What could a slowdown in client payments mean for law firms?

The importance of calculating payment cycle metrics in forecasting 2020 financial projections

For decades, **law firms** have focused their management attention on billable hours, billing rates, realization and cash collections. As **COVID-19** continues to cause widespread disruption to businesses in all industries, the pandemic may highlight one area of mismanagement that firms have struggled to address – the management of investments in client services, or unbilled and accounts receivable fees. Ostensibly, the loan portfolios extended to clients, often approved by individual partners at the time of engagement.

The pandemic is casting a bright spotlight on these loan portfolios extended to clients and is highlighting the need for robust internal controls. Should law firms consider establishing a loan committee style client-intake process?

Much like banks, law firms might consider adopting an approach to setting terms for service that mirrors the process that banks require in approving credit. Just as it would not be advisable, absent banker personal guarantees, to permit bankers to have independent authority in extending credit to clients, law firms should be cautious when allowing their partners to independently bind the firm and its assets. Law firms which employ this practice have often found it is to their detriment. Inconsistent engagement letters and associated terms of service including language about the requirements of timely payments, the consequences for failing to pay, exceptions to upfront fee deposits, and below standard billing rates and pricing terms, are examples of the resultant policy slippage. By no fault of their own, some law firm partners have struggled with understanding the relative impact that their day-to day practice management decisions might have on working capital and cash flow for funding the firm's operations. With this in mind, permitting partner sign-off on payment terms and conditions should be monitored and, in some cases, restricted altogether.

The potential impact on profits:

Figure-1 below depicts the calculation for determining a firm's turnover of unbilled fees and accounts receivable. Figure-2 is a simple illustration of the potential impact on a firm's profits in relation to slower turnover of unbilled fees and accounts receivable. The example assumes that the firm meets its annual productivity budget measured as *total value of billable hours* (USD 27,000,000), bills out 90% of that value measured as *total value of fees billed* (USD 24,300,000), and collects 95% of the *total value of fees billed* in the period to arrive at cash revenue for the period of USD 23,085,000.

Next, it projects the value of unbilled fees and accounts receivable at the end of the period will be USD 10,000,000 (USD 5,000,000 of unbilled fees and USD 5,000,000 of accounts receivable fees). By dividing the *projected unbilled fees* at the end of the period by the average *monthly value of billable hours*, and multiply that result by 30 days, it produces an average number of days to bill of 66.7 (2.2 months).

By dividing the *projected accounts fees* at the end of the period by the average *monthly value of fees billed*, and multiply that result by 30 days, it produces an average number of days to collect of 74.1 (2.5 months). Thus, the total turnover time of investments in client services (ICS), on average, from worked to collected is 140.7 days or 4.7 months. *Note: Contingent fee matters should be removed from this calculation to get a truer understanding of normal annual operating turns of investments in client services.*

The resulting budgeted income statement (P&L), assuming a 35% profit margin, before equity partner compensation, is:

Budget cash revenue	USD 23,085,000	100%
Budget total expenses	USD 15,005,020	65%
Budget profit available for equity partners	USD 8,079,750	35%

