

The Firm of the Past

Nothing stops an organization faster than people who believe that the way they worked yesterday is the best way to work tomorrow. To succeed, not only do your people have to change the way they act, they've got to change the way they think about the past.

—John Madonna, former Chairman, KPMG International

Nothing fails like success. Professional service firms have been operating under a predominant theory of the firm since at least the 1940s, which has served lawyers, accountants, among others, quite well.

The problem is, this theory is no longer relevant to the intellectual capital economy. We need a new theory of the firm. All learning starts with theory, since a fact, measurement or assertion not illuminated by a theory is absolutely sterile—we might as well read the phone book.

Why Theory is Important

There is also nothing more practical than a good theory, since it allows us to predict, control, or prescribe. We are ruled by our theories, whether we admit it or not. Professionals bill by the hour—and keep timesheets—because of a theory.

Yet theory is a dirty word in most business books and seminars. Usually the author will state something like: “This book is not based on ivory tower theory, but on real world examples you can use Monday morning.” I recoil when I hear that, because I know I’m about to be bored silly with checklists and a plethora of platitudes that rarely rise to the level of common sense.

The scientific method originated in Europe in the 16th century, and is one of the creations that has significantly bettered the human condition and shaped the world we now inhabit. It is one of the fourteen meta-inventions Charles Murray documents in his fascinating and scholarly book, [*Human Accomplishment*](#).

The concepts of observation, hypothesis, falsification, parsimony, and the experimental method are all components of the scientific method. All science progresses through dissension, not agreement, and being able to falsify theories and posit better ones is the catalyst needed in order to gain a deeper understanding of what we are studying, whether in the hard sciences, economics or business.

The Old Practice Equation

What is the theory of the professional service firm that has created the success we’ve enjoyed? If you were to think deeply about it, I believe you’d end up with an equation that looks like this:

Revenue = People Power x Efficiency x Hourly Rate

In Greek language, *analyze* means “unloosen, separate into parts,” which we will proceed to do with this theory to expose its many weaknesses.

First, since most firms have a relatively high contribution margin (revenue less direct labor costs), it gives them a false sense that *any* revenue is good. This in turn leads them to accept customers who are not as valuable to the firm as others, since marginally valuable customers take up a firm’s precious capacity, and keep it from reserving capacity for its most valuable customers.

Second, the way most firms were built in the last century was by leveraging people, literally building a pyramid structure. As technology came on the scene—and especially when the computer hit the desktop—the pyramids began to flatten and firms started to leverage technology. Most firms, however, will put revenue before capacity, always playing catch-up to the workflow and customer demand, and working their people at full tilt. Most other businesses—think of FedEx, Intel, etc.—will put capacity *before* revenue.

This constant full capacity utilization seriously hinders a firm’s ability to attract top talent, valuable customers and cross-sell additional services to existing customers, not to mention innovate. It also makes the partners and firm leaders believe the way to prosperity is to leverage people, and worse, billable hours. What David Maister calls the *donkey strategy* — prosperity by carrying a heavier load.

Third, most firms focus on efficiency by measuring such things as utilization rates and billable hours. Yet, if you study statistics going back at least fifty years, you’d find utilization rates and billable hours are within a very tight range. In other words, whether professionals are using a quill pen or a laptop computer, they can only charge so many hours in a year and realize so much on those hours.

Yet the theory leads partners to believe efficiency is the be all and end all of running a profitable firm. This is demonstrably false. I’m sure the buggy whip manufacturers were a model of efficiency before they were replaced by the automobile. What if you are efficient at doing the wrong things?

A business doesn’t exist to be efficient. It exists to create wealth for customers. The relentless focus on efficiency is misplaced in a knowledge environment, where we do not even have proper metrics to measure the output of a knowledge worker, let alone to value it. Yet we cling to our 100+ year-old metrics—designed for manual laborers—because they give us a false sense of security.

I’d rather be approximately right than precisely wrong, by making subjective judgments about the right things not precise calculations of the wrong things. We simply do not know how to measure a knowledge worker’s “efficiency,” because it’s not a simple matter of looking at inputs and outputs. No one would suggest tallying the cost of canvases, paints and the hours Rembrandt took to create his paintings in any way measures his efficiency, let alone the value of his output.

Was Einstein on budget for his research? Would you care?

No efficiency expert told Bruce and Jim Nordstrom to put pianos and piano players in their department stores. It certainly decreases efficiency, lowers sales per square foot, etc. Yet, how effective—in terms of customer service and competitive differentiation—has this strategy

been? The legal profession has let efficiency retard its effectiveness, innovation and creativity.

I would suggest the most innovative firms—from Intel, 3M, and Disney, to FedEx, Apple and Microsoft—are not the most efficient. They are, however, amongst the most innovative, and profitable. Consider 3M, which provides its employees up to 15% personal time to work on whatever projects they desire.

It's not the most efficient scenario, but if they didn't offer that type of personal time for people to create and innovate, we wouldn't have Post-It Notes (and think of the wealth created in that market). I think most partners would be horrified to implement a similar policy. Hence, professional firms are not hotbeds of innovation and creativity. If professionals brought the same methods and metrics they use in their firms to the computer industry, we'd have Vacuum Tube Valley, not Silicon Valley.

Last, the Almighty Hourly Rate. The profession has taught approximately two generations of lawyers the only thing they sell is their time. This is unadulterated nonsense, for a very fundamental reason—*no customer buys time*. How can you sell something the customer doesn't buy?

Look at how any customer judges the success (or failure) of their attorney. Customers buy expectations, results, sleep, peace of mind, etc, not hours. The focus on hourly rates has held the profession back from getting paid for the value it creates, and that has to change before another generation is corrupted.

Alternative to a Flawed Theory

It is one thing to light a candle in the darkness and shed light on the obsolescence of a reigning theory; it is a valuable undertaking in order to complete the falsification step in the scientific method. The harder work is constructing a better theory, one that comports to the realities professionals find themselves in today—an intellectual capital economy, where wealth is created from *mind*, not matter. Where ideas and knowledge—what economists term human capital—comprise 75% of any nation's, or law firm's wealth-creating ability.