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SOME THOUGHTS ON COST OF PRODUCTION

By Neil Oakes

Not that long ago, law firms were price setters. We decided what profit we wanted, tallied up the expenses, set a chargeable hours budget, and hey presto: we had an hourly rate to charge. And charge it we did. Profits often met or exceeded budget. Want more profit? Easy, whack up the rate, job done.

How times have changed. Insourcing, digital disintermediation, commoditisation of repetitive (hitherto high-margin) work, increased client mobility, a shift away from relationship purchasing to professional procurement, and the re-entry of the global accounting firms in mid- and top-tier markets have swung the pendulum. For some time now, law firms have become price takers in a competitive market.

Profitability ultimately comes down to price, volume and cost of production. Between 1992 and 2007 law firm profitability grew, exponentially. This growth was not achieved through efficiencies or productivity gains, nor was it produced as a result of greater client satisfaction or significantly greater demand. During this time, margins, utilization rates and realization rates remained pretty constant. The lever that took large-firm partner incomes from $400,000 to $1,000,000 plus was price: the fees went up between 5 and 7% each year. This had a significant compounding effect.

I know that not all segments of the legal market experienced this ride but I use it here as an example of the historical importance of price to profitability. Before the ‘shoot the billable hour brigade’ rush to Twitter, I make the point that this observation relates entirely to quantum, not pricing, methodology. Price as the most important profit lever is a germane historical fact for all major Australasian law firms and their contemporaries in other jurisdictions. This is why a shift from price-setter to price-taker presents as a significant disruptor, probably more so than any ‘killer app’ that we are likely to see in the foreseeable future.

Price will always be important to maintaining and improving profit but in highly competitive, commoditising markets the management of cost of production has, over the last few years, become the most significant lever.

Managers are embracing strategies like automation, contracted lawyers and legal project management (some better and quicker than others, some through their own initiatives and others client-led). In this article I am not going to present a grab bag of cost-savings measures for managers. Instead I want to reflect on the management of cost of production by all practicing lawyers, to encourage a shift away from the belief that costs are ‘largely what they are and there isn’t much one can do about it’. I have seen firms trade at profit margins below 20% and others with profit margins above 60%. While price accounts for some of the difference, managing cost contributes significantly.

Calculating cost

It has intrigued me for many years how few lawyers understand cost, whether determining the cost of a matter or the cost of producing an hour of chargeable time. Of course many firms have invested in professional financial managers and business

intelligence software to do the math behind the scenes, but in firms of all sizes all lawyers should understand cost and what they can do to minimise it without jeopardising the client experience.

I speak here to partners in firms of all shapes and sizes. ‘How much does it cost for you to do what you do?’ ‘What can you do to minimise the cost?’ The answers are pretty straightforward and most relate to structure and productivity.

Consider two distinct practising approaches, one that does not utilise employed-lawyer leverage, and one that does. I have used typical averages from smaller firms (2- to 10-partner firms). In these firms, non-lawyer support per lawyer varies. I have assumed some economy of scale in partner B’s practice because relatively junior lawyers don’t utilise the same amount of ‘support ‘ that partners tend to. Non-salary overhead per person (lawyers and support) also varies slightly from year to year, but it averages 50k (or near enough).

	Partner A	Partner B
Partner salary	200,000	200,000
Number of employed lawyers	0	2
Employed lawyer total salaries	0	180,000
Total direct support salaries	35,000 (say 0.5 FTE)	75,000 (say 1 FTE)
Ave non-salary overhead per person	75,000 (50k x 1.5 FTE)	200,000 (50k x 4FTE)
Total cost	310,000	655,000
Total available chargeable time	1200	1 x 1200 2 x 1000 = 3200
Ave cost per chargeable hour	258	171

The assumed numbers are not the important lesson here, it’s all about the relativities.

Three take-outs. Firstly, leveraged practices are invariably able to produce legal work significantly more cheaply than sole operators. This is particularly the case for non-time-pricing lawyers and those whose fees for a particular service are set by the client. This is primarily why ‘employed lawyers per equity partner’ correlates so strongly to ‘net profit per equity partner’.

