This paper is a supplement to Dave Bilinsky's article "10 Critical Issues for the Legal Profession" that appeared in the Summer 2008 issue of LAWPRO Magazine. This paper, the article, and other supplemental content is available for download at www.practicepro.ca/criticalissues

The Financial Numbers all Lawyers (and Managing Partners) should be Seeing:

(David J. Bilinsky)

In looking at the management of a law firm by the numbers, I assume that your firm not only has in place a proper accounting system (that records the historical financial results of the firm), but also has implemented the basic foundation for a financial system (that forcasts the future performance of the firm and compares actual results against the budgeted items). The difference between these two is profound. One reports on what has happened (by asking the question: "How did we do?"). The other envisions the future and asks the question: "How did we do relative to where we wanted to go?".

Accordingly, the preparatory work should include:

Your Operating Budget:

- Income and expenses: grouped by month and by category (increase expenses by 20%, as a fudge factor). Try to be as specific as possible.
- Annual billable hour expectations by lawyer: broken down by month, week, and day (WIP contribution). This gives you your first personal metric – or financial goal - that aggregated, will result in the firm meeting its overall goals.
- Annual collected fee expectations by lawyer: broken down by month (collected revenues). This takes your first personal metric and starts to refine it in a qualitative sense; a common benchmark is that write-offs should not exceed 5% (fees collected = 95% of fees billed). Another alternate term that is used here is *realization rate.*
- Forecast your expenses, distinguishing your fixed costs (rent, lease costs, salaries) from your variable costs (the ones that vary with the amount of work being undertaken). This way you can accurately see your cash flow needs vs your cash flow forecasts. Recall that unless you have funds in your trust account to pay your fees and disbursements, it takes 105 days on average, for lawyers to collect on an invoice. This can cause cash flow problems and should be factored into your budget.

Your Cost of Services Rendered (CoSR).

This report looks at what you expect an hour's worth of each lawyer's legal time to cost your firm, on average. For a solo lawyer, it is straightforward – it is the total forecast expenses for the firm (including the lawyer's draws) divided by his or her' billable time expectation. For example, if a lawyer expects that their practice will cost $200,000/year and they expect to bill 1500 hours/year, then their CoSR = 200,000/1,500 = $133.34/hr. This provides you with a very important metric. If you expect to work two hours on a file and you do not expect to be able to charge $266.68 for the work, then you should be asking yourself *why am I taking on this file and not referring it out to someone else?* This gives rise to a very important threshold question when looking at a new file: *will the expected fees in this file exceed my forecast CoSR?*

Managerial Reports:

Given that you have your budget and forecasts established, here are the reports that you can be seeing on a weekly/monthly/quarterly and annual basis:

Weekly Reports:

These reports allow you to keep a handle on your financial state without overloading you with information and without causing an excessive amount of work for your bookkeeper. Placing the emphasis on cash-flow, here's what we think you should take a look at weekly:

Timekeeper Report

- prepared each Monday, based on the week prior.
- billable hours recorded (WIP), compared to budget, by timekeeper
- Note that ballooning WIP may indicate personal problems in a lawyer - they are recording time but delivering very little value for that time..and are hesitant to bill same. This may indicate that the lawyer is in need of help!

Monthly Reports:

These reports go into a bit more detail and allow you to dig a bit deeper into the 'hows and whys' of what is actually happening in your firm:

Balance Sheet:

- for the month (look at your relationship between assets and liabilities: the quick ratio = (current assets/current liabilities). This should be at least 1:1 and indicates the liquidity of the practice).

Income Statement:

- by month and by Year to Date (YTD) and compared to budget and to prior period last year (note that depreciation and other factors may distort the Income Statement from the purposes of determining accurate cash flow. You may need to produce a Statement of Changes in Financial Position to arrive at your true net cash position since we use an accrual accounting method here in Canada).

Write-up, Write-down report:

- (done on an exception basis i.e. report only on those accounts that are written up or down at least 10% of the recorded billable time on the file). Look at these reports from several perspectives:
- by client (which clients are responsible for major write-ups and write-downs?)
- by file (are there particular files that are responsible for write-ups and write-downs?)
- by lawyer (do you have a problem lawyer on your hands who consistently writes down time.

Effective hourly rate:

- by lawyer (actual collections divided by all time recorded for the billed files - not just time actually billed). These reports should be examined carefully, as drops in EHR may indicate poor client selection or burnout by the lawyer – who is recording time but not being particularly efficient in what they are doing.

Accounts Receivable

- (A/R) balance for each client
- by total outstanding
- by aged balances (collections report – 30/60/90/120+)
- report fees due separately from disbursements due
- Watch for 'bracket creep' - ie an account moving across the statement - from 30 days to 90+ days - before any action is taken to try to collect same.

Client Activity Report

- fees billed by client
- Effective Hourly Rate (EHR) on those fees (fees collected divided by hours recorded, not just billed)
- fees collected
- A/R outstanding, aged (broken down be fees, disbursements)
- Accounts written off
- trust balances
- WIP (added this month, less WIP billed = total WIP)
- unbilled disbursements (added this month, total)

Write-up, Write-Down Report

The Write-up, Write-down report looks at whether any particular client, file or lawyer is responsible for large write-ups or write-offs. We suggest that you combine this report with an office policy that no write-off of more than a stated amount (for example, $1000) can occur without the signed consent of the managing partner. In this way, you have a strong disincentive to reduce fees without the oversight of the managing partner – who then is alerted to the fact.

