Chapter 1

How Can We Do Better This Coming Year?

Those words are common within law firm conference rooms each January as the partners reflect once again on the financial performance of the past year. As Yogi Berra would say, "It seems like déjà vu all over again."[1]

Why do good intentions and plans for improvement fail to produce more significant financial progress in the ensuing year? How can law firms get beyond the superficial or ineffective efforts that fail to achieve improved financial results? We hope you agree with the following answers to these questions.

Let's Talk about Expenses

A common failing of many lawyers is to think the key to improving profits comes from expense reduction while overlooking the more powerful revenue-focused approaches that follow in this book. Yes, extravagant and unnecessary spending must be eliminated. However, once those expenses are removed, repeated annual efforts to slash expenses as a means of addressing continuing financial challenges is a counterproductive approach to financial management. It does not take a rocket scientist or a three-year plan to look at the expense side of a budget and reduce or remove unnecessary expenses. Once the firm

1. Yogi Berra, The Yogi Book 9 (1998).

makes appropriate adjustments, an attempt to continue to push too hard on the expense side harms the chances of making the firm financially successful.

> There are law firms that have actually put themselves out of business by trying to meet increasing challenges through cost cutting year after year.

The majority of law firm expenses are either largely fixed or production-related. The percentage of expenses that might be classified as discretionary is low, perhaps in the 20 percent range of total expenses. Assuming discretionary expenses can be desirable and useful, the number of dollars available for savings is limited. Year after year of expense cutting will cause firm management to be faced with suffering law firm morale and further cuts of the firm's production capability.

Does it make sense to eliminate staff positions if the result is to put more administrative functions on the lawyers and paralegals? Of course not; such an approach reduces the amount of revenue capacity. Does it make sense to cut the marketing budget? Probably not, if there is a revenue problem and the goal is to develop more high-end business.

What are the lawyers thinking? It can be so painful to watch a firm struggling with a revenue problem, debating what further costs to cut to improve profits! No struggling firm has ever forged its way to success by continuously cutting costs!

Now Let's Talk about a Revenue Mindset

A revenue mindset equips the firm to take a fresh look at management concepts and plan for the changes for improving both revenue and profits. The revenue recommendations that follow are step-by-step plans leading to improved revenue and, at the same time, are compatible with maintaining positive lawyer-client relationships and healthy law firm cultures. Improving lawyer revenue and improving client satisfaction go hand in hand.

Here is what the most financially successful firms have learned: *Increasing revenue, while maintaining the same expense structure, is the most powerful approach to improving the firm's bottom line*.

Simple math demonstrates those extra revenue dollars go straight to the bottom line and make a profound impact on partner profits. For example, assume a firm generates $1.5 million annually and there is a 50 percent profit margin, meaning $750,000 goes to overhead, and the other $750,000 goes to the partners as compensation or profits.

Annual Revenue	$1,500,000
Expenses	$750,000
Partner Profit	$750,000

If the firm is able to increase its revenue by 10 percent while maintaining the same cost structure, 100 percent of the additional revenue dollars will go to the partners. Therefore, partner profits would be $900,000.

Annual Revenue	$1,650,000
Expenses	$750,000
Partner Profit	$900,000

Take a moment to think about what this means. A modest 10 percent increase in revenue produces a 20 percent increase in partner profits. A 15 percent increase in revenue produces a 30 percent increase in partner profits. This doubling percentage produces extraordinary results. Can we agree that those extra dollars make a big difference to the lifestyle and the satisfaction of the partners? Perhaps the staff may now benefit from a bonus that has long been absent in the firm.

Although there is something to be said for the concept "you must spend money to make money," please exercise caution. There are certainly circumstances when a firm can benefit from spending money on a new initiative. However, a plan designed to increase both revenue and expenses does not necessarily improve profits. In fact, it can have the opposite result.

The partners work long and hard to meet the firm's revenue budget without appreciating how 100 percent of any extra revenue dollars end up in their own pockets once the overhead has been covered. The partners who do appreciate the significance of the extra revenue might be reluctant to push in that direction because they believe extra revenue requires working more and more hours. This is not true. The extra revenue can result from a variety of sources, including better management of the revenue side of the budget, because there are almost always significant dollars left on the table.

Improving Revenue Is More Than Billable Hours and Rates

Increasing billable hours and hourly rates is often not the best solution to improving revenue and profits. Although some firms survived the 1980s and 1990s by regularly increasing billable-hour requirements and raising hourly rates, those strategies became self-limiting over time and resulted in both client resistance and a decline in lawyer morale. Increasing billable hours and/or hourly rates is not the real answer.

