

Firm Expenses: How Do You Make Sure You Stay Afloat?

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Introduction

The decision to start or manage a law firm is not one to be made lightly. There are many factors to consider when making such a decision, and in particular, one must think about the expenses associated with a law firm, both overhead and operational. Most who have spent some time working at an established law firm have had access to resources that are often taken for granted. As a result, it is important to shed some light on the important expenses that one will face in branching off. In addition, because managing the firm's finances is often left to specialists in that area, most lawyers may not have the necessary knowledge to properly deal with the expenses of setting up one's own practice. Once a law firm is operational, solid management of the firm's finances minimizes cash flow risks. Accordingly, awareness of the problems associated with financial management of a law firm can be helpful to avoid such issues in the future.

1. Starting a New Law Firm and Law Firm Expenses

Assessing Your Position

Prior to setting off on your own, you should conduct an assessment that takes into account three minimum requirements to succeed in managing a law firm: skills and experience, capital, and a client base. Solid legal skills and experience and managerial, marketing and communication skills are key aspects of successful managing a law firm. The requirement for capital is an obvious one, but one that must be addressed: you should have enough money in the bank to ensure that you can continue to pay your overhead costs when cases are pending and settlements are not coming through over long periods of time. The

discussion on cash flow will be elaborated upon later, but in general, it is crucial that you prepare a realistic budget and have access to credit. Finally, it is prudent to consider your client base and estimate what kind of client base you will need in order to stay afloat. You should think about prospective clients and which clients may come with you when you branch off.

Business Planning¹

Once you have decided that you are in a good position to start your own law practice, you must create a business plan. This will provide a general description of your business and include financial, management, and marketing plans. In this business plan, you should describe your intended practice, including information about the type of legal services that will be provided and the legal form that you will use (i.e. law corporation, limited liability partnership, proprietorship, etc.).

You should also set out your business goals. In this description, you should provide some analysis of your competition and why you believe you will excel in your practice. Operating procedures that you intend to follow ought to be included in your business plan; this includes office procedures and systems that you intend to use, a list of required equipment, and services that must be available to clients for accessibility, including elevators, escalators, parking, etc. An outline of the staff you will require and the skills that those staff must have should be set out. The insurance needs of your office should also be

¹. Lawyers' Professional Indemnity Company (LawPRO), Managing the Finances of Your Practice: Business Plan Outline, March 2003.

assessed and set out in your business plan; insurance considerations should be for general office space insurance, malpractice, and even personal insurance.

While it may be clear that you are comfortable with practicing law, ensuring that you are knowledgeable about running a law practice is partly related to your ability to manage the finances of your law firm. The business plan should include a financial plan that sets out your start-up budget and factor in one-time expenses. Such expenses include the following: equipment and services required, personnel costs (before opening), deposits, permits and costs of any office improvements, major equipment purchases, accounting start-up fees, software and hardware costs, supplies, utilities, and other services that may require a down-payment. In addition, an operating budget for a three-year period provides a snapshot of your firm's operational expenses down the road.

Identifying both a management and a marketing plan will reassure those whom you may need to convince that you are able to run a business. While office space is typically an expensive cost, the largest expense you will be faced with is staff compensation. A management plan should indicate your own traits, both strengths and weaknesses, and how you will bridge any gap with the skills and abilities of your staff. To this end, your management plan should include a description of the duties of your staff and indicate where you will need to look to people outside of your law firm to ensure necessary skills are available. You will also need to think about the salaries, benefits, and vacation time that you will offer to your staff and how you intend to replace staff that are on vacation.

A marketing plan will frame how you intend to reach your target market and should identify this market. Describe any marketing goals and how you intend to evaluate these goals

over time. In determining where you fit in the legal marketplace, you should describe how you will be able to compete with other firms on elements other than price.