The Client Activity Report delves into the clients of the firm and draws attention to problem clients before the problems become acute. It alerts management to the fact that a client may be racking up large WIP amounts while simultaneously not paying their rendered accounts. Unless dealt with, this is a recipe for trouble for cash flow in the not too distant future, not to mention problems should withdrawal become necessary.

Quarterly Reports:

Each quarter should be a time of reckoning. Accordingly, all the prior reports are produced, along with two new reports: a Leakage Report and a Profitability Report. Again, these reports should show a comparison to budget and to prior year.

'Leakage Report':

- Take a lawyer's quarterly billable hour expectation x standard hourly rate (equal to each timekeepers billing 'ceiling') and compare it to their to actual billings. The difference is the size of their particular financial 'leak'.

Profitability Report:

- determine 'cost of services rendered' for 1 hour of lawyer time
- compare CoSR x hours worked on a file to actual collections
  - determine if your collections are below, equal or exceed your costs of carrying the file
- determine fee realization rates, by lawyer
  - amount realized/amount billed (as an percentage)

CoSR report:

- in this case you would be comparing your actual CoSR against your forecast CoSR. Here you wish to see how you are doing by comparing the actual income and costs of operating your practice relative to income expectations and expense constraints that you had forecast.

The Leakage Report's purpose is to determine the difference between what each timekeeper **could** be billing as against what they **are** billing.

The Profitability Report requires a bit of an explanation. Its purpose is to try to allocate fixed and variable costs (overhead) to each timekeeper. There are many ways of attempting to try to allocate costs (salaries, for example, can be simply averaged or they can be allocated using some reasonable method of determination against each timekeeper or department). Regardless of the methods used, the profitability report is designed to answer one question: Did each timekeeper bill at least enough to capture the costs of handling a file in the office?

All firms have departments or lawyers that are not as profitable as others; regardless, the firm should make a conscious decision from a strategic position whether to offer legal services to clients on a 'loss leader' basis. If the answer is no –then the firm needs to rethink how to offer these services in a way that reduces the 'drag' of these services on the firm.

Dashboard Report:

This is the nerve-center of your cash-flow analysis, and should be done on a weekly, monthly and quarterly basis. This report looks directly at the factors most directly affecting cash flow, both in the short-term and in the slightly longer term. The components of the Dashboard Report are as follows:

Cash Flow Analysis:

- net cash at start of period
- cash additions (fees collected, disbursements collected, other income)
- cash withdrawals (office overheads, disbursements paid, other disbursements)
- net cash remaining at the end of the period
- Expected Cash Flow requirements for the upcoming period (compare to net cash remaining in the Cash Flow Analysis)

Line of Credit Analysis:

- opening Line of Credit balance
- amounts repaid
- amounts drawn down
- net balance of LoC

WIP Analysis:

- net WIP at start of period (hours x standard rates)
- WIP added during the period
- WIP billed during the period
- net WIP at end of the period

Files / Clients Report

- files opened/added during the period, by responsible lawyer and by originating lawyer
- files billed during the period, by responsible lawyer and by originating lawyer
- files collected during the period, by responsible lawyer and by originating lawyer

The first component is the cash-in/cash-out analysis (cash at the start of the period, plus any additions, less any withdrawals, resulting in the cash at the end of the period. The net-cash remaining is then compared to the expected cash needs for the upcoming period – answering the question: "Do we have enough cash on hand to keep us afloat in the short term?"

The Line of Credit Analysis looks at the buffer remaining in the firm's Line of Credit: if the net cash remaining plus remaining buffer in the Line of Credit is insufficient to meet the Expected Cash Flow Requirements in the upcoming period – the firm is desperately in trouble.

The WIP Analysis looks to see if the WIP is increasing, decreasing or remaining steady. Increasing WIP is a sign of upcoming cash shortages. Decreasing WIP indicates potential longer-term cash flow problems.

Lastly the Files/Clients Report looks at the matter from a much longer baseline – are you steadily opening new files? If not – again, cash flow may be adversely affected in the longer term. Which lawyers are billing and collecting? More importantly, which ones are not?

The purpose of these reports are to maintain a steady eye on the all-important matter of cash

Top 10 Steps to a More Profitable Practice

In closing, now that we have covered the basics, here is a "Readers Digest" list of the top 10 ways to focus your practice and achieve a greater financial return based on focusing on the financial performance of your firm:

1. Determine your overall Profit and Loss for last year.
2. Compare your Profit and Loss against your forecasted Budget (*or draw a budget for this year if you don't already have one*).
3. Find out your Profit or Loss on a File by File, Client by Client and Practice Area by Practice Area basis for the last year.
4. Select your 5 most profitable (and least profitable)Files, Clients and Practice Areas and target your marketing to pursue these targets. Try to strategially move your firm away from the least-profitable areas.
5. Set your Strategic Direction and Vision to pursue the most profitable Files, clients and Practice Areas (and drop the 5 least profitable ones from your business plan and from your marketing. After all, you have already shown that your time results in a greater return in other areas).
6. Set up your annual Budget for next year– targeting your Annual Income after expenses, your total expenses and your target gross income.
7. Determine if alternative billing arrangements can be used to your advantage and structure your systems accordingly.
8. Tweak your Compensation/Measurement System so that it supports your strategic plan (and isn't eat what you kill….).
9. Be ruthless on dropping clients and files that do not meet their financial obligations on a continual basis (according to your new written fee agreement).
10. Bill – regularly and often.

By focusing on the financial side of your practice, you can take your accounting system and turn it into a managerial system that not onoy allows you to set your goals, it ensures that you track your progress towards those goals and ensures that your financial boat stays on course!