CHAPTER 1

The Firm of the Past

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I'm willing to be occasionally wrong. But what I hate most in life is to *stay wrong*.

—Paul A. Samuelson, Nobel laureate economist

A business model is nothing more than a theory. I am defining a business model as follows:

How your firm creates value for customers, and how you monetize that value.

Let us analyze the predominant theory of professional firms. In Greek language, *analyze* means "unloosen, separate into parts." Almost every book that discusses professional firms is based on this equation:

Revenue = People Power × Efficiency × Hourly Rate

Since this model dominates the thinking of firm leaders to this day, it is worth explaining the model in greater detail to understand both its strengths and—as will be increasingly detailed—its fundamental weaknesses.

Consider a professional firm—such as accounting, legal, consulting, advertising, IT, and so on—the archetypal pyramid firm model rested on the foundation of leveraging people power, in effect their "capacity." The theory is this: Since the two main drivers of profitability are leverage (number of team members per owner) and the hourly rate realization, if each partner could oversee a group of professionals, this would provide the firm with additional capacity to generate top-line revenue, and thus add to the profitability and size of the firm. If a firm wanted to add to its revenue base, it had two primary choices: It could work its people more hours, or it could hire more people. It is no secret which choice the average

firm tends to choose, much to the chagrin of its already overworked team members.

Now compare this practice with other industries—this process of adding capacity *after* revenue is backward. If you think of any other industry or company—from Intel and General Electric to FedEx and Microsoft—capacity is almost always added *before* revenue. Consider specifically FedEx: Before Fred Smith could deliver his first overnight package, he had to have trucks, drivers, airplanes, and facilities throughout the country, all at enormous fixed costs. Most organizations operate with capacity to spare, which is vital to maintain flexibility in changing market conditions.

Next, let us look at the second element in the old theory—efficiency. Efficiency is a word that can be said with perfect impunity, since no one in his right mind would dispute the goal of operating efficiently. The problem is *there is no such thing as generic efficiency.* It all depends on what your purpose is, and how much you are willing to pay. In professional firms, the pendulum has swung too far in the direction of efficiency over everything else. It seems innovation, dynamism, customer service, investments in human capital, and effectiveness have all been sacrificed on the altar of efficiency.

The next component in the old model is hourly rates—a form of cost-plus pricing. The real antecedent of cost-plus pricing is the Labor Theory of Value, posited by economists of the eighteenth century and Karl Marx in the middle nineteenth, and falsified by the 1871 Marginalist Revolution.

Last, consider revenue. It is one thing to get *more* business; it is quite another to get *better* business. The "bigger is better" mentality is an empty promise for most firms. Acquiring more customers is not necessarily better. Growth simply for the sake of growth is the ideology of the cancer cell, not a strategy for a viable, profitable firm. Eventually, the cancer kills its host.

If market share explained profitability, General Motors, United Airlines, Sears, and Philips should be the most profitable companies in their respective industries. Yet they have all turned in mediocre profitability records, and two have been through bankruptcy. Growth in profitability usually precedes market share, not vice versa. Wal-Mart, for example, was far more profitable than Sears long before it had a sizeable market share. It seems profitability and market share grow in tandem with a viable value proposition customers are willing to pay for.

Peter Drucker once wrote, "Most business issues are not the result of things being done poorly or even the wrong things being done. Businesses fail because the CEO's assumptions about the outside provide decision frameworks for the institution which no longer fit reality" (Edersheim 2007: 243). Nowhere is this truer than in the professions. The "We sell time"

mentality is not simply a wrong pricing strategy, but far more systemic—a flawed business model.

It is a valuable accomplishment in and of itself to point out defects in a theory—or falsify it entirely. Another way to advance knowledge is to posit a better theory—a new business model for the firm of the future.