

Report to Legal Management

OUR 34TH YEAR

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Two Techniques to Dramatically Improve a Law Firm's Net Profit



William F. Brennan

By William F. Brennan

After working with several hundred law firms during the past two decades, I have identified two areas that often offer the best potential to dramatically improve a law firm's net profit. Both of these areas relate to the billing process.

What are they? Neither is a deep, esoteric secret. The first is to reduce write-downs that occur during the billing process, and the second is to implement effective collection practices. In my experience, most firms have identified these problem areas, but few are satisfied with their efforts to deal with them.

In the current economic climate, addressing these issues will be more important than before.

"Invisible" Expenses

Write-downs of billable time can be one of the largest "expenses" of a law firm. They are an expense in the sense that they use up a valuable resource of the firm, i.e., unbilled time — an asset that usually gets converted into accounts receivable and ultimately to cash. Time value that is written down is lost forever, or "expensed."

Normal expenses, such as rent, telephone, support staff salaries, postage, etc., also involve the use of a valuable resource: cash. When these expenses are incurred, they require that cash be used to pay for them. What is most unusual about the write-down "ex-

pense" is that it never appears on the income statement. This is because most law firms use the cash method of accounting and this is an accrual basis expense. Thus it is invisible.

If it were to be recorded as an expense on a law firm's income statement would it really be considered that significant? Absolutely. Consider that for most law firms, regardless of size, an average of about \$47,000 is written down for every lawyer in the firm, according to the 2007 *Survey of Law Firm Economics*, published by Altman Weil Publications, a division of ALM Research. For a 100-lawyer firm, that amounts to about \$4.7 million each year. Clearly this is a significant expense for most firms, exceeded on a per-lawyer basis only by staff expense (\$59,000 per the same *Survey*). To put this in perspective, the average expense per lawyer of occupancy costs is only \$27,500 and equipment is only \$9,000.

Despite the obvious importance of this invisible expense to any law firm's financial

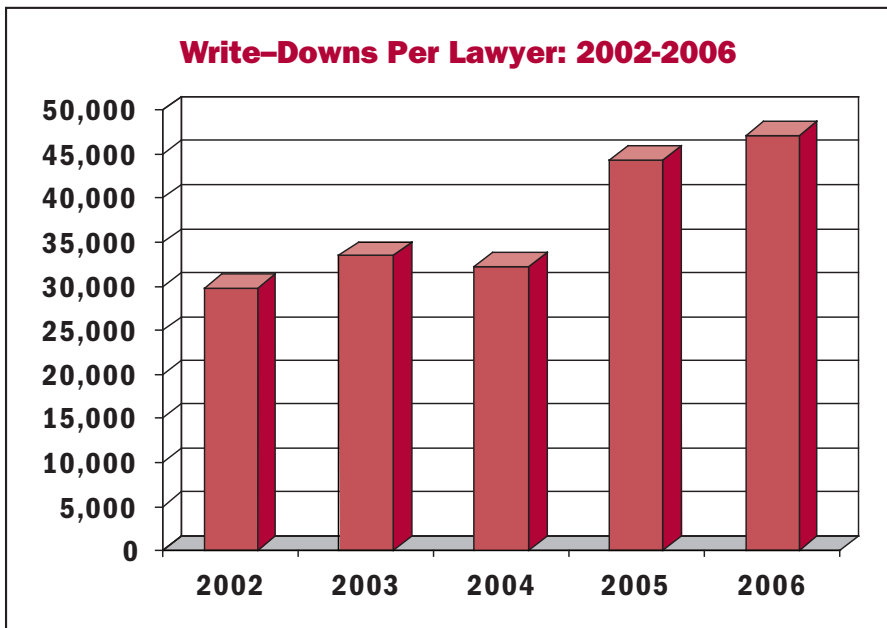
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success, most firms have not been very successful in controlling it. In fact, the problem has gotten much worse for law firms during the past five years. Consider the following graph (from the same *Survey*):



According to the chart above, the cost of write-downs has increased by 58% during the past five years, from \$29,820 per lawyer in 2002 to \$47,126 per lawyer in 2006. Stated another way, the average cost of write-downs for a lawyer has grown at the compound rate of 12% per year for each of the past four years.

What caused this dramatic increase? For that matter, what are the underlying reasons that law firms write down unbilled time during the billing process? Here are some underlying reasons that write-downs exist, as well as some possible explanations for their meteoric rise during the past five years:

1. Training of associates. The need to train new lawyers is understandable, unavoidable and of long-term benefit to the firm. To the extent this is the reason for write-downs there is no cause for alarm.

2. Billing rate increases. As billing rates increase, the amount of write-downs should be expected to increase in direct proportion. Partner and associate billing rates have increased on average by 5% per year for each of the past four

years, resulting in a cumulative increase of 22% during the same time period, which accounts for over a third of the increase in write-downs during the period.

3. Inefficient use of lawyer resources. Assignment of incoming files easily could be the cause of future write-downs if done improperly. Lawyers who dabble in a new area of law (as distinguished from training) will require extra time to perform legal services compared to a specialist in that area, and some of the excess time may not be billable to the client. Also, poor delegation techniques can result in many hours of research on legal issues that are not relevant or critical to the success of a particular matter. Better training, file assignment, enhanced communication and effective delegation should eliminate, or at least greatly reduce, such write-downs.

