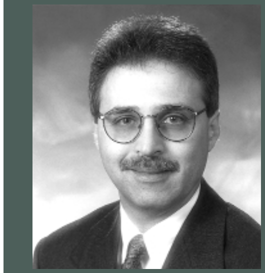
Fiscal Management of a Law Firm

By James D. Cotterman


James Cotterman

Understanding a law firm's fiscal affairs is not that difficult. One need only understand a few basic concepts — concepts that are no different for the law firm or the law firm's clients. The trick is not in understanding the numbers but in managing for results. For a law firm, this is an even greater challenge. Its owners are well educated, strong willed, success driven, practice focused, independently minded and, at least for trial lawyers, somewhat more argumentative than the general population. The number of law firm owners is also large relative to the total number of employees and those owners are active in the day-to-day operations of the firm.

Key Fiscal Performance Measures

Cash Flow

The lifeblood of any business is its ability to generate positive cash flow. It does not matter if you are Exxon or the neighborhood Pizza Shop. Positive cash flow is a requirement. That basic concept was temporarily forgotten with the dot.com companies in the latter half of the 1990s. The sudden and severe loss of market value in those companies during 2000 was primarily due to the re-emergence of that business fundamental.

Cash flow is not necessarily the same thing as income. Even for law firms who measure their economic performance on the cash basis, there are borrowings, loan payments, fixed asset purchases and depreciation that affect income and cash flow differently. Obviously these financing and investment activities are important, but they are not where law firms get into trouble (unless they have financed operations instead of investments). Generally, trouble occurs if there is insufficient focus on the cash receipts generated from accounts receivable and the cash payments generated by payroll and accounts payable.

The difference (cash gap) between these two cash streams is extremely important. The cash gap in a law firm is defined as the difference between when you pay your expenses and when clients pay you. For law firms, this number is about 105 days. Unbilled time turns over in 60 - 70 days. Accounts receivable turn over in 60 - 80 days. Accounts payable are generally around 30 days. With labor costs the single largest overhead item (usually paid bi-weekly or semi-monthly) the burden is aggravated because labor's cash gap is closer to 120 days. The 1998 - 2000 resurgence of rampant associate wage increases has compounded the situation further.

What this means is that as you operate your business, you are likely to have paid the costs to render services before you have even invoiced the client. If your time recording, billing and collection processes are inefficient or ineffective, your ability to promptly generate fee collections is severely strained. To quote an Executive Director, "If we do not have time in the system, we cannot bill our clients. If we cannot bill for services, money does not come in the door. If we have no money, we cannot pay bills…" So simple, yet successfully managing this basic function remains a problem in many law firms.

If you are growing your business, the cash gap is an even more critical issue to understand. It is possible to grow a business so rapidly, that you literally grow it into bankruptcy (even a profitable business can falter). Why? Because the growth requires ever increasing outlays of cash. Meanwhile the growth in cash receipts lag. If your capital is inadequate, you consume all of your cash and you are in trouble.

Think about what happens as you add an associate. On day one the associate begins work. Yours is an efficient law firm — the associate is put on work fairly quickly. So, by the end of the second week, when the individual receives the first paycheck, he or she is busy on client work. At the end of the month, the second paycheck comes; the associate is still busy. First of the second month, benefits begin. Middle of the second month, the partner returns the pre-bills back to accounting and the third paycheck is issued to the new associate. End of the second month, the bill is mailed to the client and the fourth paycheck is issued. By now you can see where this is heading. We are up to four pay checks by the time a bill has gone out (if you are lucky). And we have not mentioned paying for

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the laptop computer or other direct marginal costs of the individual, let alone any incremental general overhead. Did we mention the 60 days or more until the client pays? Multiply that cost by inefficiencies along the way and then again by the number of associates you hire each year.

