

Enronomics for Law Firms: Making Sense of the Numbers

**Presented by Stephen M. (Pete) Peterson
Law Firm Business Institute
Wednesday
2:00 – 5:00 p.m.**

**ALA 32th Annual Education Conference
San Diego, CA**

Session Contents

- 1. Methodologies for improving the bottom line**
- 2. Sample applications**
- 3. Other key financial measures**
- 4. How to improve your management reporting**
 - Translating the mass of financial statements and data to meaningful, short reports**

Objectives

- **Provide a high level of understanding of significant drivers of law firm profitability**
- **Provide understanding on what methods yield the greatest improvement to the top line and bottom line**
- **Provide ideas and examples for management reporting**

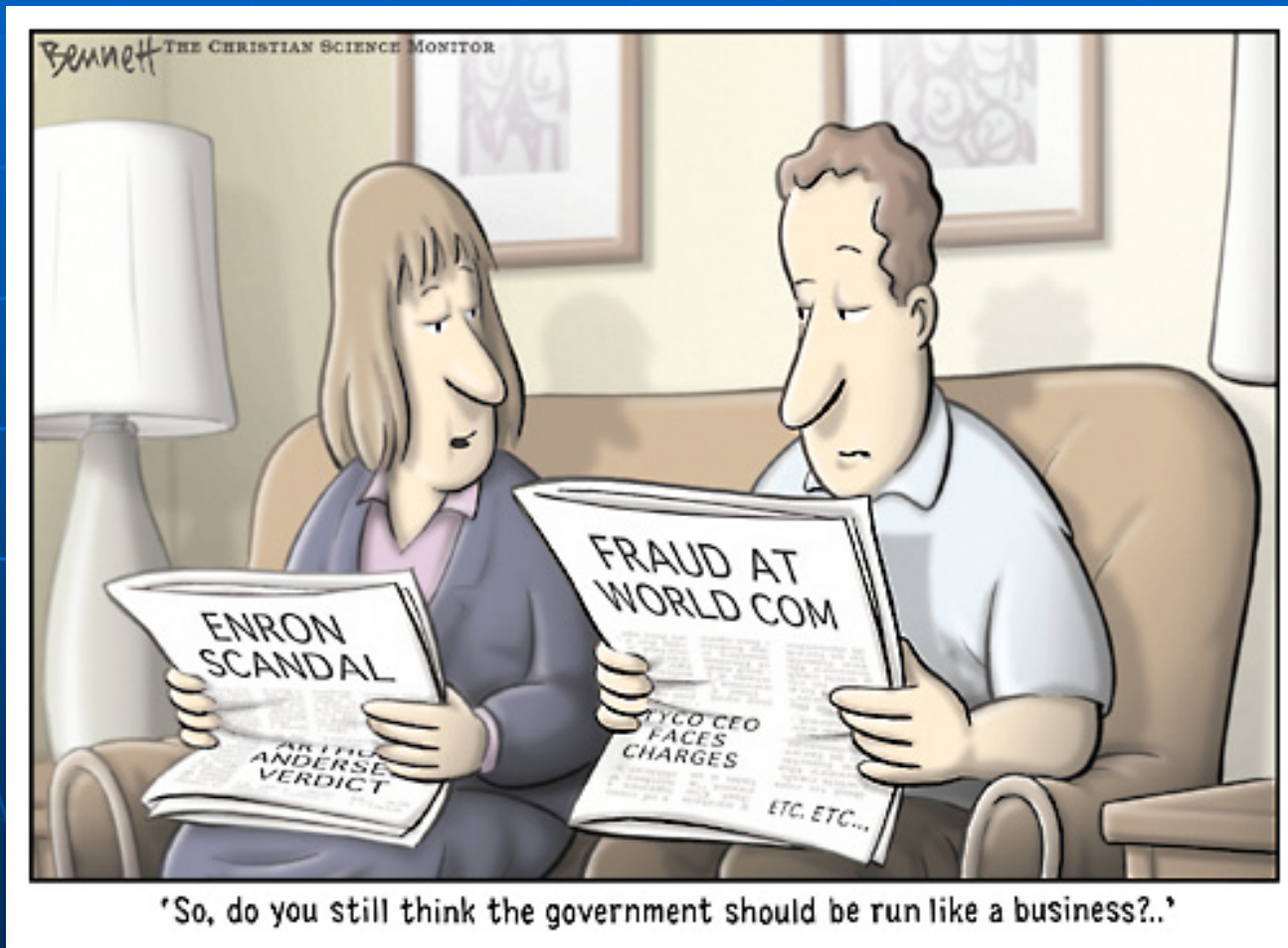
“Accounting has become the most intellectually challenging area in the field of management, and the most turbulent one.”

