



## PRACTICE

# Small-Medium Law Firm Viability 101

BY **ROB KNOWSLEY**

FOR SOME YEARS NOW THERE HAS BEEN A lot of discussion about the viability of small/medium legal practice – unfortunately, much of it quite negative.

For at least the last 30 years various pundits have signalled the eventual disappearance of the smaller, general, legal practice.

Commentators more recently have argued that we are heading to a gross over-supply of private practice lawyers, assuming that there will not be enough work to go around, and that revenues and profitability will inevitably fall.

I have a much more positive view of the future and have penned this article from that perspective, looking back across the decades since my admission in 1975, to draw on a wide range of experiences in the trenches with small-medium practices.

I freely acknowledge that my thoughts on what is important to viability will not necessarily align with what might be found in a textbook on the subject.

## Preliminary points

Law is a profession, with very special considerations applying, but for the majority of practices similar considerations apply as to those for ‘normal’ businesses. Viability is important in both.

What ‘viable’ is understood to mean will differ widely, even wildly, from practitioner to practitioner.

Many readers might consider that current conditions are somewhat less than favourable, but as always, those participants in any marketplace who best understand the keys to success and best react, getting the fundamentals right, will achieve the best outcomes.

What size delimits a ‘small-medium’ legal practice in New Zealand? For the

purpose of this article, I would set an arbitrary number of lawyers in total at 19, for the upper limit of small-medium practices. Numerous statistics use different numbers. My reasoning is that, above this level, practices tend to have genuinely experienced managers.

Around 97% of New Zealand firms fit into this grouping, as at 1 February 2018.

Importantly, although the range of numbers used to delineate ‘small’ or ‘medium’ can be a bit rubbery, the principles of viability for practices are pretty much standard.

In looking into the definitions of ‘viability’ as my logical starting point I came across these: firstly from the New Zealand Inland Revenue (IR) website tools for assessing the viability of your proposed business, and from the Australian Tax Office (ATO).

**IR...**

“Your ... venture will need to generate profits each year to meet your requirements. Profits are needed to generate an acceptable return on investment (ROI) and pay salaries or wages”.

**ATO...**

“Viability is defined as the ability to survive. In a business sense, that ability to survive is ultimately linked to financial performance and position. A business is viable where either:

- it is returning a profit that is sufficient to provide a return to the business owner while also meeting its commitments to business creditors
- it has sufficient cash resources to sustain itself through a period when it is not returning a profit.”

Readers should immediately discern therein an important difference between ‘surviving’ and ‘thriving’.

It is difficult to discuss viability without examining carefully what is meant by ‘a return to the business owner’. In my view that has to be clarified in terms of implications in day-to-day operation of a legal practice.

If the owner works in the business (as is the case in most small practices), the owner has to, at least nominally, be allocated a

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salary commensurate with their effort and market value of their work, plus normal benefits.

Why would employees be provided with various benefits beyond base salary as a matter of legal obligation, or market forces, and the owner working alongside them not?

Think annual leave, long service leave, carer's leave, superannuation, etc: it can be quite a list.

In determining a remuneration for the owner's efforts in working in the business alongside employees, it is important not to use a figure that is purely nominal and unreasonably low. To do so is to risk real confusion about whether the practice is properly profitable and viable.

It may indeed be 'surviving', but at what hidden impact on the owner?

In this regard I regularly see principals paying (or notionally allocating) themselves a salary that is considerably less than that being paid to some employed lawyers in the firm. Where that scenario is actually appropriate, it should be the exception rather than the norm.

It should also be noted that the mere 'allocation' of a reasonable salary to an owner who works in the business, for the purpose of better assessing practice viability, is not to be confused with issues of taxable income.

This basic remuneration for working in the business is one part of an owner's total return, but it is not to be confused with

'return on investment'.

After the 'remuneration package' of a working owner, what is considered a reasonable return on investment? That could be the subject of a separate article.

Practice management guidance from lawyers' professional bodies seldom, if ever, addresses what is considered to be a reasonable profit margin in percentage terms, whether before or after principal's salaries.

Businesses are valued every day including a calculation of the level of risk that historical (last 2-3 years often) genuine profit is likely to be maintainable for a reasonable period in the future.

The higher the risk perceived to the maintainability of the historical profit, the greater return an investor in the business should want to see, so they can recover their investment more quickly before any big risk factors may kick in.

