE PROFITABILITY FOR A PUBLICLY-HELD COMPANY. FUTURE PROFITS COME FROM THE MANAGEMENT OF INVESTED RESOURCES, AND THE MOST SIGNIFICANT INVESTED RESOURCE IN A LAW FIRM IS ITS INTELLECTUAL CAPITAL (IC).

Since intellectual capital does not appear on a balance sheet (and profits on it do not clearly appear as a part of PPP), IC is often managed poorly – if at all. Because IC is intangible, finance directors and managing partners view it with suspicion. We suggest that this suspicion is misplaced and outdated. Like it or not, law firms are managed more and more like businesses. In particular in Europe, a firm's ability to manage its intellectual capital effectively will soon be at the top of every managing partner's mind. When the Clementi reforms take effect in the United Kingdom (anticipated in 2008) and eventually across Europe, non-lawyers will be allowed to own or invest in law firms. Law firms will be able to attract venture capital and private equity investments. Invariably, financial investors will be keen to invest first in those firms that manage their resources best – and a firm's primary resource is its intellectual capital. In the meantime, the wisest firms will seek to increase PPP by managing IC using financial and non-financial indicators. In this article, we explain how to do this.

> ***The wisest firms will seek to increase PPP in the short-term by managing intellectual capital for the long-term using financial and non-financial indicators.***

FOCUSING ON CURRENT YEAR PPP ENCOURAGES BAD INVESTMENTS

The short-term focus on PPP has three main reasons. First, partners are interested in the profit draws of the current financial year. Long-term investments are minimized as much as possible to maximize cash draws. Second, most partners have invested little or no financial capital into the firm. Even if there is a significant capital contribution, this amount often is financed and forgotten about; only few partners see their partnership capital account as a retirement vehicle. Third, and perhaps most important, most firms still price services by the hour. This pricing method does not provide any incentive for a firm to manage the effectiveness and efficiency of service delivery: the more efficient it becomes, the fewer chargeable hours it spends and, all other things remaining equal, the lower the firm's profits.

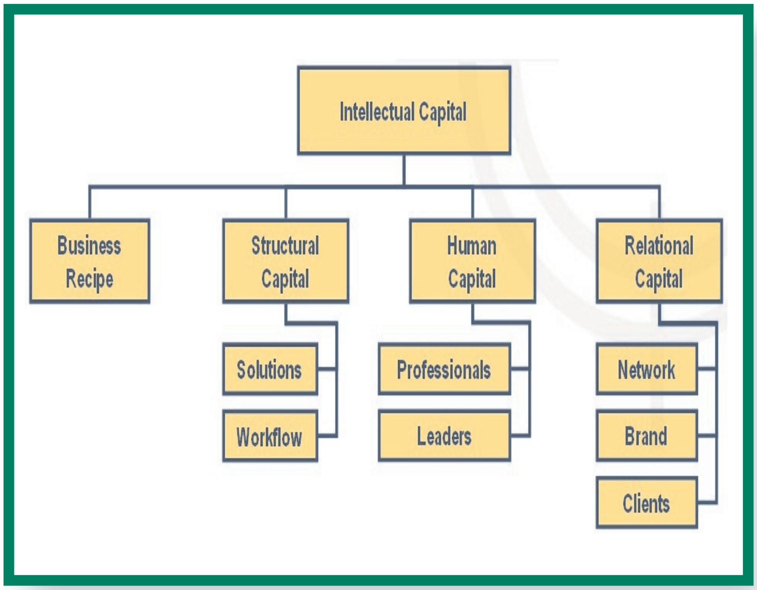
This short-term focus has caused law firms to become fairly good at managing utilization, effective rates, realization, margins and all of the other ways of increasing current year PPP. This short-term orientation works well if the firm always manages to charge by the hour and never has to succumb to market pressure. Unfortunately, every service eventually becomes a commodity; just think of insurance defense and real estate conveyance work. In financial centers, clients and investment banks almost always impose a cap on fees for initial public offerings and private equity due diligence work. As soon as work becomes more commoditized, a law firm realizes that at least some investments are necessary to remain competitive. Knowledge management systems are spawned, formal associate development programs are instituted and blueprints for client service programs are prepared. But still, firms focus on controlling current year's costs and not on wisely implementing these programs in order to strategically secure and increase long-term profitability. When a firm misapplies financial resources and professional time on these investments, it is unable to achieve any visible return, let alone the highest possible return.