-Peter Drucker

A Few Good Accountants

- **Tom: Did you order the shredding?**
- **Jack: You want answers?**
- **Tom: I think I'm entitled.**
- **Jack: You want answers!!**
- **Tom: I want the truth!**
- **Jack: (to be read at session)**

Should Law Firms be Run Like a Business?



Do Law Firms Employ Questionable Tactics?

- **Well, some firms have...**
- **Finley Kumble**
- **Keck Mahin & Cate**
- **Others who take from the poor and give to the rich**
 - **Referring to client trust fund abuse**

Law Firm Economics

Economic Drivers

■ RULES

- Represents the primary and key statistics that measure and monitor the financial success of a law firm

RULES

- **R-rates/revenue/realization**
 - **U-utilization**
 - **L-leverage**
 - **E-expenses**
 - **S-speed**
-
- **What do they mean to you?**

RULES Have Many Applications and Include:

- **Providing information for strategic planning purposes**
- **Determining profitability and at various levels-client/matter, practice group, etc.**
- **Where to invest the firm's limited resources, such as**
 - **Industry segments/practice areas**
 - **Marketing or technology endeavors**
- **Assessing merger candidates and lateral hires**

“R” Factors

■ **“R” Factors**

- **Rates—assuming we can increase rates in this environment**
- **Revenue—what other methods can be employed to increase fee revenue**
- **Realization—measuring the impact of premiums, discounts and write-offs**

“U” Factors

- **“U” equals**
 - **Utilization—statistics which track how busy our fee earners are on billable files**
 - **Very important to track in order to:**
 - **Determine growth needs**
 - **Manage leverage (and resource allocation)**
 - **Project future fee revenues**
 - **Determine if hoarding is taking place**
- **Only improved only by increasing amount of work or decreasing number of fee earners**

“L” Factors

- **“L” equals leverage**
 - **Leverage statistics measure the ratio of all non-equity attorneys to equity partners (traditionally this was the old associate to partner ratio)**
 - **All things being equal, average partner income increases as leverage increases**

“E” Factors

- **“E” equals expenses**
 - **Expense controls are a needed element in determining the profitability of a firm**
 - **From 65% to 75% of total firm expenses are people and facilities**
 - **Need to start thinking “small office, big house”**
 - **This is one category that your partners are happy to help you with**

“S” Factors

- **“S” equals the need for speed**
 - **Particularly the speed of billings and collections**
 - **Generally speaking, aging is good for wine, beef and certain cheeses**
 - **Aging is NOT good for WIP and A/R**
 - **Delays decrease realization and cash flow**
 - **Which in turn increases interest expense**

Realization-Turning Worked Values to Cash

Standard billing rates	= \$100
Fees actually billed	= \$ 90
Fees ultimately collected	= \$ 80

-Billing realization = $\$90/\100 = 90%

-Overall realization = $\$80/\100 = 80%

High profit firms achieve realization of 96% or better.

