

Law Firm

MANAGEMENT

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What to expect when you're merging

Although mergers among U.S. law firms slowed during the recent recession, encouraging signs suggest that deal activity is picking up in 2011. According to legal consulting firm Altman Weil, there were 16 mergers in 2011's first quarter, including several involving large multinational firms.

If you've thought about merging or have already begun talks with another firm, you may be looking forward to gaining new clients, experienced rainmakers, greater geographic reach, increased specialization and broader expertise. But before you can reap the benefits of merging, you'll need to close the transaction. That's often easier said than done.

First things first

In most cases, the word "merger" is a little deceptive — the majority of deals are, in fact, acquisitions, with larger firms buying smaller ones. Whether you're the buyer or the seller will determine what you need to accomplish before your merger is considered complete.

For example, while sellers will want to ensure a prospective buyer can finance the deal, most information gathering falls on the buyer, which

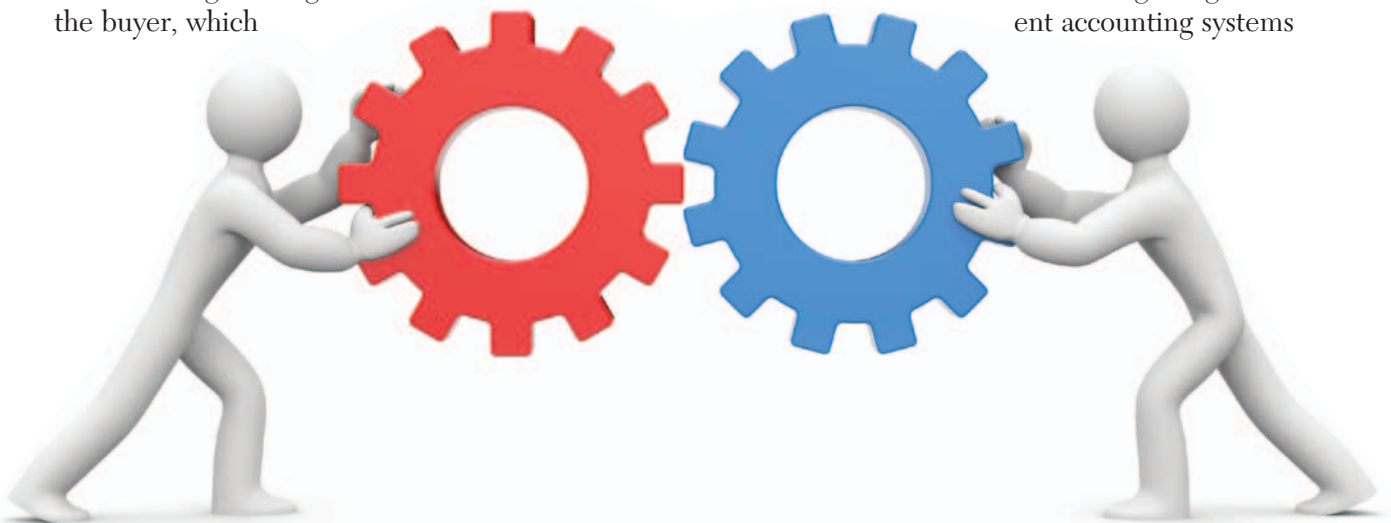
needs to perform thorough financial and legal due diligence. Buyers also bear most of the responsibility for integrating the two firms — often the most difficult stage of a merger. However, in mergers of similar-size firms, the parties may share many responsibilities and decisions.

Neither party, however, should enter deal talks without the help of experienced advisors. There's plenty that can go wrong with a merger transaction before it closes, including financing difficulties, personality clashes, cultural incompatibilities and poor planning. Experienced advisors can help guide you through each stage of the deal.

A team effort

To close a merger quickly and efficiently, form a deal team that includes your managing partner, practice group leaders and heads of HR, accounting and information technology. The deal team may be responsible for identifying and dividing up tasks, managing problems as they arise, preparing and reviewing due diligence documents, and keeping the merger on schedule.

Most merging businesses must make difficult decisions about such issues as integrating different accounting systems



and determining whether staff layoffs will be necessary, or whether physical offices should be merged or remain separate. Law firms have several specific decisions your managing partner or deal team, with help from advisors, must make.

For example, if the merging firms' partner compensation methods differ, you'll need to decide on a single, fair approach. You'll also need to form a new management team, which entails evaluating the merits of various partners and possibly choosing between several partners to represent one practice area. Such decisions can lead to disgruntled partners. It's important to deal with these and other "problem" partners before you close a deal. Otherwise, the issues will likely resurface during the critical integration stage.

Money and other matters

Merging law firms often have special financial issues, too. During the due diligence stage, buyers typically review at least three years of the selling firm's historical financial performance. Items of particular interest include debt decisions — such as the firm incurring debt to compensate partners rather than to enhance operations. Partner capitalization requirements, unfunded retirement plans and outstanding receivables, all of which could harm the combined firm's value, should also be scrutinized.

