Mueller Prost PC
CPAs + Business Advisors

ATTORNEY'S REPORT

Summer 2013

BEYOND STANDARD STATISTICS

Follow the RULES of Law Firm Profitability

Many law firms are still gauging profitability simply by how many hours their attorneys bill out.

However, savvy firms are looking at new statistics and using a combination of metrics to get a clearer picture of profitability. Often this data is already within a firm's financial management system — it just needs to be evaluated in new ways.

One such combination of metrics is known as the **RULES.** Outlined in Robert J. Arndt's book "Identifying Profits (or Losses) in the Law Firm," the **RULES** enable firms to evaluate profitability by looking at five key metrics:

1) **R**ealization of billing rates
2) **U**tilization of attorneys
3) **L**everage of lawyers
4) **E**xpense control
5) **S**peed of billings and collections

Piecing Together the Puzzle

According to Arndt, evaluating these metrics can help attorneys and law firms better understand just how much money they are truly making per hour. Ultimately, evaluating the multiple data points that comprise the **RULES** means you aren't just looking at one piece of the profitability puzzle.

1) Realization

Firms typically look at the fees billed and/or collected by their attorneys to establish this measure of how much is ultimately collected versus the effort expended. While this information can be useful, Arndt notes that, by itself, it does not provide any clear relationship to profitability. Rather, he suggests that firms establish annual revenue projections based on the hours that they can reasonably expect each of the firm's timekeepers to bill and their respective billing rates.

The result is a firm-wide composite hourly realization rate, which serves as a realization benchmark to compare against over the course of the year. By evaluating variations from the benchmark, management can then focus on those billing issues that bring the firm the greatest benefit.

Takeaway: By determining how close your realized rates are to the standards set in your projections, you can make more informed decisions when considering changes to your billing rates, negotiating fixed-fee arrangements, or providing discounts.

2) Utilization

This measures how timekeepers are using their time on billable vs. non-billable activities. Of course, the goal is for everyone to maximize the efficiency of their billable hours. But, to accurately measure (and eventually increase) utilization, the firm must first ensure that all time, billable or otherwise, is being entered promptly and correctly by all timekeepers. With this data, the firm can accurately judge all the factors that determine what should be billed on certain matters and help evaluate the efficient use of the timekeeper's time.

Takeaway: After taking steps to ensure accurate time entry, establish and publish billable hour objectives against which staff attorneys need to measure their performance. There are many factors involved here, including current economic conditions and the time lag in collections, so make your objectives realistic, but not compromised.

3) Leverage

Arndt defines leverage of lawyers as the "ratio of associates or non-equity partners to equity partners in the firm." In a firm with 10 associates and 10 partners, the leverage is 1:1. A firm with more partners than associates will have a ratio of less than one, while a firm with just a few partners and higher number of

BEYOND STANDARD STATISTICS

Follow the RULES of Law Firm Profitability, Cont'd.

non-partner attorneys will be "highly leveraged." As the leverage decreases, a greater percentage of the firm's net income must go to partners to maintain or increase their income.

Takeaway: Even a highly leveraged firm can generate more income for the equity partners as long as associates at the lowest levels are working at their highest productivity. The key, of course, is to manage your payroll correctly while continuing to bring in work.

4) Expense control

This one is self-explanatory, yet many firms aren't very mindful of this part of the **RULES**. Expenses aren't always as controllable as the other parts of the **RULES**, but should nonetheless be diligently documented so that a realistic business picture and sound law practice funding are maintained.

Takeaway: While expense control is important, it doesn't have nearly as much impact on profitability as realization, utilization and leverage. For example, controlling overtime can add tens of thousands of dollars to your firm's profitability, but not nearly as much as adding new clients or billing more hours.

5) Speed

This final metric measures the gap between the time when billable hours are incurred and the time when payment is actually received. To get a handle on this, it is essential to review two statistics: Work in Progress (WIP) and Accounts Receivable (A/R). For example, if you have two months of billing currently relegated to WIP and three months in A/R, it means that it is taking five months from the time billings are posted on the books until the money is actually coming through the door.

Takeaway: Looking at your collections data this way may point out the need to have your attorneys get their time in promptly so they can bill clients more often and reduce the lag time between billable hours worked and getting paid. The standard practice of billing monthly actually slows down cash flow by giving clients what are essentially interest-free loans.

If your firm isn't as profitable as you'd like, it might be time to play by some new **RULES**. Here, using a different combination of metrics may provide a clearer picture of your firm's true profitability.

Revenue metrics can be heavy stuff indeed. Mueller Prost PC has a dedicated team of accounting professionals who can help you with this analysis. Give us a call today at 314.862.2070.

BANKERS AND LAWYERS:

Why a Healthy Banking Relationship Matters

Often, attorneys have a cynical view of bankers. They see them as number crunchers who are unwilling to lend when a law firm needs it, but all too willing when it doesn't.

Truth is, a solid relationship with the right banker can be a mutually beneficial and effective business alliance. Attorneys tend to be attractive prospects for banks, which often view them as low-risk financial clients with a good potential for new business referrals.

