

# infocus

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## Law firm profits up by 19%

By Sam Coupland

**With the financial year having just ended, many firms are likely to finish well ahead of 2007 in most of the key financial metrics.**

**The 2007 annual FMRC Inter-Firm Comparison Survey showed that, on average, gross fees for participating firms rose by more than 12% and net profits increased by 19%.**

This strong financial performance was not universal. Many suburban practices did it tough as did quite a few smaller regional and CBD practices. Reduced profitability of these firms was not unexpected. For the past five years we have been reporting a 'cost / price squeeze', where the costs of practice have increased at a far greater rate than legal fees.

Firms with limited capacity to cope with shocks such as departing solicitors or increased price competition have seen profits eroded, despite increases in gross fees.

Successful firms ensure all partners are aware of the profit drivers that impact on the firm and how they can incorporate that knowledge into the operations of their practice group. Key areas to focus on are:

### Leverage

Most practices consider leverage in terms of the number of fee earners per equity principal. For many years this was the primary measure of leverage used by FMRC in our benchmark surveys. Whilst managers and partners of law firms know that leverage is only successful when each of the fee earners is fully utilised, the historical measure of leverage using head count distorted this.

FMRC has been working with leading firms using Business Intelligence



software to improve performance. One outcome has been to assess leverage as a ratio of employee chargeable hours to partner chargeable hours.

The following table illustrates two practice groups with the same headcount leverage of 3 fee earners per principal. Each practice group is generating a total of 4,600 hours per annum.

Realised Chargeable Hours		
	Prac Group A	Prac Group B
Partner	1,450	1,000
Senior Associate	1,130	1,200
Solicitor	1,010	1,200
Solicitor	1,010	1,200
Total hours	4,600	4,600
<b>Hours leverage</b>	<b>2.17</b>	<b>3.60</b>

The difference between the two practice groups is best illustrated in the hours leverage: 2.17 compared to 3.60. All things being equal, the benefits flowing to Practice Group B will include:

- partner time being freed up to invest in client development and mentoring staff; and
- better utilisation of solicitors – leads to improved retention

Our experience has been that by using this approach to leverage, firms are able to identify and improve key



components of performance such as:

- whether or not practice groups are appropriately staffed
- the effectiveness of delegation within practice groups
- where time is being written off

This measure of leverage is appropriate for firms of all size.

Among other things it will encourage partners to focus on the performance of their team as a whole, rather than their personal billings. Well managed firms have a greater hours leverage than they do headcount leverage.

## Chargeable Hours

For more than 10 years our survey data has reported that the average recorded chargeable hours generated by solicitors is 1,200 hours per year (or 5.2 per day).

Regardless of pricing strategy, in the crudest analysis, law firms sell time. This time may be packaged a number

of ways but the primary input is the time spent by the lawyers on client matters. In successful, commercial practices all employed lawyers are recording a minimum of 1,380 hours (6.0 per day) of which 1,265 hours (5.5 per day) are billed to clients and collected. Partners and practice group leaders have some budgetary relief to ensure each of the lawyers is utilising their time in the most effective way.

Approaches used in high performing firms to ensure lawyers achieve their hourly budgets are:

- meeting daily with junior lawyers to help them plan their day - the open door policy is not an effective substitute for structured daily meetings
- reviewing the file load of all lawyers to ensure they have properly prioritised their time and that no critical dates slip through the net
- a one-on-one meeting each week with each fee earner to discuss objective and subjective performance issues
- 6 monthly file closing days where all lawyers bring their difficult files. The group as a whole work through each file with the aim of closing or advancing as many as possible. In addition to the obvious financial benefits, there is a positive impact on lawyer stress levels as their difficult files have been turned into fees.

## Pricing

For the past couple of years price has been the primary driver of increased profitability for many firms. Stagnation in leverage and chargeable hours has been offset by increased hourly rates. This increase has been a function of both an annual review of rates and bracket creep. Bracket creep occurs when an individual solicitor's charge rate increases in line with their skill and experience.

There has been little uniformity in the Australian legal profession when determining and setting hourly rates. In most instances it is driven by the ability of the partners to sell value irrespective of an hourly rate. This introduces a personal nature to hourly rate pricing. As a result, we have seen principals in country towns charging \$400 per hour without discounting whilst some of their peers in mid size CBD practices are agonising over their capacity to get close to this.

