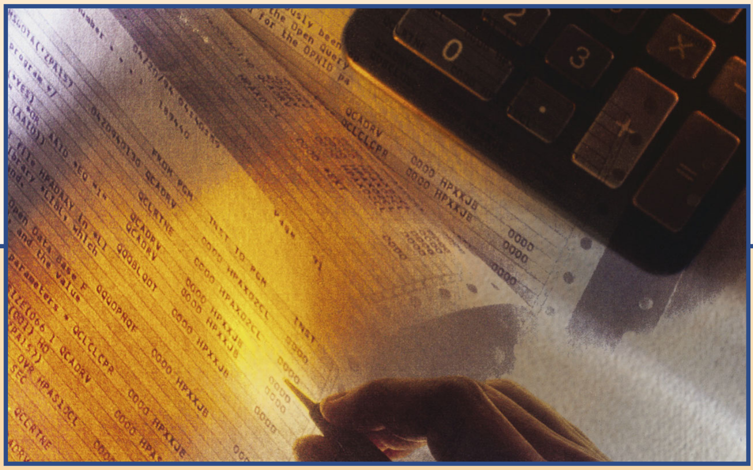
Why Cash Is King

Cash Management Essentials for
The Professional Services Organization

BNA

KENNEDY INFORMATION

IOMA



Compliments of

Microsoft Business Solutions

Table of Contents

Introduction

Why Cash Is King

Cash Management Essentials for The Professional Services Organization

Compliments of
Microsoft

With a relentless focus on the public markets, the business press would have us believe that corporate profits are the bottom-line measurement of success. Indeed, profits are a critically important indicator of success; firms are in business to make a profit at what they do. However, small and midsized business (SME) owners know that there is something even more fundamental to the success of their businesses: cash. Without it, profits don't matter. Put another way, highly profitable companies can run out of cash quickly, thus making them vulnerable to serious problems and even failure.

As the old adage says, "cash is king." Professional service organizations (PSO) spend a great deal of time thinking about billing rates and utilization, both key factors in managing and improving profitability. Cash is often seen as something that is relegated to the accounting department to worry about. It is merely a collections issue. Consultants, attorneys and even accountants deal in hourly rates, not cash. However, cash and cash management are at the center of a smoothly operating organization. Without strong cash management, the firm may find itself unable to make the investments in people, technology, and other assets it needs to be competitive. It may end up paying more for its money through borrowings than it might otherwise pay through its own cash flows. And firms whose billings are concentrated in one or among a few large clients are vulnerable to losing control of their cash management if those clients turn out to be slow payers.

In this paper, we look at the differences between profits and cash, define cash management, and describe how to set up and maintain a robust cash management system. We then identify cash management best practices specific to PSOs. It is designed to highlight the importance of managing cash across the firm and to underscore reasonable steps that you and your employees can take to ensure that you will have adequate cash flow to finance the profitable growth of your firm.

What Are We Talking About Here? A Few Definitions

Let's start with a few definitions.

Profit is simply what is left over after you subtract revenues from expenses. It does not discriminate between revenue that has been booked, collected, and is sitting in the bank versus that which has been booked but is languishing in receivables. It also does not reflect the impact of non-cash items such as depreciation. (You may pay for 100% of an asset, such as computers or a copier, but only depreciate part of the expense over time. Thus, the impact on cash is greater than the expense you book.)

Cash, on the other hand, is literally what you have in the bank. It is the only truly liquid asset. Although assets such as accounts receivable and inventory can be converted to cash, they are not the same as cash. Receivables cannot become payroll unless they are collected ahead of that payroll. Consequently, while profit is good and – ultimately – essential to the viability of the firm, it does not keep the doors open. Cash does.

Cash flow refers to the inflows and outflows of cash over some period of time. Whenever there is more coming in than going out, the business has a *positive cash flow*. When that is reversed, *a negative cash flow* occurs. When the latter happens, the firm must dip into its cash reserves or borrow money in order to make the cash flows neutral or positive.

The key to monitoring and managing these flows is to ensure that there is always a reasonable buffer between what flows in and what must flow out. A cash-flow statement is the primary tool to determine whether or not cash flow will be positive or negative, based on forecasted inflows and outflows. In a PSO, arming partners with cash-flow statements that provide details about origination and spending will help them better understand the firm's finances and identify problem areas in time to address them properly.[1]

The typical cash-flow statement is divided into three parts:

1. *Operating activities.* This section illustrates cash flow from the firm's operating activities to reveal the practice's liquidity.

