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GEFFEN MESHER
& COMPANY, P.C.

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS CONSULTANTS

AN INDEPENDENT MEMBER OF DFK INTERNATIONAL

Capital concerns

Ensuring your firm has the financial resources it needs

Whether you're starting a new law firm or managing a long-established one, capital — how much you have and how much you need — is a constant consideration. A successful firm requires both working capital to fund daily operations and long-term capital to buy assets and make strategic investments. Unfortunately, determining your firm's capital needs and meeting them are two of the most difficult tasks you'll face as an administrator.

One size doesn't fit all

Conventional wisdom says that law firms need capital to cover at least 12 months of operating expenses. That's not a bad place to start, but it fails to take into account many factors. For example, as some firms have learned the hard way over the past few years, severe economic downturns can last much longer than anyone expects.

What's more, every firm's needs are different. If, for example, you pay substantial out-of-pocket expenses on behalf of clients, your capital requirements will be greater than those of a firm that covers expenses through the use of retainers. Your billing and collections practices also may necessitate a smaller or larger capital cushion, as will your strategic plans. Firms with aggressive growth objectives generally need greater capital resources than those pursuing slow and steady growth.

Crunching the numbers

Established firms can get a rough estimate of their capital needs fairly easily. Just add your one-year operating budget to the cost of any major asset purchases and strategic growth initiatives (for example, making acquisitions or hiring new associates) planned for the coming year. Then make adjustments for unique situations, such as the need to pay out a senior partner who will soon retire.

Capital needs calculations are tricky for startup firms; you first must estimate how long it will be before you see positive cash flows. This period could last several months or a couple of years, depending on such factors as:

- Type of practice,
- Overhead costs,
- Billing frequency,
- Collection percentage, and
- Amount of revenue you reinvest in the firm.

Ensure you have the capital to cover all ordinary — and extraordinary — costs during the startup stage or your firm will fail before it ever has a shot at succeeding.

Funding sources

Once you have a ballpark figure of your capital requirements, if you're short, you'll need to decide where you'll get the additional

Is your firm undercapitalized?

Although it's not a hard and fast rule, law firms with less than a two-month reserve of capital are likely heading for financial trouble. Having so little cash on hand can hinder both daily operations and long-term growth plans. And undercapitalization means that everything from rising energy and health care costs to the loss of a major client could threaten your firm's future. Watch for warning signs such as:

- **Increased borrowing on short-term bank loans,**
- **Aging accounts receivable, and**
- **Reduced partner distributions.**

If you find these red flags, address them immediately. A financial advisor can help your firm create an action plan, which may include such remedies as increasing partners' capital contribution requirements.

funds. Typically, capital comes from a combination of bank debt, capital leases, undistributed earnings and partner contributions.

Due to the credit crunch, bank debt has become difficult for business borrowers to obtain. However, law firms most commonly borrow in the form of working capital lines of credit secured by accounts receivable and term loans secured by assets being purchased — which can be easier to get than other types of loans. Here, your firm's financial history, business plan and relationships with bankers will be critical.

Whether you can secure capital through bank borrowing — or through capital leases — will also depend on your firm's financial philosophy and appetite for risk. For example, are your partners comfortable borrowing against future collections? Do they mind financing office furniture and IT equipment with capital leases?

If not, they'll likely need to contribute more from their own pockets. Contributed capital includes cash paid in when partners join your firm, as well as additional cash they may be required to contribute periodically. Your partnership agreement may require equal contributions from each partner or allow contributions to be determined based on the amount of income each earned in the previous year. If the current contribution method isn't covering your firm's capital needs, you may need to revisit this agreement.

> *Capital needs calculations are tricky for startup firms; you first must estimate how long it will be before you see positive cash flows.*

A moving target

Determining your capital needs and funding them is only the start. Firm growth, including adding new partners, practice groups and offices, and operational changes, such as adopting alternative billing arrangements, make it necessary to regularly review your capital target. So incorporate the task into your firm's annual budgeting process to keep your target current. ▣

Survive an IRS audit

So far as you know, your firm's partners file accurate and timely tax returns. And you personally can attest that your firm's financials are on the up-and-up. So why did you just receive an audit letter from the IRS?