The recommendations in this book are far-reaching and comprehensive, but also simple and logical. Unfortunately, getting partners to dedicate time to their own business methods is a hard sell. For those partners who do recognize the need to make fundamental changes to their own practice methods, their approach is often superficial, scattered, and lacking in the necessary follow-through. This is understandable. Lawyers generally do not like to spend time managing. Lawyers do not like change. Lawyers want to practice law. That said, we ask the reader to seriously consider the following perspectives concerning revenue.

> There is no other profession, or business, that pays so little attention to the underlying issues of revenue production.

Establish Revenue Capacity

The best way to identify the money "left on the table" is to start with a capacity analysis. The revenue capacity of a law firm is the amount of money the firm should be able to generate with its lawyers and paralegals working at their highest and most efficient level given the firm's existing support, present systems, and current technology. It represents the most revenue the firm might hope for with its present operating structure and practice methods. Use the firm's capacity as a benchmark to measure how the firm is doing and the extent the firm has unrealized revenue potential rather than only examining the comparison to the results for the prior year.

Revenue capacity has nothing to do with actual revenue or the current performance of the firm. In fact, revenue capacity has elusive subjective elements. But we can get a rough idea of capacity by looking at certain objective information relating to the firm's operations. Once revenue capacity is determined, this number can be compared with actual performance. The gap helps to focus on finding ways to bring the firm's performance more in line with its capacity in the following year.

Begin by taking the standard hourly rate of each lawyer and paralegal and multiplying the rate by the anticipated number of billable hours. The total hours should be realistic based on the size and location of the firm, the type of work involved, and the culture of the firm. Include as necessary any historical information about each individual's performance in prior years.

A small firm could be expecting from each lawyer 1,200 billable hours while a mid-sized firm could be expecting 1,500 billable hours. For example, assuming the hours set out below are consistent with the firm's culture:

Lawyer A	1,500 hours × $300 =	$450,000
Lawyer B	1,600 hours × $225 =	$360,000
Paralegal	1,200 hours × $110 =	$132,000
		$942,000 Revenue Capacity

The calculations assume the work performed is billed based on hourly rates or, if other billing methods are used, the hourly rates provide the basis for estimating anticipated revenue. The analysis assumes each lawyer and paralegal has an adequate workload, all billable hours are billed to clients, and all bills to clients get paid. Although these are aggressive assumptions, they represent the important point of reference for further analysis.

> Understanding your firm's revenue capacity is the most important step toward increasing revenue.

Your firm's actual revenue will be lower than its revenue capacity. Determine the amount of the shortfall and analyze whether the shortfall is due to lack of business, a poor work ethic, write-downs of billed time, clients with financial difficulties, collection problems, or more likely a combination of these reasons. Identifying and understanding the reasons for the shortfall enables the firm to take corrective action where possible.

Let's take the example of the firm above with a revenue capacity of $942,000. If the actual revenue is $623,000, then the firm is realizing 66 percent of capacity. At this point in the analysis, the response might be, "Well everyone knows 100 percent of capacity is not realistic or achievable." Well yes, but wait a minute! Think about improving the firm's revenue from 66 percent of capacity to 76 percent of capacity. In this example, an improvement of 10 percent of capacity produces additional profits of $92,920 to be shared by two partners. Or, an improvement to 86 percent of capacity would produce additional profits of $187,120 to be shared by two partners. This percentage improvement toward capacity causes a very significant improvement in profit for a small firm while remaining below 100 percent of capacity!

That is what capacity analysis is. Please pause and reflect on this important concept. The reason this concept is so important is because the actual revenue results in small firms are often between 60 percent and 80 percent of capacity. While a percentage less than 80–90 percent is disappointing, the good news is this: the lower the percentage, the more room there is for improvement. For most small and mid-sized firms, understanding the actual percentage of capacity achieved will compel attention and motivate you to take these concepts more seriously—and to continue reading this book! Refer to the Revenue Capacity Worksheet at Appendix C-2.

Financial Reports

The step of identifying why 34 percent of the example firm's potential revenue was lost depends on having adequate financial reports. Unfortunately, many small and mid-sized firms do not have the information necessary to effectively manage their profitability. A comprehensive analysis of the financial data is necessary to verify both the nature of the problem and the needed corrective action.

> → A bookkeeper with no understanding of the data needed to effectively manage a law firm may set up the books to only track invoices, revenue received, vendor payables, and payroll.

Many small and mid-sized firms operate with either inadequate financial software or limited knowledge as to how to use the software. Many lawyers lack the data necessary to understand underlying issues and are not able to make important management decisions. Even worse, in some cases, data gets presented in a way that can work against the behaviors the firm is trying to encourage.

