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WILL YOUR BUDGET BE BUILT INFLATION-BASED OR ZERO-BASED?

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Decades ago, when my work world was filled mostly with numbers and newly emerging technologies, the approaching new year was my favorite time at work. I greatly enjoyed crafting a new budget for the upcoming year. I took particular pride in how accurate they would prove to be. Yes, I know I'm weird!

The new year resets starting balances for revenues and expenses to zero. It provides me with a sense of renewal and optimism. To quote one of my favorite movie series, "Terminator": "No Fate!" Nothing is predetermined before the year unfolds. Of course, there are always market forces beyond a firm's control. But that doesn't mean the firm can't be resilient enough — prepared enough — to weigh heavily in the outcome.

For most of you reading this, you're thinking that this topic is about as stimulating as watching paint dry. I get it. Most lawyers aren't comfortable with numbers; aren't good at understanding the numbers which are "key" to staying on top of the firm's performance; and view the budgeting process as a perfunctory accounting function. The smaller the firm, the less likely it invests adequate time and strategic thought into budget preparation. For solo attorneys, it seems a monumental waste of time.

Basically, there are two methodologies for building a budget. The first is referred to as inflation-based budgeting. This is the most frequently used method. It works well when the economy is steady; when the firm is stable; and when there are not a lot of strategic changes being planned.

This method starts with the prior year's actual numbers, and then extrapolates based on what factors in the coming year will impact the numbers to go up or down, and by what percentage.

Let's use payroll as an example. First, the firm will determine any increase or decrease, based on decisions about desired hiring and/or reductions in staff. Then, based on the anticipated percentage allocated for pay increases, a final adjustment will be made.

As you can imagine, not much thought needs to go into this process. And it can be surprisingly accurate. Based on this single expense category, a lot of other budget items will recalculate quite simply: items such as payroll taxes, pension contributions and so forth.

As another example, let's look at benefit expenses, which can be a significant part of the budget, particularly in a law firm where benefit plans are more generous than other industries. The firm's insurance broker can advise what kinds of increases are being seen in the marketplace for disability, health, life, and so forth. Based on the anticipated number of employees, the new budget numbers are easy to calculate.

The fact is, inflation-based budgeting was so easy, I always had a spreadsheet prepared in advance of budget meetings with my "what if" columns waiting for discussion. What if we add four more associates instead of two? What if we eliminated three staff positions? Changing the key number in the "what if" column rippled through all the payroll, taxes, benefits and other related costs. It then recalculated the bottom line. What if it applied to revenue projections as well. What if we lost this client? What if we successfully cross-marketed and increased our caseload for a particular client?

The partners could instantly see the impact on profit. We didn't have to keep coming back to the table for additional meetings and discussion after the math was done. We could think and decide with lightning speed. Especially when the more conservative partners could see how minimal certain changes were to the bottom line.

As I mentioned, inflation-based budgeting works well when the economy is steady, when the firm is stable and when there are not a lot of strategic changes being planned at the firm. So let's talk about when that isn't the case. Like *right now*.

Our economy is anything but stable. Business work is up, then it's down. Large firms were understaffed and hiring every capable body, and less than a year later we began to see large, publicized layoffs, followed by even more stealth layoffs. It's hard to anticipate which practice areas will experience sustained workloads or sudden increases.

As I wrote in a recent article, the number of mergers are accelerating at firms of all sizes. We are still seeing long-time firms closing here and there. Some are large enough to get press coverage. Most just fade into oblivion. Lateral movement of attorneys and entire practice groups are at an all-time high. For smaller firms, just the loss of one key attorney identified as a successor can destabilize the firm and kill the succession plan.

Smart firms today will be working hard to strategize and put strategic thought into action, finding and further developing its differentiation factors. Developing a laser focus on ideal clients and how to reach them. Building a brand that helps the firm stand out in an overcrowded marketplace and aligns all the citizens of the firm under the same mission flag. Leveraging new technologies to increase efficiency.

Simply, none of these things fit into the model of inflation-based budgeting. We must use zero-based budgeting. This method sets the budget to zero for every expense category. And then begins by questioning every need and justifying the accompanying expense. In economically challenging times, a zero-based budget will be far more effective in containing costs.

Let's use payroll again as an example. I refer to this process as the "Titanic exercise." Conceptionally, every employee of the same status is thrown overboard into the icy waters. We must justify pulling each out of the water onto a seat on the lifeboat. Those that find seats wind up on the payroll budget.

It's a thoughtful process which requires meaningful discussion about what the firm should actually be doing, with full knowledge of the costs and reasons, rather than just assuming that things will and should continue as they have previously. This is the best process if the firm wants to change staffing ratios or downsize. Those lifeboat seats get filled first based on capability and willingness to adapt to new conditions, rather than seniority or for whom one currently works for.

Let's face it, there's a lot of spending that goes on at a firm because "that's the way we've done it before." Meaningful change doesn't happen based on what went before, but rather what we want to do starting tomorrow. For that reason, most line items on the budget that are built by design, and not by default, will align better with desired changes.

So the question is, what method of budgeting will work better for your firm? Notice I didn't ask whether you should have a budget for your firm. That's a given, even if you're a solo. Perhaps you can use inflation-based for some areas and apply zero-based to the areas which require a more precise or change-oriented approach.

Not sure? PBA members are encouraged to schedule a call to discuss such matters with me in confidence, and even review a sample budget.

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