Your first impulse may be to panic, but try to keep calm. By working with your CPA and cooperating fully with the IRS, you *can* survive an audit.

What the IRS knows

As part of its Market Segment Specialization Program, the IRS trains examiners to specialize in particular market segments. Examiners assigned to your case, therefore, are familiar with legal industry issues, practices and terminology. Typically, they've honed their skills auditing many other firms and will know which questions to ask and records to examine to expedite the audit process.

> *If a dispute arises and you're unhappy with the result, let your accountant handle it.*

Typically, the IRS uses a "penalty point" computer system to identify taxpayers with strong audit potential. Law firms that handle large sums of cash — such as personal injury and immigration practices — typically attract greater IRS notice. The agency also looks closely at real estate lawyers because they may take a property interest in a transaction and fail to report it. However, partnerships in general are more likely to be audited than other business types, such as sole proprietorships.

Protecting your firm

Obviously, your best strategy to dealing with the IRS is to avoid an audit in the first place. You can protect your firm by working with experienced tax professionals and having partners sign statements annually verifying they've filed their returns.

Maintaining good records is also critical. Examiners usually are more lenient when firms being audited have thorough records that include accounting documents, updated cash-receipt and cash-disbursement information, and completed time records and journals. Examiners are particularly interested in money borrowed from clients that is later forgiven for services provided. They also look at each partner's partnership or limited liability company (LLC) interests or stock received in lieu of cash for services provided. Be sure your firm's attorneys document and report such transactions.

Audit process

If you do receive an audit letter from the IRS, call your CPA. He or she will likely instruct you to respond promptly and may be able to help you delay or even avoid the need for interviews. Often, the IRS simply needs taxpayers to clarify a detail. Delaying your response or ignoring the IRS may raise suspicions about your intentions.

The IRS may, however, ask to meet with you. Arrange to meet at the auditor's or your accountant's office. Meeting at your firm's office can give the auditor an opportunity to compare your surroundings to the income stated on the return and may raise red flags, even if unwarranted.

Keep in mind that the IRS will look at a particular item only a finite number of times, so be sure to point out any previously audited items. For example, if an auditor examined the same entry (such as mixed automobile use for business and pleasure) in the past two years and made no change, your CPA may be able to persuade the current auditor to bypass this part.

Probably the most important thing you can do when the IRS comes calling is to maintain professionalism. If a dispute arises and you're unhappy with the result, let your accountant, who is more likely to approach the situation with a cooler head, handle it. If necessary, he or she might request a meeting with the auditor's supervisor or a district supervisor.

As a last resort, you can file an appeal with the IRS's local appeals office. But avoiding litigation usually is your best course of action because the IRS wins the majority of these cases and appealing a court decision typically costs more than paying the tax.

Quick and painless

Although many taxpayers assume that an audit letter automatically means the IRS is going to put them through a long and painful process, that's simply not the case. In most instances, the agency wants to clear up any questions or discrepancies as quickly and painlessly as you do. ▣

The Y factor: Working effectively with your youngest attorneys

Whether you refer to them as Millennials, Generation-Ys or just "kids," Americans born between the late 1970s and the early 2000s make up a huge generation, numbering 75 million-plus. So it's likely at least a few have joined your firm in recent years. While new associates of every generation share certain characteristics — all struggle at first to manage the demands of various partners and multiple cases — Millennials require special care.

Millennial traits

To ensure you're taking advantage of these young attorneys' skills and providing them with incentives to stick around for the long haul, you need to recognize how they differ from their elders — and how they don't:

Work ethic. This group commonly is considered the most privileged and spoiled generation in American history. Its members also are known for their high self-esteem and outsized

sense of entitlement. But given the right incentives, they're just as willing to work hard as their older colleagues.

Most young attorneys value work-life balance. So instead of dangling higher salaries and bonuses, offer them paid time off, sabbaticals, generous maternity and paternity leaves, flexible work schedules, telecommuting and non–partnership-track options. When they know you respect their time and personal priorities, they're more likely to respect the firm's and give everything they've got while they're on the clock.