Now let's consider the financial reports. These reports are necessary to adequately address revenue concerns:

- **Revenue and expense budget**. There are many small firms that do not operate with a budget. The checkbook balance is the only financial indicator they use to operate the firm. For those that do operate with an expense budget, many do not have a revenue budget. Without a budget, it is not possible to know the variances from your reasonable financial expectations.
- **Balance sheet**. The balance sheet will reveal the financial health of the firm by disclosing assets and liabilities, including any short- or long-term debt. The balance sheet will alert the partners to any decline in the book value of the firm. It normally is checked at the end of the year, but can be evaluated at any point. Rely on your certified public accountant to ensure the balance sheet is properly prepared.
- **Profit and loss statement**. The firm should have an annual budget against which the profit and loss statement can be compared. The profit and loss statement should be reviewed monthly to learn if there is a developing shortfall of revenue compared to the budget, or if there are excessive expenses not reflected in the budget. These differences are known as variances. Ask your firm's bookkeeper to monitor and report these variances.
- **Billable hours report**. The billable hours for each timekeeper should be checked at the end of each month. The hours report is the earliest warning of a potential revenue problem surfacing months later. If the shortfall for a timekeeper is because of lack of work, examine how to shift work to make everyone productive. If the shortfall is due to insufficient support (the timekeeper is doing too much nonbillable work), examine how administrative support is used. Address any shortfall immediately to limit the impact later. One added collected billable hour of a timekeeper pays for multiple administrative support hours.
- **Billing report**. Watch the monthly billing report. A lower-than-expected number for any partner signals either lack of work or a delay in billings. Get on the issue quickly and provide the support necessary to get the bills out without unnecessary delay. Delay is sometimes due to the

YOUR BILLING BUDGET

January's billing budget is 33 percent of the December 31 balance of unbilled time. February's billing budget is 33 percent of the December 31 balance of unbilled time plus January's unbilled time minus January's billing budget, and so forth.

perfectionist lawyer who uses two or more edit steps before approving the final bill.

- **Aged work-in-process**. If you see an individual's work-in-process building for no apparent reason, it signals poor billing habits. Make sure the partner is reminded of the need to bill regularly and in a timely manner. Consider using a billing budget report described in the sidebar on page 7.
- **Billing realization**. Track the amount of time written off and, if more than 5 percent, examine the reasons and take corrective action.
- **Cash receipts**. Cash receipts are vital, of course, to pay the rent and the staff. Make sure your receipts are tracking the prior month's billings. If there is an unexplained drop off, review the accounts receivable aging report and speak with the billing partners for those clients with balances over 60 days old.
- **Aged receivables**. Your receivables should be sorted by age. Focus on the 60-day column and take action while the receivables are relatively fresh (recently billed). For management purposes, establish an age (perhaps 12 months), and automatically remove receivables from the list and place them in the doubtful accounts category.
- **Doubtful accounts**. Doubtful accounts are those receivables no longer counted for revenue projections and that have been moved to this category for the purpose of continued collection efforts. Each such account may require a separate strategy before attempting collection.
- **Collection realization**. Track the average percent of billings collected and, if the collection realization is less than 95 percent, initiate more aggressive collection efforts by reviewing the aged receivables report.
- **Disbursements**. Management should track client disbursements carefully from month to month and make certain they are billed and recovered at the earliest possible time. These costs are advances on behalf of clients, not costs of doing business.

→ There are several places to look for lost revenue:

- Failing to work the intended billable hours
- Failing to record all the billable hours worked
- Delayed billing
- Writing down time before billing
- Failing to pursue receivables in a timely manner

Each of these reports plays an important role toward improved revenue and profits. Combined, these reports become your "dashboard" for quickly understanding the financial trends of the firm. Financial reports should be monitored monthly and any troublesome trends addressed without delay. In most cases, it will be easy to identify the areas where lost revenue can be recovered. The firm's bookkeeper should also be very aware of what those reports portray and draw your attention to any questions.

Low-Hanging Fruit

The first two steps in addressing the need to increase revenue and achieve a larger percentage of capacity is doing a better job managing client expectations and making certain the firm's partner compensation system is providing the correct incentives. Ignoring these two steps almost always negatively affects revenue.

Client Expectations

> For many firms, discounting invoices is the place where the most money is lost.

Indeed, no issue diminishes revenue possibilities more than failed client expectations. If only one of the recommendations set out in this book is implemented, this is the one to focus on to assure significant improvement in revenue.

> Law firm audits reveal that the most successful approach to increasing revenue is through giving better attention to meeting client expectations.

Write-downs of billings and write-offs of accounts receivable cause the most significant loss of revenue for small and mid-sized firms. There may be acceptable reasons for discounting an invoice and each one may not seem significant, but if you track them and add them up at year-end they are often a shocking total.