4. Pre-emptive reductions. Some lawyers simply do not think they are worth the standard hourly rate they have been assigned, or they believe they took too much time to finish the job. They do the work, record their time, and then when it comes time to bill it, they prefer to cut the time charges to a level that is more "reasonable" in order to avoid potential client objections to the bill. I believe that a large part of these write-downs are unnecessary and can be minimized by effective control procedures.

5. Unforeseen delays. Occasionally circumstances will cause delays that cannot be avoided, requiring extra work that could not have been foreseen and for which the client should not be charged. These write-downs should primarily be associated with fixed-fee matters rather than matters charged on an hourly billing basis.

6. Success. Some firms are content writing down time value on a small percentage of clients in order to realize the increased fees they can collect from a large percentage of their clients. That is, to a large extent the financial success of many law firms during the past five years has been fueled primarily by billing rate increases as opposed to more billable hours, increased leverage or reduced expenses. In order to continue enjoying that success, some firms recognize they must give discounts to a small number of clients in the form of write-downs or risk losing those price-sensitive clients. This strategy is hard to argue with, but it should be a conscious decision the firm makes in advance of performing the legal services.

7. Sinister purposes. On numerous occasions I have encountered situations where some lawyers were

writing down time of other lawyers in the same firm for emotional reasons. In certain instances the behavior could be considered almost internal terrorism designed to hurt others in the firm. Admittedly this has been relatively rare, but it cannot be ignored as a possible reason for some write-downs.

Although there are probably many other reasons as well, the above list is at least a representative sample of the types of causes of write-downs in general, and their recent increase in particular.

Collecting Receivables

The other area where law firms can dramatically improve their profitability is in collecting receivables. The only thing that lawyers hate more than recording time and billing clients is collecting their overdue receivables.

This is understandable since it entails communicating with a client to ask for money, often via the telephone. Very few people enjoy calling another person to ask for money, since there is a high probability of getting rejected. Who likes rejection? No one, especially not high-achieving partners in law firms.

This process also invites comments from the client about the quality of the work itself, which could be embarrassing to some partners if the imagined quality is less than perfect. Some of the common perceptions lawyers have about this issue are not true, however, as indicated below.

Collection calls involve confrontation.

- **Truth:** Collecting receivables can actually be a positive experience and promote client goodwill if you use a “win-win” approach. Each client contact is an opportunity to express appreciation for the client’s business, to identify any problems

with the legal services rendered and to actively listen to the client’s concerns. Making the effort improves overall communications with the client.

You will get paid at the same time, whether you do anything or not. Why bother with collections?

- **Truth:** You *train* your clients over time as to how you want to be paid. If you historically pursue collections and demonstrate that you expect to be paid in 30 days, you will be paid more promptly than if you just wait.

Collecting accounts receivable is an event that takes place infrequently.

- **Truth:** It is a process that begins when the company becomes a client, and continues with every subsequent contact. If you don’t clearly spell out what you are to be paid and what services are covered at first, you will have trouble collecting your billings later.

We might injure our relationship with the client and lose their business.

- **Truth:** If you pursue collections in a professional manner you can actually improve your relationship with the client. Every contact should be professional, factual and courteous. Unless your client never intended to pay you from the outset, they will not be offended by your following up on overdue receivables.

It’s not worth pursuing an old receivable.

- **Truth:** For even relatively small amounts, there is tremendous value in each overdue receivable. Assume that your firm’s average profit margin is about 50%. This means that for every \$1,000 of revenue collected about \$500 is profit available for distribution to partners. It also

means that in order to replace the profit that would be realized by collecting an account receivable of, say, \$2,000 you would have to obtain new work totaling \$4,000. This is because your firm would need to pay for all normal operating expenses (staff salaries, occupancy, etc.) in order to generate a profit of \$2,000 from that new client work. The value of receivables to a firm’s profit is clear.

Fortunately, the collection process can be structured to be a positive experience. Here’s how:

1. **Capture billable time as promptly as possible.** Have lawyers submit time records on a daily basis if possible, but at least weekly. This will minimize the amount of billable time that slips through the cracks.
2. **Bill as promptly as possible.** The value of services rendered diminishes in the mind of the client over time. Your ability to resolve a critical problem of a client today has great value. If you bill promptly for the work performed it will generally be paid promptly. Next year at this time the client will not even remember the problem and will hesitate to pay any invoice you submit for it.
3. **Assign responsibility for collecting receivables to one person.** Make sure the individual making your collection calls understands the billing process, is familiar with how paid and unpaid receivables are filed, and has ready access to copies of uncollected client invoices.
4. **Use a computer system to track your calls if possible.** A computer software program that has a calendar reminder capability will

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be helpful in keeping track of your conversations with different people and will greatly increase your effectiveness in collecting overdue receivables.

- 5. Build upon personal relationships already established.** Avoid sending out form letters from your computer system to their computerized accounts payable department. Make the communication with the other party more personalized by making a hand-written notation on the form letter.

You will find that addressing the two areas described above will substantially increase your law firm's profitability, even in this challenging economy. ♦

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