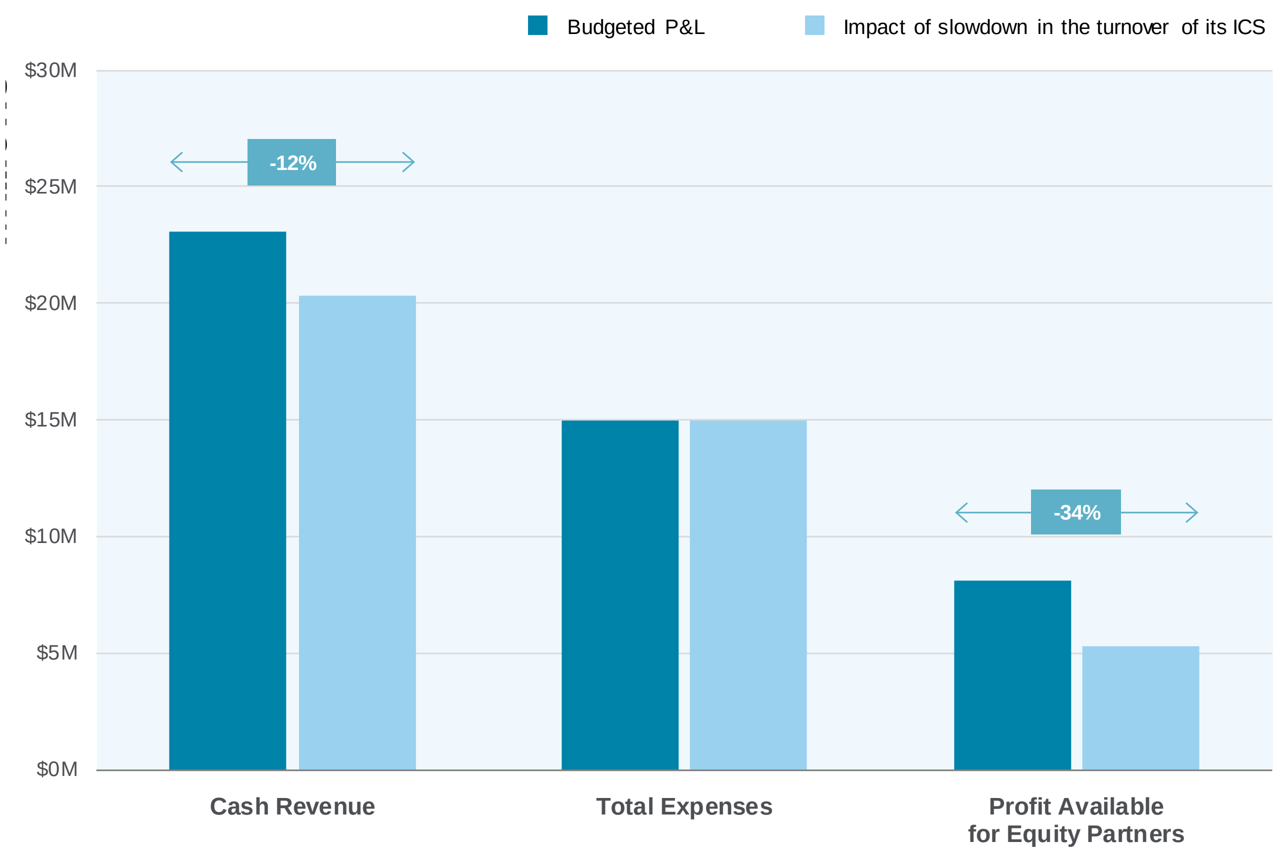
Calculating the Firm's Turnover of Unbilled Fees and Accounts Receivable (Figure-1)

	Annual Budget	Realization
Projected unbilled fees at end of period (A)	$ 5,000,000	
Total Value of Billable Hours for the period	$ 27,000,000	100%
Monthly Value of Billable Hours (B)	$ 2,250,000	
Calculation of average days to bill: (A/B)*30	66.7	
Projected accounts receivable fees at end of period (C)	$ 5,000,000	
Total Value of Fees Billed for the period	$ 24,300,000	90%
Monthly Value of Fees Billed (D)	$ 2,025,000	
Calculation of average days to collect: (C/D)*30	74.1	
Total Turnover of Investment In Client Services (ICS) in Days	140.7	
Total Turnover of Investment in Client Services (ICS) in Months	4.7	
Calculation of cash revenue per day:		
Cash Revenue per period	$ 23,085,000	95%
Number of work days	250	
Cash Revenue Per day	$ 92,340	

If the firm were to experience a 30-day slowdown in the turnover of its ICS (140.7 days to 170.7 days), given the budgeted cash revenue per day of USD 92,340, the potential impact to profits could be USD 2,770,200 (USD 92,340 X 30 days). The resulting income statement, assuming no change in expenses and USD 2,770,000 reduction in cash revenue, would be:

Potential Profit Impact of a 30-day Slowdown in Turnover (Figure-2)

Cash revenue	USD 20,314,800	100%
Total expenses	USD 15,005,020	74%
Profit available for equity partners	USD 5,309,780	26%



Key takeaways:

Managing liquidity or working capital during these times is of utmost importance. Given that inventory turnover is the principal component of law firm working capital, firms need to be particularly vigilant in anticipating and understanding the implications of client payment slowdowns when projecting financial performance and developing contingency plans in 2020 as well as in the foreseeable future. Missing budget on billable hours and billing realization will result in even greater challenges when combined with slower turnover.

Managing the firm's balance sheet and improving turnover is of equal importance to productivity, and may be a one positive take-away for partners when it comes to better **law firm financial management** in the future.

If you would like to discuss any of the information in this article, please contact **George J Wolf, Jr**.