Improving Realization is Key for Improving Bottom Line Results

- **Increasing realization from 90% to 96% for firm with \$50 million in revenue**
 - **Yields \$3,000,000 to the bottom line**
 - **Increases per partner income by nearly \$60,000 (assuming 50 partners)**
- **Normally, no expenses incurred for increasing realization**

Improving Realization

- **Speed**
 - **Time entry**
 - **Billing**
 - **Collecting**
- **Alternative billing methods**
 - **There is an upper limit on billable hours**
- **Client intake procedures/policies**
 - **Being cognizant of troublesome industries**
- **Client communication**

Improving Realization- the Billing Cycle

- **Timing**
 - **Process and mail by date certain**
- **Bill while there's a tear in the client's eye**
- **Communication-invoices contain perception of value**
 - **Use greenmail messages**
- **Employ a default system**

Improving Realization-the Collection Cycle

- **Firms need to adopt and employ collection procedures and polices**
- **The passage of time is detrimental to collections**
 - **Do not allow invoices to “marinate”**
 - **Shrinking dollars affect**
 - **After 30 days, a dollar is worth 90 cents**
 - **After six months, it’s worth 57 cents**

Discounting/Write-offs

- **Discounting is costly**
 - **For example, a 10% discount for a firm with a 40% profit margin actually costs 25% in terms of loss to the bottom line.**
- **Cost of replacing the value of services written off**
 - **A \$40,000 write-off needs \$100,000 in new fees to replace lost income**

Minimizing Adjustments

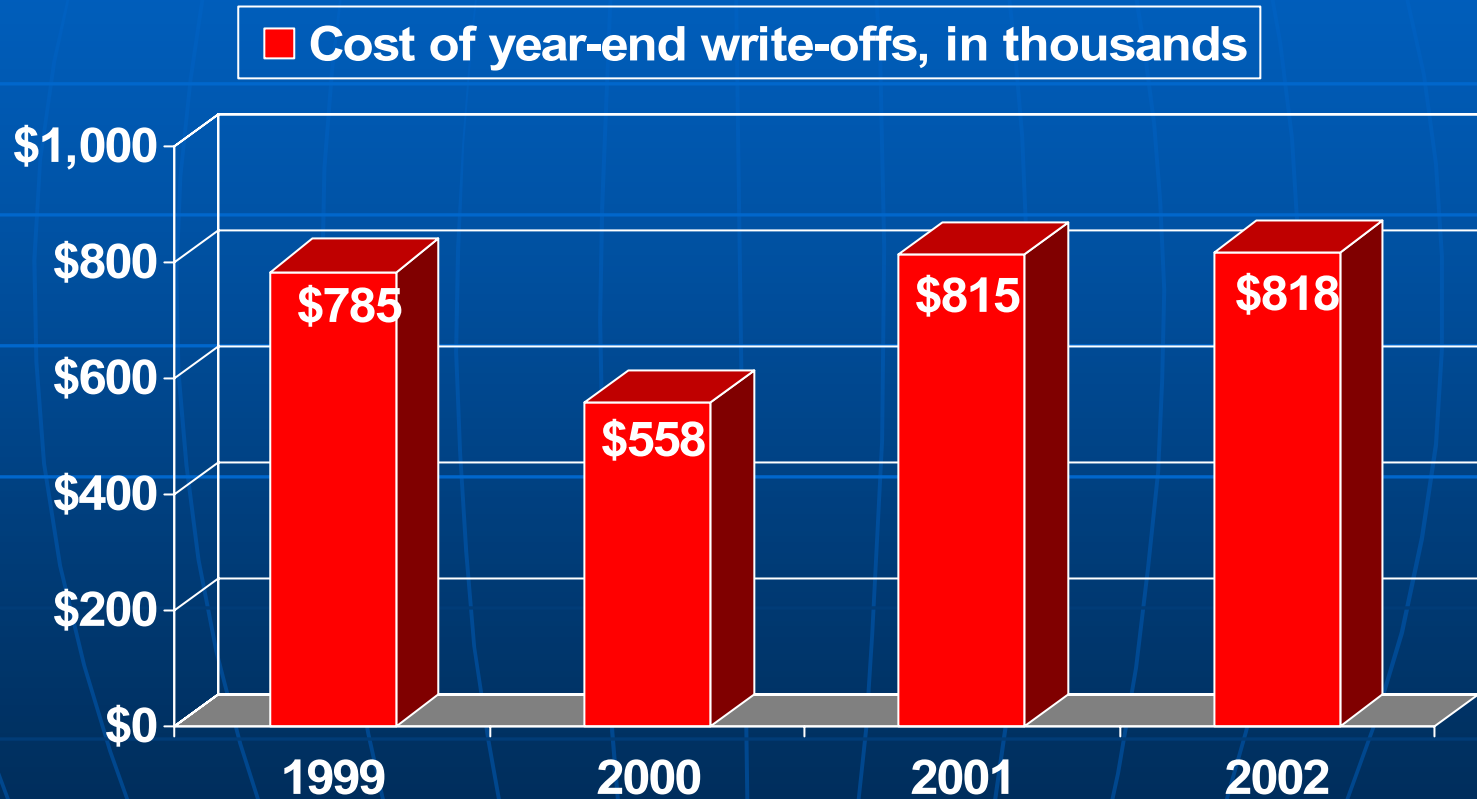
- **Is the new matter eligible for alternative billing arrangements?**
- **Need for stronger matter management**
 - **Better supervision over work**
- **Timely, clear and consistent communication with the client**
- **Type of work**
 - **Have we done this before thereby benefiting from knowledge management?**
 - **Or, is this a green cow with purple dots?**

