



HOW MUCH DOES YOUR HOUR COST TO PRODUCE?

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Why should you be able to answer this question?

A large number of you out there read the title of this article and immediately thought, “Who cares?” After all, if you’re charging a competitive market rate for your work, and billing and collecting, isn’t that all that really matters? Well, the truth is that if you’re always working on a billable hour basis, practice primarily one area of law, have no partners or associates, and always have as much cash and profit as you’d like, then this may be irrelevant information. For the rest of you out there, let me present some real-life situations where knowing the answer to this question will help you immensely.

Situation One: A prospective client asks you to give them a quote to do work on a flat fee basis. How comfortable do you feel about it? Chances are, not very. In fact, *most* attorneys are highly uncomfortable with the prospect of flat fee billing. There are a number of reasons for that. First, it is often difficult to know how long it will take to complete the work because so many different factors can change the difficulty of the project and therefore the number of tasks required to complete it. Second, most attorneys just don’t know how long it takes to complete most individual tasks.

Truth be told, most attorneys and firms just don’t consistently track and analyze information over time which will help reveal how long it takes people at various levels in the firm to complete the component parts of a task or project. Nor do they analyze and have a strong handle on exactly what steps or tasks go into completing a given project. When attorneys worship primarily at the altar of the billable hour, there appears to be little or no incentive to perform this analysis, nor to use it to define and refine “best practices” for the sake of efficiency.

Haven't you ever wondered why so many other professions have the ability, without blinking, of quoting work on a flat fee basis, or at least providing high quality estimates, when you cannot? Don't kid yourself that it's because their work is ultimately so much more predictable. The difference is that they have carefully analyzed over time exactly what tasks are required to be performed by different levels of workers, and know the component cost of labor and out of pocket costs for each task involved in the project. And if you've gotten estimates for various services, you know there are always caveats about "unknown" factors not included which may create additional costs. You should be able to do this with comfort too.

Situation Two: Your department is trying to develop a strategic plan. You want to know which areas of practice / industries provide better profit opportunities for practice expansion. That's not to say that you may not want to develop a wide-spectrum marketing approach. But given the limited time resources most firms have available, (not to mention budgeting constraints), it usually makes most sense to identify targets of greatest opportunity either in terms of available clients, or in terms of lucrative work, and concentrate efforts accordingly.

Situation Three: You are part of the management committee at a firm, and want to determine just how profitable a department, client, or attorney really is. Whether you are looking to expand, acquire, promote, demote, or downsize, you will need the same information.

Situation Four: You do contingent work, and although there is plenty of money, you want to know just how much profit you are really making on various cases, and what the respective investment is, so you can more accurately determine whether taking on a case has good profit potential, and whether the resources are available.

Situation Five: You have been a solo for more than 10 years. You want to begin to scale back your work to just a few practice areas. Which will provide the highest yield for each hour you choose to work? Which the least?

Situation Six: You want to determine whether one or more attorneys / paralegals in your firm is working as efficiently as possible, or determine whether your in-house training/mentoring program is effective.



I could continue to provide examples of actual situations you may have already encountered, or likely will encounter in the future. What they all have in common is that your firm's ability to answer the question or make the right decision is based upon 1) knowing the component cost of producing an hour; 2) knowing how many hours get produced in given time spans like days or years; and 3) knowing how many hours get consumed performing identifiable tasks and projects.

Remember, in the absence of good data, one cannot make good business decisions.

I am reminded of a true story my father told me. He was a successful manufacturer's rep who sold lamps by the millions. His customers were huge national chains like Macy's, Sears, Montgomery Ward, and K-Mart. They bought each item by the boxcar load. One time my dad designed a new item, and as usual had the cost estimator give him the total cost to manufacture each unit. Based on that number he produced the showroom model, took the stock photo, and priced it accordingly.

His first customer ordered 5 boxcar loads of the lamp. Right after the order was placed, the cost estimator called my dad and informed him he had made a miscalculation. Based on the wholesale price, the manufacturer would actually *lose* a little over a dollar for each lamp produced. Being a man of his word, my dad filled that order at the quoted price anyway.

I was very young when this happened, but my father spent his life imparting business wisdom to me anecdotally from an early age. I never forgot the points of this important story. From an ethical perspective, one's word must be one's bond. More importantly, from a bottom line perspective, quantity means nothing. Not quantity sold, nor gross receipts in the door. Making money is not about volume. In fact, in the absence of accurate business data, one can "sell" oneself into the poor house quickly.