In your business plan, you should set down a timeline within which you anticipate your business will be up and running. After addressing the above mentioned factors in your plan, you should have a better sense of how long it will realistically take you to get your practice started. According to Edward Poll, a certified management consultant in the United States, it takes time to establish a law firm so you should probably allocate about six months to a year to establish one.²

Marketing

In order to get the word out on the street that a new legal service provider is operational, it is important to implement the marketing plan that has been set out in your business plan. This involves setting aside money to invest in advertising and accessing a client base. Advertising may include the following avenues: a Yellow Pages ad, creation of a website, television/radio/billboard advertisements, office signage, adding the law firm to the law society's Lawyer Referral Service, distribution of firm brochures, client newsletters, attendance at various seminars and conferences, announcements, and speaking opportunities at continuing legal education (CLE) programs. If your practice intends to target a particular type of client (such as providing services to individuals of a particular cultural affiliation due to language proficiency), you may consider heavier marketing efforts in areas more populated by your typical potential clients.

² Edward Poll, *Secrets of the Business of Law – Opening Your Own Office: What Will It Cost?*, the Canadian Bar Association (CBA), 2010.

Finances

While the management of a law firm's finances will be discussed in greater detail below, in the early stages of establishing a new law firm, you need to consider your sources of finance. Initially, you cannot rely on revenue from client files to pay your overhead costs. Accordingly, you will need to secure financial resources that will be at your disposal, both at the start of your business and while it is operating. Given that it could take years to bill a file, you need to consider how you will survive during the months where little to no income is coming into the firm accounts.

Before starting your own practice, it is likely that you will have one key source of credit to draw upon: personal savings. However, it is also likely that this will not be enough to ride you through the tough times, once your start-up costs are considered and operational costs set in. Sources of credit from financial institutions, such as banks, include a personal/business loan, home equity, a line of credit, and lease/equipment loans. Additionally, various types of bank accounts and services must be set up, including a trust account, a business operating account for expenses and payroll, short term savings, a firm credit card, and cheques.

Infrastructure and Office Space

There are basic things that must be acquired in order to have an operational work environment. First and foremost is an office space that can grow and expand to the anticipated size of the law firm. After determining the type of practice that you wish to set up, location and demand for that type of practice are central considerations. While initially, the size of the law firm may be small, you may want to consider the possibility of

expansion in your present office space, and any need for future renovations should be contemplated in order to estimate the future costs of obtaining a particular rental space (if applicable). The type of rental agreement that is most appropriate may be a short term rental agreement, sub-lease or something involving less commitment such as a month-to-month rental.³ An office sharing arrangement may also be something worth considering at the initial stages of operation, as you may have access to office resources that are already in place. You may also need to think about issues of accessibility and parking spaces, which may be important conveniences for clients.

Technology

One of the largest costs of starting and operating a law firm is technology. While technology amounts for a significant outlay of funds initially and over time with updates to newer technology, the largest part of it occurs at the start of the business. Apart from the costs of the hardware itself, software purchases must be accounted for. In particular, the following are commonly required software packages: word processing (Office Suite), time and billing/accounting, calendaring and docketing, conflicts checking, case management, document assembly, virus protection for computers, voice recognition and any other specialized software that you may require, depending on the nature of your practice. In terms of required hardware, the following are the basics: computers (including both the operating system and the back-up system), printers, a network/firewall, scanners, laptop computers, and personal digital assistants (PDAs, such as BlackBerries).

³ *Supra* note 2.

Office Equipment/Supplies

Along with computers and associated technology, an operating law firm requires other office equipment and supplies, including the following: fax machines, photocopiers, scanners, shredders, dictation equipment, internet service provider, email addresses, high speed internet access, telephone systems, complete with voice mail capabilities, local and long distance carriers, conference calling, and cell phones/service, postage scales and mail equipment, office furniture for lawyers, staff and reception area, writing and organizational supplies (pens, paper, files, etc.), business cards, and law firm paraphernalia to give to clients. Although the initial outlay for this equipment may be expensive, some of the equipment, like a photocopier will be a profit centre. Copies can be charged to the client (a majority of which will be paid by the defendant as a partial indemnity of costs at the conclusion of the case) and will bring in a substantial amount of revenue over the lifetime of a file.

