

infocus

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Benchmarking – focus where it matters

Over the past 12 months many legal practices have endured the most difficult business conditions for almost two decades. The broader slow down in the economy is being compounded by industry specific forces such as increased competition and heightened awareness around legal fees.

Despite this environment, the recent results from the FMRC Legal Business Monitor www.legalbenchmarking.com.au show a number of practices were achieving enviable profit results when others were floundering.

Whilst the more financially successful firms share some strategic and operational traits, there is no one true model for guaranteed success. The benchmarking data emphasised you don't have to be big to be profitable. In fact, you don't even have to be busy. Being big or busy does not ensure profitability. The profits of even the busiest firms can be hampered by poor managerial practices. Understanding and managing the economic drivers of your practice will make it profitable – and keep it that way.

In the following sections, I address common management challenges facing the profession and the relevant performance measures owners and managers need to be conscious of.

Capacity management

Most firms have a practice structure that does not match their service offerings. Common misalignment includes:

- Excess capacity – where there are more personnel than the work flow requires
- Top heavy firms – where there are too many senior lawyers given the commoditised nature of the work
- Hour glass – firms with lots of seniors and juniors and no mid level lawyers.

In most cases firms are not willing or able to do much about these capacity issues. Worse, cultural norms have crept into practices that exacerbate the problems. The following measures highlight capacity and alignment issues.

Leverage

The number of employed fee earners per equity principal is commonly referred to as leverage.

Leverage is a straightforward economic model. If one is in the business of selling time, the greatest impediment to financial success is the availability of one's own time. It is beneficial to acquire additional units of time beyond those available to the principal and on sell them at a profit. The more you sell, the more you make.

In addition to the more obvious benefits of quantum, leverage also provides compelling cost advantages as many of the fixed costs of practice can now be allocated across a greater number of chargeable hours. In short, a fully utilised leveraged practice has a lower cost of production than a non-leveraged practice.

Leverage ratios need to be considered in the context of the legal services offered. For example, a practice that specialises in complex tax matters will find it difficult to leverage beyond two or three fee earners per equity principal, whereas a high volume conveyancing practice may have leverage of greater than eight.

Hours leverage

Most practices consider leverage in terms of the number of fee earners per equity principal. Given that leverage is only successful when each of the fee earners is fully utilised, this measure of leverage only tells part of the story.

A better measure is to assess leverage as a ratio of employee chargeable hours to partner chargeable hours. Ideally, hours leverage would be higher than headcount leverage as this indicates effective delegation rather than work being hoarded by those at the top.

Our experience has been that by measuring hours 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; or where time is being written off.

Pricing Measures

There are few issues in the delivery of legal services that have gained as much media attention as the pricing of legal services.

Hourly rates

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.

When it comes to the mechanic of price, lawyers have several options.

Time based pricing is relatively straightforward, fixed fee pricing and value billing more complex. Given the importance of price in profitability, successful firms are at the leading edge in terms of rates – hourly and fixed fee.

Cost of production

In successful firms the cost of production underpins all pricing decisions be they hourly rate or fixed fee. These firms know that each practice group 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.

A critical element in determining cost of production is time recording. The cost of delivering legal services is hourly driven, regardless of how those services are then priced. It is not surprising that the best performing practices are diligent about time recording – as a management tool and a pricing methodology where appropriate.



Realisation

Realisation involves turning activity into cash and refers to the percentage of work-in-progress on matters that is invoiced to clients. Recent benchmarking showed that the realisation for many firms was decreasing and WIP write offs were on the rise. 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 benchmarks 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
- failing to set and meet client expectation

Productivity Measures

Chargeable hours

In more profitable practices fee earners are capable of doing significantly more chargeable work than their contemporaries in other firms. It is not unusual for employed lawyers to average 900 effective chargeable hours a year, better performers are capable of 1,200 chargeable hours a year, some achieving 1,400 in the Australian and New Zealand markets.

Maximising productivity involves adherence to policies and systems as well as effective delegation and supervision. Where lawyers fail to achieve performance benchmarks, supervising partners should work with them to determine the root cause.

The old maxim 'if you measure performance, performance improves' holds true with chargeable hours. If your pricing mechanic and cost of production rely on chargeable hours, it is essential to capture all activity.

Return per dollar of salary

A false rule of thumb is to assume that all lawyers should be generating three times their salary.

The reality is that return on salary is largely a function of experience. Lawyers with less than two years' experience will struggle to generate

more than \$2.30 for every dollar paid in salary. Those lawyers with between three and six years' experience will often be capable of returning 3.5 to 4.5 times their salary.

For more experienced lawyers – i.e. those with seven and more years' experience - this return drops back toward \$2.25 for each dollar of salary. The loss of return for these senior lawyers is due to salaries increasing and their roles within the firm expanding to include more client and staff management.

Our benchmarking has shown some firms are struggling to generate a \$3 return on salary for their lawyers, whilst senior associates and salaried partners can be as low as \$1.50. At these levels the firm is providing charity.

Performance relative to budget

There is enormous variation within firms as to lawyer's capacity to meet budget. Whilst the aim is to achieve at least 100% of budget, it is worth noting that lawyers who manage busy general practices seldom record the quantum of chargeable time that highly specialised lawyers, who only work on a couple of files at once, manage to record.

One should also remain aware of the reality of available work. Underutilised lawyers never achieve benchmark performance.

Margin management

The salaries, overheads and profit margins in a firm will be impacted by the practice structure.

A well-leveraged firm will most likely have a salaries margin (excluding the equity principals) of greater than 40%. This will usually result in a profit margin (before principals' salaries) of less than 30%. The

overall profitability of such a firm, in terms of net profit per principal, will be quite high as the profit is shared among fewer principals.

Conversely, a non-leveraged firm usually has a lower salaries margin and a very high profit margin. This high profit margin does not accurately reflect the profitability of the firm as no salary cost of the equity principals is taken into account. Usually the net profit per principal of low leveraged firms is low unless their charge rates are significantly higher than average.

As a benchmarking exercise, salary margin, overhead margin and profit margin are all lag indicators. In terms of directly managing the margins, there is very little that you can do except reduce expenses.



Next steps

Emulating the performance of the successful firms is within reach of most practices regardless of size. Information is an essential tool in this process. Using benchmarks, to analyse the performance of your firm relative to others across a number of different performance indicators, is a logical starting point.

Benchmarking provides an indication of the potential of your practice. It illustrates your areas of strength (to be capitalised on) and areas where the practice needs to focus attention. This forms a solid base when determining appropriate performance targets for the firm.

Success in law firm management is more about managing the results than analysing the numbers. The big challenge is time. 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.

To benchmark the performance of your firm visit www.legalbenchmarking.com.au

This link takes you to the Legal Business Monitor which is an online application. Your subscription provides you with access to these law firm performance tools throughout the financial year:

- An instant comprehensive report addressing factors impacting your firm's performance
- The ability to select benchmarks appropriate for your firm – e.g. turnover, location and specialisation
- An export to Excel for you to tailor your own graphs and reports
- Comprehensive salary and charge rate application that enables you to assess salaries, budgets, productivity and charge rates for all support staff and fee earners by years' experience
- Scenario modelling capability to conduct 'what if' analysis on your firm – an ideal training tool for partners and lawyers

