

Variable Cost Base: Why, What, and How?

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The legal profession, and arguably all professions, have to date been comprised of top-line focussed firms. In its simplest terms, the management thinking could be summarised as 'If we get the revenue right, the costs and profit will take care of themselves'.

In most cases this proved very effective. For the thirty years prior to 2010, many of the leading firms enjoyed average annual growth rates somewhere in the range of 8% to 12%, with only the occasional hiccup. This experience was also enjoyed by many smaller firms. Indeed, if the firm had capable lawyers and a business-savvy management team, it was difficult *not* to thrive regardless of firm size or market serviced. This period was an environment where lawyers enjoyed a 'sellers' market'.

The Global Financial Crisis or Great Reset (or whatever you want to call it) that began in 2008 gave purchasers of all goods and services cause to examine how they engage with their suppliers. The advice from many commentators as to how firms could best respond to clients now flexing their purchasing muscle was to change their pricing methodology and embrace the optimistically named 'value billing' methodologies. What was absent from the conversation was how firms should be structured in order to thrive in the new market place.

Some of the clues have come from the new entrants in the legal profession. What many of these 'new law' models have in common is a variable cost base. Existing firms with a solid client base and the managerial wherewithal to change their structure are in the box seats.

With staffing costs comprising 70% or more of a firm's total expenses, the next generation of winners in the law will be those who do away with the standing army approach to staffing, and instead staff themselves at the troughs of their workload. The challenge comes in how to manage the peaks. There will be no 'one size fits all', but the things to consider include the following:

Buy an hour to sell an hour

A valuable human resources professional will be one who can source lawyers on a short-term contracts basis (weeks not months) to satisfy the work-load requirements on a matter-by-matter basis. The firm will, in effect, only pay these lawyers for the work that is billed. For this system to work will require enhanced project management skills where a partner, having looked at their pipeline of work for the next two weeks, can work out their staffing requirements and identify any shortfalls.

Contractors

It is not too much of a stretch to envisage a time when all firms will have a pool of contract lawyers they can call upon as needed. These contractors may work exclusively for the firm (such as former employees, where their family circumstances are better suited to flexible working arrangements) or they could be from an agency.

Outsourcing

To date outsourcing has effectively been a form of labour arbitrage where legal services are provided from lower cost locations. This will pick up pace as smaller firms are able to access outsource providers for some elements of their more routine matters.

All back-office functions are in line to be outsourced. Consider an office tower in a major city which may contain five or more small- to mid-size law firms. All these firms will have a back-office team covering finance, marketing and human resources. The cost of this replication is significant. One business could provide these services to the five firms (plus many others) at a cost per firm that is markedly less than the combined salaries and other costs of the existing back office.

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.

I can't put a time frame on when these changes will become mainstream, but what is certain is that change is needed – and that those who begin the journey early will reap the benefits.