Mary Vandenack provides the transcript from Legal Visionaries podcast on Key Financial Metrics for Law Firms

**Mary**: On today's episode, my guest is one of my favorite humans ever, Britt Lorish. Britt is a partner with Affinity Consulting Group. She is a past chair of the ABA Law Practice Division's Law Firm Finance Committee, as well as the past chair of the ABA TECHSHOW. She has over 25 years of legal technology and law firm management experience, and regularly works with firms on how to improve their efficiency, productivity, and profitability through process and workflow analysis. I would tell you that Britt has the special role of being one of the few people who is able to call me out on various accounting and tax issues over the years. I questioned her and we had to go over regs and she was right, and I was wrong, so she has a lot of respect from me for that strangely. Anyway, I asked Britt to talk today on this episode about law firm financial metrics. Thanks for joining me today, Britt.

**Britt**: Oh, thanks so much for having me, Mary. Always a pleasure.

**Mary**: What are the most important financial metrics or KPIs that law firms should be monitoring?

**Britt**: Well, there are a lot of important metrics to monitor, and some may of course vary depending on the type of work being done by the firm. For example, if a firm does hourly work versus flat fee or contingency work, those metrics are going to vary a little bit. But overall, I would say that a firm needs to monitor its overall profitability as its number one metric. A firm should always know if it's making or losing money. It's one thing to have a bad month, everybody does, but if something that's happening regularly, the firm can't stay in business very long without making some changes, so that would be the most critical metric, I would say. But there are plenty of others, including cashflow, age of WIP and AR, how long it's taking you to bill out the work you're doing versus how long it's taking you to collect. Those are all things that you need to consider because at the end of the day, your law firm isn't a bank, and cashflow is critical. If your firm has too much in aged AR or WIP, then changes need to be made so you can improve your cash flow.

**Mary**: That all came off your tongue with ease because that's all back of the hand, although I don't really know the back of my hand that well, but that's all basic to you. How can law firms effectively measure their profitability, the profitability is important, right, and what are the metrics they should consider?

**Britt**: There's a number of levels at which a firm can measure profitability. The most obvious and basic level, of course, is looking at your financial statements, gauging your net income for the firm as a whole. Technically you're profitable if your income exceeds your expenses, but that really only scratches the surface of what you should be looking at. Now depending on whether you're a boutique firm like your firm is what I would call a boutique firm, Mary, if you're a boutique firm or you're more of a general practice firm, you should know what type of work makes you the most money.

In other words, let's say you're a general practice firm and you do both family law and estate planning. Do you know in which practice area your effective hourly rate is higher or what your effective hourly rate is in each of those practice areas? Likewise, you should be looking at how profitable each of your timekeepers are. You might have someone billing a lot, but if their overhead is significantly higher than that of some of your other timekeepers, they may not be ultimately as profitable as you initially think they are. I think it's important to look at overhead to income ratios, not only for the firm as a whole, but also by practice area or department, depending on how your firm operates, and also by timekeeper.

**Mary**: Cashflow management is essential for any business, including law firms. What are some key KPIs that law firms should use to monitor their cashflow effectively?

**Britt**: Yeah, so as I mentioned earlier, it's really key that the firm is not a bank and recognizing trends in your cashflow is incredibly important. Many legal accounting products have a statement of cashflow that can be monitored by the firm. If your accounting product does not have that feature, then it will take you a little more time to generate that manually, but basically the bottom line is do you have more money coming in than you have going out in any given period?

Now, again, it's understandable that you may occasionally have a bad month where more money went out than came in, everybody's got those months. I'm not talking about the every single month scenario. I'm talking about is it a trend? When you have more money going out than coming in on a regular occurrence, then you really need to dig into the why behind that because again, you're not going to stay in business very long if that's a trend. Is it because you're having trouble collecting? Is it because you don't have enough work? Is it because people are slow paying and maybe you need to take more upfront in retainers? Are your expenses too high? There really needs to be a deeper evaluation when you see negative trending in your cashflow.

