The law firm economic model (hourly billing)

In professional service firms that bill by the hour, the following formula with five drivers can be used to compute profits per partner. (In this discussion, “partner” means equity partner.

Profits per partner = Realization rate (actual firm revenues ÷ standard rate revenues[2]) **x**
Average standard rate (standard rate revenues ÷ # hours billed) **x**
Leverage (# timekeepers ÷ # partners) **x**
Margin (revenues - expenses, as a percent of revenues) **x**
Utilization (# hours billed ÷ # timekeepers)

Timekeepers consist of partners, of counsel, associates, paralegals and certain other specialists who bill by the hour, with partners (equity and non-equity) and associates responsible for the great majority of time billed. In business terms, these five drivers can be thought of as follows:

- **Realization rate** is the percentage of standard billing rates that is actually collected. (Standard rate revenues in the formula above are the revenues that would have been earned if the hours of the various timekeepers had been billed at the firm’s standard hourly rates.) Realization rate reflects agreed-upon discounts from standard rates, write-downs (fee reductions taken before sending the bill) and write-offs (fee reductions after sending the bill);
- **Average standard rate** represents the blended hourly rate for the firm that would have been realized if billed hours were collected at standard rates. Average standard rate multiplied by realization rate equals the firm’s actual average hourly rate;
- **Leverage** is the ratio of fee-earners to equity owners – conceptually the associate/partner ratio. Mathematically Leverage is 1 plus the associate/partner ratio;
- **Margin** is the traditional profit margin concept – the percentage of revenues that become profit after payment of related expenses; and
- **Utilization** is also sometimes referred to as Productivity. It is the average number of hours billed by each timekeeper during the period being considered. For a firm that bills by the hour, the most productive timekeepers are those who work the most hours.

In practice, almost any action may affect more than one of these drivers, often in different directions:

- **Rate increase.** For example, if the firm raises standard rates, Average Standard Rate will increase but Realization Rate is also likely to drop, offsetting some of the profit improvement, because the rate increases won’t completely ‘stick,’ especially in the current economic environment for law firms.
- **Lawyer training.** As another example, if the firm increases billable hour targets for associates, Utilization will increase because most lawyers will seek to meet the new targets. However, efficiency may decrease as lawyers become fatigued, which will likely cause lower Realization Rates as clients resist higher fees for the same work. In addition, lower morale may result in associate departure, which will reduce Leverage. The net effect on profit will depend on the extent to which lower Realization Rates and lower Leverage offset the effect of higher Utilization.