

Definitely Mabey

Economic sustainability through break-even analysis

The 2013 CBA Law Firm Leadership Conference is being held Nov. 4 and 5 in Halifax and is focused on the new economics facing law firms, with particular attention to mid-size Canadian firms. In addition to wanting a large turn out because I am on a panel on the last day of the conference, I think pricing decisions and the resulting economics will play a critical role in 2014 and beyond in law firm management.



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Going out on a limb (it is always where the sweetest fruit is) I am predicting 2014 will not be a rosy year for law firms and in fact, many firms will see a reduction in their profitability. If this prediction is even partially correct, the need to be on top of the pricing game becomes even more critical.

One of the sessions at the conference involves a presentation by Rod Bristol of Profit Mastery out of Seattle, Wash. While its client base has been traditionally corporate, the conference organizers, Michael Sherrard of Sherrard Kuzz in particular, grasped how understanding break-even analysis would be beneficial not only to pricing but all kinds of situations including decisions such as taking on additional floor space.

So I decided to jump the gun a little and hopefully create a need-to-know curiosity in the break-even analysis Bristol will work through. While attendance is optional, knowledge of the tools required to manage your firms in these increasingly challenging financial times is mandatory.

Before we venture too far, explanation of some of the terms is likely helpful.

Break-even analysis in its purest form will help firms understand the relationship between cost-volume-profits.

From a pricing of legal services perspective it will enable firms to understand whether the rates or fee quoted are making a positive or negative contribution to the firm's profits.

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The costs we speak of are divided into two buckets: variable and fixed. The former are those that vary (up or down) in direct relationship to a firm's revenue. Some variable costs in law firms are bad debts; some associates' compensation; contract lawyers' compensation; some staff compensation; borrowing costs; etc.

The latter type of cost does not directly vary with revenue and in fact would exist if the firm did not bill anything. Some fixed costs include rent; errors & omission coverage; law society dues; some marketing (web sites, ads); etc.

Another term necessary to understand is contribution margin. This is calculated by subtracting the variable costs from the revenue and is the amount left that is available to cover fixed costs and profits.

Because things expressed in percentages are often easier to grasp than gross numbers normally both variable costs and contribution margin are expressed as a percentage of revenue.

The last term to remember is return on investment, which in analyzing expenditures can be the percentage firms want to receive as a payback on their investment. In the case of pricing analysis it's the profit factor.

Expenses

For those attending the conference Bristol will take you through the mechanics of the break-even analysis in more detail including classification of expenses as variable and fixed and with more examples but for purposes of this column I have developed the following example.

Sole practitioner Able has billed \$375,000 and has \$95,000 in variable costs and \$70,000 in fixed costs. His variable costs are 25.3 per cent and therefore the contribution margin is 74.7 per cent. So here are three common questions:

1. What are sole practitioner Able's break-even revenues?
2. What is the revenue required to generate a \$75,000 profit?
3. What additional revenue is required if Able's rent increases by \$1,000 a month?

Break-even revenues are not what were actually billed but the amount required to be billed to ensure the fixed costs are covered. To determine this you take the total costs of \$70,000 and divide it by the contribution margin, since we know for every dollar of revenue there is \$0.747 available to cover fixed costs. Therefore the break-even revenue is \$93,708.

In order to generate a profit we first have to cover the fixed costs. So in order to determine the revenues required to make a profit of \$75,000, we divide the sum of \$70,000 plus \$75,000 by the contribution margin. Therefore the revenues required to generate a \$75,000 profit are \$194,110.

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Remember we said rent was a fixed cost and we calculate the revenues required to cover fixed costs by dividing the fixed costs by the contribution margin. Therefore the annual revenues required to cover the increase of \$12,000 annually in rent is \$16,064.

Before moving on to how this analysis can be used for pricing there is the obvious caveat: The allocation of

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expenses between fixed and variable is an important exercise and not a simple one as some expenses will be seen as both fixed and variable—e.g. associates and staff salaries— because they can't always move on a timely basis with changes in revenue. You have to decide your preferred allocation methodology and stick to that interpretation.

Pricing

The following discussion and example is not taking a stance on the much-heralded death of the billable hour as a billing unit, rather deals with it as a costing unit whether for fixed fee or billable hour fee.

Increasingly firms are being asked to budget the number of hours a matter will take and then produce an estimated fee. Clients are onto taking the hours times a standard rate so firms must strike a fee they hope makes a contribution to their profitability.

The basics of the break-even analysis raised earlier in this column will help firms do this with an increasingly higher degree of accuracy (allows for some trial and error initially).

The best way to show how this tool will assist firms in making this call is by way of example:

ABC LLP billed 5,000 hours last year which resulted in \$1,500,000 in revenue. The firm's variable costs were \$600,000 and had fixed costs of \$400,000. So here are five common questions:

1. What was the contribution margin per hour?
2. What is the number of hours required to be billed to break even?
3. What is the break-even fee for a matter estimated to take 250 hours?
4. If my fees drop two per cent how many more billable hours do I have to bill to break even?
5. If my fees increase two per cent how many fewer billable hours do I have to work to break even?

To calculate the contribution margin you first calculate the revenue per unit by dividing the revenue by the hours billed to arrive at \$300 per hour. Next you divide the variable costs by the number of hours billed to arrive at \$120 per hour (or 40 per cent). The contribution margin per hour is therefore \$180 (60 per cent).

To calculate the number of hours required to be billed to break even you divide the fixed costs by the contribution margin per hour. That means ABC LLP must bill 2,222 hours to break even.

The total fixed costs were \$400,000 or \$80 per billed hour. Fixed costs for 250 hours therefore would be \$20,000 and, using a contribution margin of 60 per cent, the break-even fee on the matter is \$33,334.

With a two-per-cent drop in fees the revenue per unit would be \$294 and the variable cost per unit would be \$118 resulting in a contribution margin per unit of \$176. With the same fixed costs (not revenue sensitive) it would take 2,273 hours to break even or 51 hours (2.3-per-cent more units to break even).

"...the increase in the number of units required to break even when fees drop is greater than the

Of note here is that the increase in the number of units required to break even when fees drop is greater than the percentage drop in the fees.

percentage drop in the fees."

With a two-per-cent increase in fees the revenue per unit would be \$306 and the variable cost per unit would be \$122 resulting in a contribution margin per unit of \$184. With the same fixed costs (not revenue sensitive) it would take 2,174 hours to break even or 48 hours (2.2-per-cent fewer units to break even).

In setting the fee for a single matter the firm would add in the level of profit they desired to arrive at the proposed fee. This example simply shows what a break-even fee would be.

Reminder

As I indicated earlier, Bristol will take you through the mechanics of the break-even analysis in more detail than I could in a single column, including classification of expenses as variable and fixed and with more examples. I hope to see you there.

Until next month, as Harry Beckworth is attributed as having said,

"Setting your price is like setting a screw. A little resistance is a good sign."

Comments or Questions?

First Published in *Canadian Lawyer* October 2013. Copyright © Applied Strategies Inc.

