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What does your firm's balance sheet tell you?

In an effort to increase the net worth of their law firm, smart partners should be paying more attention to five important intangible assets on their often-neglected balance sheet, writes Joel Barolsky.

Law firm partners pay a lot of attention to their firm's profit and loss statements, but they tend to glance over the asset section of their balance sheets.

This is a missed opportunity in my view.

There are three main reasons assets are largely ignored. Firstly, in 'zero-in zero-out' partnerships no one is buying or selling their equity state, so there's no immediate need to place a value on the firm.

Secondly, in some firms, the accountants lump all intangibles into a vague and unhelpful construct called 'goodwill'. And thirdly, balance sheets tend to list boring things like plant and equipment.

From a strategic management perspective, there is a significant benefit in framing goals around making the firm more valuable. It can help identify specific activities, people and technology that are value adding and those that are value destroying.

Here are five important intangible assets that will have a positive impact on your firm's net worth.

#1 Relationship capital
Relationship or social capital refers to the strength and stickiness of existing client relationships and, where relevant, referrer and community connections.

One way to measure relational capital is to add up the lifetime value of all the firm's major repeat clients. Lifetime value is calculated by adding up likely profit from a client relationship over the years ahead and then bringing that to a net present value by using a discount rate that reflects the riskiness of that income.

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So, for example, a lifetime value of one loyal client than typically provides $18,000 of fees per annum would be $110,000 – assuming 40 per cent margin, 30 years and a 5 per cent discount rate. Firms with many of these $110,000 'assets' will be worth a lot more than those that struggle to earn the long-term trust of their clients.

Other proxy measures of relationship capital include client commitment indices, net promoter scores, client loyalty rates, average service mix per client, share of wallet of platinum and gold clients, social network strength and percentage of sole-sourced work.

#2 Human capital
Human capital refers to the quality, performance and commitment of all partners and staff. Management reports often include data on salaries, recruitment, training and turnover, but these don't get to the heart of tracking human capital growth or depletion. Additional measures might include:

- toe-to-toe analysis comparing the quality of key practitioners in the firm versus direct competitors;
- loyalty and career intention indicators
- succession and talent development pipelines by practice area;
- diversity and inclusion metrics;
- Glassdoor, Seek and social media ratings;
- employee net promoter scores;
- leadership capacity and capability;
- culture maps, highlighting hot spots or blind spots; and
- real-time measures around staff morale, firm climate, employee experience and discretionary effort.

#3 Brand capital
This refers to the strength of the firm's brand and reputation in key target markets.

Traditional measures include brand awareness, consideration, preference, use, boardroom impact, recommendation and social media following. An ability to attract star recruits is also an indicator of a firm's brand capital.

One benefit of a strong brand is the ability to command a price premium. By way of example, in 2019, Apple's brand premium enabled it to capture 66 per cent of smartphone industry profits and 32 per cent of overall market revenue while only selling 13 per cent of total handset units.

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Proxy measures around the firm's pricing clout impact might include the percentage of bids won where the firm was priced higher than competitors, depth of discounting and percentage of matters with supernormal margins.

#4 Data capital

Most firms are sitting on mounds of valuable data, with most of it stored on disconnected databases collecting digital dust. The main data islands include:

- client data such as matters delivered, interactions, service feedback, event participation, agreed pricing and billing;
- staff data such as demographics, salaries, tenure, engagement, training, feedback and performance records;
- operational data such as time records, matters processed, productivity and utilisation; and
- financial data such as revenue, margins and expenses.

Joining these data sets and applying some smart predictive analytics will allow firms to make much better decisions. For example, the analysis could point to using a specific team with a defined process to do a specific type of matter for a certain client category using a specific pricing model. Each of these choices might mean a 2 per cent improvement, but accumulatively you're looking at a +10 per cent gain without working any harder.

#5 Intellectual capital

The last category is for important bits of firm know-how that don't neatly fall into one of the other four areas. This might include proprietary legal products, algorithms, websites, domain names, precedents, templates, applications, patents and trademarks.

Growth in intellectual capital could be assessed by things such as the firm's investment in research and development and its innovation portfolio. Quantifying the revenue from new products and services can indicate success or otherwise in this asset class.

A call to action…

Take a quick glance over your firm's strategy papers and board reports over the past 12 months. Is there a way to elevate your firm's strategic thinking by delving into the intangibles that will sustain your long-term success? I bet there is.

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