Simply put, the higher the risk, the faster the investor should be wanting to get their capital invested repaid. That said, it is reasonable that different owners will be happy to live with different expectations about returns, but need to be mindful that potential successors may well have different expectations, that could well impact their perception of the value of the practice. (More on this later).

Well-managed small-medium legal practices are, on average, only moderately risky in my view, and ROI sought might be expected to be 20-25% typically. Note

the critical qualification, 'well-managed'.

It should go without saying that responsiveness to enquiry, quality communication, and doing the legal work well and promptly are givens.

At the heart of viability are profitability and management of working capital.

## Planning

Planning is essential, but it is important not to over-complicate planning at the expense of continuous execution of a good basic plan.

Identify a manageable group of key things you need to always do well to achieve reasonable goals, and arrange to do them, regularly tracking performance.

Too many firms invest a lot of effort in overly-elaborate plans, and begin to fail on execution the moment the plans are completed. The plan is not the end goal, only the preparation for the start of the next stage of the journey.

Identify a level of profitability that would be acceptable, and work out how you would achieve that, generating sufficient revenue to cover expenses (including all salary of owners discussed earlier), and creating an acceptable profit margin.

Identify the types of work that you believe are available that you and your team have strong skills in, and that generate acceptable fee levels.

Build into the planning a strong understanding that the majority of revenue will go to expenses, including *all* salaries and

associated outlays. It is only after all that revenue is generated that additional revenue will create your genuine margin. This is a key part of the reason not to take planning lightly.

If you haven't done this exercise before it would be wise to target a modest margin of 10-15% of revenues. This is where the vast majority of small-medium firms sit anyway, and once achieved, provides a very sound platform for significant improvement.

This exercise will, in effect, give you a basic budget.

The revenues in the main will come from the labour of your people applied to the clients' files. Doing some careful human resources planning will show you how much of the available labour can be applied to client files if they are available to be worked on, and how much labour needs to be allocated for investment into what I term, FirmTime.

FirmTime covers such things as marketing, technology, training, knowledge management, supervision, services development, premises and general administration.

In this aspect of your planning, appreciate that the cost to you of each available hour of labour is the same whether the investment is applied to ClientTime or FirmTime. Plan both carefully, matching skill sets to whatever type of work that you expect to need/want to get done in each planning period.

### Cash flow and credit control

There will be few lawyers who don't appreciate the very practical difference between when a file gets worked on, when it can be invoiced in whole or part, and when the fees may be paid.

Only a limited number of firms are well-enough organised to not need a cash flow budget, simply because in most firms invoicing doesn't immediately follow the work being done, and in many firms payment to you doesn't immediately follow invoicing.

Take into account cash flow expected from debtors carried forward from earlier planning periods, and of course factor in the availability or otherwise of an overdraft facility to assist in smoothing cash flows, and the need to expend funds on capital items not included in your expenses.

There are plenty of other items to plug into your cash flow, especially GST flows in and out, and anticipated regular drawings over and above salary.

Credit control has not historically been a strong point in a lot of legal practices, and it is essential to have clear, reasonable terms for all types of work, and you do not slip into the error of honouring terms more in the breach than the observance.

Cash can dry up quickly, and as it starts to flow less regularly than it should, pressure comes on owners first. That pressure can impact owner performance on legal work and running the practice, further impacting the financial and general health of the practice.

The fees you can create through the work of your team, and invoice and collect, depend on the availability of the right

types and volumes of work, effective timely attendance to the work, and sensible pricing of the work.

Despite this critical 'recipe' few small-medium firms do much planning around the required flow of new work needed to keep each person/team properly busy.

### Marketing

In my experience this failure ties in to many lawyers dislike of marketing. That is, they would prefer not to accept that the volume and type of work that will come to the firm is a direct result of the quality of execution of the range of activities they undertake now.

Many tend to believe that the work will ebb and flow naturally, and will come at satisfactory levels in the future if they simply do a good job on the work they already have.

The reality is that even when the existing work is done well, there are many reasons why new work can reduce to a level where the practice can no longer generate a margin at all, let alone a reasonable one, and owners have to take less and less from the firm, or worse, have to inject more of their own capital to keep the firm going.

A firm should view sensible marketing as helping existing clients, referrers, contacts and the wider public with information that is useful to them in navigating their lives and/or businesses.

