Margins: What's Real, What's Hype?

In stating the obvious, the *American Lawyer* may be reminding us of an important point.

By Ed Wesemann

Yesterday's edition of the *AmLaw Daily* did an analysis of some of their AmLaw 100 data which they called "Margins: What's Real, What's Hype." In the article they discovered and presented charts showing that:

1. Single tier partnerships had a strong positive correlation with high profit margins;
2. Lateral growth had a negative correlation with high profit margins; and
3. Firms with above average leverage tend to have below-average profit margins.

Duhhh! Next will they tell us that black is a dark color and the sun rises in the East?

In this spirit of stating the obvious, we should point out that profit margin is the amount of revenues left over after expenses have been paid, typically expressed as a percentage. So, if a law firm had $10 million in revenues and paid out $6 million in expenses (salaries, rent, magazine subscriptions, etc.), the firm would have a profit margin of 40%. If expenses go up without a corresponding increase in revenues, profit margin goes down. If expenses go down, profit margin goes up.

Accordingly, if our $10 million firm was made up entirely of equity partners, it would have no salary expense for lawyers, which would result in low expenses and low leverage but a profit margin that was, compared to most firms, quite high. If the same firm had one equity partner and all the other lawyers were paid a salary as associates or non-equity partners, the expenses and leverage would be high, but the profit margin would be low.

So, of course, single-tier partnerships, where the compensation of all the non-associate lawyers is not treated as an expense, show a correlation with high profit margins. And, lateral growth, where firms are bringing in lawyers, at least initially, as associates or non-equity partners, means more expense for salaries (plus those headhunter fees and an empty WIP and AR pipeline) meaning lower margins.

Now, if there is anyone in a leadership position with a law firm to whom the conclusions in today's *AmLaw Daily* come as a surprise, they should immediately go to Amazon.com and buy any of David Maister's books. You need a quick dose of law firm economics 101.

But, seriously, credit where it's due. The obvious conclusions of the *AmLaw Daily* do remind us that many law firms spend too much time talking about margin. Expense control is an important aspect of managing a business. And, if you're General Motors building Buicks, margin, as a statistic, is vitally important. But if you are a law firm where you can control how much of your labor costs hit the P&L, don't fool yourself into believing that having a high margin, by itself, has anything to do with profitability.

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