**Mary**: Billing and collections play a significant role in law firm finances. Actually, I always find it interesting that sometimes that's so basic to me, you get a bill and you got to collect, that sometimes it's interesting, really trying to convey the importance of that, 'cause I know we all love practicing law, and we all hate the billing, but at the end of the day, we want to get paid. But can you share some of the essential metrics that help law firms track and improve those processes?

**Britt**: Absolutely. Obviously how a firm bills is going to vary depending on the type of work they do. Firms who do only contingency work, for example, really don't bill and have to forecast their cashflow differently because of the less consistent way they collect. However, firms that work more on hourly or flat fee work can forecast a little better based on how much is in their work in process. That's what I refer to when I say WIP. If you hear me use the term WIP, it's work in process, unbilled time and expenses. Any given time, you should be able to look at your aged WIP. There's a whole bunch of factors that go into your WIP and your AR, but first, I think probably the most basic thing that people have to do is you have to have some confidence that your timekeepers are in fact getting their time in somewhat contemporaneously.

If you go to look at a WIP report the last week of the month and 75% of your timekeepers don't have the bulk of their time entered for the month, it's going to be almost impossible for you to forecast billings for that month. If I'm being honest, if your timekeepers aren't billing contemporaneously, then the likelihood is you are losing a lot of revenue, because let's face it, most people can't remember what they did an hour ago, much less a week ago. If you're a firm that bills hourly, I really can't stress enough the need for contemporaneous time entry to stop lost revenue. I would say that's one of the things that I would monitor first is missing time by your people and the length of time and how contemporaneously they are tracking their time.

The next thing I would say is to make sure there's a regular cadence to your billing cycle to assure consistent cashflow. Monitoring aged WIP reports, it's critical to make sure things aren't getting missed. I actually started working with a firm not that long ago, and one of the things I noticed was in their 180 day plus aged WIP, there was over $1 million and I about passed out. I was like, "Whoa." This firm did mostly hourly work, it wasn't flat fee or contingency, so I was stunned. It turns out, so were they, because apparently no one had been monitoring that and needless to say a lot of that time was over a year old and they didn't feel they could go back and bill for it, so they lost all that money. It was just really tragic. For sure, monitoring aged WIP.

Then in conjunction with that, monitoring aged AR. Again, I'm always amazed when I go into a firm and I see they've got this giant number in 180 day plus AR, and they're surprised. I go, "Well, you should never be surprised by the age of your AR because someone should always be looking at it and always making collection efforts on that." If they're not, then again, the question is why. You have to dig into the why. Do you need to hire a collection agency? Do you need to take more retainer monies upfront? Are you charging finance charges? Some of this, again, how you deal with it is going to depend, are you doing more consumer law? Are individuals more your clients? Are you doing more B2B work and dealing with larger companies because there's a lot less you can do on the B2B side, but you really have to stop and look at the why.

**Mary**: I'm going to ask kind of an off question in the sense that on the whole flat fee issue, I've talked to and we've brought attorneys in who worked only on flat fees, and so they never tracked their time. I've never been able to figure out how do you know whether you're ahead of the game, whether you're making money or losing money, if you're not tracking your time on flat fees? I know that as lawyers, the number one thing we'll complain about is I hate justifying my existence in 0.1 units of time or whatever the unit might be.

**Britt**: Right.

**Mary**: But do you think is there a way to tell if you're making money, if you're doing flat fees but not keeping track of your time?

**Britt**: It's a lot harder. I'm not going to say it's impossible because there's ways you can look at income to expense ratios for the people who, if they're only doing flat fee work. You can sort of back into those numbers other ways, but it's a lot more challenging and a lot more time-consuming to do it. I am a big proponent of, even if it's just loosely tracking your time, maybe not that every six-minute increment, but at least ballpark tracking your time on flat fee and contingency matters, I think is the only way to understand. Did you make or lose money on that particular item, really.