Cyclical Nature of Write-offs

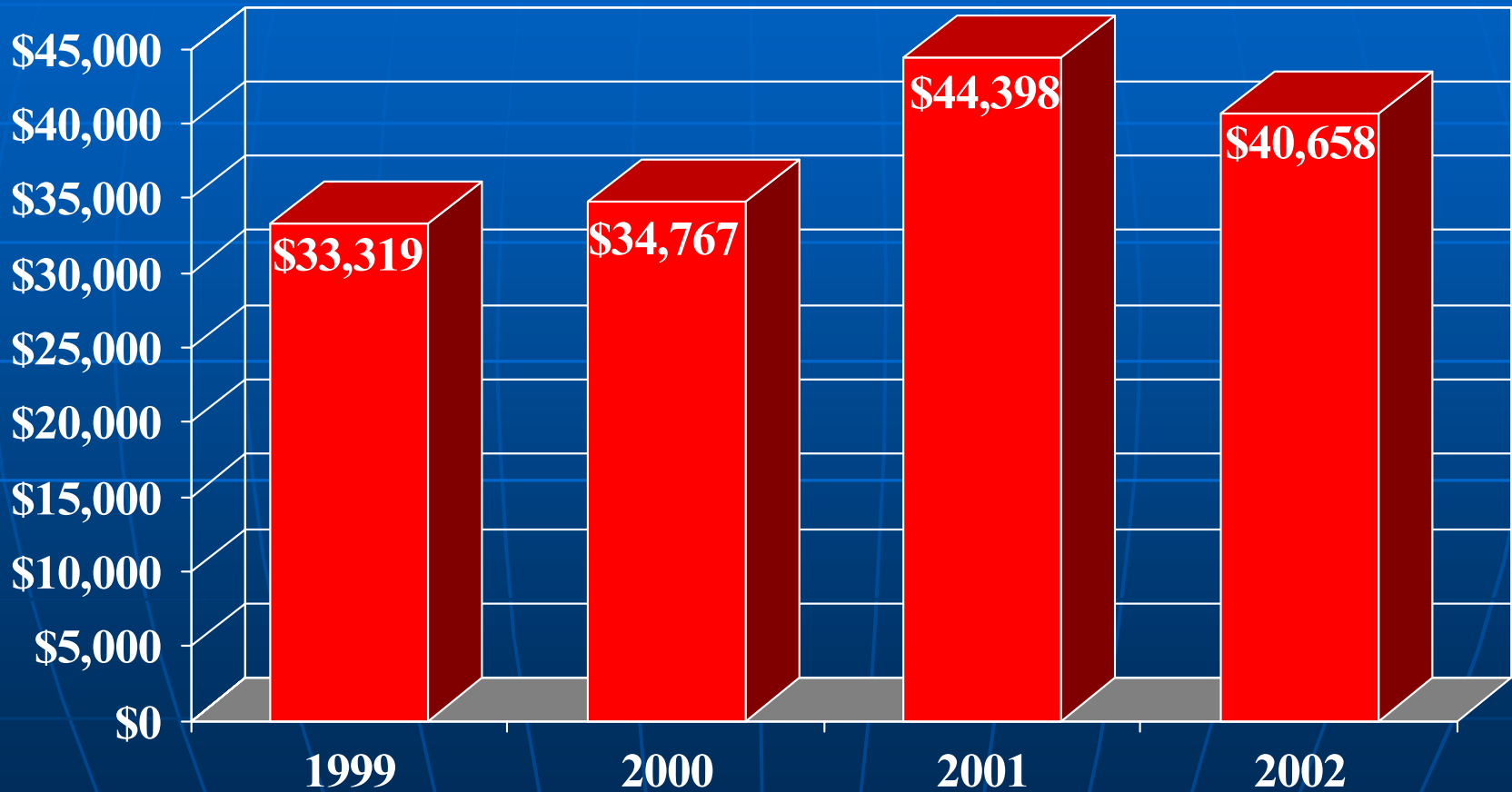
Typical Collection Cycle (in thousands)



