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Understanding the Basics of Law Firm Profitability

Katie Langer · Friday, October 4th, 2024

Why Profitability Matters for Law Firms

Profitability is one of the most critical measures of success for any law firm. But while it's easy to fall into the mindset of "more billable hours equal more profit," the reality is more complex. Simply focusing on the standard math equation of revenue minus expenses equals profitability doesn't always tell the full story of a [firm's financial health](#).

In a recent webinar, "The Next Generation of Law Firm Profitability," Debbie Foster, CEO of [Affinity Consulting](#), and [Paige Roncke](#), Chief Revenue Officer at Centerbase, explored the essential components of law firm profitability, moving beyond the basic math to consider how different practice areas, lawyer cost and billing rates, client profitability, revenue generation, and cost management play a crucial role.

How Do Law Firms Calculate Profitability?

At a foundational level, profitability is calculated as revenue minus expenses. It's a straightforward equation, but there are multiple factors influencing law firms' revenue and expenses.

"While the simple math for profitability is accurate," Debbie says, "in law firms, we need to look beyond what the profitability number *is* to what the profitability number *could* be in order to maximize what is left."

To do this, you can define your firm's profitability inputs by considering:

- What do we want the end profit to be?

- What comprises our law firm's profitability? This could include: Practice area profitability, lawyer profitability, client profitability, and matter profitability.
- How can we use technology to help us track our firm's profitability?

“There are many ways to look at profitability, so you have to double down and figure out what combination of these inputs makes sense for your firm, and how will you track it,” Debbie suggests.

Let's take a look at where to start.

The 5 Key Drivers of Law Firm Profitability

To move beyond the basic profitability equation, analyze the underlying factors that influence both revenue and expenses at your firm. By doing so, you can identify opportunities to [maximize profits](#) and make data-driven decisions. Here are five key areas to assess in your firm.

1. Lawyer Cost Structure and Billable Rates

Each lawyer in a firm has a different billing rate and cost structure. Partners might bill at a higher rate, but they come with higher compensation. Associates, on the other hand, may have lower billing rates but can be profit centers if their work is leveraged effectively.

Take the time to figure out each of your lawyer's cost rate — what it costs them to provide their services — factoring in their salary, benefits, office space costs, and technology costs. By calculating this cost, you can determine the minimum amount each lawyer needs to bill to cover their expenses and contribute to the firm's profitability.

Example of a lawyer cost rate calculation

1. Start with the lawyer's annual salary — for easy math, we'll use \$120,000.

2. Calculate the monthly salary: $\$120,000 / 12 = \$10,000$
3. Factor in billable hours. Divide the monthly salary by the lawyer's expected monthly billable hours to get an hourly rate: $\$10,000 / 100 \text{ billable hours} = \100 per hour
4. Add benefits and overhead. Factor in the cost of benefits per hour (e.g., $\$30/\text{hour}$) and overhead per hour (e.g., $\$70/\text{hour}$) to get the lawyer's hourly cost rate: $\$100 \text{ per hour} + \$30 \text{ hourly benefits} + \$70 \text{ hourly overhead} = \$200 \text{ hourly cost rate}$

$$\frac{(\$120,000/\text{year} \div 12 \text{ months})}{100 \text{ billable hours}} + \$100/\text{hour} \text{ benefits \& overhead} = \$200/\text{hour cost rate}$$

Actionable insight: Now that you know how much it costs for this lawyer to provide their services, you can better determine a billable rate that will enable profitability. Follow this method to calculate the hourly cost rate for each lawyer and compare it to their hourly billing rate. If a lawyer's cost rate is higher than their billing rate, this could indicate a profitability problem. Ensure that work is assigned based on each lawyer's cost-effectiveness, balancing their rates with the profitability of the cases they handle.

2. Practice Area Profitability

Not all practice areas are equally profitable. Some might generate higher revenue but come with greater expenses, while others may be less lucrative but require fewer resources. For example, family law cases might involve more administrative work, while corporate law could bring in larger retainers but demand more expensive expertise.

Actionable Insight: Start by analyzing each practice area's cost rate to determine its profitability. Track the hours billed, expenses incurred, and the average rate charged. By understanding which areas are most profitable, you can make strategic decisions about where to focus your resources and who to leverage in your firm for different types of work.

“Understanding cost structure gives insight into appropriate billing rates for attorneys within a

practice group,” Paige says. “With this information, you can balance the practice area’s work, having attorneys with a lower cost rate handle work that doesn’t require a senior partner’s expertise, which starts to help you adjust your profitability for that practice area.”

