Billable hours

Law firms are experiencing unusual circumstances currently as the somewhat steady U.S. economy, while good for many industries and businesses, is a challenge for the legal profession due to the decrease in bankruptcies and lack of litigation needs. Revenues have remained flat and firms are merging into regional and national practices to address lagging business, and to consolidate practice areas and services.

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2016 Financial overview for middle market law firms

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RSM US LLP recently reached out to law firm clients and leaders around the United States, gathering observations and experiences on financial parameters affecting their firms. Barry Rosenthal, RSM national practice leader for law firm services, used that information, along with his experience in the legal field to outline key issues middle market law firms should consider when they are looking at the financial health of their firms. Findings were categorized by law firm practices less than 50 attorneys (<50) and more than 50 attorneys (>50) in the illustrations below. Observations were collected in 2016 and reflect 2014–2015 financials. Key findings include the following:

Billable hours

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Expenses

Major operating costs for law firms continue to include compensation, office occupancy and technology fees.

For middle market and larger firms, office occupancy expense remains steady at 6 to 7 percent (see illustration), which is consistent with the standard goal of no more than 7 percent of fees collected. In the next few years, however, many firms will push that standard and look to relocate to new offices due to the momentum from the construction boom in major cities. Newer spaces will be available along with refreshed leasing options. Because of this, rent occupancy costs will increase to 8 percent or greater for many firms unless law firm partners follow what other professional services firms have done. Large and expansive offices are no longer needed to conduct business. Cost conscious law firms would be wise to focus on having modest-sized conference centers within their offices which can decrease the square footage costs per partner and contain occupancy expenses overall.

Technology expenses are another area where firms must be mindful of their spend, but in this area firms must stay on pace with increased expenses for key technology needs. Firms should consider spending at least 4 percent of fees collected for ongoing technology essentials, however many spend just 2 to 3 percent. If firms do not keep up with technology needs, particularly around cybersecurity, huge costs may hit those firms later due to inefficiencies, antiquated systems and security risks. In firms with less than 50 attorneys, they are spending 1.3 percent on technology expenses while firms with more than 50 attorneys are spending 3.5 percent.

Net income as a percentage of fees

A critical performance metric for law firms is net income as a percentage of fees collected. Net income is the amount available to pay an equity partner or shareholder their compensation. A profitable firm should be dropping in excess of 40 percent to the bottom line in terms of their net income percentage. See the graph to the right for data on the firms RSM surveyed in preparation for this report. Firms must be mindful, however, that this number for many becomes masked and reflected as a lower number because firm leverage is not at an appropriate level (see next section). Firms must be aware of this possible skew in their net income assessment.

Leverage

Leverage is defined as the number of associates for each partner. In a well-run firm, leverage should be 1:1, meaning one associate for one partner. The challenge is, some firms, in order to keep quality people, promote associates to a level of income partner, which decreases the number of available associates to align with partners. This decreased associate pool lowers the model leverage ratio. As indicated by this chart, firms are actually utilizing .55 associates and lower for every partner (equity and income), a less than ideal efficiency for busy partners in need of associates to help with the rigors of heavy caseloads. This inefficiency can put a strain on firm productivity, billable hours and the key performance metric, net income as a percentage of fees.
Revenue

For firms over 50 attorneys practicing in major cities, revenue per attorney should be at least $600,000 annually. For less than 50–attorney practices, the range should be $450,000 to $500,000 annually (see graph). An ideal revenue scenario includes high-chargeable hours, competitive billing rates and a realization of 90 percent. In addition, the most optimum time frame for revenue cycle is 90 days, which represents 30 days in process, 30 days to bill and 30 days to collect fees.

Additional data

The following graphs indicate expenses to fees collected related to marketing, human resources (HR) and accounting. This data remains mostly unchanged from year to year for middle market and other firms.

Final thoughts

As discerning clients challenge higher billing rates, compensation and operating costs rise, and demand for legal service is sluggish due to volatile economic conditions, law firms may be facing problematic times in the next two to three years. Savvy firms will look for ways to control operating costs and rising compensation, optimize billable hours and revenue cycle, tighten margins, stay on pace with growing technology needs, and in some instances, consolidate practice areas and workforces, if needed. For additional insights on how firms can stay on a more profitable track, read Strategic planning more important than ever for law firms.