Experience shows that practical marketing can be done reasonably easily, at reasonable cost.

There are many potential channels for information, and it is not particularly difficult to test some. Websites and social media may have a place, as may seminars and newsletters and speaking engagements, to name just a few. Sadly, one-size-fits all is not applicable.

An effective contact database is an important tool to underpin many of these efforts, and keep track of them and their relative success, and your return on investment of time and money. Not all 'off-the-shelf' practice management systems incorporate contact databases of sufficient power and flexibility for this undertaking.

In financially healthy businesses, marketing and pricing are closely inter-linked.

All of us recognise that when new work is pouring in we are usually more confident

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with setting out our pricing and payment terms, and then sticking to them. The opposite is true when the possible piece of work we would like to be instructed on is one of very few on the horizon.

Being heavily tied up in work that cannot ever produce a decent margin is very inhibiting, dispiriting, and almost certainly preventing any clear thinking on the right way to get out of the maze.

Aside from the need for confidence when scoping and estimating fees for potential new instructions, there is great scope for lawyers in small-medium firms to improve their skills in pricing.

With all the discussion of the failure of lawyers to record their time spent accurately, it is easy for lawyers to assume that if they do record accurately, the time they will thus be able to charge will be both acceptable to clients, and provide a good profit margin.

Neither of those assumptions are necessarily correct.

Many clients are looking for better value in the services they receive, and the thoughtful lawyer will combine an improved level of skill in communicating value to each particular client in each particular matter, with a wider range of pricing options to meet the wide range of circumstances.

The thoughtful lawyer will be aware that psychology plays an important role in clients' perception of value.

Again, the vigorous debate over the inappropriateness of charging clients by time spent regularly obscures the harsh reality that charging merely by time is often a very poor outcome for the lawyer given the value the client is delivered.

Planning for your team to be properly busy to planned levels involves knowing how much new work that will entail from time to time, approximately what it should produce in revenues, and how to go about ensuring you do in fact get it -through sensible, cost-effective, marketing.

Having enough work and charging properly for it will, of course, go a long way to guaranteeing viability.

## Technology

Make your technology choices based on a clear understanding of how they will improve your achievement of your particular goals, not because something seems exciting or interesting, or because many

competitors seem to be using it.

Technology needs to be in a practice for a clear purpose, and the potential to assist is undoubtedly huge.

However, the relationship between technology and its perceived purpose is often not managed by lawyers such that the benefits are highly tangible. All too often the cost is incurred, but the training has not been undertaken properly to ensure that at least the bulk of the benefits are actually delivered. Expensive equipment and software sits largely unused.

As professionals we are blessed by the range and power of the technology available to us, far greater than ever before in history. To quite a degree technology has closed the capability gap between smaller firms and large, but only if it is used smartly to help achieve clear goals.

## Succession

As with so many other aspects of legal practice, what a particular owner hopes for by way of succession will vary greatly from the hopes of others.

Some hope for little more than a smooth transition for their remaining clients to a new lawyer, while some others have inflated views of the value of what they perceive they have built over many years of hard work.

The main debate these days appears to be whether succession can reasonably be achieved by a sale in which one or more purchasers pays an owner of a small-medium practice for a share of the practice assets including goodwill.

Certainly, it is happening much less frequently than it used to.

In my view the main reason for that is that the vast majority of such practices are hardly profitable, and the key factor

behind that situation is poor management over considerable periods of time.

On the other hand, where practices can be demonstrated to be profitable beyond principals' salaries, financially stable and relatively low risk, with strong client bases and excellent marketing, good sales are still being achieved.

In the real world beyond ill-informed opinion and urban myth, goodwill still exists, and is being bought and sold in profitable practices.

## Summary

Populations are growing, families are continuing to change, business is continuing to develop rapidly (both local and global), laws are continuing to become more complex, and people will need quality legal assistance more than ever.

There is an ever-increasing array of service offerings in the marketplace aimed at different segments of the population. The internet is playing an increasingly large role.

Nevertheless, there is a very bright future for small-medium legal firms that are clear in who they want to assist, with what services, and in what manner.

They do need to plan and organise well, deliver excellent services that clients perceive to be good value, charge sensibly, have quality credit management, be good leaders and managers, good marketers, and good financial managers.

Beyond merely being "viable" there remains great opportunity to thrive. ■

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