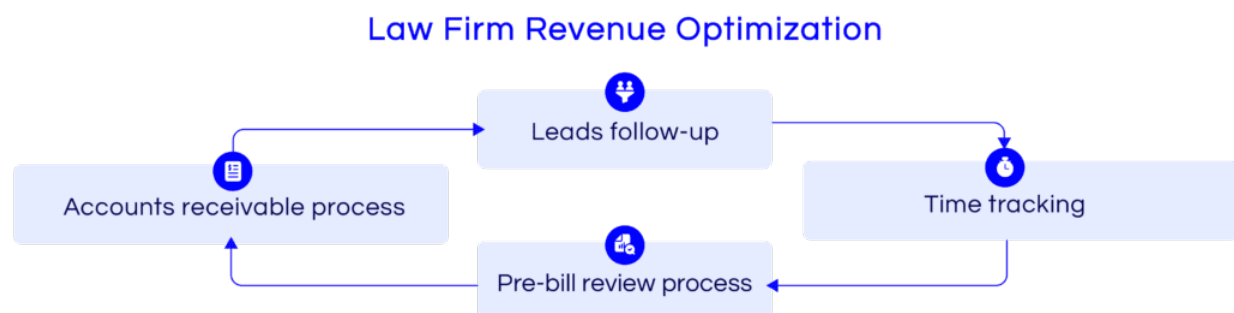
3. Client Profitability

Not all clients are created equal in terms of profitability. Some may require more time, resources, and attention, while others are more straightforward and generate higher profit margins. By understanding which clients contribute most to the firm's profitability, you can make more informed decisions about where to invest your time and effort.

Actionable Insight: Regularly review client profitability by tracking the time spent on each client’s matters and the revenue they generate. This will help identify high-maintenance clients who consume resources without delivering commensurate revenue, enabling the firm to renegotiate terms or focus on more profitable clients.

4. Revenue Generation

Maximizing revenue might seem like a straightforward goal, but the practical aspects of capturing all billable time, diligently following up on leads, minimizing write-offs, and optimizing accounts receivable collections often fall by the wayside. It's common to underestimate the significance of these seemingly mundane yet critical tasks that can make or break your firm's profitability.



Actionable Insight: Maximizing these revenue-generating tasks comes down to having the processes and tools in place to set your firm up for success. Paige sums up four actionable areas to optimize your firm’s revenue.

- **Following up with leads.** Implement a process for following up with leads efficiently to turn them into clients. “Following up with leads is your first chance to generate revenue for the firm,” Paige notes.
- **Time tracking.** Implement [time-tracking technology](#) to ensure all billable hours are captured. “Whether it's texts, phone calls, emails, meetings — you want to capture every moment of time worked for a client,” Paige says. “Even small increments of missed time can add up significantly over the year, impacting overall profitability.”
- **Pre-bill review process.** How much time gets written off at the pre-bill stage because of your perception of the client's willingness to pay? Establish clear billing policies to minimize these pre-bill write-offs.
- **Accounts receivable process.** Enforce a structured accounts receivable process for efficient collection. Paige notes, “When you send an invoice, it doesn't stop there. There's negotiation that happens, and it changes per client. You want a policy in place, so you don't get stuck in the 90-day mark writing off outstanding bills.”

5. Cost Management

Law firms have three main expense categories — personnel, office space, and technology — and managing these costs is another important factor in a firm's profitability. However, it's not necessarily about minimizing expenses, but rather optimizing what you spend.

“It's important to not waste money,” Debbie says, “and you do that by making sure you're leveraging what you buy. You need to think about people planning, space planning, and technology planning to utilize them all effectively.”

Actionable insight: Using technology as an example, if you invest in cloud-based software but don't review the updates and learn about new features regularly, then you're not leveraging the software — or your money — to its full capacity. Similarly, when you hire new staff members but provide little training on the firm's processes, technology, and culture, you're not optimizing personnel or technology, and you're risking additional expenses through attrition if staff members become disengaged to the point of resigning.

Law Firm Profitability is About More Than Just the Bottom Line

Understanding profitability isn't just about looking at the revenue minus expenses equation. It's about going beyond basic math and exploring how you can optimize each component of your business. By focusing on core drivers of profitability — cost and billing structure, practice area profitability, client profitability, revenue generation, and cost management — your firm can uncover opportunities for long-term growth and profitability.

Stay tuned for our next article, which will focus on the impact of technology and how to leverage it for law firm profitability.

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