Secondly, the bad news. The most immediate lever for reducing cost is available chargeable time, regardless of pricing strategy. As admirable as ‘working smarter not harder’ is served up to be, working harder would seem to have its merits. I know that’s a cheap shot at managerialese, but the fact remains that salaries are usually paid on an annually negotiated basis and non-salary costs vary little with volume, therefore the greater the volume relative to this fixed-cost base, the greater the resulting profit margin. Without the lever of price, productive, chargeable effort becomes integral to profit. In the professions it has been forever thus.

Thirdly, the difficult news. The more junior (and therefore cheaper) **capable** employed lawyers are, the greater the impact of employed-lawyer leverage on cost minimisation. Again, this is most pronounced when clients set fees or the firm determines a fixed price for a service. In a price-taking business, firms that recruit graduate lawyers, train them and retain them for 3 to 5 years are going to be more profitable than firms whose employed lawyers are all highly paid senior lawyers.

Having said all that, lawfirm strategy is a complex beast. Profitability is a small part (although its absence does sharpen the focus in most partnerships). Regardless of the impact on cost of production, the long-term strategist should, in my view, continue to invest in diverse partnerships that accommodate part-time equity partners. We should continue to invest in training and retaining graduate solicitors. Finally we should never stop investing in improving the client experience.

Firms and partners shouldn’t be driven by price and cost but they should understand them. Find out what the client wants, and what they are prepared to pay for it, then manage your costs accordingly through structure and productivity.

CAN LAW-FIRM ASSOCIATES LEARN TO GOVERN?

By David Cruickshank

Many firms have gone beyond the usual training diet of substantive law and ethics to offer management and business-development skills for associates. One of the next challenges is to learn law-firm governance. But is this a topic for associate training, and does it matter?

From our consulting engagements we know that firms of all sizes have significant problems with governance. Some problems are structural – the over-sized executive committee, for example. Other problems stem from an absence of skilled leadership or a clear understanding of a partner's role in governance. Firms that take a long view, as they do with business development, should consider the case for teaching associates to govern this firm, or another, when they become partners.

It's Already Happening

Right now, the closest that most associates come to contributing to governance is during recruitment season. Many sit on a recruitment committee or are part of on-campus interviewing and selection decisions. Associates may also contribute to talent evaluations. They may be formal mentors. However, the gate closes when it comes to decisions on promotion or "managing out."

Associates can make contributions to professional development. I have worked with associate committees in planning in-house training or retreats. This involves a committee that does more than choose the retreat entertainment and menus. They help the professional-development team design the entire retreat. Working with an outside consultant on management-skills training will mean direct contact with that consultant and conversations about content tailored to their needs. They may ask for certain partners to be speakers (not always those that management would choose). In my experience, engagement with an associate planning committee is win-win. The outside expert gets to know a few of them through advance meetings, and you lower the risk of missing the skills they feel are needed.

Another opportune time to learn governance is in training on the firm's finances. The most transparent firms train associates on how the firm makes money, then follow it up with midlevel and senior associate training on the firm's financial statements, profitability and revenue projections. On making partner, there is no "cliff" to leap over in understanding the levers of profitability and how you must contribute to the firm's success.

The Case Against Governance Training

The common arguments against developing "governance competence" are:

- "We only need a few leaders, and they will emerge as natural leaders."
- "Why train associates who will not make partner and will depart."
- "The more they get involved in our governance, the more they will want decision-making power (that should be left to partners and senior staff)."
- "They are too inexperienced to know what to do with the training."

