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Our first foray into analyzing law firm failures focused on liquidity. This second expedition focuses on "activity ratios," and we will transition to exploring "profitability ratios" in a later installment.

Activity ratios have one foot planted in liquidity, one in profitability. The reason is they are based on assets (receivables, inventories, total assets) and their conversion to cash. For cash basis reporting, accounts receivable become income when [collected] — not when created (billed). Law firms have little other revenue generating assets, so receivables are a key. However, law firms do have a significant inventory of "potential" receivables, which is work in process (WIP). Managing receivables is generally recognized as important, but WIP is less well understood. And it's critical to survival of the firm.

Receivables

A receivables analysis can be used to determine the quality of the receivables and how successful the firm is in collections. For the service profession, we want to look at the overall rate at which timekeeper worked hours are converted to recorded hours, the rate at which recorded hours are converted to billings, and then how billings are converted to cash.

We are also concerned with time consumed in each phase above, as the firm must pay compensation and overhead costs on a current basis to generate receivables, then wait a period of weeks and months before cash is received. With a forecast operating profit of 36 percent on collected monies in our hypothetical firm with $100 million in net revenue, that means 64 percent of every dollar received was paid out in advance — before partners receive a penny.

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There is no precise measure of conversion of actual work performed into recorded hours. It is generally accepted that more accuracy is lost the longer the gap between doing and recording the work. Daily submission of time sheets is the best; twice a week is adequate if not ideal. But not having them in by month end is damaging — and not turning them in until weeks, or months later is simply terrible.

Once recorded, there is review of the cost/value proposition of the time spent. As every fee must be "reasonable," there will be time that should not be charged. There may also be time that is more properly considered as business development, relationship maintenance, etc. The point is, there tends to be pre-billing adjustments. Assume for our firm it averages 10 percent of recorded time. We watch this at the firm aggregate level for variations over time, and for each practice group and each partner. If adjustments are consistently higher than average, we may have issues.

Time taken between month end and the date the bills are sent out is next. Obviously, shorter is better.

Once billed, there is time to process and pay by the client, and the prospect of further reductions. For our example firm, use 5 percent of receivables outstanding as forecast write downs.

Now that we have the net receivables, we compute the "receivables turnover." This computation is dividing net revenue by average net receivables outstanding. (Average of beginning of year receivables and end of year receivables). If our average net is $30 million, with annual net revenue of $100 million our result is 3.33 times, or every 109.5 days. We may also want to track our performance on collections month-by-month or quarter-by-quarter. For example, if our Q1 collection is slower than the annual average, say only $15 million, but we are working at a steady pace throughout the year generating $25 million of future income, we see the numerator as a smaller number, and the denominator increasing as a function of lower collections. The Q1 receivables inventory will grow by about $10 million during Q1, and the average increase in the receivables asset base for the period is $5 million. This shows us what we should expect to collect this year, and what the slower collection is doing to our liquidity profile. We are making what will ultimately translate to profits by Q4, but we probably aren't collecting enough cash to pay our bills currently in Q1, using this example.

While it is laudable to reduce the turnover period, once you achieve a lower turnover period you have to maintain it just to stay even on profits from one year to the next year, ceteris paribus. Sustainable performance may be preferable to overcollecting.

Work in Progress

This analysis converts classic inventory ratios to measure work performed and recorded, but not billed. In a perfect model, at month end WIP is fully recorded, and within two weeks fully billed. But that rarely happens. Some components of WIP

See Page 7 — TURN

Turn billings into gold

Continued from page 6

may be for matters that are more business development that may be charged if the matter is engaged; other matters may be billed like some real estate transactions that are billed at closing; and still other matters may require court approval before billings may be submitted, and so on.

As a consequence, WIP can accrue to a sizable number in law firms. Without contingency cases, it may become the equivalent of two or even three times the amount of a firm's average monthly billings. It is essential to monitor WIP and its historical levels, and rate of billing, to establish a baseline comparison. It should also be tracked by practice group, understanding that some practices are going to carry larger WIP balances.

A firm that has a historical rate of billings and collections on hourly rates that suddenly experiences a strong rise in WIP might have a confluence of events that will convert to billings in short order. But it could also be a contingent matter that presents a serious liquidity issue because those hours are paid for by the firm — an expanding investment in future collections whose realization could be problematic. Can the firm afford it? For how long can the firm afford to sustain the investment before partners protest? Will the leadership response be to increase firm debt, decrease partner distributions, make partner capital calls? Managed well it can be no problem, but managed poorly, a WIP imbalance can destroy a firm — quickly.

A drop in WIP balance due to significant billing and collection must be recognized in the evaluation of other financial performance ratios as a possible nonrepeating event.

There can be allocated to the WIP a cost for each recorded hour based on the firm's historical experience with costs per recorded/billed hour. They can be adjusted by experience for each practice group, and by individual lawyer as well. Then, by conversion of recorded hours to billed hours to collected hours experience, the "investment" in WIP can be deducted from the forecast revenue and projected partner profit as well. "It's going to be okay" is not an acceptable answer to the question of what is this case going to mean for us this year if we don't collect it?

Then there is drilling down on movement of WIP. Is the WIP cost/profit value increasing or decreasing and why? Is there an uptick in work? Is there a degradation in quality of what is being done with lower possibility of collection? Is the firm throwing bodies into contingent work simply because it doesn't have anything else for them to do? Just because you are "busier than ever" doesn't mean that effort will translate to dollars in your pockets.

Scrubbing receivables to assure they are a fully performing high quality asset base is important, but closely monitoring the status and growth/reduction of the WIP "bucket" is equally critical as an earlier sign of change in quality of client intake, efficiency in conversion of work to cash receipts, and risk management. It can give clues as much as 60-90 days earlier than receivables analysis to where operationally the firm needs to improve, and possibly take quick action to mitigate potential losses.

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