KEY: Use this section to spot issues relating to difficulty selling services or collecting receivables and to identify declines in revenue and earnings. If receivables are growing and aging, for instance, this could point toward a future cash collection problem. Make sure you and your partners understand why there is a problem by comparing net income (on the accrual-basis income statement) with cash provided by operating activities. If these two numbers are close, then your practice is probably strong. Comparing the growth rates for net income and operating cash is another good check. The closer the better: when cash lags behind net income growth, problems may also lurk. Even if your firm's income statement shows that earnings are growing by double-digit percentages, flat cash collections should raise a flag. Also keep a close eye on a rising tide of growing accounts payable. A problem may exist if your firm must delay payments to vendors because of cash shortages.

2. *Investing activities.* This section highlights several areas, including the purchase and sale of property and equipment. Firms typically use cash for these ongoing needs to invest in technology and other office equipment. This section may also cover lending by the firm and the subsequent collection of loans, as well as the sales and purchases of long-term securities.

3. *Financing activities.* This section defines a firm's financing other than that for daily operations. Optimally, distributions to partners comprise the largest cash outflow in this section, but financing activities also include loans from banks and others, as well as capital provided by the partners – either through contributions or loans.

KEY: For a rapidly growing practice to consume more cash than it generates may be appropriate. Likewise, if a firm has substantial debt, you will notice the repayment's effect on cash available for distribution.

Billing and Collections: Lifeblood for PSOs

Your firm's billing and collections practices are more important today than ever, given the uncertain economic situation and the likelihood that growth, if there's any, will be slow. Firm owners must see to it that their bills are prompt and clear and that the firm collects what it's owed for its services. Unresolved issues with billing and collections can undermine all your good efforts to enhance partner profits, so it's wise to review and bolster your procedures.

The average collection period is now 62 days, according to IOMA's *2003 CPA Firm Practice Management Survey.* A two-month wait for your money is too long in today's market, so your firm should aim to shave a few weeks from that average. Below, we list a number of action steps PSOs can take to improve billing and collections practices.[2]

1. *Evaluate your initial client interview procedures.* Whatever your firm's current situation, you need to take more care than before when accepting new clients. Firms that need the work may be tempted to take any client that comes through the door, but PR urges you to create a checklist to flag problem clients (see item #3 for suggestions on how to do this). The initial client interview is one of the few times when your firm holds all the cards.

KEY: Use this advantage to forge a business arrangement that will be most beneficial to your firm.

2. *Do your homework on prospective clients.* This relates to item #1 and is worth your investment of time, since clients that have financial difficulties may be dishonest with you about their situation. Use Web sites like hoovers.com to gather information. Other options include Dun & Bradstreet and NEXIS.

3. *Formalize your client approval process.* Appoint a committee to approve new clients, have the managing partner approve all new clients at your firm, or get at least one other partner to sign off on a new client. A firm's criteria will differ depending on its practice and goals, but all firms prefer clients that are stable in terms of personnel and finances. Also consider a client's history with prior firms. A client that didn't pay your competitor is likely not to pay your firm either.

4. *Don't discount your firm's rates to win work.* When you're trying to build volume by bringing in new clients, or just trying to keep existing ones, you may be tempted to offer discounts, but this can be a slippery slope to declining profitability. Nor do you want to be in the position of having to increase fees that were too low at the start of the engagement; it will take too long to get them up to where they should have been in the first place. The value of your services is inherent in everything you do – including how you price them. The implications for cash flow are that you may not be collecting sufficient fees (inflows) to cover your cost of services sold (outflows).

5. *Seriously consider alternatives to hourly rates.* Using alternatives can help your firm better market its services and gain the appreciation of clients that will be more likely to pay promptly. You can set fixed fees for certain work, use a combination of fixed – plus hourly (depending on the engagement), or set hourly rates with a floor and a ceiling.

6. *Try to get retainers from new clients.* This practice is now more accepted at certain types of PSOs, including law and design firms. CPA and consulting firms should adopt it as well. Getting cash up front is always better than waiting for it, especially for large and complicated engagements that will involve a series of bills. Three months of fees is an acceptable amount to ask for at the start, and then have the retainer "replenished" for ongoing work.

7. *Protect your billable time.* Administrative staff are best suited to handle billing matters, and the firm must offer them proper support. For partners to maximize their billable hours within the firm, they must be free of nonbillable tasks and distractions.

8. *Consider a centralized approach to engagement letters, fee schedules, and billing methods.* Putting these functions into the hands of your firm administrator, comptroller, or other administration expert can free time for billable work. It also ensures consistency in the language of engagement letters and in your billing and collections practices.

9. *Notwithstanding #7 and #8 above, use your compensation system to reward partners who do well with collections.* Firms can set this up in a number of ways: rewards can be based on subjective evaluations or an objective portion of your formula, or included in year-end bonuses.