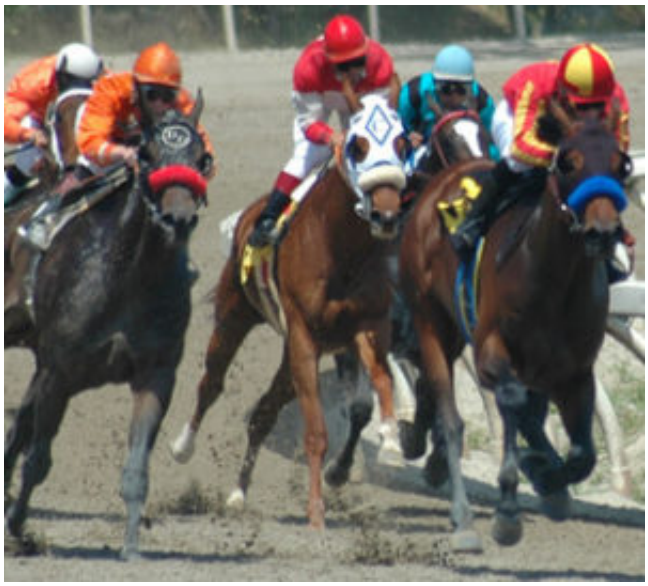
The Long-Term Payoff

The case for greater associate competence in governance begins with decision-making. If associates sit on committees, they should not be window-dressing. Along with partners, they should help with decisions on recruitment, diversity, pro bono, training, advancement and early business development. Down the road, I even envision associates on a finance committee. Once they can contribute to decisions, their incentive for getting training and experience is elevated. As for the “naturally selected few” argument, the response is to increase the pool of future partners leaders by developing the breadth of their governance competence. And if they leave? They will be ambassadors and leaders in client companies, government, public-interest and other firms.

Latham Watkins knows the payoff. It is widely seen as a very well governed firm. They train associates in governance and give them a place to apply the lessons. For years, they have had a firm-wide Associates Committee (about 50 members, a mixture of associates, counsel and partners). That committee makes decisions on training, recruitment priorities, advancement of associates, and even on who should be put up for partner. Latham Watkins has never retreated from the view that trained and informed associates will do the right thing, will make the firm stronger and will create competent future partners.

ONE MEETING YOU MUST HAVE: THE KICK-OFF MEETING

By Aileen Leventon



And they’re off… like thoroughbreds breaking from the gate and barreling down the track in single-minded pursuit of the finish line. Get the best people mobilized, act fast and make sure the client or sponsor knows you’re on it. Does this image capture the typical start of a major matter or new project in which you are involved?

The kick-off meeting is the forum for collaborative planning and the foundation of project management. It also sets the tone for sound stewardship of resources, accountability of team members, and the goals of sound economics and delivery of value. Rapid action and deliberative planning can co-exist.

“But we already planned”

Many matters and projects start with limited information provided by the client or sponsor. On the basis of some information, “known unknowns,” and a reservoir of knowledge from prior experience, it is often possible to develop a preliminary assessment, outline a strategy, identify a team and sketch the timing of key events.

There will also be many unarticulated assumptions and cognitive biases that affect resources, costs, scope and success. As we are increasingly called to account for the value we deliver, is it possible to be casual in how we manage our work? Early unstructured conversations and the free flow of documents are no longer adequate as the typical first shot at a plan.

Establishing the tone for the matter

The kick-off meeting establishes both a plan and a mindset: team members understand *why* they are doing the work or the project, what they are doing and when. They have addressed assumptions and unknowns, committed to transparency and established communication channels. How does this happen?

The business context. Start the kick-off meeting by clarifying the business purpose of the legal work or project and the resources that have been allocated. Quantify it. This gives essential context and establishes that the legal work is not an end unto itself, but an investment in achieving a business outcome. The same applies to projects in which the business case must be explicit in order to assess success.

Stakeholders. A stakeholder is a person who will be integral to or affected by the work process or outcome. “No surprises” is the watchword in project management; it is critical to identify stakeholders early and anticipate their involvement.

Many stakeholders may not be in the room – these are the people whose opinions or behavior could derail the best-laid plans and may include key decision-makers. They may be the people who are most concerned about the project’s impact on revenue, risk, and profitability, the people who must be briefed about status or decisions, the people within the organization who will review, revise or even co-author your work product. They may even be a competitor, vendor, regulator or constituent who has standing to challenge strategy or disrupt your approach. Soliciting information from the team at the kick-off meeting is essential in drawing the stakeholder map and may help in avoiding questions as the matter unfolds.

