

## **Administering a Profit-Center Compensation System**

A profit center compensation system, in conjunction with other compensation criteria, is a method for distributing profits to partners, on a cash received basis, by allocating firm income and expenses among partners, and substantive departments and practice areas. The purpose of the profit-center system described below, is to allow managing partners and members of executive and compensation committees to determine the profitability or costliness of the performance of each partner and/or substantive department/practice area. This objective data, when considered together with the subjective contributions of each partner, will enable lawyer management to recommend the most appropriate allocation of profits to the partners. The profit-center system, described below, has been implemented with success, in firms that utilize subjective, formula driven and/or combination compensation plans for allocating profits to the partners.

It is a recognized function of lawyer management to not only recommend and administer an equitable plan of compensation but also to utilize the plan to motivate partners. It has been the author's experience that partners are most effectively motivated by cash when (1) their compensation is based upon an accurate assessment of their total performance, in whole, or substantial part, and (2) they accept those criteria which constitute the benchmarks for measurement of their performance, as well as the relative weighting of these factors.

It is obvious that any compensation plan should be widely perceived within the firm for being fair. Partners should understand the plan's underlying principles and be able to articulate what they are. Also, the plan should be relatively easy to administer and supported by objective data, to some extent. It should meet the needs of the firm, as it exists today, and inspire by its administration and/or incentives, those activities the firm wants to encourage, including new business development, high production, maintaining key client relationships, assuming management responsibilities and training associates, etc.

### **Profit-Center Compensation System**

The components of the profit-center compensation system include: (1) Fee Income, (2) Expenses, and (3) Profit. Each of these components, including how they are calculated and utilized, is described below.

#### **Fee Income Calculations**

Fee income calculations are prepared when fees are received. Income is allocated to the appropriate timekeepers in accordance with the time value of their billed time. For example, let's assume that three partners worked on a client matter last month. Partner A billed five hours and charged \$200 an hour. Partner B billed ten hours and charged \$150 an hour, and partner C billed five hours and charged \$100 an hour.

When the client pays the bill for last month's work on that matter, each partner receives credit for their time value, assuming there was no write-off or write-up of time. If the bill can be written-up, then each partner shares proportionately in the write-up. If the bill is written-down, it is presumed that each partner bears a proportionate share of the write-off. This aspect of the system causes partners to pay more attention to their supervisory responsibilities on a file. It also deals with the problem of partners' writing-off associate time, but not their own, to some extent.

Problems may arise, such as a huge write-up or bonus coming at the end of a case, perhaps in a month when only a small amount of time is recorded by only one of the lawyers working on the file. In such a case, we usually recommend that the huge write-up or bonus should probably be based on time spent throughout the entire file. It is further recommended that the Managing Partner or some other partner be appointed to resolve, or oversee the resolution of such problems by the partners involved, in a fair manner.

For purposes of cash flow, income allocations to the partners should be made to coincide with the firm's billing cycle, i.e., on a monthly basis, or quarterly if the firm bills quarterly. The monthly profit center reports will quickly become reports the partners learn to understand, and read with great interest.

#### **Expense Calculations**

Under this system, all firm expenses should be allocated to the timekeepers. The partners must make some practical decisions about how precise the accounting process will be.

Secretarial costs are allocated to the attorneys those particular secretaries work for. If all attorneys' offices are roughly the same size, office space (rent) expenses are usually divided equally among attorneys. If some offices are significantly larger than others, or some attorneys utilize considerably more space for storage, secretarial or paralegal personnel or require a library dedicated to their practice area, the rental expense attributed to those partners will be higher than the amount charged to other partners who do not require the additional facilities. Firm library costs and most administrative expenses are usually allocated equally, unless there are cogent reasons for the proportionate sharing of these costs. If, for example, a firm has a word processing center that only the litigators use, or if they use it 80 percent of the time it is used, these costs should be allocated accordingly.

The majority of firms that utilize the profit-center system treat paralegals as separate profit-centers, although they do not bear an equal share of the rent or administrative overhead as the attorneys. Also, the expense (as well as income and overall profit) calculations can and should be allocated to departments or practice areas. It is very useful to have this information because it helps determine the types of business that generates profit for the firm.

Obviously, it will be necessary to make some practical decisions about how to allocate certain costs. If, for example, the firm's best client decides the firm should make a \$10,000 contribution or to pay \$10,000 to join a local economic development council, how should that cost be allocated? It has been the author's experience that if most or all of the firm's departments do work for the client, probably all of these costs should be shared equally. However, if only one department does work for that client, the costs should be allocated to that department.

#### Advantages and Disadvantages of Profit-Center Compensation

Proponents of the profit-center compensation system report that this system enables their firm to determine which attorneys and practice areas are more profitable and which ones are not. Generating this information provides an incentive for attorneys to work on other attorney's files, and allows the firm to know which types of client work should be emphasized or de-emphasized. Having this information also enhances the opportunities for firms to consider alternative billing methods than pure hourly billing. Further, because of the correlation between the expenses incurred by the firm and its practice areas and the partner's income, attorneys become more conscious of how firm money is being spent, and try to contain costs. The author is aware of a firm in which the implementation of a profit-center system facilitated the acceptance of secretarial sharing between mid-level and senior partners.

Opponents of a "pure" profit-center compensation system, exclusive of using other criteria, claim that since the profit-center approach is oriented toward time value (production), rather than business origination, it cannot be used exclusively. Further, there may be a tendency for this system to interfere with the firm's or department's "team" approach, at least at the inception of the program. Three other concerns with this system relate to (1) the professional and interpersonal relationships among attorneys when they begin to see which attorneys and practice areas are the more profitable and which ones are not, (2) the tendency to believe that profit-center compensation will emphasize short term rather than long term thinking for the firm and its practice areas and (3) little or no credit will be provided to partners for performing consequential non-billable hours that are beneficial to the firm and its practice areas.

In light of the above comments, the profit-center compensation system may not be appropriate for every firm. There is no single objective method that will precisely evaluate the total contribution of every partner. Nevertheless, when used in conjunction with other compensation criteria, the profit-center compensation system has proven to be a valuable management tool to measure the total contributions of partners.