Research/Library Costs

With the advent of research services such as QuickLaw and WestlaweCarswell, the need to amass large volumes of journals and reporters to be housed in a firm's library is next to non-existent. However, subscriptions to such services are costly and depending on the size of the law firm in question, access to one or more of such services may not be cost-effective. Regardless, the cost of access to these types of research resources is a consideration for a law firm. Also, despite the tendency to look to electronic resources and internet sources, hard copies of important textbooks and treatises on particular areas of law are valuable and should be accounted for in budgeting for research/library costs.

Companies like Taran Virtual Associates can assist you with your research and drafting of facta and allow you to charge that expense to the file. This will allow you, possibly, to defer from hiring another associate until you can justify their necessity.

Office Personnel

A law firm is made up of lawyers of varying levels of seniority and a mix of staff that ensure the smooth operation of the law firm's business. At the initial stages, it may not be necessary to have a large staff on hand to handle the administration and management of the law firm. However, depending on the anticipated size of the law firm in question, you may need to forecast appropriately and consider the number and type of staff that you will need once the firm is fully operational.⁴ In addition to considering your needs, again, the issue of the costs of these personnel must be addressed. In general, staff for the following areas may be necessary: administration, operations/facilities, marketing, information technology, accounting/finance, and legal support, such as law clerks and legal assistants. As the practice builds, the availability of such staff members is sure to lighten the lawyers' load and free them up for tasks of a strictly legal nature. Again, whether or not a new firm requires personnel support in each of these highlighted areas depends on the volume of work and the size of the firm itself.

2. Cash Flow Management

Once a law firm is fully operational, the challenge is being able to stay on top of its finances and ensuring that cash flow is not a problem. Realizing that settlements often

⁴ Robert A. Hardie, *A Practical Guide to Successful Law Firm Management* (Canada: LexisNexis, 2006).

take years to be paid out, it is important for any law firm to ensure that it has enough liquid assets to account for important expenses that cannot be curbed, such as overhead costs of office space and employee compensation. Accounting for fees owed by clients on a regular basis and ensuring that billings are sent out in a timely fashion help law firms anticipate what their work in progress (WIP) amounts to.

In order to successfully run a law firm, management must have a strong grasp of key financial performance measures. Three such performance measures are cash flow, revenues or collected fee receipts, and profit margins.⁵

When assessing cash flow, it is important to reconcile the difference between cash receipts generated from accounts receivable and the cash payments generated by payroll and accounts payable, also referred to as a cash gap. In plain terms, this simply means that firms pay the costs to render services before invoicing clients. For a firm that is starting out, it is easy for this cash gap to widen quickly, as growth requires increasing outlays of cash. Because cash receipts take longer to come into a firm, this could create a problem if the firm does not have enough reserve funds to rely on.

Revenues or collected fee receipts are significant to the profitability of the firm. The level of profit earned by a firm is contingent on the level of revenues collected. It is essential to remember that one of the largest and regular expenses of a law firm is compensation of lawyers and staff. This expense is unavoidable and as such, paying salaries without receiving payments from clients regularly will eventually give rise to a cash flow problem.

⁵James D.Cotterman, Fiscal Management of a Law Firm, *Report to Legal Management*, September 2001.

A final performance measure of importance is a firm's profit margin. The way in which law firms typically consider profits is by income per equity partner. In terms of other costs, however, profit is simply revenue minus costs. Accordingly, while increasing revenue is a natural focus of any business, firms should also look to reducing overhead costs; understandably, this is not always possible, but overhead costs, including compensation, occupancy and technology, should be adjusted to revenues.

There are many things to consider in order to ensure that cash flow is steady and that profit margins continue to grow. While there are different ways to ensure that these financials stay above levels that cause alarm, most will concur that a systematic approach to financial management of a law firm will significantly reduce the likelihood of shortfalls later.