Scope of work and underlying assumptions. “No surprises” applies to the scope of work as well. Experienced practitioners know how a matter is likely to unfold, where they are making assumptions, and that unknowns could have major implications for strategy and budget. The goal at kick-off is to share that knowledge and discuss the implications of assumptions or information still to surface. Document what is outside the scope of work, either because it is unnecessary, within the sponsor’s risk tolerance or because someone else has been designated to handle these activities. Be explicit. This is the best way to minimize waste and rework.

Timeline. The time line established in the kick-off meeting plots the sequence of activities in the work plan. Sub-groups will use this as a skeleton to form their own work plan and time line. The initial meeting is also the time to clarify roles and responsibilities, and to justify the participation of outside experts. It is important to ensure that schedules are harmonized and there is commitment to the timetable.

Budget and Resource Allocation. The budget can be refined now. This is not a bait and switch – a low-ball initial estimate to get the work that is followed by materially different numbers. The preliminary budget is likely based on incomplete information and may have included caveats and disclaimers. Important aspects of the scope of work, stakeholders and priorities may not have been known. Early assumptions may prove wrong. Facts may have changed. New information may emerge. Material changes may justify change in scope and budget.

Monitoring and managing change At this point, the kick-off meeting has served its purpose. There is a work plan and a time line, identification of project risks, assignment of key roles and responsibilities, as well as budget numbers or resources attached to phases or deliverables. In formal project management parlance, this is the Project Charter and Work Plan. This living plan will evolve and serve as the basis for monitoring and communicating during the course of the matter. Describe how and when that monitoring will occur and change will be communicated. If there is buy-in, it will reduce re-work and the need for more meetings.

* * *

The kick-off meeting concludes. Then and only then, open the gates and unleash the focus, intensity and urgency to get the job done well.

APRIL 26TH, 2017: AILEEN LEVENTON, ATLANTA

By Edge International

04/26/17 ACC Value Challenge Georgia Chapter

Training program on business skills for in-house counsel

APRIL 19TH, 2017: AILEEN LEVENTON, DALLAS

By Edge International

04/19/17 Texas General Counsel Breakfast on Legal Project Management

MAY 26TH, 2017: GERRY RISKIN, BELFAST, NORTHERN IRELAND

By Edge International

05/26/17 Keynote IBA Senior Counsel Meeting

DRIVE LAW FIRM SUCCESS BY HELPING EACH LAWYER SUCCEED

By Gerry Riskin

(This article was originally published in the February 2017 edition of TLOMA Today*, the newsletter of The Law Office Management Association of Ontario.)*

In my many years of consultation with law firms around the globe, I have learned that the most successful firms are those that offer the best leadership for their individual lawyers. One of the most gifted managing partners I ever met made it one of his priorities to conduct an ongoing, never-ending study of what made the individual lawyers in his firm, and the firm as a whole, tick. Being sensitive to the idiosyncrasies of the people you lead, and helping individual lawyers in your firm to refine their practices so that they find them more challenging and rewarding, will result in long-term benefits to the company as well as to individual practitioners.

Lawyers are among the most ferociously independent people on this planet who have ever chosen to work in groups. Many of us chose the law because we wanted to be able to apply independent thinking, and have a lot of control. We wanted to be able to decide for ourselves how to conduct a matter, and how to serve a client.

In addition to being independent, lawyers are also highly critical and analytical. When we review a legal document we are always looking for omissions, and thinking about how to improve the wording. We have been trained to listen to arguments with a view to destroying them. In short, by default we tend to approach everything we see and hear in a highly critical and analytical way.

While these skills are essential to good lawyering, they can get in the way of our ability to be innovative when it comes to building practices that we find personally satisfying. The human brain will not allow us to be critical and analytical, and innovative and creative, all at the same time. As a result, many lawyers get themselves into ruts, where they find themselves performing exceedingly well in practices that they find less than satisfying.

The lawyers in your firm deserve practices that are personally satisfying while also returning the financial rewards that are commensurate with the value they give your clients. As a law firm leader, you can help individual lawyers to create a vision for attaining personal fulfillment, while also contributing to the law firm as a whole, by providing them with the tools they will need to make those personal visions a reality.

