

New Times - New Measures

New Times Require New Measures for Budgeting

Abstract:

Too many law firms are still using a projection of past revenues and expenses into the future budgets. The environment has changed and so must budgeting. There are no more guarantees. There is a much higher standard of performance expected from lawyers. The old budgeting approaches do not encourage lawyers to adapt to those changes. Budgeting sends a very strong message to lawyers on their behavior and their focus. Use this approach to encourage the right behavior and save your firm.

In the past, while helping clients put mergers together, I have found a disturbing problem in those we are trying to acquire. The target firms have not been using their financial planning to build their firms. They have been taking the past and projecting it in the future. This has inhibited risk taking and mutual accountability between partners. What is the worst example? When asked how the firm planned its finances, the response was: "We divide the revenues from the last year by the number of timekeepers last year and then multiply the result by the number of timekeepers for the next year. Other approaches were only slightly better a projecting the past into the future. The result? There is no focus on improving the quality of the work or in improving the performance of the entire firm. How can this be said? Such budgeting relies on faulted assumptions.

Faulted Assumptions

One success factor is perceived to be that value of services rendered is equal to the effort (billable hours worked). *False!* Growth in income will come through growth in volume of hours produced by the firm. *False!* Any work is better than no work. *False!* The future is best based upon the past. *False!*

Clients do not equate effort with the value added by the lawyers. If there is no perceived

value added, clients will ask for discounts on rates or will discount the fee bill. Volume of hours produced and fees billed will not necessarily produce higher income. If the volume of hours billed goes up there is a very high probability that there will be a lower return on rates due to fogging, churning, and rate transfer. Fogging is adding time to a file without adding value e.g. "Review of file." Churning is running too many people through the file, each having to spend time coming up to speed on the file. Rate transfer is when a higher rate person does work that a lower rate person should do because he or she "needs the hours" to make budget. If a firm sets hourly budgets too high, people must choose between the trailer park and treachery. And they will choose treachery every time. Also heard at many law firms is "any work is better than no work." That would be like Southwest Airlines saying: "let's fill up every seat, even if we have let them fly for much less than it cost us to fly that seat." Sure, the argument is that such work might cover overhead, but in most cases, the rate of return on the file won't even cover the compensation of the partners and associates running the file. Finally, the future is not based upon the past. Legal work is becoming more episodic and transactional as clients move to lower their legal costs by picking and choosing what they will give to any law firm. Most legal work is perceived by sophisticated clients as a commodity and priced that way. Their sophisticated risk managers are now in charge - - not the outside lawyers.

The New Measures for New Times

Although volume is important, in these times the key success factor in performance and viability must be the return on established rates (realization). First we must define "rate." Rate is not a reflection of value added. Rate is a reflection of the expected return on the investment the firm has made in building the experience, expertise, and knowledge base of a timekeeper

within the firm. Back to the airline analogy again, if an airlines has a cost system that cannot be cut without destroying the competitive advantages of the airlines, a load factor of 65% might be the break even point. If they are flying at 65.5% they are making a million a day, if they are flying at 64.5% they are losing a million a day. The same rules of economics affect law firms.

A simple starting point is to focus on only 9 key variables that drive income.¹ In Figure 1 the top lines shows the potential revenue per partner of the law firm. The next row shows the return the firm is getting on its investment in people and clients. The result of the top two lines is the net inflow per partner. The third line shows the funds that are being used up in operations. The result is the Distributable Income Per Partner (DIPP). An old Stanford Business School Model says: “When your outflow exceeds your net inflow, the upshot is your downfall.”

Insert Figure 1; Critical Performance Measures

The top line, potential revenue, is the result of the Leverage employed per partner times the average lawyer Pace (hours worked) times the average Benchmark Rate (the expected return on time). The second line shows the return on the top line. Realization one (R1) is the return on the benchmark rates as work is accepted. For example if the client is promised a 10% discount, R1 becomes 90%. Realization two (R2) is the return on the value of work in Work-In-Progress (WIP). For example if the billing lawyer relieves \$10,000 from WIP and only bills \$9,000, R2 is 90%. Realization three (R3) is the return on the value of work in Accounts Receivable (A/R). For example, if the client gets the billing lawyer to write off 10% of the fee billed, R3 will be 90%. The result: The net revenue is now only 72% (R1 times R2 times R3) of what it could have been had the firm had a stronger intake process, managed projects more effectively, or had a better understanding of the client’s issues and billing guidelines. The third line represents the use

of the net revenues after discounted by realization. Expenses (E) per partner plus the Investments in capital items (I1) and the Investments due to the increase in WIP and A/R balances over the measurement period (I2).

