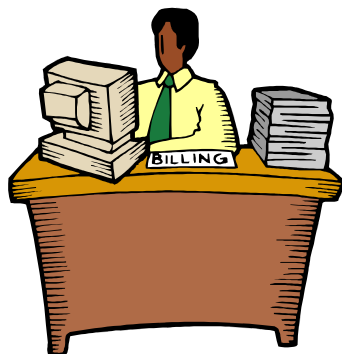


## MANAGING WORK IN PROGRESS (WIP)

And why it matters

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Debate continues over the place of WIP, how it should be valued, the 'ideal' volume relative to annual fees etc. Many in the profession cling to a notion that a 'bottom drawer' full of WIP is tantamount to saving for a rainy day whereas in reality any WIP over three months old is unfair competition with High Street banks. They at least charge the customer interest!

WIP is part of what has been described as the Achilles Heel of the profession – working capital management. Setting the 'right' quantity of WIP is virtually impossible as so many influences come into play: the lag between instruction and commencing the matter, the type of work undertaken, terms of engagement with the client, attitude to disbursements/interim billing and more. In the final analysis **WIP is best kept as low as practicable**.

Discussion with fee earners shows just how many do not appreciate the affect on profitability of poor WIP practices. Junior staff solicitors are often unaware of the time between the initial client enquiry and the firm getting paid. Most staff solicitors estimate the period at 2-3 months when the 'real' figure is nearer 6. Average performing firms have about 3 months WIP and wait up to 60 days from the time the matter is processed until payment is received and credited to the bank account.

The cost of financing WIP at this level can have a significant impact on a firm's balance sheet once the true interest is factored in. In cash terms the cost of financing WIP at an average firm, on current overdraft rates is about \$41,000 per annum for every \$1M of fees earned in a year. Every dollar saved from the financing WIP goes straight to the 'bottom right hand corner' of the P&L account and is available for distribution. This fact has persuaded many practitioners to chivvy partners into issuing bills rather than sitting on them. In addition to the P&L changes, the balance sheet also looks healthier, making a firm more solvent and reducing pressure on partners' own capital contributions. A further benefit can occur by way of increasing the effective borrowing power of the partnership. Money hitherto used to finance operational costs can be used to fund expansion plans, upgrade equipment etc.

There is no 'magic bullet'; making changes in WIP levels requires a number of factors to be present:

- Quality management information systems
- All fee earners need to understand the dynamics of the firm's cash flow
- Billing practices have to uniform across the firm – no exceptions
- Client engagement policies need to be in place – and used.

It is worth mentioning the tax implications on WIP and note what is happening overseas. At present the IRD will accept small and new firms accounting on 'cash basis' despite it being against the principles of the GAAP. Cash accounts ignore WIP, effectively applying a zero value to it. For the rest the so called 'conventional basis' is used. This recognises debtors but not WIP.

In UK a formula is applied that values WIP and income is taxed accordingly. Whether or not such a system will ever see the light of day here is open to conjecture. When the UK regime was introduced there was a lot of bleating from all the professions and many practitioners had a lean time for a year or two. The outcome in terms of WIP has seen considerable reductions in volumes and assisted the mandated process (in UK) of informing clients of anticipated costs in advance.

Valuation of WIP is another area to consider. As a rule of thumb 65% of 'full' selling price is about right.