Here is an overview of some of the approaches that leaders at successful firms around the world have taken to help individual lawyers in their firms create and deploy personal action plans:

- Provide lawyers in the firm with the leeway to create a vision of the kind of clientele and the practice they want within the scope of the firm's initiatives;
- Offer professional development sessions that will facilitate their moving closer to their goals, by honing skills in such areas as courting prospective clients, cross-selling services, asking for referrals, and transferring clients within the firm;
- Conduct workshops in areas relating to client interaction that many lawyers find difficult, such as handling telephone inquiries, requesting retainer fees, and managing files where fees exceed estimates;
- Build leadership skills for those in situations requiring leadership;
- Help individuals learn ways to combat the pressures of time;
- Work with all lawyers in the firm to make firm meetings more productive and desirable for attendees;
- Offer workshops in practical areas such as billing, managing finances and optimizing the firm's technology.

Small Bites

When it comes to facilitating skill development on the part of a firm's lawyers, there is a lesson to be learned from some of the most successful corporations in the world: they have determined that trying to take people out of their work for chunks of time to train them is not as effective as providing small doses of training from time to time on an ongoing basis. Specifically, a training session of one hour – perhaps during lunch once a month – is far more effective than trying to take someone away from their work for a day or two.

Many lawyers resist being asked to spend weekends or parts thereof in training – and lawyer buy-in is key to the success of training and coaching initiatives. One of the biggest benefits of ongoing training in small amounts is that the real-world experience between sessions can influence the evolution of the training. By way of an analogy, imagine that we trained lawyers first to hit a golf ball off a tee. When we come back for the next session, we can get feedback from the participants as to how the golf game was affected by the previous session. That will allow us to debrief and fine-tune the previous session before going onto the next segment – which might be hitting the ball from the middle of the fairway, and so on. Compare that approach with an attempt to give a lawyer lessons on golf from the tee to the putting green all at one time. Your instincts will tell you which approach will be more effective.

Lead by Example

The second lesson those corporations teach us is that peers and seniors within the organization must be a critical part of the training process. An outsider may have impressive credentials, but that is no match for the credibility that the top performers within the organization enjoy. The most effective coaching teams include in-house leaders and a gifted outside professional who has both substantial knowledge and facilitation skills, so that optimal results are achieved utilizing those inside top performers.

Law firms with lawyers who have happy and fulfilling careers will prosper. Competitors cannot easily emulate them, and the advantages enjoyed by firms who have worked with lawyers to develop their own personal action plans quickly becomes obvious – resulting in benefits not only in the work environment but also on the bottom line.

MERGERS & STRATEGIC ALLIANCES – WHAT SHOULD LAW FIRMS EXPECT OUT OF SYNERGIES IN INDIA?

By Bithika Anand

There is no doubt that law firm mergers are trending like never before. One may examine the reasons why. Is it a strategy to grow numbers in terms of turnover? Is it sending a message of larger technical expertise and bandwidth? Is it a part of strategy to outsmart competition? In this article, we talk about the driving force behind exploring options of mergers and strategic alliance by firms in India, and what law firms should expect out of synergizing.

Alliances have, historically, been one of the ways in which countries used to bond and come together to form a stouter force against other, rival countries. Following a somewhat similar approach, law firm mergers are being considered as a move that would make them stronger vis-à-vis other firms. The expectations are very simple – enhanced bandwidth, more partners contributing to the top line, addition to the array of practice areas offered to clients and advantages of established brands. We will examine these factors one by one.

One of the primary factors that encourage law firms to merge is the addition to practice areas that the firm would be able to offer to its clients as a result of merging with another firm of diverse practice areas. Also, between firms of similar practice areas, mergers are a prudent strategy to let the merged firm become known as a ‘stalwart’ in a boutique practice area. This is an especially growing trend in recent times owing to increased interest by clients in specialized or boutique law firms.

Another major factor drawing law firms to look for mergers is the advantages associated with an established brand. This is largely applicable for law firms with a smaller practice, looking to merge with a law firm with a larger practice. Subject to working out modalities with respect to name change (most likely, smaller firms drop their name or get their name in the subsequent order in a joint name), smaller firms tend to gain advantages from the robust client base and well-known brand of the larger law firm.

