EDGE INTERNATIONAL
FOUNDED 1983

inquiries@edge-international.com

Some Thoughts on Cost of Production

Featured in the March 2020 edition of the Edge International Communiqué

By Neil Oakes

(Note: This article first appeared in 2017, but due to its ongoing relevance and popularity, we are pleased to repeat it with a few updates.)

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 more than a decade, most law firms have lived a price-taker reality 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 margin, utilization rates and realization rates remained pretty constant. The lever that took large Australasian law 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 do not 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 Costs

It has intrigued me for many years how few lawyers understand cost. This is true 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 maths 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 practicing approaches, one that does not utilise employed-lawyer leverage and one that does. I have used typical averages from smaller firms (two to ten partners). 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' as partners tend to do. 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 cheaper 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 seems to have its merits. Salaries are usually paid on an annually negotiated bases 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 three to five years are going to be more profitable than firms whose employed lawyers are all highly paid senior lawyers.

Having said all that, law firm 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.

Dr. Neil Oakes has served the Australasian legal profession since 1989. Neil lives on the mid-north coast of NSW near the small coastal town of Scott's Head and enjoys all of the pleasures of coastal life. He has a large garden in which he tries to grow vegetables organically, battling every bug in Christendom. His interests include art, cooking, eating and the odd glass of wine.