Just as critical to the prospective merger's value is client retention. Whether merging firms can hold on to their clients often depends on whether the partner responsible for the account stays with the firm. So it pays to provide incentives to those attorneys who work on large or prestigious engagements.

Communication prevents problems

Even if your prospective merger partner is profitable, offers practice synergies and shares your professional standards, strategic objectives, and partner compensation methods, you're likely to

encounter a few obstacles on the way to closing the deal. Because poor communication is responsible for many of them, be sure to communicate effectively with:

Your merger partner. The two parties' deal teams should talk regularly to ensure they're providing required information in a timely manner and that both agree on the merger's progress to date.

If the merging firms' partner compensation methods differ, you'll need to decide on a single, fair approach.

Employees. As soon as feasible, inform associates and staff about the merger to prevent rumors and anxiety from disrupting your firm's business. Enlist the help of HR personnel to communicate changes related to salaries and benefits, as well as other sensitive information, such as possible layoffs or relocation.

Clients. Partners should meet with larger clients to assure them that they'll continue to receive high quality work and personal attention — even during the integration process. This is also an opportunity to sell clients on some of the merged firm's new specialties and expanded services.

Deal with the bumps

These are only a few of the issues you'll encounter when merging with another firm. Most mergers hit a few bumps in the road, but as long as you're organized and work with experienced advisors, your chances of closing a deal that benefits both parties are good. ▣

More profit, less loss

Point associates to the bottom line



When you hire associates you expect them to bring new skills and energy to your firm, allowing you to expand capacity and grow. But associates cost money. Some experts estimate that it takes three to five years for law firms to break even on their investment in a new associate.

Although your associates' first priority is legal work, they also need to be aware of your firm's investment in them. One way you can do this is by creating a formal leadership training program to teach associates how to think like business owners. But perhaps the best way to turn associates into fiscally aware members of your firm is to have them create individual profit and loss (P&L) statements.

Reducing billable time

Like any P&L statement, the individual version starts with revenues. In this case gross revenue equals the associate's billable time.

Billable time must be reduced by several items, including write-offs. Gross revenue (billable time) – write-offs = net revenues. Your time and billing system software may assign specific write-

offs against an associate's time or perform a general markdown of time against everyone who worked on a particular engagement. Less sophisticated systems may use a blended or average write-down percentage based on practice areas or the firm's overall write-down percentage.

Billable time is also reduced by direct costs, including an associate's:

- Salary,
- Benefits,
- 401(k) plan matching contributions,
- Dues,
- Car allowance, and
- Payroll taxes.

Direct costs also might include individual expenses that typically aren't passed on to clients, such as nonbillable portions of monthly cell phone bills.

Overhead per timekeeper

Associates also must reduce billable time by overhead allocations. One method of doing this is known as the "overhead per timekeeper."

A timekeeper usually is defined as someone whose primary purpose is to work on client matters — partners, associates and paralegals.

Overhead expenses generally equal total expenses less the direct expenses allocated to timekeepers (salary and benefits). They normally include rent, business and liability insurance, support staff, office supplies, computer software, postage, delivery, subscriptions, research database fees, and other expenses needed to keep a firm operating.



The total operating expenses are then allocated to the timekeeper using the full-time equivalent (FTE) allocation system. Many firms do this by assigning an FTE of 1.0 to associates, 1.5 to partners and 0.5 to paralegals, but your firm can customize the equation. Add up the number of FTEs and divide it into the total overhead expenses; then multiply, for each timekeeper, that result times their respective FTE number.

Take, for example, the fictitious firm Sullivan James Greenberg (SJG). The firm has five partners, 12 associates and seven paralegals. This gives them FTEs of 23, or $(5 \times 1.5) + (12 \times 1.0) + (7 \times 0.5) = 23$. If the firm's overhead expenses total \$900,000, the allocation to an associate would be \$39,130 $[(\$900,000/23) \times 1]$.

Sample statement

Sarah Fuller, a second-year associate at SJG, billed 1,800 hours in 2010 at a rate of \$200 per hour. The firm wrote off 15% of her gross work-in-process. Her salary was \$120,000 with a 10% bonus, and benefits and payroll taxes equal 20% of her salary expense (before bonus). As previously shown, SJG's overhead expenses were \$900,000 for the fiscal year.

So Sarah's P&L statement would look something like this:

Revenue	
Gross revenue from billable time	\$360,000
Less work-in-process write-offs	<u>(54,000)</u>
Net revenue	<u>\$306,000</u>
Direct costs	
Salary and bonus	\$132,000
Benefits, payroll taxes and other direct costs	<u>24,000</u>
Total direct expenses	<u>\$156,000</u>
Gross profit attributable to Sarah Fuller	\$150,000
Less overhead allocation	(39,130)
Net profit attributable to Sarah Fuller	<u>\$110,870</u>

Eyes on the bottom line

Asking associates — and even partners — to create individual P&L statements can help attorneys see their financial role clearly. It's common for associates to evaluate their performance and worth based on billable hours. But a P&L statement provides a more sophisticated and accurate view of the bottom line. ■

Not at my firm!