In larger countries like India, especially the ones that are diverse in terms of geographical expanse and language, customs, religions and local practices, law firm mergers are a popular way to make inroads to far-off locations. In order to be the ‘Go-To’ firm for their clients across all locations, law firms try to open offices in different cities, covering the entire landscape of the country. Now it may not always be possible for a firm to establish an office from scratch and invest capital in building an infrastructure and office. In such cases, law firms explore the options of entering into synergy with a firm/lawyer based out of particular location by various means – say by way of merger, brand merger or referral relationships. The aim is to enhance the service offerings from a particular geographical location with least investment in terms of time and capital to set up a practice.

Another trend that has been noticed in the recent past is the ‘Panic Button Merger’. There are times when the key stakeholders, say managing or founding partners, either lose interest in running the firm, or understand the limitation in their capability to take the firm to the next level of growth. In such a state, the merger comes to them as an option to overcome the panic-struck state and reform the firm under the expert hand of a firm that has been running more efficiently or under a more efficient leadership.

What to Expect from A Merger

Now that we have examined some of the factors that drive law firms to synergize and form alliances, we should also understand

what the firms should truly expect from a synergy. The factors driving the need for synergies are like swimming on the surface. One needs to dive deeper and understand what lies beneath the synergy. Are the firms merging only to create a statement within the fraternity? Or is there a better offering to the clients? Is there a true acceptance of best practices from the synergy? Are the firms being one-up in terms of technical competency? These are some of the questions both of the synergizing entities should consider.

By merely opening an office in another city, the clients are not obliged to direct their mandates to the firm. They will obviously need to be convinced that there is a technically sound lawyer to advise them on the most correct legal course of action. Hence, the firm must look to merge with another firm or lawyers after being convinced of their technical expertise, talent, experience, legal acumen and quality of work done in the past. Due weightage must be given to the benefit in terms of talent that will be on-boarded with a synergy.

Considering that synergies are once-in-a-lifetime kind of events in the life of a law firm, the approach to exploring a synergy cannot be treated like a formality or ticking off a bucket list of desired advantages. It is definitely a serious exercise that calls for all the parties to contribute to the planning and examine all the strengths that can be synergized to raise the service offerings to the client. It calls for imbibing best practices followed by the other party without any ego and hitch of dilution of power. One cannot be driven by short-term advantages like gaining from a better brand or larger share of profits, etc. There are deeper concerns that should not be overlooked by the merging firms. Activities like culture test, practice planning, financial budgeting, marketing strategy etc. are too often ignored. After the merger, their effects are far-reaching, and sometimes irreversible.

To sum up, a truly synergized entity is one that is integrated in its aim, and its approach to achieve that aim to serve nothing but the best to the clients. Law firms should look for synergies with a view to creating better service avenues for clients and to get on board a team of quality professionals. The merging parties should be like-minded in their vision to build an entity that is managed efficiently, that swears by best professional and managerial practices, that offers its services at competitive prices, and that aspires to be a ‘one-stop shop’ for all legal requirements of their clients, serviced by a team of best legal professionals.

FORGET SYSTEMS AND STRUCTURES – “GETTING THE JOB DONE” IS THE KEY

By Sean Larkan

Successful businesses and law firms succeed because *they get the right things done*.

They determine a vision, identify strategic key objectives, strategies to achieve those, make decisions around these and then make sure they are implemented. This gets results – the real test of everything.

Too often I think firms and even my consulting colleagues around the world don't put enough emphasis on this simple but challenging concept and need. This is possibly because "getting the job done" is so hard. How often have you heard of firms, possibly even your own, making important decisions or bringing in advisers to develop new systems and processes, only to find they get patchy or no real buy-in or results? This costs time; it costs money. It can also give some really important initiatives a bad name, from which they might never recover.

Somehow it is assumed that putting in a new system or structure will, in itself, provide results. What we forget is that it is people within firms who implement stuff, do things and ultimately ensure the firm gets results and achieves success. We need those same people to naturally coalesce around and support things we are trying to do, rather than micro-management to get them across the line.