Revenues or Collected Fee Receipts

In addition to minding the cash gap, law firms also must focus on sustainable profits. Banks do not want to loan money to sustain partner incomes, so the success of the enterprise requires real economic profit. In law firms, the level of profits is dependent on the level of collected fee receipts (revenues) more than any other factor. This is such an important productivity, and hence profitability, metric that it should consume a majority of your time as a manager. View this metric in many ways – trends by year, current month versus same month prior year, actual versus plan, and actual versus relevant industry benchmarks.

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When examined in the aggregate, your firm’s revenues measured as a percentage of some other industry aggregate (city, state, region, etc.) can tell you how much market share you are getting. And if the percentage is increasing (i.e. your revenues are growing faster than the market segment you are measuring against), it can tell how effectively you are penetrating the market. But do not be fooled by the heady illusion of success if you are growing. If the new revenues are clients that are not consistent with your strategy, or are not profitable, or are not sustainable, then you have a serious and growing problem.

In order to measure productivity, prepare the revenue comparisons on a full-time-equivalent fee earner basis. Productivity is a second critical metric for successful firms. Irrespective of the business model a particular law firm uses, if its fee earners are not productive (generating an adequate level of revenues per capita) then it will not be profitable. Compensation is the single largest expense in a law firm. The fee earners consume 60% of every dollar of collected fees. With administrative and support staff included, that metric increases to 75% of every dollar of collected fees. Measuring this is akin to measuring return on assets in most other businesses. Your people are a very mobile and easily perishable asset. How well they are recruited, developed and deployed is vital to the firm’s bottom line.

Another productivity measure that the author finds useful is “revenue per fee earner for same fee earners from prior period.” In retail it is known as same store sales. This metric culls out growth and part year start up or phase out anomalies. It is simply measuring the revenue metrics only for those fee earners who are employed for both periods being measured. It is little used in the legal profession, but it is a different view that tells a slightly different story about what is happening to the base business.

Productivity is determined by how hard people work (utilization or billable hours) and how much they can charge for their services (pricing or billing rates). You begin by managing the outcome — collected fees. If that metric is not satisfactory, you examine the pricing and utilization data.

Caution is advised when managing billable hours. Getting a requisite number of hours on the books is not the required outcome, collecting the requisite levels of fees is. All too often the author has observed hours-driven cultures falling short because the hours produced did not convey value to the client and ultimately did not produce fee receipts. Even worse were the implications for client satisfaction and employee morale.

The need to generate hours is counter to the client’s desires — they seek value and efficiency. Clients perceive when a matter is being over-worked or over-staffed and the result is lowered satisfaction. This is important because of the relationship between client satisfaction and client retention. High client retention rates require very high client satisfaction. A small decrease from “very satisfied” to “mostly satisfied” has profound implications for retention.

The issue of pressuring the associates for more hours is pervasive, particularly when the market is slowing and/or their wages are high. But, the typical response to create the various scorecards illuminating the associates’ deficiencies ignores the cause. Associates understand the need to work hard and that high salaries include high expectations regarding the work ethic. They are success-driven (as lawyers tend to be). Yes, there are generational work ethic differences, but that is not the problem either. What is needed is counseling at the partner level to involve and develop associates in meaningful work and then to push work out to them.

Pricing is an art and in a law firm it is an art practiced by all billing lawyers. Whether it is hourly rates, fixed fees, contingencies or some other means to establish the value of the services rendered, pricing is discerning the value of the solution to the client and then getting the client to accept that valuation.

The best pricing is done when the lawyer is able to see the value of the solution in the eyes of the client. Or when the lawyer is able to price the services in a manner consistent with the way the client's business is run. Consider the real estate lawyer who serves a major commercial real estate developer. That developer is used to costing things on a square foot basis. By pricing his legal services on a square foot basis, this lawyer has considered how the developer views his business. The legal services are now fixed per square foot and the developer knows in advance his costs. In this example, the developer began to exclusively use this lawyer. The lawyer understood his business and the developer well enough to price competitively whereby small projects probably did not cover their costs, but large projects were quite remunerative (not unlike the world of the developer) — and the developer did mostly large projects.

