

The importance of WIP valuation

As a law firm what's the biggest number on your balance sheet? It is likely by far to be your Work-In-Progress (WIP).

And here's the scary thing – it is likely to be the most inaccurate number in your set of accounts!

If you are a partnership there is less emphasis required on annual audit testing of WIP. This can lead to yearly 'drift' and that can mean a balance sheet number that varies dramatically from the real WIP value.

True horror story #1: A firm in the south of England recorded WIP on their balance sheet in a haphazard and inaccurate way. They still assumed it was 'there or thereabouts' – valued at £1,400,000 on the balance sheet. The partners wished to retire and found a potential buyer. Due diligence found the real value was £700,000. Result – the firms Bank pulled the plug and the business sank. The profits made in previous years had been constantly overstated.

True (lesser) horror story #2: A firm mistakenly undervalued their WIP to the tune of £1m. Whilst the partners were delighted to find their balance sheet was worth more than was recorded it led to a huge tax bill on the horizon based on adjusted upward profits. This put huge pressure on cash flow leading to trading difficulties.

If WIP is valued wrongly it can also distort the results of fee-earners depending on the performance measurement system used. And in turn the firms monthly profitability reporting will be inaccurate.

How can such dramatic drift to under / over valuation of WIP happen?

There are a number of factors:

The value WIP is booked and recorded at bears no resemblance to the value of the work done or to the cost of doing the work.

WIP not billed out is not removed from the WIP Balance Sheet number and inflates the valuation in the accounts.

No proper case management / recording systems.

Lack of finance knowledge in the business.

It's therefore important to ensure WIP is valued correctly and measured regularly to ensure it is accurate within at least 5% of the Balance Sheet number and to avoid on-going 'drift'. This can be achieved through implementing a simple standard costing process and measurement reporting. Many firms do not have such a set-up meaning the accounts and valuation of the firm is questionable.

WIP is the cornerstone of an accurate set of accounts and vital to the firms stakeholders both internal and external.