Why such a focus on realization? Lawyers must keep their eye on the ball - - increasing the size of the pie for the entire firm. Focusing on overhead and cost accounting takes their eye off the ball. The focus on Realization requires the following partner-driven tasks. First, they must realize that every new matter results in an investment by the firm on which the firm should receive a fair return. Second, partners are responsible for managing their matters responsibly so as not to incur write-downs. Poor project management, poor training, poor delegation skills, and the resulting turnover of lawyers and staff will guarantee lower realization on the values created in WIP. Third, lack of agreements with the clients on their expectations and an understanding of the financial responsibilities, the abdication of responsibilities in billing and collection, and the inadequate effort to develop a long-term client relationship will drop the realization on the value of services in A/R.

An example will help the reader see the impact of realization on a firm. There are two partners in a law firm. Partner A, Mr. Shark works 2,000 hours a year. His benchmark rate is \$300 per hour and his compensation and overhead is \$600,000. His collections were \$1,500,000. Partner B, Ms. Team works 1,800 hours a year. She makes the same amount as Partner A and has the same billing rate. She collected \$1,000,000. Who should make the most money?

Hold on, we are not through. Partner A's overall realization was 72% which meant that the firm invested \$2,083,333 to get the \$1,500,000. Partner B's realization was 98% which meant that the firm invested \$1,020,408 to get the \$1,000,000. If associates typically bill

\$350,000 each and carry salary and overhead of \$200,000, then Partner A used 4.24 associates and Partner B used 1.37 associates. After deducting the partner's compensation and overhead and the associates' compensation and overhead, Partner A's return on the firm's investment was \$52,381 while Partner B's return to the firm was \$674,519. Now who should make the most money?

The Checklist for Setting Up Budgeting for the New Times

Step 1: Point out to partners the importance of realization to the firm. People who grew up in the culture that effort equals value and volume equals profit will not come along quietly. You can use the following to make the argument. First, if the firm generate \$50 million in revenues and can increase their realization by 10%, then revenues would be about \$5 million dollars all of which would go to the bottom line. Second, if salaries were reduced by 10%, an almost impossible task, the amount returning to the bottom line would be about \$1.8 million.

Step 2: Set new targets for benchmark rates and realization for each time-keeper. Each time-keeper should be given a benchmark rate that accurately reflects the expected return on their time regardless of type of practice. For example, litigators who do commercial litigation and litigators who perform insurance defense work must be given the same benchmark rates. If then an insurance defense lawyer gets only 70% of benchmark rate because of discounts, he or she must leverage work more effectively to maintain and overall realization rate for R1 that the commercial litigators get.

Step 3: Start with a zero based budget on expenses, investments in capital items, and investment in WIP and A/R. What must be in place in overhead to make the realization targets? How much will the firm, based upon history, invest in WIP and A/R?.

Step 4: Don't focus on cost accounting. Focusing on the profitability with cost accounting will focus the partners on all the wrong factors e.g. their personal or team costs. Set up the benchmarks for realization based upon the overhead that must be carried. For example, if given the overhead numbers, the break even point for minimum partner distributions is 65%, focus on that critical performance measure.

Step 5: The spreadsheet for revenues. Each timekeeper should be listed in one column. Across the top the following columns should be labeled. For each of the last three years the collections, R1, R2, and R3. That will take Columns A through M. For the coming year the following Columns should be created. Column N: Hours expected. Column O: Benchmark Rate (the expected return on the investment of the firm in the individual). Column P: Columns N times O. Column Q: the expected realization on benchmark rates (R1). Column R: Columns P times Q. Column S: the expected realization on WIP through better project management and training. Column T: Columns Q times S. Column U: The expected return on A/R in getting to collected dollars. Columns Q, S, and U are targets agreed upon by the partners who are tasked to improve the overall return from their clients.

Step 6: Set up benchmarks and review points. For the targets set up by the leadership with each partner, create the programs that will enable them hit their targets. Set up review points after the end of each quarter for the leadership to review status and make adjustments.

Step 7: Use the realization numbers to identify problems and drill down to specific programs that need to be executed more effectively. For example, should individual practice groups or sections be more focused on leverage, alternative pricing, client loyalty, expanding the bundle of services to provide legal related services, turnover, training, or other key programs.

Critical Performance Measures

Kiss Law Firm Management for Distributable Income Per Partner (DIPP)

OLD



Just too many interrelated Items to Measure!

NEW

| | | | |
|----|----|----|-----------------|
| L | P | BR | Accrued Revenue |
| | | | Times |
| R1 | R2 | R3 | Realization |
| | | | Less |
| E | I1 | I2 | Outflow |
| | | | |
| | | | = 's DIPP |



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1. A more in depth discussion may be found on this subject in Chapter 11 “Ways to Implement the Crossover from Cost-Based to Value-Based Billing,” to appear in Win-Win Billing Strategies: Alternatives that Satisfy Your Clients and You, (the sequel to Beyond the Billable Hour), Richard C. Reed, editor, the American Bar Association's Law Practice Management Section, December, 1991.