10. *Ensure that your bills are clear, concise and leave no room for client confusion.* It is best to spend time each day documenting what was done for the client and why. On a weekly basis, this discipline pays off by streamlining the billing process. When clients receive bills that show what was done by whom, and that are not filled with questionable billed activities, they are more apt to make prompt payment without need for discussion or clarification.

11. *Accept credit cards.* The firm gets its money on time and solves its collection problems and the client gets frequent flyer miles.

12. *Craft comprehensive letters of engagement.* If you are still using last year's letters (or even older versions), you need to update them, as the environment has changed. Get in touch with your liability insurance provider to make sure your engagement letters touch on all the necessary areas. You may need to adapt the letters for specialized services and niches. Have your firm's attorney review the engagement letters. It is better to pay the lawyer now than the costs of litigation later.

13. *Visit and survey your firm's top 10 or 15 clients.* Your managing partner or partners from the management committee should visit these leading clients each year. In addition to using these meetings to cross-sell and keep clients enthusiastic about your firm, such encounters can help with collections.

14. *Let your accounting or administration department send all bills.* Partners can write a personal note to clients on bills if they want to, but let the administration staff see to it that the bills go out. This ensures prompt, efficient, and regular billing.

15. *Don't send bills by mail.* Use technology to the maximum by e-mailing or faxing your final bills – or even all your bills – to clients. These can be followed up with a paper bill if the client requests.

16. *Make professionals accountable for time-sheet deadlines.* Ideally, all partners in your firm should submit time sheets by the first working day of the month (if you can get weekly submissions of time, so much the better). Draft bills should be out by the end of the second or third working day of the month, so staff have their bills back in by the seventh working day of the month.

THE GOAL: Get 90% of your bills out the door by the 18th calendar day of the month.

17. *Bill monthly.* If your firm bills quarterly, seven months can elapse between the time you bill and the time you get paid. Remind staff that monthly billing cycles are better for cash flow. Also remember that clients are generally more willing to pay smaller bills than larger ones.

18. *Give everyone who discusses billing and collections issues access to client spreadsheets.* These should be on your firm's network with a client number, so your firm's managing partner and all other owners can see detailed information about the client, including contact information, engagement specifics, and a chronological list of billings and collections. Not only will this allow the firm to track trends, but you'll be able to immediately spot a client that used to pay bills regularly but stopped.

19. *Analyze your clients.* The most profitable clients are not necessarily those who pay the highest hourly rates, although this should be a factor in your firm's ongoing assessment of "A," "B," and "C" list clients. A client-quality analysis will help you determine the average rate per hour worked and rank clients by write-downs, write-offs, or speed of payment.

20. *Look at realization by partner and by department.* Divide revenue that's come in the door by the number of hours worked to determine this valuable benchmark.

21. *Collect by 90 days.* It can be the bridge point between a client that's going to pay and one that isn't. If you have more than 40% of your aging in excess of 60 days, your collection program isn't very good.

22. *Make owners and staff accountable for late billing.* Although it's hard to keep up with timesheets during a busy season (such as with CPAs during tax season), it's the only way to keep your bills current. If necessary, hold partner draws or take other actions to enforce your time-sheet deadlines. While you can't hold back staff pay, you can track late billers and penalize them in terms of bonuses or other perks.

23. *Follow up quickly when clients call about missing bills.* Use fax or e-mail, and call after you reissue the bill to see if they have any questions.

24. *Know when to make offers that clients can't refuse.* Sometimes you've got to accept that you're fighting a losing battle. Taking 70% payment is better than nothing. Invent a procedure for determining when to quit pursuing full payment, so that your administration and billing personnel know what rules apply.

25. *Communicate proactively.* Keep clients informed with personal notes and calls from partners in charge of their engagements. Make it a priority to return calls and e-mails from clients promptly, and encourage all staff to do this as well. Poor communication – or the perception of it by clients – can seriously affect your firm's billing and collections improvement efforts.

Converting Inventory Into Cash

Most PSOs have a difficult time dealing with "inventory."[3] The concept is foreign to many owners, who are caught up in rendering services and sending out bills based on hourly rates. Good receipts mean success; not-so-good receipts mean failure. What is a PSO's inventory? It's the value of work in process (time that the professionals have incurred, but not yet billed) and accounts receivable (time that the firm has billed, but not yet collected).

The true test of a firm's ability to manage its financial affairs rests with how it manages the conversion of this inventory into cash to pay its bills and owners. Thus, firm managers must shift their emphasis from cash receipts to the examination of inventory accumulation, whether it's in the form of unbilled time or billed but uncollected time.

