

The Future Value of Today's Inventory

By Derek Schutz

Most law firm managers understand intuitively that the value of inventory (both WIP and A/R) degrades over time, but by how much and how quickly? The ability to understand and answer these two questions is the first step in preparing a realistic, forward-looking valuation model — one that can identify opportunities and drive action.

To begin to assess the future value of current inventory, it is important to recognize that there are two different forces diminishing a firm's return on work performed, and both have the same basis: time. In essence the old adage "time is money" is true; as time passes, a firm's inventory becomes less valuable.

THE COST OF CAPITAL

The first and most basic of the two forces is widely understood and easily calculated. A dollar today is worth more than a dollar tomorrow. Anyone who has ever used a credit card, carried a mortgage, or borrowed or lent money in any fashion, understands the concept of the time value of money ("TVM"). However, few law firms step back and consider the view that the discount rate used in this calculation should reflect a market expectation of a return on investment. Too often, law firms calculate the carrying cost using their going debt rate, resulting in a negligible amount.

Illustration A uses a simple method (with two different Discount Rates) to determine the cost of time on a firm's inventory: (Amount) × (Daily Discount Rate) × (Open Days); where the Daily Discount Rate = Yearly Discount Rate/365 days.

CALCULATING RISK

The second and more important consideration when discounting inventory is the risk of default (both on payment of receivables and not billing work in progress). This is the risk that a firm will not realize a portion, or the entirety, of the value of work performed. Most finance managers instinctively understand that receivables a year old are less likely to be realized than those just billed. But how

does a firm measure this concept?

One approach is to use historic billing and payment patterns to develop a forward expectation curve. The curve is applied to current inventory to determine the amount that is likely to bill or collect. This method can be developed at a high level or made more complex by specifying the levels at which the expectation curve is developed (e.g., by practice group, type of work, client, etc). The concept remains the same — past performance serves as a predictor of future performance.

In Illustration B a curve is constructed based on a client's history, then applied to three outstanding invoices. A total of \$200,000 has been billed over the life of this client, with \$175,000 eventually being realized (87.5%). The majority of historic collections (> 50%) occurred within the first 90 days.

The Forward A/R Expectation Curve reflects these historic patterns and can be applied to current A/R to derive expected collections of those invoices. Consider the point on the line chart that corresponds to 240 days on the X axis. Based on this client's own history, if an invoice ages to 240 days there is a 50% likeli-

hood of collecting it. Of course, as with any forecast, this approach will not be precisely correct at each level of granularity, but it does provide a logical and historically proven method to value inventory, particularly when aggregating total A/R.

FROM VALUATION TO VALUE

Applying discount rates and assessing at-risk amounts are just two potential approaches to the valuation of inventory. Regardless of the approach taken, the true value to a firm will lie in its ability to identify potential problem accounts before they can't be put back on course. And in times of economic uncertainty, forecasting cash flow isn't a game where bluffing is a winning strategy.

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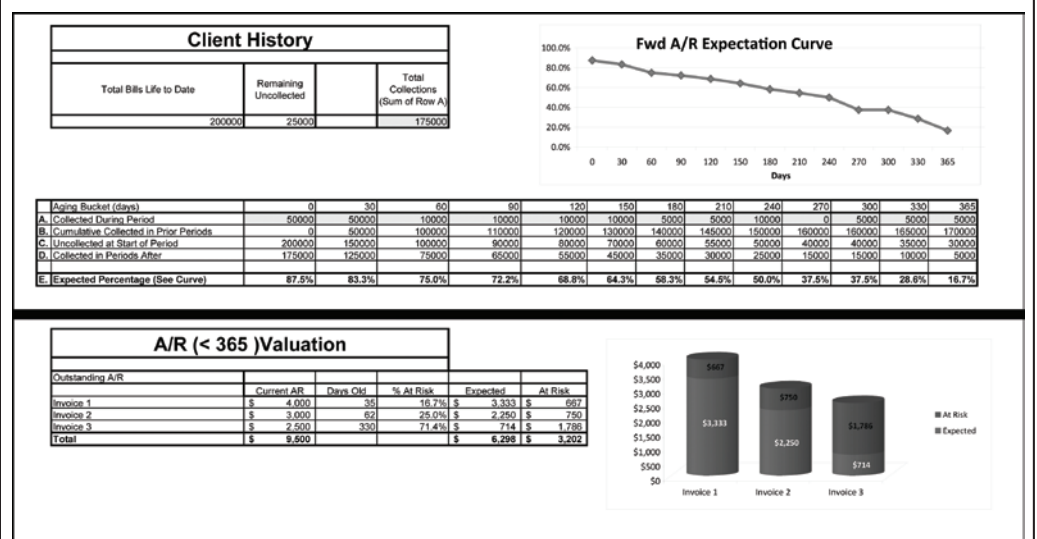
Illustration A

Scenario 1	Yearly Discount Rate	5%	Amount	Open Days	Time Value Charge	Amount after TVM Charge
	Daily Discount Rate *	0.014%		**		
Matter 1			\$100,000	180	(\$2,466)	\$97,534
Matter 2			\$100,000	330	(\$4,521)	\$95,479
			\$200,000		(\$6,986)	\$193,014

Scenario 2	Yearly Discount Rate	15%	Amount	Open Days	Time Value Charge	Amount after TVM Charge
	Daily Discount Rate *	0.041%		**		
Matter 1			\$100,000	180	(\$7,397)	\$92,603
Matter 2			\$100,000	330	(\$13,562)	\$86,438
			\$200,000		(\$20,959)	\$179,041

* Daily Discount Rate computed on simple (non-compounded) basis
** Open Days is calculated from Work Date until Collect Date (if collected) or Current Date

Illustration B



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