Firm loyalty. Long gone are the days of lawyers retiring from the same firm they joined straight out of law school 40 years earlier. Young attorneys are pragmatic and don't expect their legal careers to follow a straight path — they may not even plan to always practice law. If you don't offer the learning, growth and leadership opportunities they seek, they're likely to look elsewhere.

Millennials are accustomed to thinking critically and creatively, which includes speaking their minds and offering their own solutions.

Be sure to assign to new associates mentors who can help them carve out fulfilling roles within your firm. Also, don't skimp on feedback — particularly praise. In the absence of regular appreciation, Millennials have been shown to lose interest in their work and, by extension, their firms.

Attitude toward authority. As Jordan Kaplan, a managerial science professor, told *USA Today*, "Generation Y is much less likely to respond to the traditional command-and-control type of management still popular in much of today's workforce." A young associate who challenges a partner's case management methods may come off as rude and disrespectful, but that's probably not the intention. Millennials are accustomed to thinking critically and creatively, which includes speaking their minds and offering their own solutions to what they perceive as problems.

Instead of shooting associates' ideas down, partners need to find ways to enlist them for the benefit of the firm. Most Millennials are technologically savvy, so you might, for example, ask an associate to study your firm's current case management practices and find ways to improve efficiency with new technology solutions. And associates with strong collaborative skills — another shared characteristic of Generation Y — should be put to work on client matters where teamwork is critical.

Focus on fulfillment

Obviously, characterizing employees based on their birthdates is only so useful. Every new associate you hire will have his or her own ideas about what makes a fulfilling legal career. The best thing your firm can do is remain as flexible as possible. ▣

How to make outgoing referrals pay off

Most attorneys give little consideration to their outgoing business referrals — and that's a mistake. Properly managed, outgoing referrals can contribute to a law firm's bottom line by generating referral fees, reciprocal referrals and satisfied clients. So your firm's attorneys need to look at referrals as a critical piece of your business development and client service programs.

An inevitable situation

Attorneys make outgoing referrals to other attorneys for a variety of reasons, including:

- Conflict of interest,
- Lack of expertise in a specific practice area,
- Inadequate time or resources,
- Geographical limitation, and
- Jurisdictional issues.

Whatever the reason, your attorneys inevitably will encounter situations that require them to refer clients to other firms. Left to their own devices, attorneys may refer business to others for their own, possibly ill-conceived reasons. For example, they may direct clients to a cousin or law school buddy who needs the work but isn't necessarily qualified to handle it. It's important, therefore, to formalize your referral procedures so that attorneys use the opportunity for your firm's benefit.

Setting up a single system

Your system should coordinate outgoing referrals to maintain common standards. A single system helps ensure that your attorneys channel business to only reputable firms with the potential to reciprocate. What's more, it minimizes the likelihood of losing a client unhappy with his or her referral attorney, or, even worse, being held liable for making a "negligent referral."

Prepare a "preferred referral" list of firms you know and respect, organized by practice area specialty and location. Don't overlook smaller firms. Qualified smaller firms present less of a competitive threat for a referred client's existing business with your firm. Also be sure to review and update the list regularly based on results, reciprocity and developments at the referred firm, such as a partner's retirement or elimination of practice groups.

Your system should include a method for tracking all referrals — both inbound and outbound — and collecting any referral fees generated as well as procedures for following up with clients to measure their satisfaction. To make the process easier, consider assigning one attorney or your firm administrator to act as a referral coordinator.

You might also consider incorporating nonattorney referrals, such as those to CPAs, bankers, insurance professionals and real estate agents, into your system. Reciprocal referrals from nonattorneys can be an excellent source of new business.

Don't miss out

If you don't already have formal referral procedures and ways to track them, you're almost certainly missing out. A referral system creates the potential for new business from both inbound referrals and clients pleased with the handling of their referred matters. ▣

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Geffen Mesher

& Company, P.C.

Certified Public Accountants & Business Consultants

888 S.W. 5TH AVENUE, SUITE 800
PORTLAND, OREGON 97204

TELEPHONE: (503) 221-0141 (800) 819-0141
FAX: (503) 227-7924
www.gmco.com

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