Timing of Most Write-offs and Adjustments



Per Partner Write-offs by Year



Utilization—A Measure of Overall Productivity and Capacity

Average Hours	Actual	Budget	Utilization Percentage
Partners	147	145	101%
Associates	139	150	93%
Paralegals	100	120	83%

Effects of Leverage on Profits

- **As previously noted, average partner income increases as leverage increases**
- **This assumes a number of key points:**
 - **Each non-equity attorney contributes something to profits**
 - **Need adequate utilization**
 - **Need adequate realization**
 - **Mix needs to include substantial number of mid-level and senior associates**

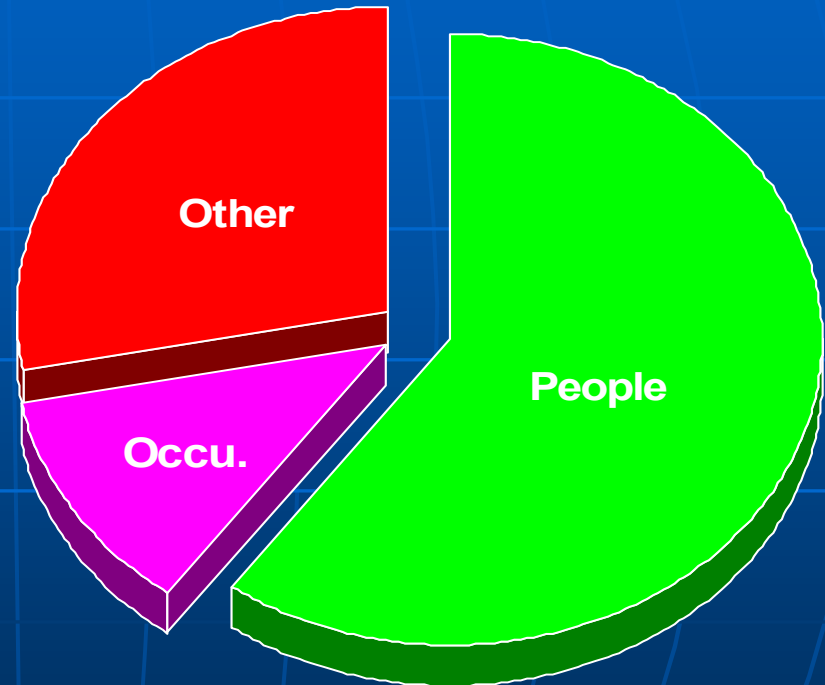
Expenses

- **Blinding flash of the obvious—
reducing expenses combined
with a flat or increasing level of
revenue results in increased
profits**
- **You need to monitor expenses
but don't get carried away**