For the attorney, having a banker who understands and takes an active interest in the practice can mean not only ready access to financing, but also additional networking possibilities and opportunities to grow your practice.

Find a Business-Friendly Banker

It's unrealistic to assume that every lawyer can properly represent every client. Likewise, not every bank is appropriate for every law firm. Consider these tips for finding a business banker who meets your needs:

- **Learn who's lending.** Although small and mid-sized banks control only 22 percent of all bank assets, they account for 54 percent of small business lending.

BANKERS AND LAWYERS:
Why a Healthy Banking Relationship Matters, Cont'd

By contrast, the largest 20 banks, which now hold 57 percent of all bank assets, allocate just 18 percent of their commercial loan portfolios to small businesses, according to the FDIC.

- **Find a banker who will make time for you.** Believe it or not, the business banker who actually comes to your office and learns how your firm operates does still exist. Look for a business banker who will spend some time with you to understand both you and your practice.

- **Look for a "*trusted advisor.*"** Look for a banker who's willing to ask questions and offer solutions. A skilled business banker can help you properly manage growth and use business financing wisely. He or she can also provide guidance on how to best structure your deposit relationship and manage your cash.

- **Do your part.** Educate yourself about the fundamentals of business financing. Take a look at the SBA's Loan Application Checklist (http://sba.gov/content/sba-loan-application-checklist) to learn what you will need to provide and discuss with your lender. You'll also need to spend the time communicating with your business banker - updating him or her on your business and providing up-to-date financial reporting.

How the Right Bank Can Help

Ultimately, an attorney-friendly bank can be a valuable partner in helping you manage the business side of your practice by providing the following services:

- **Cash management** – A business savvy banker can help you put collected funds to work quickly and efficiently. For example, with a "sweep" account, excess funds are automatically transferred from an operating account to an interest-bearing account.

Likewise, with remote deposit capture, staff can digitize checks for deposit using a special desktop scanner, eliminating time consuming trips to the bank for manual deposits and providing faster access to the funds. Increasingly, banks are offering an expanding array of online cash management services as well.

- **Financing** – Ultimately, a law practice, whether a solo or traditional firm, is just like any other business - it needs cash. Good banking relationships help provide the necessary funds to cover a myriad of needs, from evening out cash flow shortfalls when collections lag to upgrading technology and expanding into new practice areas. The right banker will evaluate your capital needs and suggest a mix of financing options, from lines of credit to equipment term loans.

- **Merchant services** – A good business banker can get you set up to process credit card payments which can mean a tremendous convenience for your clients and a cash-flow boost for you. The few dollars you'll pay in processing fees are easily offset by the ease and assurance of payment and the speed of collections.

- **Trust accounts** – A banker familiar with the legal profession can help you set up an effective process for managing trust accounts, from withdrawing retainers or flat fees to establishing an IOLTA checking account for attorney escrow funds.

Finally, remember that while they may have business banking products, not all banks are business friendly. Take the time to find the business bank that meets your firm's unique needs.

Closing the Cash Flow Gap

Your law firm's cash flow gap is the time lag between when you pay your expenses and when clients pay you. Historically, this number has been about 105 days for most firms. The good news is that by following a few practical steps, you can easily close the gap.

Own it.

Some attorneys are notoriously indifferent to accounts receivable, considering collections an administrative matter and delegating it to a paralegal or clerk.

Action: Take a cue from commissioned salespeople and consider withholding compensation or deducting collection expenses for billings that don't turn into cash. Likewise, consider rewarding lawyers who have a high realization rate.

Bill it.

All too often, billing is deferred until the end of the case by which time the psychological "value" of the work begins to fade in the client's mind.

Action: Invoice regularly as the case progresses, and issue monthly statements broken down by "aging" (e.g., 30 days overdue, 60 days overdue, 90 days or more overdue).

Follow up.

Failing to promptly follow up once a client account becomes delinquent is typically the weakest link in a law firm's collection system. A client who is allowed to go unpaid for 60-90 days receives the subtle message that the bill is not urgent and moves on to other priorities.

Action: Establish a set collection timeline. For example, automatic re-billing is done after 30 days, telephone follow up after 45 days, a collection letter is sent after 60 days, and a determination of termination or legal action is made after 75 days.

Our experienced professionals can help evaluate your time recording, billing and collection processes to ensure efficient fee collections.

Mueller Prost PC is a team of CPAs and business advisors headquartered in St. Louis, Missouri. From humble beginnings on a ping-pong table in 1983, the corporation has grown into one of the leading CPA and business advisory firms in the area, operating out of two locations with more than 90 staff members. By ***Advising with Vision***®, we offer clients new and unique ways to look at their businesses. Our forward-thinking CPAs and advisors stand ready to provide the depth of expertise, strategies and resources required to help clients set and achieve their goals at every stage of the business lifecycle. As a member of PKF North America (an association of independent CPA firms), our team has the ability to leverage national resources when needed to benefit client engagements.

Our firm offers a full range of professional tax, audit, accounting, litigation support and management advisory services to the legal community.

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