Profit Margin

The last basic concept is profit margin. In law firms the profits are generally considered to be income per equity partner. This definition is not an entirely accurate economic definition (partners render services that have an economic value that would otherwise require the cost of another producer, thereby reducing profits). However, this is an easily determined number and a metric that is readily available in the marketplace.

When there are concerns about the level or direction of margin, it is easy to turn quickly to overhead and start a cost-control initiative. First, very few law firms are inattentive to their overhead. Second, managers understand that cost management is an ongoing exercise in a dynamic marketplace of goods and services. So their efforts and vigilance are ongoing.

The significant error that the author sees law firms make is to build-in a high fixed cost of operations. Earlier we mentioned the toll labor extracts out of each fee dollar. The number two cost is occupancy, followed closely by technology and marketing. Consider labor costs that are predominantly salary and deferred salary (bonuses that are implemented as the 27th paycheck at year end) — with substantial recent upward pressure. Consider occupancy — a long-term commitment that could result in sticker shock when new terms are negotiated (the one benefit of a slowing economy generally and a slowing technology economy specifically, is that some of that pressure may be mitigated).

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The error is that the variability of expenses is not aligned with the variability of revenues. Labor, occupancy and technology consume 85% of every fee dollar. Those costs are not easily changed in the short run (partially due to contractual obligations and partially due to the difficulty partners have in making radical and unfavorable personnel decisions). The remaining overhead is not all that variable either. The single most important cost initiative that law firms can undertake is to increase their flexibility in overhead. The place to start is the direct cost of producing revenues — fee earner compensation. That does not mean pay people less. It does mean to have pay programs that can adjust to the revenues in a way that does require drastic measures.

Managing to Success

The most successful law firms do many things well — they attract and retain the right people; they are focused; they are productive; they have interesting clients and work; they achieve strategic (clients, industries, geographic presence, practice specialties, pricing) and operational (structure, governance, systems, culture and leadership) alignment. The key fiscal concepts provide you with metrics to quantify the results of your efforts in these tasks.

Each law firm must determine the type of practice it wants and then what business model will be successful for that practice. Will the key profit driver be margin or leverage or productivity? The conventional wisdom states that you want to maximize all of the profit levers (rates, utilization, realization, margin and leverage). But we all know that an insurance defense firm must operate with a different business model than an emerging business corporate boutique. The former relies on productivity and leverage; the latter on high pricing with little leverage. Both can be successful. Both can fail. The challenge is to manage each to its appropriate business model.

Although managing by the numbers has a certain attractiveness to it, it is managing people that leads to change in the numbers. Managing people requires communication, which can come in many forms. However, communicating

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by voice-mail, electronic mail, memorandum or handwritten comments in margins of work products provide only a small piece of what is necessary.

The hard part about managing can also be the most rewarding. It is the interpersonal relationships between two people (mentors and mentees, supervisors and supervisees) as well as the relationships of peers and team members that can make managing people very rewarding. It can also make it very hard, as you must be able to preserve the relationships at the same time that you honestly and candidly counsel individuals on performance.

Use the numbers to isolate the problems and issues. Look at the data in a variety of ways. Consider what outcomes you, as manager, want (never go to the people without a game plan, but be willing to have your plan altered if it is appropriate to do so). Then go to the people involved and discuss what you've discovered, make sure that the facts are, indeed, accurate and that you have properly interpreted them. Get a dialogue underway early on as to how corrective action could be implemented. Support the efforts to change and make sure the people have the resources and skills to bring about the change. Then follow up to encourage the successes and to help fine-tune when things go awry.

The current economy has an uncertain outlook. We could have recession, or something close – a general malaise. Either way, it is important to stay on top of how your firm is performing and not ignore the early signals that the numbers can provide. Equally important is the need to be visible as a manager — and to attend to issues as soon as they arise. ◆

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