No matter how much you prepare, some level of uncertainty is inherent in the financial future of your law firm’s business. How your firm addresses this uncertainty makes all the difference.

How do you make decisions regarding the amount of the firm’s fee receipts to include in your 2020 budget; the amount of expenses to include in your budget; the amount your partners should expect as compensation in 2020? How confident are you in those decisions? Do you rely on the current year’s performance plus or minus a little? Do you go with your “gut” and make judgments, or perhaps present those decisions to a group and accept the consensus as the best answer?

I’ve seen and heard of many methods applied, including firms that use different methods depending on the type of decision. This article is about forecasting, which is a decision-making method used to predict future outcomes based on past events and management insight.

The article will describe some of the management challenges in which forecasting could support your decision-making and methods to improve the accuracy of your firm’s forecasting.

Where Can Forecasting Help?

Most firms use some level of forecasting in their decision-making, but fewer implement it as often as they could. Forecasting can enable you to foresee future developments, such as the added profit from hiring a lateral attorney. Its greater potential, however, is to provide the opportunity for you to decide on changes that will improve the future outcome, such as negotiating a more favorable deal with a lateral attorney. So, how do you know if you’re making the most of forecasting procedures? Let’s consider some financial decisions on which forecasting could help you make more informed decisions:

- Prepare a budget for the upcoming year with experience-based predictions of fee receipts and of every type of expense.
- Predict what your partners will earn in compensation for the year, or if each partner’s compensation is a year-end judgment, then predict the amount of the pool for partner compensation.
- If you are changing your current partner compensation method, estimate the probable result for each partner, or the range of possibilities.
- If you are hiring an associate, preview the firm’s resulting net income from that associate, which can help with deciding salary and initial billing rate.
- Decide whether the next month’s cash availability will be sufficient to fund a partner distribution or pay certain large vendors’ invoices.
- Approximate the reduction in your firm’s annual net income when your timekeepers are averaging 10 fewer hours per month per timekeeper than you budgeted.
- Your partners are hopeful that all timekeepers will increase their billable hours in the fourth quarter – would it be helpful to know if your recent years’ history supports that conclusion?
- You are considering an increase in the percent firm contribution to your employees’ 401(k) plan. How much would that increase the firm’s cost in the initial and second year, and how much would it reduce the partner compensation?
- Predict the amount of the upcoming month’s billing and the amount of the upcoming month’s collections.
- Your fee receipts are lower than budget, June year-to-date, and you want to know the average number of hours’ increase needed for the rest of the year to meet the fee receipts budget.

Improving the Accuracy of Your Forecasts

In some firms, forecasting is used infrequently because previous forecasts were inaccurate. Seldom are forecasts accurate from the start; it takes time to refine them. Fortunately, there are a few fundamentals to follow to improve the accuracy of your forecasting so that it works best for your firm.

1. Start with a clear objective. (What will the cost of the firm’s medical insurance be in the upcoming year?)
2. Document your assumptions. (Medical insurance in the current year cost $X for Y number of employees; we assume Z number of employees in the upcoming year, an increase of ABC% in premiums, with the increase effective July 1.)
3. Use reasonably accurate data, at least to begin, and data which you understand. For example, it is important to know the difference between all hours worked and billable hours.
worked; between hours worked and hours billed; between standard billing rates and rates adjusted for write-downs, etc. Much of the data you would need is in your accounting database, which you can use to identify and quantify patterns. There are also many other sources of information relevant to your financial forecasting.

4. After you have decided on a forecast, check the detailed variances between your forecast and actual every month to analyze differences (what is the variance amount) and understand the causes of the variance (why did it occur).

5. Modify your starting assumptions if they were incorrect. Use those modified assumptions for the next round of forecasting.

6. Repeat the process.

The behaviors which cause the financial patterns in law firms are very stable, or they can be predictably unstable. For example, if your firm adds several attorneys who practice a different type of law, their patterns may vary considerably from your firm’s previous experience. Both the stable and the recognized unstable patterns can be predicted with forecasting.

Forecasting alone does not produce the answers, but it can be a helpful tool to use when making many of the business decisions that have a future dimension. The most important parts of forecasting well are continuously following the basic methods described above, applying patience and attention to detail through the tedious work to track the variances and refine your assumptions, and trusting the statistical methods.