

How Healthy Is Your Inventory?

By Kris Satkunus

All businesses that accumulate material amounts of accounts receivable (“A/R”) rely on metrics that measure the turnover of those receivable balances as a gauge of risk and liquidity. One of the most common metrics used is what many industries call Days Sales Outstanding (“DSO”), a measure of the relationship between outstanding receivables and sales levels. Law firms are no different. They measure Days of A/R.

While the concept of Days of A/R is straightforward, there are nuances to measuring inventory results that require insight and critical thinking. Ultimately, analytics are only as valuable as their application, and the

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application of misinterpreted results could prove costly to a law firm.

MANAGING CASH FLOW

There are many variations of the Days of A/R metric, both in its calculation and its name. Regardless of the version used, its purpose is to provide information about the time it takes clients to pay their invoices (note that the same sorts of metrics are used to analyze the turnover of work in progress to invoices; for purposes of simplicity, this piece focuses on analyzing receivables).

One method of computing Days of A/R is to divide the firm’s receivable balance at a particular point in time by [the rolling 12-month bill amount divided by 365]. A firm with a result of 75 days has two and a half months of billing activity on hand in its accounts receivable.

Firm managers measure Days of A/R as one tool to help manage cash flow. Inadequate intake procedures, poor follow up on aging receivables, and many other factors can lead to an increase in Days of A/R. And an increase in Days of A/R can lead to cash flow problems. However,

as is often the case with metrics, putting too much stock in one metric can lead to an incomplete story at best, or at worst, a faulty conclusion.

DON’T BE LED ASTRAY

What does it mean if Days of A/R is high or increasing? Receivables are growing faster than the pace of billing. On the surface, this would appear negative. Likely reasons are that inventory management is deteriorating, or clients are having difficulty paying. But before leaping to a conclusion, consider that many situations can lead to misleading results when performing inventory analysis.

- **A/R that should really be written off.** If a firm has a material amount of receivables from invoices that are more than a year old, the numerator in the equation is inflated, Days of A/R are inflated, and there is no understanding of the trends for the true receivables of the firm. For firms that won’t write off aged A/R (though remember that taking a write-off on paper doesn’t mean ceasing collection efforts!),

analysts should at least filter them out of the equation to have a more pure starting point.

- **Unique deals.** Contingent matters or other special arrangements can materially skew numbers, particularly when measuring Days of WIP. Filter unique matters out of analyses.
- **Client Mix Shifts.** A growth practice is going to have a relatively high portion of new clients whose invoices will drive up the numerator of Days of A/R faster than the rolling 12-month denominator can keep up. On the flip side, a practice in decline will have an inflated denominator. Make sure that the cycle of a practice is understood before drawing conclusions from the Days of A/R metric.

THE REST OF THE STORY

Days of A/R has a sister metric that many firms do not calculate or utilize. It's called Age of A/R. This metric measures the number of days since the invoice date (calculated at the invoice level and weighted on the bill amount of each invoice when aggregated).

Consider two examples:

- Over the past six months Practice 1 has had a fairly stable Days of A/R of 60 days. Its Age of A/R is 100 days and has been creeping upward over the past six months.
 - Over the past six months Practice 2 has had a fairly stable Days of A/R of 60 days. Its Age of A/R is 60 days and has been fairly stable.
- What's different about the receivable portfolios for Practices 1 and 2? One possible explanation is that Practice 1 has a material amount of stagnant A/R, invoices that are old and getting older. The rest of the receivable balance in Practice 1 is being turned over on a regular basis. Practice 2, on the other hand, does not have a significant portion of aged A/R.
- The bottom line is that a Finance Manager should feel better about an A/R portfolio that contains invoices billed within the last 60 days versus one in which half the balance billed more than 90 days ago, and the other half billed in the last 30 days. And exclusively analyzing Days of A/R does not provide this sort of information.
- There are pitfalls to watch out for when analyzing Age of A/R. Age of A/R can be affected dramatically by fairly common occurrences:
- Collections that include material amounts of very new bills (like what happens at year end) will drive the age of the remaining receivables up.
 - Write-offs of old A/R will drive the age of the remaining receivables down.

- Collecting some very old receivables will drive the age of the remaining receivables down.

APPLYING ANALYTICS

For firms equipped to measure both Days and Age of A/R, the goal is to have both metrics be low and stable over time. Analysis can be performed at the firm level, practice level, or at whatever level A/R management responsibility exists. Once risks and problem areas are uncovered, the next step is to dig into client-level details, discuss with responsible attorneys, and develop action plans to get inventory metrics back on track.

Savvy firms are expanding their tool kits to effectively manage the business of law. Inventory analysis is a critical component, and used wisely, can point to risks and trends early, preventing cash flow problems down the road.