INTELLECTUAL CAPITAL AS THE SINGLE MOST IMPORTANT SOURCE OF TOMORROW'S PROFITS

The financial markets recognize that only companies that are able to harness and manage innovation and technology can compete in the marketplace long-term. Key ratios used by investors are moving away from comparing market-capitalization-to-tangible-book-value and towards intangible values, recognizing that a company's intellectual assets provide the primary competitive advantage in a knowledge-based economy. The increase in importance of intellectual capital (being equal to market value less tangible book value) is, indeed, extraordinary: in 1929, 70% of a company's market price was made up by its tangible book value, in 1970 it was 50% and today it is around 20%. Businesses are working hard to harness intellectual capital and maximize their return from investments in IC. The long-term success of a law firm – which does not have many hard assets – depends even more on how well it harnesses, creates, maintains and maximizes its single most important source of future profits.

Yet, most law firms manage their intellectual capital only at the most rudimentary levels because it is difficult to manage it by the numbers. Indeed, when looking at any law firm's balance sheet, we see cash, accounts receivable, work in progress, equipment and maybe leasehold improvements as the most significant financial items; the law firm's intellectual capital does not appear on the firm's financial accounting balance sheet. While one can argue that this is appropriate given the external financial reporting function of the balance sheet, for internal management purposes it is negligent to exclude intellectual capital from financial management just because the firm's IC does not meet certain conditions imposed by accounting principles designed for external reporting purposes.

In the law firm context, intellectual capital can be broken down into three categories: Human Capital, Structural Capital and Relational Capital. How each is nurtured and combined for the success of the firm is the firm's Business Recipe, as follows:



We believe that it is the task of the law firm's finance director to help the managing partner devise financial and non-financial performance indicators that allow the firm to manage its intellectual capital along these three categories. With effort, the managing partner and the firm can maximize and utilize the IC needed to execute the firm's strategy.

FINANCIAL MANAGEMENT OF STRUCTURAL CAPITAL

Structural Capital consists of work flow and processes on the one hand, and solutions and innovation on the other. Investment in

Structural Capital has three measurable benefits: First, on the asset side of the equation, these initiatives are a significant differentiating factor to the clients and are powerful tools to implement the firm's strategy. Second, on the PPP side of the equation, streamlined solutions enable day-to-day engagements to become less dependent on individuals, reducing partner fear of delegation and increasing utilization. Third, and perhaps most important, innovative solutions, especially those co-developed with clients, generally allow the highest margins – not only because no one else will have this particular solution but also because the client's financial and non-financial costs of switching to another firm have just skyrocketed. This understanding of Structural Capital reaches far beyond most firms' understanding of know-how management.

Key performance indicators for Structural Capital often will be non-financial in nature; some very simple financial indicators include the following:

Cost value of time expended on new solutions and return on new solutions.

Tracking cost value of time expended on new solutions allows the firm to track how these costs develop over time (i.e. if sufficient time is spent on such initiatives) and to measure a return on those costs in terms of both time saved and profits derived from new matters that make use of these new solutions.

Ongoing training costs, expressed as cost per existing partners, associates and staff.

Many firms distinguish among training costs in nonsense ways that only satisfy the curiosity of a misguided head of professional development (one example accounts by "books, DVDs, external trainers, continuing legal education, dues and memberships, travel and other"); more useful would be tracking costs by groups of fee earners, practice groups and even client programs. In addition, the benefit of managing costs of time is clear: a decreased cost per class of fee earner or per practice group highlights potential underdevelopment.

Financial management of Human Capital

Any firm will argue that its most important assets are its people, thinking about the capacity of partners, associates and paralegals to produce billable time. However, it is equally important for partners and professionals to be capable of managing engagements, people, teams, departments and other groups (at varying levels of degree). The firms that have understood this look beyond the fee-earning capabilities and see management staff not as overhead but as one resource of a productive enterprise.

Human capital often is managed by non-financial indicators, such as average absenteeism, number of applicants for lateral partnership or employment with the firm, employee satisfaction, average number of engagements led per senior associate and the like. Managing partners for whom these indicators appear too soft may consider the financial indicators that view Human Capital as an asset first and an expense second.

Partner and employee turnover by headcount and by cost.

Turnover costs include at least recruiting costs, termination expenses, costs of client retention efforts; some firms also include the costs of initial under-productivity associated with lateral hires (both at the partner and associate level). Measuring turn-over costs by qualification and practice area allows the firm to view the developing demographics of the firm and facilitates intelligent hiring decisions that match trends in the market by practice area.

