American Bar Association Young Lawyers Division
The Young Lawyer

Career Transitions
Law Firm Finances
A Primer for the New Partner

By Michael E. Mooney

Most law firm associates are told to focus on delivering quality legal services to clients and to leave financial management responsibilities to the partners. That can change overnight with election to partnership. Suddenly, as a brand new partner, you are an owner of the business and are expected to take a hand in running it. Will you be ready?

Law firms today rely on a number of basic financial tools to monitor and measure their financial performance and to plan for the future. A working knowledge of these tools is essential to understanding how the firm's business operates. The most important of these include:

Income statement. Usually prepared by the firm and distributed to its partners each month, the income statement gives the partners an idea of how the firm is doing in generating income and controlling expenses on both a month-to-date and year-to-date basis. The income statement reflects, first, the revenues the firm has received during the month (and year-to-date), principally for client services, but also from other sources, such as interest earned on funds the firm has set aside or invested temporarily in its bank account for a "rainy day fund." Promises of future payments or value of time worked generally are not included on the income statement.

Equally important on the income statement is information with respect to the expenses of the firm for the month and year-to-date, as the net profit is only the excess of the revenue received over expenses paid. Like revenue, only amounts actually spent by the firm are reported on the income statement. As a helpful planning tool, expenses for the current month may also be compared to the firm's budget for the same period (are we spending above or below budget in a particular category?) and to the same period in the prior year (are we spending more or less than last year and why?). The firm's monthly net income is determined by subtracting its expenses from its revenues.

Balance sheet. The balance sheet is a financial tool that lets partners see the firm's assets, liabilities, and how much capital the partners have "invested" in the firm. A law firm's balance sheet can be relatively simple. Its assets include cash in the bank, fixed assets, and investments. Its liabilities include amounts owed but not yet paid. The difference between the assets and the liabilities is the firm's capital. By way of example, if the firm has $500,000 of assets and $300,000 of liabilities, the firm capital is $200,000.

WIP report. The income statement and the balance sheet tell only part of the story as to how the firm is doing. Also important is the firm's work-in-process (or WIP) report.

The WIP report provides partners with an indication of the value of the legal services it has provided but not yet billed and how long ago that work was performed (an "aging" of the WIP). WIP is determined by multiplying the unbilled hours diaried by lawyers through the date of the report times their billing rates. This information gives the firm a sense of what revenue should hit the income statement in the coming months.

But WIP numbers alone may be misleading. To use a WIP report as a planning tool, it is important that the firm have a sense also of what percentage of the WIP eventually will be billed and at what rates (full or discounted) and, when billed, what percentage will be collected. In other words, of the total amount reported on the WIP report, how much income will be realized by the firm in the form of cash receipts? That is called the "realization rate."

Accounts receivable report. An accounts receivable (A/R) report reflects amounts owed by clients of the firm for services that have been provided and billed but not yet paid. The A/R report usually includes an aging of accounts receivable to help the firm monitor collectability, breaking down receivables into the categories of less than 30 days outstanding, between 30 and 60 days, between 60 and 90 days, and longer. Remember, as a partner of the firm, it is not sufficient just to do the work; you must bill for it on a timely basis and then collect the amount billed. Sharing the A/R report with all partners can create an incentive for them to collect promptly.

Billings and collections cycle report. A billings and collections cycle report explains the average number of months and days between the date an hour of work is performed and the date the revenue associated with that hour is collected by the firm. Most firms bill on a monthly basis, so a cycle of less than two months is almost unknown. An hour of work performed on the first day of the month is not billed for approximately 30 to 40 days, and even a prompt-paying client may take 15 to 30 days to send the check. A cycle of over four months, on the other hand, may spell trouble, reflecting lax standards either in billing or collection.

Realization report. The realization report explains how much of each hour worked is actually collected. To keep it simple, let us look at an example of a single client's work for one month.

Work done for client ABC during September of 2010 consisted of 100 hours, with all of the work done at a single billing rate of $300 per hour. The gross value of the WIP for client ABC is $30,000 (100 hours x $300 per hour). Due to some duplication of effort, the partner in charge of client ABC suggests that the firm can bill client ABC for only 90 of the 100 hours diaried. The WIP realization rate for client ABC this month, therefore, is 90% ($27,000/$30,000). Assume further that when client ABC receives the bill, it insists on paying only $25,000 for the work done. In this case, the A/R realization rate is 92.6%. This means that the overall realization rate on the work for ABC (WIP and A/R) is just 83.3%

Most of us have already learned that knowledge is one of the most important tools in achieving success on behalf of a client. The same rule applies within law firms. Having a clear understanding of the financial tools that help a law firm measure its performance benefits not only the firm, but also the new partner trying to better understand the firm's finances.

NEXT STEPS

100 Plus Pointers for the New Partner (PDF). 2010. PC # 2050204PDF. ABA YLD.
Making Sense of the Tax Provisions of Partnership Agreements (CD Package). PC # CET10MSTC. Forum Committee on Affordable Housing and Community Development Law, ABA Center for CLE.

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