Typical Cost Structure

Largest costs

- **People**
- **Occupancy**



Speed

- **Time is always of the essence**
 - **Just ask your clients**
- **From the time it takes to open a file to the collection for services rendered**
- **By far the easiest thing to correct**
 - **Yet often overlooked**
 - **Lack of systems and discipline**

Speed

- **Speed issues—you must review these 2 statistics:**
 - **Aging of WIP and A/R**
 - **Reviewing all significant accounts over 30 days old**
 - **Number of months or number of days invested in WIP and A/R**

Investments In WIP and A/R

	Work-in-Progress	Accounts Receivable
Annual fee revenue	\$25,000,000	\$25,000,000
Days in Year	365	365
Revenue per day	\$68,500	\$68,500
Period end balance	\$4,375,000	\$7,292,000
Days invested	64	106
Goal	45 days	70 days
Excess investment	\$1,301,500	\$2,466,000

An Exercise in the Manufacture of Money and Profits



ABC Law Firm Profile

- **Annual revenue of \$22,500,000**
- **Average hours of 1,650**
- **Average rate of \$225**
- **Realization of 87%**
- **60 attorneys**
- **Leverage 1:1**
- **Profit margin of 30%**

Hypothetical Illustration of RULES Improvement

Application	\$ Increase in Avg. PPP	% Profit Increase
R-Increase realization by 2%	\$15,000	6.7%
R-Increase rates by 2.5%	\$18,750	8.3%
U-Increase associate hours by 3 hours/week	\$23,400	10.4%
L-De-equitize 2 partners	\$7,150	0%
E-Decrease selected expenses by 4%	\$2,000	.9%
S-Decrease days invested in WIP and AR by 10 days	\$20,500	9.1%
Total improvement	\$86,800	35.4%

New Key Financial Terms

- **From FIFO and LIFO**
 - **To FISH**
- **From GAAP**
 - **Generally Accepted Accounting Principles**
- **To PCAP**
 - **Politically Correct Accounting Principles**

Profit: An archaic term no longer in use.

See Enron, Worldcon, Kmart, HealthSouth, United Airlines, Xerox, etc.

What Are Law Firm Profits?

- **Net profits**
 - **Tells us nothing without further review**
- **Profit Margin**
 - **Commonly used but not very useful**
- **Profits per Partner**
 - **Also commonly used and accepted**
 - **Can be misleading**
 - **What partners are you including?**

Reviewing the Net Margin

- **Can be very misleading**
- **What is an acceptable net margin?**
- **Depends on a number of factors:**
 - **Cost structure, locations (S.D. vs. S.D.)**
 - **Leverage**
 - **Utilization**
 - **Realization**
 - **Pricing**

How Leverage Affects the Net Margin

- **Firms can have a high net margin but low average profits per equity partner (PPP)**
 - **Because of lower leverage**
- **Firms can have a high net margin, low leverage and high average PPP**
 - **Because of multi-tier partnership structures**
- **Firms can have a low net margin but high average PPP**
 - **Due to higher leverage**

How Other Factors Impact the Net Margin

- **Firms with a higher realization combined with cost structures and leverage of similar firms will have a higher net margin**
- **Same holds true for firms with better utilization**
- **Other factors include type of work, pricing of work**

Illustration of Net Margins

	Firm A (H.V.)	Firm B (M.V.)	Firm C (L.V.)
Type of Work			
Average hours (utilization)	1,900	1,700	1,900
Rate	\$220	\$180	\$120
Fees per earner	\$418,000	\$306,000	\$228,000
Fee earner salary	\$130,000	\$105,000	\$70,000
Overhead	\$160,000	\$120,000	\$105,000
Profits per fee earner	\$128,000	\$81,000	\$53,000
Leverage	4:1	6:1	9:1
PPP	\$640,000	\$567,000	\$530,000

**Understanding the Numbers
Provides You With a
Creative License**

Management Reporting Considerations

- **Provide more in the way of knowledge, less in the way of data**
- **Use simple presentations:**
 - **Use “drill-down” technique if overly complex**
 - **Answer the 5 W’s**
- **Present reports that reflect what the partners need to know:**
 - **You need to determine what data the partners need to know and understand**
 - **And then, educate them on what they need to know and help them interpret results**

Who Gets What?

