



Business of Law Module Supplement

In order to understand the business of law firms, you first have to understand some key vocabulary terms used to define law firm profitability.

Gross revenue is all of the money earned and collected by an organization. In the case of a law firm, this is the total of fee income from legal work. An organization's **net income** is the money left over after expenses are paid. This is calculated by subtracting all expenses from the gross revenue. Note that equity partners' compensation is not an expense. Rather, net income is the firm's profits and equity partner compensation is a share of the profits. A firm's **profit margin** is calculated as a percentage and tells you what percentage of gross revenues remain after all expenses are paid. It is calculated as net income divided by gross revenue.

People are the largest expense of a law firm, including non-equity attorney and staff compensation and benefits. Together, these typically account well more than half of all law firm expenses, even up to 80%. Other expenses include real estate costs, technology, and marketing, though as they comprise the minority of expenses there is often little room to control expenses even as they are critical to partners.

Overhead is an informal term for organizational expenses other than compensation and benefits, though some organizations will include compensation and benefits in the term. It is valuable to understand what is being discussed when using this term.

How to Figure Attorney Profitability

You're an attorney in private practice. Your hourly billable rate is \$300. You had a strong year and billed 1,800 hours. You know your firm's realization rate for the year was 85%. What was your annual revenue to the firm? Multiple your hourly rate by the number of hours billed, then multiple that number by the firm's realization rate.

Your annual revenue is \$459,000.

But your annual revenue doesn't represent the bottom line. To figure out your profit to the firm, to subtract annual expenses from your annual revenue. Those expenses are your annual salary, the cost of the benefits provided to you by the firm, and your share of the firm's overhead expenses.

You know your annual salary is \$160,000. You find out from HR that the annual cost of your benefits is \$50,000. Accounting tells you that the firm's Overhead per Associate cost is \$200,000 for things like your portion of the rent/office space you occupy, your portion of your assistant's annual salary and benefits expenses, your monthly technology and data charges, training and your legal research subscription fees.

With this information in hand, what is your Annual Profit to the firm?

That is \$49,000.

To put this another way, the firm needs you need to bill and collect at least \$410,000 before your firm makes a profit from employing you.

A simple example to illustrate the importance of realization rate:

A law firm bills your time at \$250 an hour and you average 1,800 billable hours per year. Your firm has an 80% realization rate for fees collected. After subtracting out the value of your salary, benefits, and overhead costs, the firm has determined that your annual profit is \$5,000.

This table shows what effect various changes in billable hours and/or realization rates will have on the annual profit per associate amount. The more profitable each individual associate is, the more profitable the firm is.

	Billable Hours Per Year		
Realization Rate	1,800	1,900	2,000
70%	(\$40,000)	(\$22,500)	(\$5,000)
80%	\$5,000	\$25,000	\$45,000
90%	\$50,000	\$72,500	\$95,000