Disbursements

In addition to time billed for work done on a file, law firms also must decide what to do about disbursements made on any given file. Once a law firm decides how to deal with various types of disbursements, such as photocopying, faxing, messenger service, overnight mail, and postage, it must ensure that it is vigilantly charging clients for those disbursements and is documenting them in order to explain them to clients that may want a detailed break down of the costs incurred on their file.

Bridgepoint Financial Services Inc.

For law firms practicing litigation and specifically, personal injury law, cash flow may pose a particular problem, given the length of time that it may take to get a settlement or a

judgment for a given case. One option is to secure financing from an alternative source, such as BridgePoint Financial Services Inc. Bridgepoint offers specialized financial services to the Canadian litigation market. It is aimed at providing financing to plaintiffs, counsel and experts that are called upon who cannot obtain the necessary funds from banks and other lenders. The difficulty in obtaining financing from traditional lenders is that they may not understand the nuances and risks associated with particular legal claims, and as such, they are not willing to provide funds upon which counsel and plaintiffs rely on. BridgePoint provides loans, albeit at interest rates higher than most banks, for litigation-related claims in the areas of personal injury, class actions, and other legal claims, including wills and estates, employment, general commercial, corporate securities, real estate, and bankruptcy and insolvency. Alternative sources, such as Bridgepoint Financial Services Inc., exist and may be an option when finances are needed.

File Intake

A very important consideration in managing your law firm is file intake. One should do a cost-benefit analysis of each case before agreeing to act for the plaintiff. More than one law firm has gone bankrupt by taking on the wrong file or “biting off more than one can chew” on a file. When you are starting out, you cannot afford to take on risky files. Losing or not being paid on a file could mean the difference between surviving or going bankrupt. One must screen their file intake very carefully. If it is not a “slam dunk”, you should not be taking on the file when you first open your practice. As you build your cash reserves and get more experience, then you can take on riskier files, provided the risk is not greater than the benefit. The problem is that when you first start practicing, it is very difficult to be selective because you feel you have to be busy and pay the overhead. This is a mistake.

Although being able to assess risk comes with experience, most of us recognize early on when a file is not something we should take on because liability is difficult or you do not have the necessary skill set. If this occurs, speak to a senior lawyer in the Bar. You may be able to “partner” up with them on the case to reduce your risk or refer it to them and obtain a referral fee. As my late father used to remind me, “you have to be able to walk before you can run” and “anyone can get a client a million dollars, you just have to screw up a \$2 million case!” Remember: don’t be greedy. Being a lawyer has the potential to be a long and fulfilling career; don’t ruin it early on by taking unnecessary risks.

Conclusion

In general, there are many expenses to consider to start and operate a law firm. Additionally, there are several things that can go wrong, causing cash flow problems and thereby jeopardizing the livelihood of the law firm. However, the following are suggestions to minimize such risks:

- Address your bookkeeping arrangements and consider how well these arrangements have been working for your law firm;
- Assess your firm’s practices in minimizing cash flow risk, such as disbursement tracking, regular billing cycles, and invoice collection;
- Look at the availability of up-to-date information related to file-related transactions at any given time, such as your work in progress, unbilled and billed disbursements, invoices issued, unpaid invoices, and payments received;
- Keep track of unbilled fees and disbursements by lawyer, client, and area of law;
- Review client trust account balances periodically;
- Assess the firm’s tax and other upcoming liabilities throughout the course of the year;
- Project monthly billings and review them with actual monthly billings;
- Review actual costs and budgeted costs;

- Understand and be able to interpret your firm's financial reports to be able to meaningfully analyze your firm's performance from time to time; and
- Assess every file with regard to risk to ensure that there is an extremely high likelihood of success and ultimately being paid.

In short, realistic expectations regarding firm expenses and sound financial management practices will help to make sure your law firm stays afloat..