- **Management committee--more detailed**
- **Partners—condensed reports reflecting one-firm reporting**
- **Practice Group Leaders-generally same as management committee but for their group only**
- **Associates**
- **Staff Management**

Sample Presentation to the E.C.

- **Review current period financial statements**
- **Include an introduction piece**
- **Drill down on certain expenses**
- **Provide other key information:**
 - **Utilization**
 - **Realization**
 - **Staffing and leverage**
 - **Investment in WIP and A/R**

Commentary on Current Period Results

- **Hours are behind plan by 2,148**
- **Need to focus on improving billing and collections—behind plan by \$192k**
- **Experiencing softness in 3 practice groups**
- **Also experiencing some slippage in realization**
- **Expect productivity improvement in 2nd and 3rd quarters**
- **Some negative expense variances due to timing issues**
- **Staffing levels are temporarily high**
- **Projected results look good and but we might expect to fall short of plan by \$215k**

Balance Sheet Highlights

(in thousands)	<u>Current</u>	<u>Prior Mo</u>	<u>Prior Yr</u>
<u>Assets:</u>			
Cash	\$233	\$529	\$697
WIP	1,986	1,632	1,545
A/R	3,659	3,102	2,864
<u>Liabilities/Cap:</u>			
Accts. Payable	176	421	118
LOC o/s	578	0	311
Long term debt	1,367	1,423	1,183
Cash capital	543	766	213

Income Statement Snapshot

(\$ in 000's)	<u>Actual</u>	<u>Budget</u>	<u>Var.</u>
Billable hours	13,079	15,227	(2,148)
Billable dollars	\$4,581	\$5,062	\$(481)
Receipts	4,510	4,702	(192)
Expenses	3,622	3,788	166
Available	888	914	(26)
Distributed	946	927	(19)

Operating Expenses

(In thousands)	<u>Actual</u>	<u>Budget</u>	<u>Var.</u>
Salaries/Benes.	\$2,028	\$2,100	\$72
Occupancy	278	308	30
Marketing	327	267	(60)
I.S. Dept.	252	183	(69)

Cash Flow Statement

Net income from operations	\$888,000
Add back depreciation expense	54,000
Cash provided from operations	942,000
Other sources and uses of cash:	
Partner distributions	(946,000)
Increase in LOC	578,000
Reduction in Long Term Debt	(56,000)
Reduction in Accounts Payable	(245,000)
Increase in client advances/disburse.	(204,000)
Purchases of FF&E	(365,000)
Net other sources and uses of cash	(1,238,000)
Net decrease in cash	\$(296,000)

Practice Group Utilization

(reporting version A)

	Actual	Budget	Variance
Nano	1,316	2,484	(1,168)
Corp	2,003	3,967	(1,964)
IP	679	994	(315)
Bankruptcy	3,854	3,076	778
Litigation	5,227	4,706	521
Total	13,079	15,227	(2,148)

Practice Group Utilization

(reporting version B)



