IN BRIEF

THIS ISSUE
August 2007
Issue 101

OREGON STATE BAR 1995
PROFESSIONAL LIABILITY FUND
www.osbplf.org

Malpractice Prevention Education for Oregon Lawyers

Assessing Your Financial Fitness

Do you know how to calculate your effective hourly rate? Do you know which of your clients consistently don't pay? Do you know how to run a "leakage report" or how to compare projected billings to cash flow? If you answered no to any of these questions, you will want to read this article describing the many different profitability and client activity reports you can examine to assess the financial fitness of your practice.

■ **Fees Collected.** If you compare legal fees collected from each client, you can determine which clients contribute the most toward your total revenues. If you divide each of these client totals by your total annual revenue, you can spot whether a few clients are in a position to make – or break – your practice.

■ **Write-up, Write-down Report.** This report compares your actual fees billed on each matter over a certain time period against a standard measure – usually your regular hourly rate times your actual hours spent on each matter. This comparison reveals which matters or clients result in high write-ups or high write-downs. The typical benchmark is that an hourly-rate biller should have, on average, a 5 percent write-down rate, and a contingency-fee biller should have, on average, a 150 percent write-up rate. If any of your client matters fall outside that range, this report will draw these clients to your attention.

■ **Fees Billed.** Fees billed is a simple volume indicator allowing you to rank clients based on their fee generation, from high to low.

■ **Accounts Receivable.** By date-aging your receivables (current, over 30, over 60, and over 90 days) and then ordering them from highest to lowest in each date range, you can see who is costing you money (since you are, in effect, financing unpaid fees). Law firms typically see a 105-day delay, on average, between sending an invoice and receiving payment. Your accounts payable are generally due in 30 days or less. Since the typical payment is received about three payables periods later, monitoring your A/R becomes an exercise in cash management.

■ **Outstanding Disbursements.** Clients who generate large disbursements use a disproportionate amount of the firm's capital, particularly if the firm carries the disbursements for any period of time. By ranking outstanding disbursements by client from largest to smallest and dividing your total outstanding disbursements by each client-owed amount times 100, you learn the percentage that each client bears of outstanding disbursements. You can then see which clients are using a large proportion of your capital devoted to expense advances.

■ **Trust Balances.** This is a report to determine which clients' funds on deposit may soon be depleted. Make sure trust accounts are replenished regularly to avoid having to finance your client's expenses.

■ **Work in Progress.** Your work in progress (WIP) is your inventory. It is useful to know the number of days that WIP sits in inventory before it is billed. Create a report that lists WIP per file, along with the days it has been in inventory. WIP should turn over every 60 to 70 days. If you have large amounts

Continued on page 2

of WIP that approach 60 days (or longer), it may be time to consider billing them and converting them to accounts receivable.

■ **Effective Hourly Rate.** Your effective hourly rate (EHR) results from dividing fees collected per client by the hours billed for a matter. If you then sort your clients by EHR from high to low, you'll know which are high-margin clients (those that make you the most money for the least effort) and which are low-margin clients.

Knowing your EHR is more informative than just knowing revenue. For example, assume you have two clients, each of whom you billed $10,000. Assuming you collect the entire amount from each client, the revenue is the same. Now assume that for client A you spent 100 billable hours and for client B you spent 500 hours. Client A's EHR is $10,000/100 = $100/hour, while Client B's EHR is $10,000/500 = $20/hour. You don't know the absolute profitability of either client, but in relative terms, you can clearly see that client A is much more profitable than client B.

■ **Projected Billings vs. Cash Flow.** If you have large upcoming cash requirements (e.g., liability insurance premiums, bonuses, income tax), you must bill an adequate amount well in advance to ensure that the funds are on hand when needed. Accordingly, a report comparing your projected billings to your cash flow needs allows you to anticipate a cash-positive or cash-negative situation.

■ **Realization Rates.** No one uniformly collects his or her stated hourly rate. The realization report allows you to more precisely determine your actual hourly rate earned by client or matter. To generate this report, divide fees actually received by actual hours spent on the file (not just hours ultimately billed to the client). If you rank the results, you can see which clients or matters generated the highest and lowest realization rates.

■ **Leakage Reports.** These reports determine the lost income resulting from time leakage – from failure to record billable time, to writing off time when billing, to writing off unpaid amounts at the time of collection (or, more accurately, non-collection). By comparing the difference between your billable fee "ceiling" (your regular hourly rate multiplied by your annual billable hours target) and your actual annual fee receipts, you can see the total amount of your billable time leakage. By determining the time written off, you also can figure your leak volume.

■ **Exception Reports.** You can produce reports that provide only the exceptions – for example, unpaid fees or disbursements over a certain dollar threshold and a certain date range. In this way, you separate the forest from the trees, focusing in on the information necessary for problem solving.

■ **Profitability Reports.** To determine your average hourly cost for providing services, divide your total annual expenses by your annual billable hours expectation. This provides a ballpark cost per hour or standard cost to render services. If you are not collecting at least your billable hour total times your standard cost on a particular matter, you are losing money on that file.

For example, assume you expect $100,000 in draws from your practice annually. You pay your assistant $45,000 in salary and benefits per year. All other overhead expenses total $25,000 for the year. Your total annual expenses are $100,000 + $45,000 + $25,000 = $170,000. Assume you bill 1,700 hours per year. Your "standard cost" of rendering services would be $170,000 ÷ 1,700 = $100/hour. If you are not collecting at least $100 for each hour you put into a matter, that matter is costing you money.

If your firm is composed of multiple timekeepers, you need to determine each time-biller's overhead rate or decide to treat all fee-billers equally, at least for computing standard overhead rates. Knowing your standard cost amounts will allow you to determine the absolute profitability of clients, files, lawyers, and practice groups. This is the first step toward moving from simply looking at revenues to looking at true profitability factors, such as hourly cost of services, EHR, and realization rates. You can then make decisions about client selection and retention, compensation, bonuses, capital contributions, and other financial decisions based on hard financial data.