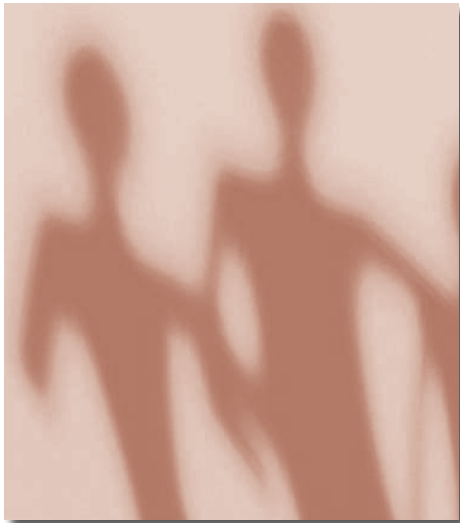
**In successful commercial practices, lawyers record a minimum of 6.0 hours per day of which 5.5 hours are billed and collected.**

The successful firms we have worked with have calculated the cost of production of each fee earner in the practice. This cost of production underpins all pricing decisions be they hourly rate or fixed fee. These firms know that each practice will have a different cost of production based on how the practice is structured, the salaries paid, the overheads consumed and the level of utilisation of fee earners. In this environment a broad brush price setting approach where the firm pegs its rates to a narrowly sampled market rate means that some firms will win and some will lose.

Pricing methodology attracts significant media attention. It is likely that many firms will continue the fixed fee trend. Partners should develop strategies that ensure fixed fee pricing does not lead to commoditisation.

## Realisation

Realisation refers to the percentage of work-in-progress (WIP) on matters that is invoiced to clients. The 2007 Law Firm Performance Survey showed that the realisation for many firms was decreasing and WIP write offs were on the rise. Some firms had partners and solicitors writing off more than 25% of their WIP for a realisation of only 75%. High performing firms usually have realisation in the range of 89% to 93%.



In a busy practice one would not expect reduced realisation – quite the opposite. Our surveys indicate poor realisation in busy and slow firms alike. Low realisation is usually a combination of:

- poor pricing for fixed fee matters
- inappropriate structure of practice groups
- firms submitting lowball pricing to secure tenders
- poor training of juniors
- junior lawyers doing work that cannot be charged

These factors can contribute to what may become a culture of write downs in a practice. This is a situation where partners are almost programmed to write off significant amounts of WIP to meet their perception of value.

Firms with strong realisation have a rigorous billing system in place. Solicitors do not sign off on the final invoice. If there has been a culture of write downs in the firm, the managing partner has to review all WIP write offs over a certain (small) percentage.

## Tying it together

Many partners and managers operate with a 30 day financial horizon where the focus is on meeting monthly budgets. As a result the activities that would make a positive long term impact on the firm are pushed aside.

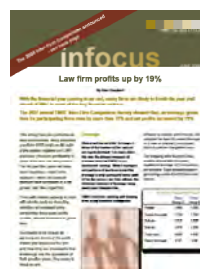
As an example, spending time mentoring and training junior lawyers is time consuming and does not have an immediate payoff. The flip side is that improving the hours leverage in the practice requires this investment in time of senior practitioners. How often have we said to ourselves 'it is faster and more accurate if I do it' knowing that we have made the decision for short term gain at the cost of long term improvement.

Successful practices have achieved incremental improvement over time in the above drivers. There is acknowledgement that partner time needs to be invested to effect this improvement. The difference between the successful firms and the rest is that the successful firms take a long term view and value the time invested.

## Profitability – a special infocus series

In the coming weeks you will receive electronic versions of a 5 part series on law firm profitability examining the 5 profit drivers:

1. Leverage
2. Margin
3. Pricing
4. Realisation
5. Utilisation



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## 2008 Inter-firm Comparison Performance benchmark survey for law firms

The Profit and Performance Improvement Guide gives your firm practical solutions for profit improvement – quickly.

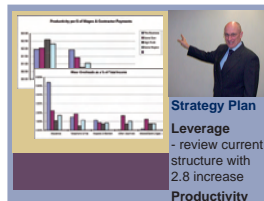
Last year we identified an average profit improvement of \$1.4m per firm.

### Outline of survey

#### 1. The Profit and Performance Improvement Guide

Your firm's financial performance is compared to other firms, including high profit firms, by size, type and location. Your confidential survey report has specific recommendations presented as a transparent profit improvement map. Your report highlights what you need to know to improve the firm. This annual business survey of the legal profession has allowed FMRC to be the trusted advisers in practice performance, measurement and improvement for 30 years.

Within two weeks of submitting your data, you receive a comprehensive report with an easy to understand summary allowing partners to gain an overview of the firm's performance. You will also have access to a live web meeting for one hour for your partners and management team.



Results discussed at a live web meeting with your partners.

#### 2. Salary Survey



This survey report will allow you to make informed salary decisions during your budget cycle. This is the only Australian survey that connects a person's production to the salaries of lawyers.

This survey reports relevant average salaries, charge rates, budgets, work done and compensation packages for all staff. It is released in December this year.

#### Your Investment

\$2,200 (inc GST) to participate in the survey for which you will receive the Inter-firm Comparison Report; meeting with adviser to review the results and plan action; and Salary Survey.

#### Guarantee

We believe that these reports will enable your firm to implement profit improvement strategies which will recoup the cost by a factor greater than ten. If we cannot identify improvement opportunities of this magnitude we will return the registration fee to your firm.

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