So there you have it, folks. What really matters, when it comes down to it, is component profitability. And the only finite component we have in a law firm is the hour. If you don't have the best possible information about each hour, you're devoid of the most basic and important information necessary to run the firm, strategically plan, and manage and improve profitability. Don't assume that because you or others at your firm are working at a feverish pace that you are going to make more money and be more profitable. Just the opposite could be happening.



Answering the question posed in the title of this article isn't too hard. It does require tracking certain information, however. For example, it's based upon accurate timekeeping. There's just no way to determine the actual cost of producing an hour if you don't record the hours produced. That means that even if the work is flat fee or contingent, pro bono or even non-billable to a client, you still should know with a high degree of certainty how *many* hours were produced, *where* they were invested, and at what *rate* of return.

HOW TO CALCULATE THE COST

On a firm-wide basis, the cost of an hour is calculated simply by dividing the firm's actual total overhead cost for a given time period, (excluding partner compensation and benefit costs), by the total number of hours produced in the same time period. When the analysis is done to determine the actual cost and/or profitability of an hour by attorney, office, or department, the math gets a little more complex. Costs of production must be broken down and categorized as either direct or indirect costs. Then the sum of direct costs and share of indirect costs are divided by the total hours produced by that attorney, office or department.

Direct costs when computing attorney profitability include such things as compensation, benefits, dues, CLE and travel costs. Generally, direct costs are those which are easily identifiable and associated with a particular person.

Some costs can be correctly classified as *either* direct or indirect. For example, costs for shared staff like a secretary or paralegal might be easily determined on a direct basis by dividing the total cost for the secretary between two assigned attorneys. But when it gets too dicey because one uses a much greater share of the resource or accounts for a greater percent of the cost than the other, it may be better to categorize the expense as indirect. Bookkeepers, receptionists and administrators, for example, are allocated indirectly.

All the indirect costs are added up and then divided among the timekeepers in a manner which makes sense. A typical allocation may be based on a factor of 1.5 for each partner, 1.0 for each associate, and .5 for each paralegal. Another typical formula for a different type of analysis, say by department or office, would be to allocate indirect costs based on the proportionate number of hours produced or number of associated timekeepers.



Professional liability insurance is an example of a cost which can be categorized as direct or indirect. Typically it is treated as an indirect cost, so it is added into all the other indirect costs and divided by the number of attorneys to get the cost applicable for each attorney. That's what is normally done. But if one area of practice (IP for example), or department, or even attorney with a bad claim history, is responsible for an unusually high premium, the firm may instead decide to allocate different percentages of the premium directly to individual attorneys or practice groups.

Within a single expense category, some items can be direct, while others are correctly categorized as indirect. A perfect example would be marketing expenses. Firm-wide initiatives like client parties, cost of an outside consultant, or maintenance of the firm's web site, would typically be indirectly applied. Whereas, costs for specific client entertainment, client seminars, and maybe even a TV or yellow pages ad, may be directly attributable to an attorney, department or office.

Another name for what I'm describing is cost-centered or profit-centered analysis. And so I must add a word of caution. This information is essential, but can also be dangerous. Just as gasoline is a necessary ingredient to drive a car, but is highly dangerous if carelessly handled, so too are the results of cost-centered analysis.

Performing this analysis is essential regardless of firm size. You really need to know how much each hour costs you to produce, and know how it varies based upon client, type of matter, office location, or timekeeper. You really need to know how much profit that hour produces based on the same variables. But this information is for management purposes only, and often is best viewed *only* by management. The various judgments made regarding how to classify costs, directly or indirectly, must be made with scrupulous honesty and dispassion, and consistently applied. Consistency is key to credibility and reliability of the data.

I don't want you to think for a moment that performing this analysis is an extremely simple process. It might be. If your firm has decent accounting records and timekeeping habits, it really can be fairly simple. If you're starting a new firm, and/or installing a new time & billing / accounting system, with some forethought you can set everything up to make it easy. On the other hand, over the years I have assisted many firms in performing this analysis. It often calls for an overhaul of the chart of accounts, better accounting and timekeeping procedures, and sufficient time for new data to



accumulate in order to be properly analyzed. In each case, however, the firm was enlightened by the resulting information, and improved its decision-making and profitability as a result.

There are a few good publications I can recommend to help guide you through this analysis. Keep in mind that my assistance is just a telephone call away.

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