Days in recovering recruiting costs.

Recruiting costs can be measured in terms of days required to recover a fee earner's recruiting costs. The shorter the number of days, the better the firm's processes for training laterals and business case procedures for hiring laterals. Our informal research across the clients we have worked with shows that an associate on average requires as much as eleven months before his recruiting and direct costs are recovered in cash terms by fee earning activities, i.e. before a lateral becomes profitable on a net cash basis.

Cost data by demographics.

Most US firms generally keep demographic data. Collection of cost data related to hiring, retention and turnover across age, gender, law schools and other aspects of people's backgrounds can yield helpful insights about where the firm may wish to focus its future human development efforts. Of course, the benefit of maintaining these data should be balanced against potential litigation risk associated with managing based on these data.

FINANCIAL MANAGEMENT OF RELATIONAL CAPITAL

Relational Capital is made up of a number of factors, but the most important are the firm's client base, its brand and its network. A client's willingness to retain a law firm (or individuals who practice as part of the firm) is at the heart of every firm today, and retaining clients in an age where partners are willing to leave the firm for better PPP elsewhere is at the top of the mind of most managing partners.

Client loyalty indexes, average time spent on client relations, number of visits to clients and brand awareness are all valid non-financial key performance indicators by which a firm could manage its Relational Capital. The most advanced firms will find a way to estimate market share (i.e. the total legal spending in their market and their slice of it). These firms are few and far between, in part because they do not want to expend the effort of benchmarking themselves against their competitors.

Key financial performance indicators for the management of Relational Capital in a law firm include:

Return on client relations costs per existing client, per potential client, per industry and per practice area.

Most firms have just one gigantic line item for Relational Capital: "marketing expense," broken down by useless categories, such as "printing & advertising, website management, promotional materials, sponsorships, outside consulting and other." While these are nice-to-knows for cost control, they are not very useful for managing Relational Capital. The trick here is not just to focus on costs incurred: what matters is the effect that these investments have on long-term client potential. For management purposes, a firm might capitalize all client relations costs and amortize them over a three year period; the balance represents the denominator, and the numerator represents profits earned from that client.

Cost of client turn-over.

Client turnover is a non-financial measure and is fairly easy to measure (number of clients that have not used the firm's services during the year divided by total number of clients). However, the costs of client turnover are somewhat more difficult to measure, simply because the opportunity cost (the amount of revenue this client would have generated) is difficult to ascertain. For the largest clients, competitive and market share information helps: How many deals did they do with us last year compared to the total number of deals they did, and how many deals did they do this year?

FINANCIAL MANAGEMENT RELATED TO THE FIRM'S INTELLECTUAL CAPITAL

In order to maximize their competitiveness, law firms must manage their intellectual capital as rigorously as their PPP by (a) investing in the firm's IC in a way that supports the firm's strategy and (b) using financial and non-financial indicators to manage that intellectual capital. Yet, all of the above seems somewhat distant from the traditional view of financial management in a law firm. What we have described above is a methodology for managing the balance sheet side of the business which should be firmly tied into the firm's other management systems. If the balance sheet is managed well through the firm's intellectual capital, PPP will reflect the results of that management in the short-term as well as in the long-term.

This will require firm management to look beyond the firm's traditional financial statements and will require the financial management function to be refocused so that it can manage the law firm's intangibles as well as its tangibles. In order to do that, financial directors and managing partners alike must leave behind their old accounting and controlling legacy and anticipate how the firm's strategy translates into requirements for Structural, Human and Relational Capital. They must look beyond the yearly cycle of satisfying profit-hungry partners and build an institution that works irrespective of its current partnership composition. They must manage and unite the functions of professional, knowledge and business development (or training, knowhow and marketing) in a constant effort to optimize the firm's business recipe.

The long-term success of a law firm – which does not have many hard assets – depends even more on how well it harnesses, creates, maintains and maximizes its single most importance source of future profits.

One key to success will be to institutionalize Human and Relational Capital – those types of intellectual capital over which law firms have the least control – into Structural Capital and develop key performance indicators, both financial and non-financial, that are right for a particular firm against the background of the strategic goals of the firm. This can occur only if data related to the firm's investments in intellectual capital are captured and measured in the right way and are tied to the partners' performance as well as their compensation.

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