Leverage and Staffing

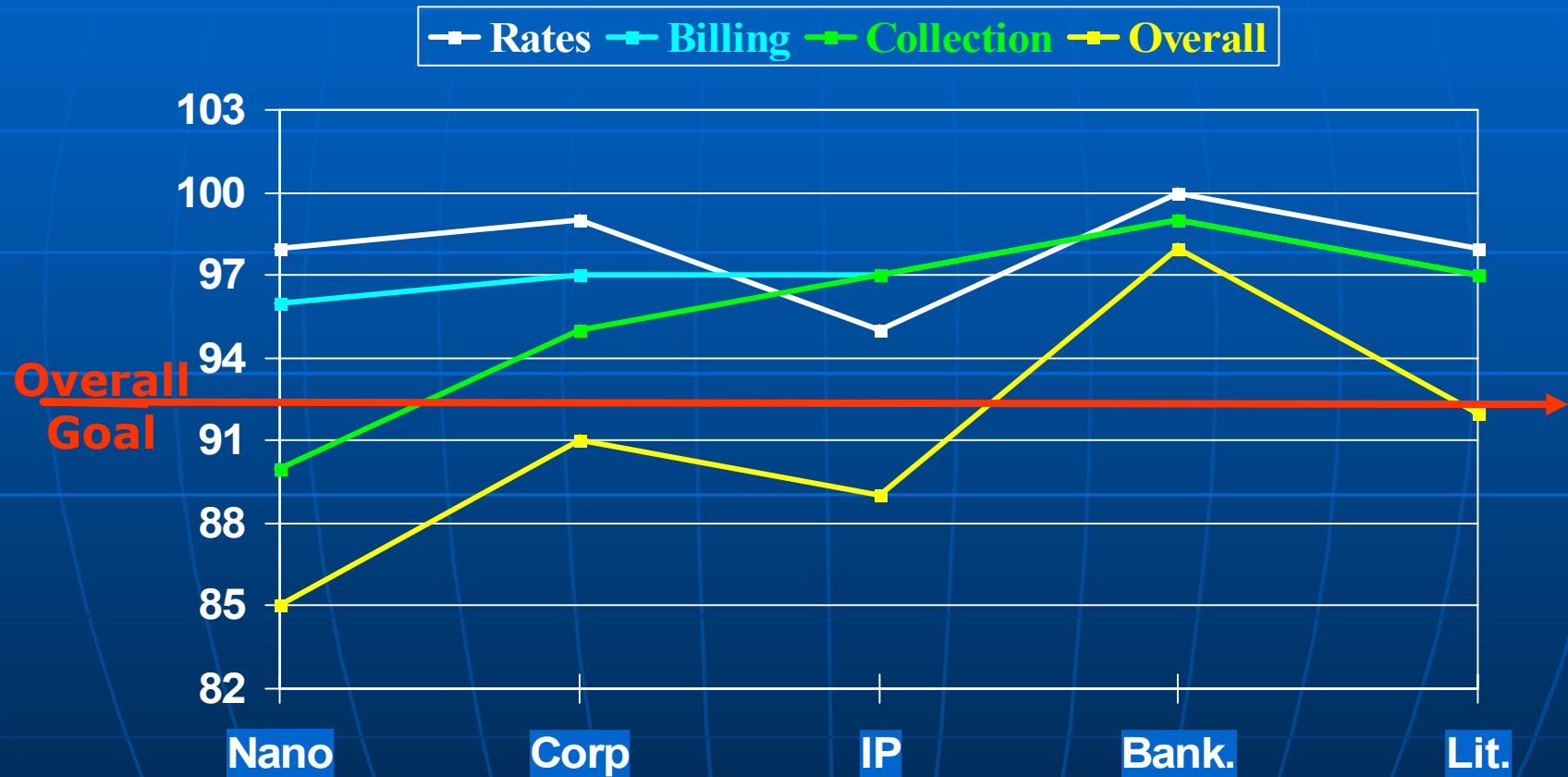
	Actual	Budget or Goal	Variance
Partners	29	30	1
Associates	30	34	4
Secretaries	36	30	(6)
Other staff	42	36	(6)
Leverage	1.03:1	1.13:1	(3)
Secr/atty	1.64:1	2.0:1	(6)
Staff/atty	1.32:1	1.15:1	(10)

Investment in WIP and A/R

(by Practice Group)

Partial listing	WIP	Accts. Rec.
Nano	\$125,877	\$387,544
# of days	66	202
Corp	\$297,555	\$600,541
# of days	46	93
IP	\$102,050	\$312,983
# of days	70	214
Total	\$525,482	\$1,301,068
# of days	63	171
Goal # of days	45	76
Dollars available/ Excess investment	\$150,138	\$722,816

Practice Group Realization



Questions/Comments

Opportunity for Follow-up

Law Firm Business Institute

Stephen M. (Pete) Peterson

Managing Director

pete@lawfirmbiz.com

T: 303.981.1118

F: 970.626.2226