Expense report cheating is both easy and common



You probably think lawyers would know better. But the fact is that expense report padding is rampant in many law firms. And it's easy to see why. Lawyers and support staff travel and work offsite frequently, and they have plenty of opportunity to accrue legitimate — and invent illegitimate — expenses for reimbursement. What's more, the long hours, stress and time away from home may lead some to cheat because they "deserve" a little extra for their trouble.

Expense report padding may seem like a minor offense. But it's still fraud and it can harm your firm's profitability — not to mention your reputation.

Creative schemes

Inflated car mileage or exaggerated restaurant gratuities typically add only a few extra dollars per report. Over time, however, a few dollars can become thousands. And some common expense-related fraud schemes can get costly

very quickly, such as when employees claim expenses related to:

- Business trips that have been extended for leisure,
- Meals and travel for family and friends,
- Canceled trips,
- Nonreimbursable expenses such as entertainment and alcohol, and
- Supplies, technology equipment and other items purchased for personal use.

Attorneys and staff might also claim small “cash” items that come in just under the amount that requires a receipt. Or they might “double bill” by submitting both a receipt and a credit card statement for the same expense or bypass individual item limits by breaking expenses into several pieces.

Don't make it easy

One cheat can cost you a lot of money, but firms with lax ethical environments and weak

Who cheats?

Unfortunately, fraud perpetrators don't wear nametags that say, “Hi, I'm a cheat.” Attorneys and staff who steal — via expense reports or other methods of occupational fraud — typically don't have criminal records. Often, they're otherwise honest people taking advantage of a work culture where “everybody does it” without repercussion. Or personal problems, such as gambling debts, addiction or divorce, may motivate them.

Many lawyers also dig themselves into debt trying to maintain appearances. The recent recession has driven down salaries, bonuses and partner shares in many firms. Attorneys who drive expensive luxury cars and maintain second homes — even when they no longer can afford to — may have a powerful incentive to steal.

internal controls usually have more than one. That's why the first step in preventing expense account fraud is to write, communicate and enforce an expense report policy.

Be specific about which expenses are reimbursable and to what amount. For example, will you pay for first-class plane tickets or only the cost of a coach seat? Can attorneys submit for reimbursement bar tabs accrued while waiting for a dinner table? Whatever you decide to allow, be sure you revisit your policy annually to keep pace with inflation and other changing circumstances.



Your policy should also specify acceptable forms of documentation. For example, you might accept original receipts for every expense over \$25, but not photocopies or credit card statements. Require direct supervisors to review and approve each report. Larger expense reports should also be reviewed by a managing partner.

If you're still using a manual expense reporting system, consider switching to an electronic one. They make it almost impossible for employees to alter receipts, and some software is capable of importing receipts directly from hotels and rental car companies. These systems can flag suspicious items and trends that a supervisor or accounting staff member might overlook, such as numerous receipts that come in just under the amount that requires authorization or that have similar totals every month.

Insult to injury

It's bad enough that expense report fraud can hurt profitability, but when you bill clients for those purportedly case-related expenses, it's even worse. You may face lawsuits, and the damage to your reputation could drive other clients away. Keep this from happening by putting fraud prevention policies in place now. ■

Fee agreements: Bill like you mean it

So you say you want to get paid. Are you sure your clients know that? If your firm struggles with a low collected-to-billed rate, it may be your fault.

Particularly in hard economic times, companies and individuals prioritize their bills, paying the most urgent invoices and the most insistent service providers first and the rest when they're able. You can help make your firm's bills a priority by being clear about your expectations. This starts with a comprehensive fee agreement.

In black and white

The ABA doesn't require written fee agreements, except for contingency cases (although your state or local rules may require them). But if you're serious about collecting from clients, formalize your relationship with a fee agreement, contract or retainer letter.

The complexity of this document depends on many factors, including services to be provided and fee structures. For example, specify whether you'll bill:

- By the hour,
- Against an advance or general retainer,
- A flat fee,
- A contingent fee, or
- A combination of fee types.

Explain how each fee is calculated and specify dollar amounts, including variable hourly rates for team members such as experienced partners, newer associates and paralegals.

If you plan to pass actual costs on to clients, list them. Costs related to such items as travel and meals, photocopying, electronic research and customized software (such as database programs) can add up. Finally, be sure to state



whether you charge late fees and interest on past-due accounts.

Make collecting easier

Specify in your fee agreement when you expect clients to pay invoices — typically within 30 to 60 days — and whether you'll withdraw representation of delinquent clients (keeping in mind the ABA's and your state bar's Codes of Professional Conduct). The agreement should also list acceptable methods of payment. Law firms that accept credit cards or have online payment systems generally have an easier time getting paid.

And don't forget to discuss your collections policy — including how you track and handle delinquent or unpaid accounts and when you turn them over to collection agencies.

Keep them current

Even when you make detailed fee agreements, there will always be a certain percentage of clients that pay late or never pay at all. But when you put your expectations in writing, you know you're doing your part to avoid misunderstandings, and your firm should begin to see the rate of accounts that are current rise. ■

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