**Mary**: Most law firms have various practice areas, even us as a boutique has various practice areas. How can firms look at the financial performance of each of those practice areas? What metrics should be considered?

**Britt**: Yeah, and as I sort of alluded to earlier, if the firm handles multiple practice areas, you should definitely know which one is most profitable. One key metric, again, depending on what kind of billing you're doing, might be the effective hourly rate. It tends to be a good indicator profitability unless you spend considerably more in overhead in one area versus another. But assuming your personnel costs, marketing costs, general overhead costs are relatively equal in the various areas of practice, if you see an effective hourly rate, for example, for estate planning that is double what your effective hourly rate is for criminal work, well, what practice area do you think you should put more time and effort into expanding? It's kind of common sense.

Realization rates I think are also important. This compares what was worked, what was billed, and what was billed to what was collected. The effective hourly rate, certainly we'll take that into account, but it's always good to be reviewing time worked and what percentage of that was billed, what discounts, write downs, write ups, write-offs, all of those factor into that effective hourly rate and the realization rates of that work. If you've got a lot of discounting happening, understanding why those discounts are happening, because you may need to address, let's say a work product of a particular associate, maybe if there's heavy write downs on a particular person. Really looking at that, digging into those numbers for each area of law I think is important.

**Mary**: I'd say as somebody who's been doing that for a while, what I think's really important to realize is that sometimes you think you sort of know where you're writing it off, but when you really look at the data and the reports, and you've been through some of ours with me at times, I'm like, "What? What?" and not realizing that. I think it's comparable to not always really realizing that there's somebody that's referring you work, where there's somebody who you think is that actually isn't, and it's the same thing. You get this idea in your head so that looking at those reports and data is really, really important.

**Britt**: It is.

**Mary**: In terms of expenses, what are some of the critical KPIs that law firms should monitor?

**Britt**: Well, certainly monitoring net income as a percentage of revenue is one key item. Most law firms have a profit margin somewhere between 15% and 40% depending on their practice area, their firm size, their geographic location, and various other variables. But most firms target that one third rule where they aim for the 33% profit range, that's sort of a common theme that we see. But benchmarking these numbers to see if they're increasing or decreasing over time, I think is an important trend to keep track of. Obviously, you can monitor your operating expense ratio. This basically monitors the proportion of operating expenses to total revenue, so just divide your operating expenses by revenue, basically.

A common benchmark for a healthy operating expense ratio is usually in the 55 to 65% ratio, and there's some others. I guess budget tax expense variance is another key item. Hopefully everybody is creating budgets for each year that they're in business, and then sort of trying to make sure that you're staying on track with that budget. If you have a massive variance from that and your actual to budget is much higher than what you budgeted, then why? What happened to make you blow that budget right out of the water? That's important.

Cost per employee and client acquisition costs, those are other metrics that might be good to monitor. Cost per employee really focuses on, as you know, the biggest expense of any professional service firm is personnel, so looking at salary benefits, payroll taxes, and getting that total cost per employee is a good number to be mindful of. Then the other one I mentioned was client acquisition costs. That's another valuable metric, though sometimes a little bit more difficult to gauge without the right software and without tracking everything because so many things go into to acquiring a new client. It's not just marketing costs, it's business development time and all these other non-monetary things that go into that, but that's another good metric to look at.

**Mary**: A lot of times firms really care about that profit per partner number, that's an important metric. How can firms calculate that accurately? What factors should they consider?

**Britt**: Well, typically the base formula for this is total net profit of the firm divided by the number of equity partners to obtain an average. However, this doesn't necessarily take into account equity ownership percentages, varying partnership structures or compensation agreements you might have. If you're benchmarking metrics with an eye to improving them, then this works well, that basic formula works well, total net profit divided by number of equity partners, but most firms don't use this as a compensation formula without of course factoring in all those other elements.

**Mary**: Productivity is key for law firms. What are some of the metrics or KPIs that can help firms measure and optimize their productivity levels?

