

Inventory Management

What Opportunities Remain?

By Bo Yancey

As many of us are painfully aware, the credit crisis in the financial markets has resulted in downstream effects for almost all businesses, both in the United States and abroad. Law firms have not been shielded from the downside. Not only have clients provided less work as the economic slowdown has worsened, but they have also been more reluctant to part with cash, and some have increasingly used vendors and accounts receivable as sources of financing. None of this is good news for law firms that measure both their income and profitability on a cash basis.

Bo Yancey is the Director of Professional Services at Redwood Analytics. He leads a team of consultants who provide practical advice to law firm leaders interested in using analytics to manage the business of law.

Clients withholding payments directly impacts partners' bottom lines. As such, law firms are always focused on billing and collecting as much as they can in the last quarter of the year. The current crisis has trumped even the most diligent efforts of law firms to bring in cash, and it illustrates the importance of having sound inventory management practices that are followed throughout the year.

Just how much of an impact was felt in 2008? At Redwood Analytics, we routinely collect and analyze data to monitor firm inventory management trends. At a high level, our benchmarking output does not appear to indicate anything to worry about. Collect speed, or the number of days between the date of billing and the date of collection, was stable compared to the prior year (57 days). The same goes for bill speed — both 2007 and 2008 reflected 55 days between date of work and date of billing. But analytics need to be taken past this high-level review. There's more to the story.

LOOK BENEATH THE TRENDS

Taken in the context of today's economy, perhaps it is concerning that the average bill speed is 55 days. First of all, 55 days on average leaves lots of room for improvement. Consider what 55 days means in terms of a normal billing cycle. As an example, consider an attorney who enters time for work on March 15. An efficient billing practice would reflect this time on an invoice in the first week of April, resulting in a bill speed for this time entry of approximately 20 days. An average bill speed of 55 days means that the majority of time does not get billed the month after it is worked.

Secondly, billing practices are activities that generally are controllable by law firms, and we would expect them to receive greater scrutiny in the face of declining economic conditions. A client can't pay an invoice it hasn't received, and it's surprising that in 2008 there wasn't a bigger emphasis on improved billing practices. Given that billing is usually an

internal function, it represents an area where many firms can focus on improved efficiency. It remains to be seen, but this may have been a missed opportunity by firms in 2008. It will be more difficult for firms to maintain strong inventory turnover results as clients continue to face tightening credit.

TIME MATTERS

It shouldn't be news to firm managers that there are sound financial reasons to bill and collect as quickly as possible. Of course, it's critically important to the cash cycle, even more so now than during economic growth periods. But many firms lose sight of the primary reason to manage inventory efficiently: Inventory becomes less valuable as it ages. This is as true in professional services as it is in industries dealing in tangible goods, and it has been proven time and again through the use of forward realization curves. Every firm's curves look exactly the same — the realization on both unbilled time and receivables declines the longer it takes to bill or collect. Typically, a firm's realization rate on one-year-old invoices is only about 15-20%.

What else did we see in 2008? Larger firms tended to do the best job of managing WIP and A/R. They tended to have fewer days of unbilled and uncollected time on the books than mid-

sized or smaller firms.

Our analysis tracked collection of invoices that aged to 60, 90, and 180 days, and under all three cutoffs, the larger firms outperformed (*i.e.*, collected a greater percentage of aged invoices). For instance, invoices that aged to 90 days in large firms resulted in a 67% realization, but in smaller firms, only 60%.

The distinction among results of different sized firms may be a valuable benchmarking data point, but the bigger take-away is that the realization rates themselves, even for the large firms, are not good. Losing 33 cents on the dollar in 90 days shows how quickly losses can accumulate. While we could point to best practice firms, the "best, best practice" is to avoid allowing accounts receivable to age significantly in the first place.

MONITOR IN 2009

Keeping in mind the level of loss associated with aged receivables, we stress the importance of understanding how much of a firm's monthly billings are collected within 60 days, 90 days, etc. For the invoices of 2008, we found that 70% of total bill value was collected within 60 days, 82% within 90 days, and 92% within 180 days. In the case of these metrics, there was little difference by size of firm. For firms that track the forward

collection progress of the bills of a period, using the 70% in 60-day benchmark is a good gauge for increasing levels of risk.

When firms cannot count on rate increases or maintaining levels of productivity they have become used to, the fundamentals of rate retention, billing procedures, and collection management become much more important. In any industry, as margins become compressed, more problems are exposed. We foresee billing and collections fundamentals, and their corresponding metrics, becoming much more important to overall profitability and a critical early warning indicator for firms over the next 24 months.