5 key ratio performance indicators for law firms

Ratios are an essential method to measure the performance of any business and to track progress in delivering strategies and targets. They also provide stakeholders with a straight forward way of assessing the health of a business over a period of time.

There are countless ratios a business can derive from their financials and operations but it is imperative the business carefully considers the factors critical to its survival, success, and strategy so measurements are relevant.

Law firms vary in many aspects of course but some or all of the 5 ratio measures below will have relevance to many practices:

Cost per hour of fee-earner:

$$\frac{\text{Fee-Earner salary / draw + Ers NI + Allocated Overhead}}{\text{Fee-Earning hours undertaken}}$$

Just as a manufacturer of products would 'cost' its production, it is imperative that law firms understand their cost base and how much investment is required to deliver fees. This allows decisions to be made on work allocations, work type offerings, pricing, and central costs to name just a few. A clear and accurate budget is required so central overheads are known and can be allocated to fee-earners (based on a pro-rata of hours worked). Of course if a fee-earner is working less hours than expected then the cost per hour increases so the measure also aids the understanding of efficiency and input of a fee-earner and what they need to do to create profit at the required levels (hours and recovery).

Profit/Loss per matter:

$$\frac{\text{Fees billed on matter}}{\text{Cost of fee-earner input to matter}}$$

The first ratio considered provides a cost per hour to the firm of a fee-earner. This in turn gives us information that allows an accurate indicator of % margin on any case, and in turn consideration of departments as a whole. We can also assess any capacity issues from the result of this ratio – if matters are making a satisfactory return but overall profitability is not as required it suggests that there is too much 'down-time' / lack of work for the amount of resource the firm is employing.

WIP / Debtors Lock up days:

$$\frac{\text{WIP + Debtors}}{\text{Fees Billed}} \times 365$$

Legal firms often fail through 'a lack of cash rather than a want for profit'. Work in progress is inevitable and debtors likely. Hence it is important to control these levels as they can strangle cash flows. Law firms will have differing lock up day ratios depending on the type of work they do so it is helpful to benchmark against similar firms. Looking at monthly trends is important to see if there is drift. A review of this ratio allows an assessment to be made, targets agreed, and then for strategies to be agreed and implemented. An increase of the days can also mean old and unbillable WIP is growing and a ‘dusty files’ review exercise should be considered on a regular basis.

WIP Realisation: $\frac{\text{Fees Billed}}{\text{WIP Realised on bills}}$

Ensuring WIP is written down correctly when billed is imperative as it ensures the business is calculating profitability correctly on work done. A starting point is required to ensure WIP values are accurate and are in line with expected return (fees) from the work (the first ratio discussed can help with this exercise). On a regular basis the WIP realisation value should be calculated to check the correct level of WIP is being written down against billing. If there is too little then there is a chance the WIP balance sheet value is being inflated and profitability is not as high as thought.

Debt-Service coverage: $\frac{\text{Earnings before Interest and Taxes (EBIT)}}{\text{Total Interest Expense}}$

Many firms have to carry considerable WIP due to the nature of their work and this needs funding. Lenders can get very nervous about this ratio – effectively it asks the question of whether a firm can service its debt repayments. If a firm is making 40k EBIT (Earnings Before Interest & Tax) a month and had loan repayments of 40k its debt coverage ratio for that month would be 1. Anything under 2 is likely to make a lender nervous! Considering funding requirements and ability to service debt in tandem is crucial. Strategies are needed to ensure funding can be invested to create profit levels high enough for this ratio not to be a problem.