**Britt**: Productivity takes into consideration a number of things. Obviously, billable hours are one piece of that, but write ups, write downs, write offs are a big piece of that as well. You might have an attorney that bills a ton of time, but if they have an unusually high percentage of adjustments to that time, you have to factor that in and look for ways to improve that. That all factors into their effective hourly rate and into their productivity. Utilization rate is another one. That is basically a metric that calculates the percentage of billable hours out of the total available working hours, so what percentage of their time that they actually work is being spent on billable work? Then of course, we already kind of referenced realization and collection rates, so what percentage of the billable work done was collected and realization tends to look at the percentage of billable hours, whereas collection rate, it looks at the percentage of collection. They're very similar, but it depends on whether you're doing hourly work or flat fee, which metric is a little more valuable to you.

**Mary**: Well, let's talk about client satisfaction and retention. Those are crucial factors for the success of a law firm. Are there any KPIs that firms should use to gauge client satisfaction and loyalty?

**Britt**: Yeah, certainly if a firm regularly sends out client satisfaction surveys, that's probably the best way. It's an extremely valuable tool, and I encourage that. Many firms will ask how likely the client is to recommend the firm's services to others, when they do that survey, they'll actually ask that question, and that's referred to as a net promoter score. We do that with our own clients. We send out those surveys, and we have a net promoter score. That's a really excellent metric for gauging client satisfaction and loyalty, because obviously if they're willing to refer you to somebody else, that shows a great satisfaction rate. Tracking your client referral rate is probably another one that I would recommend. In other words, how many of your new clients, or what percentage of them, were acquired through referrals from existing clients? If you can gauge that, that's a pretty powerful metric for you.

Referrals, by the way, also significantly reduce your client acquisition costs. That was one of the metrics we were talking about a few minutes ago was client acquisition costs and if you can reduce that through referrals, then there's no better publicity for your firm.

**Mary**: Technology is continuing to have a real impact on the legal industry. As that continues, are there any specific metrics or KPIs law firms should focus on to assess the impact of their technology investments?

**Britt**: This one's a little more challenging and it's a little more subjective, but I would start with measuring adoption rates. What percentage of your users are actually actively using all of the tools, the technology tools, they've been given, and how many have completed training on those tools, assuming you offered it? You can have the best software, the best technology in the world, but if your users don't know how to use those tools or simply don't use those tools because they're bound and determined to do things the way they've always done them, then they become shelfware, and that's not going to help your ROI. Monitoring workflow efficiency to assess whether processes have been streamlined, manual tasks have been reduced, the speed of task completion has improved, those are all good indicators. The use of technology to automate repetitive tasks, things like document assembly, which I know you're a big proponent of, contract review, scheduling tools, those are all good examples of tools that you can streamline things with and that should improve your efficiencies. Theoretically, if your timekeepers are using the tools that reduce these redundant tasks, then they can focus more of their time on substantive billable tasks, which theoretically means your billable hours go up if you're someone who does track billable hours. But again, more subjective than some of these other metrics.

**Mary**: You packed a pile of information into this episode. If somebody said, "Wow, I want to learn more about that or get a list of everything she mentioned," the script will actually be posted on the website so they can read that when we release the episode, but do you have any other places somebody could look to get some good information about what you've been talking about? The Affinity website perhaps?

**Britt**: Yeah, the Affinity website for sure. It's affinityconsulting.com. You can always reach out to me personally, I'm blorish@affinityconsulting.com. Happy to talk to anyone who wants to learn more about KPIs and metrics. I know we've covered a lot today, and I'm sorry, I hope it wasn't too overwhelming. Hopefully everybody took one or two little tidbits out of this and are able to maybe go back and evaluate some things they weren't previously evaluating and get some helpful information.

**Mary**: Well, thanks so much, Britt, for participating in this episode today. As we reach the end of our episode, I want to thank our sponsors, Interactive Legal, Carson Private Client, Veterans Victory and Business Centers, and Foster Group. That's all for now. Thanks for listening today's episode and stay tuned for our weekly releases.