Firm leaders must also be aware of the effect that too few hours in one month may produce four or five months down the road. Depending on the firm's turnover rate (the time it takes to convert a dollar's worth of time into a dollar's worth of cash), it is possible to project several months out based on current workloads. For example, if the turnover rate for a firm is generally, say, five months, then a bad billable hour month in January could mean a bad collection month in May. This assumes that the work being performed is that which generally fits into the turnover pattern of the firm. Work that is converted more quickly will produce cash faster, and vice versa, for longer pay-cycle work.

Is your funnel full? Firm leaders must be ever mindful of the "funnel" concept. Time goes into the top of the funnel and comes out the bottom as cash receipts. Along the way, certain factors come into play that prevent the conversion of time to cash. These could be write-offs at the billing and collection levels or accumulation of work in process and accounts receivable. The extent that this accumulation prevents

How PSOs Can Improve Billing and Collections

Each month, leaders examine and re-examine various statistics on firm and billing professional performance. However, the issue of how your organization is faring against its budget can be reduced to its ability to convert billable value into cash receipts. This value resides in the work in process and accounts receivables that existed at the beginning of the year and in the additional billable value created during the year. You can compare your cash receipts budget to the total of these three items (WIP, A/R, other billable value) to create a percentage. Then, apply the percentage against the amounts for each billing professional. This process will allow you to see which ones are failing to bill on a current basis, thereby preventing the firm from reaching its net income projections.

Consider the following example:

Work in process (beginning of year)	$650,000
Accounts receivable (beginning of year)	$525,000
Value of time added through period	$1,750,000
Total available for collection	$2,925,000
Receipts budget	$1,667,250
Performance percentage required	57%

You should then look at each primary billing professional and prepare the same analysis. Suppose that Partner A had the following:

Work in process (beginning of year)	$250,000
Accounts receivable (beginning of year)	$175,250
Value of time added through period	$625,000
Total available for collection	$1,050,250
Performance percentage required	57%
Receipts budget	$598,642
Actual receipts	$475,280
Deficit amount	$117,361
Performance percentage	45%

This analysis is the one that really counts. It puts the responsibility for performance clearly in the hands of billing professionals who control the majority of the firm's time that must be collected to ensure that projections are met or exceeded. With this analysis, management will know what to emphasize and where it needs to apply pressure to decrease write-downs and write-offs, decrease the time-to-collect cycle, and avoid cash-flow problems. It also helps make all billing professionals accountable for the client files under their control.

Source: John Iezzi, *Law Office Management & Administration* the firm from meeting its budgeted turnover projections materially affects cash flow. Moreover, if the time is not going into the top of the funnel in accordance with the projections, then at some point cash flow will decline.

The firm that is able to produce the largest percentage of time (in the form of cash) coming out the bottom of the funnel in relation to that going into the top will generally be the most financially successful. Thus, firm managers must be ever vigilant of time value based on billable hour projections, of accumulation of time either due to poor billing or collection efforts, or of reductions in time value due to write-offs at the billing or collection phases.

Firm leaders must recognize that if they are not filling the funnel in accordance with projections, then to continue on the budgeted net income track, they must: (1) bill and collect that which is available at a much faster rate than originally projected; (2) reduce expenses by the end of the year to produce the same net income level; or (3) prepare for the net income shortfall that will affect the personal financial situation of each of the owners. Although the firm could borrow money to pay owner draws, this has been shown to be the worst solution to a projected net income deficit.

Conclusion

All billing professionals should stand in the shoes of their firm's Controller for a day to appreciate the value of speeding up billing and collections as a central part of a robust cash management system. Firm owners need a healthy appreciation of the importance of creating and managing cash-flow projections in order to fund the profitable growth of the firm. Profits without positive cash flow make for a short-lived celebration.

There are numerous ways in which to speed up the billing and collection of receivables, from qualifying clients as financially sound to standardizing collection methods. This paper illustrates steps to take as well as metrics that all PSOs can use to evaluate their performance.

About BNA

BNA is the foremost publisher of print and electronic news, analysis, and reference products, providing intensive coverage of legal and regulatory developments for decision makers in business and government. BNA produces more than 200 news and information services, including the highly respected *Daily Report for Executives* and *Daily Tax Report*.

Headquartered in Washington, DC since 1929, BNA is an independent publisher and the oldest wholly employee-owned company in the United States.

BNA's subsidiary companies – Kennedy Information and IOMA – offer customers the same high-end coverage in ways tailored to their specific needs – using different publishing technologies, price points, and delivery mechanisms to help them do their jobs better.

---

[1] Leask & Leask, CPAs, Fairfield, Connecticut, as seen in IOMA's *Partner's Report for Law Firm Owners.*

[2] Ideas provided by Jim Fairchild of Ziegler Ross, Inc., San Francisco, and found in IOMA's *Management Library.*

[3] Iezzi Management Group, Richmond, VA, as found in IOMA publications.