Sure, some firms do just this via draconian checks, balances, disciplinary systems and 'punishments,' but fortunately these are in the minority. Such approaches also usually only get short-term results.

Far more attention and thought needs to be given to making sure there is an approach or philosophy and culture in place in a firm which will more or less guarantee that decisions taken by firm leadership, or strategies determined by a firm, will have a good chance of getting implemented and supported by people throughout the firm.

To me this is the real, non-sexy, X-factor around achieving success. It is also the most difficult aspect of law firm management and leadership, mainly because it usually involves people changing their thinking, behaviours and styles of interaction. There is always a need for some supporting systems and structures, but these must always be the supportive means rather than the end.

Most of my work involves helping firms solve major problems or build strength and success when they have hit a brick wall, or can't work out why they aren't getting there. Invariably in such cases I find there are some acceptable systems and processes in place, and some good people, but the real problem is the missing link, the X-factor – getting folk in the firm, as a natural part of their everyday work, to help achieve implementation, results and success.

Most of these people are what I call '*bums up, heads down, working on files'* people, only interested in their immediate work challenges. You have to break them out of that mode and their cocoons and get their buy-in to come along for the ride.

In some thirty years working in or helping law firms try to achieve success I have found that only when we ensured we built these types of philosophies and culture into firms did we achieve lasting foundational strength, well-being and success.

There is no 'one size fits all' for such approaches; they need to fit the firm and its circumstances. This can be quite challenging, as it is not as simple as talking about, say, a new '*Succession Planning System'* or '*Strategy'*. It is far subtler than that. It also takes winning trust and support from oft-skeptical colleagues, but earn that you must.

LAW FIRM CAPITAL

By Sam Coupland

This article looks at specifics around law firm capital, and should be read in conjunction with the excellent article by Sean Larkan entitled, "Ignore your law firm capital structure at your peril."

Capital structures of law firms are varied among firms and there is no "one size fits all". In Australia and New Zealand there have been few instances where a call on capital has been necessary, and the amount of capital contributed by partners has not changed for years.

Of the firms reviewed for this article, very few knew why their capital contributions were set at the levels they were. In terms of the dollar amount of contribution, the range was from $150,000 per partner to $500,000 per partner with an average of $310,000.

Broad comments about the appropriateness of the capital contributions were difficult to make. There was little correlation between capital contributed and debt levels – some firms had both low capital contributions and low debt per partner, whereas others had high levels of both debt and equity. Theoretically, capital planning should be done with consideration of the firm's operating needs, growth plans and unexpected events.

Operations – day-to-day and growth

The day-to-day operations of a firm are usually funded by a mixture of debt and equity. The financing needs will vary by firm, but will usually include the firm's billing and collection cycle, some asset purchases and a cash reserve.

Of the firms reviewed, the capital contributions covered between one and five months of operating expenses, with an average of just under three months. This average does not leave much room to fund expansion. Debt is often used to cover asset purchases or fund office fitouts with the amortisation of the debt being aligned to the depreciation of the asset, which makes for relatively painless repayments.

Debt has been also used to fund expansion initiatives – both the infrastructure needed as well as the operations. Lateral hires or tucking in a practice group will require additional funding of at least three months (or more depending on practice area) before the new hire or group generates sufficient cash to cover expenses.

Looking to the future

Most firms have set their capital structure based on "business as usual", with little plan for unexpected events – loss of clients, loss of practice group or general economic downturn. In each of these instances there will be cash constraints unless the firm is able to reduce expenses in line with any revenue loss. There have been a number of instances, not necessarily among the firms reviewed, where – following a downturn – borrowings were used to support partner compensation. Over the long term this is a ticking time bomb.

Maintaining a financial cushion in terms of real equity capital on the balance sheet should be a goal for all firms. This is most easily done by retaining profits during buoyant times. Unexpected events will arise: some will cause a cash crunch, others may

be an acquisition opportunity. In either case, having a strong balance sheet will make it easier to cope.