Careful management of client expectations, including at intake, is the best method for minimizing these losses. Having reasonable expectations at the outset is critical, as well as managing expectations throughout the engagement. Lawyers who effectively manage client expectations are less inclined to discount invoices and, at the same time, clients will take their payment responsibility more seriously. Paying attention to client expectations also has the effect of assuring improved client satisfaction. The next question is how to do a better job at managing and meeting client expectations. Chapter 3 provides details that assist in assuring client expectations are met to the extent possible and thereby reduce needless write-downs and write-offs.

The Significance of the Partner Compensation Method

Another barrier to improving revenue and profits in small firms can be the partner compensation system. Compensation systems are often a function of the firm's history, its culture, and likely the attitude of the firm's founder. Books are written on this subject, but the approach taken in Chapter 6 highlights the factors directly motivating the behaviors required to improve revenue and profits. Too often, compensation systems do not promote the behaviors necessary to maximize firm revenue and, in fact, may promote the opposite result.

Other Revenue Enhancers

There are additional methods successful firms are using to improve profits. These require a change in approach to lawyering and may take longer to develop and implement. The first of these approaches is the more profitable use of associates and paralegals. The second is alternative billing methods sometimes referred to as "value billing."

Effectively Leveraging Associates and Paralegals

Many partners in small firms do not focus on the possibility they can be more profitable by employing and effectively utilizing associates and/or paralegals. Do not consider them just another pair of hands to lighten the load or functioning as help to take on unproductive projects. Too many lawyers come up with the idea that if they cover the associate's salary they are break-even and that is enough. Partners who only focus on their own personal production severely limit their ability to produce revenue for the firm. Chapter 4 discusses how to enable associates and paralegals to be more profitable, which is common in the most successful firms.

Value-Based Fee Agreements Are Important

Lawyers have been around for centuries, but it was not until about 50 years ago that some consultants came up with the idea they should charge clients based on the time invested by using hourly rate billing. More recently, commentators have argued effectively that hourly billing for general civil matters is not fair to lawyers or their clients. That said, changing back to value-based billing has been a challenge. Today, most law firms offer value-based billing for some services and are moving away from hourly billing wherever possible. Clients like the predictability of flat fee billing. It removes an area for potential controversy that often causes the need for write-downs or results in collection problems. Chapter 5 is a guide to assist in moving areas of your practice to value-based billing.

> Managing: doing things right.
>
> Leadership: doing the right things.

Leadership and Management

Do not overlook the importance of leadership. Compare a financially successful firm with a struggling firm, and the significance of strong leadership becomes obvious. Lawyers who have good law practices in a firm with ineffective leadership will not be able to maximize financial success for themselves or for the firm. It takes strong positive leadership to guide a firm toward implementing new and innovative practice methods. Effective leadership is the only hope for getting lawyers to change what they do or how they do it.

> Management is:
>
> - Planning (setting goals)
> - Organizing (putting into place the means to accomplish the goals)
> - Implementing (doing the necessary tasks)
> - Controlling (measuring results)

Implementing the recommendations of this book cannot be achieved by sending an e-mail or by only the hard work of a managing partner or a law firm administrator. Moving the law firm to a revenue mind-set and implementing the changes in setting goals, tracking data, improving practice methods, using appropriate fee agreements, and assuring positive client-service approaches must reflect a decision of the firm and all its lawyers. Without a strong commitment from the lawyers, paralegals, and staff, the efforts are doomed to erratic application and ultimate failure.

Once the firm has buy-in to these concepts and goals, the next challenge is to develop the long-range plan to guide the firm in implementing the necessary changes. There might be questions about the order in which the issues are addressed and which approaches are taken. But remember the partnership meeting agenda reflects the attitude of management. In setting the agenda, management creates the priorities of the discussions and the tone of the meeting. Look forward, not back. The best way to change the mind-set of the partners is to create an agenda that focuses attention on future revenue production and future business development.

Conclusion

The personal observations of the authors are that partners in small firms can match the compensation made by lawyers in much larger firms. Too often lawyers in smaller firms are quick to assume they cannot do better because of the lifestyle choice they made. The recommendations in this book reflect the approaches to be taken by partners who understand and accept how to make good money in a small firm environment.

The focus of this first chapter is on providing an overview of the importance of a revenue mind-set and the financial data that enables all the lawyers to better understand the connection with meaningful changes that are necessary for improving revenue and profits. Moving beyond the math, this book presents a number of substantive practice management approaches for achieving the revenue and profit goals that may have been elusive in the past. Not all of the Appendices are referenced in the text, so be sure to review the table of contents for the Appendices so as not to overlook any helpful resources.

We hope the discussion in the following chapters helps you think through what is achievable in your law firm. Refer to the Master Planning Worksheet at Appendix A-1. Remember, this is not an "overnight" process. But your patience and commitment will yield satisfying results. And we hope it also will yield some fun!