

Six financial hazards every contingency firm should avoid

If you don't create and constantly update a cash-flow statement, your ship could be headed for the rocks

By Michael Blum

You went to law school to become a lawyer, not an accountant. But the reality is to the profitability of your firm, finance is as almost important as winning cases. Your law school didn't prepare you for this and most likely, if you had them, your mentors either couldn't give you what they didn't have or they didn't have time for this type of training. The need for business skills now lands squarely on your shoulders, and it frequently creates significant managerial problems for a contingency law firm. But if you know *The Six Hazards to Avoid*, you can make a great case for your practice's long-term success.

Hazard #1: Not generating a cash-flow forecast

Just the words can make one tense and irritable. In essence, this is the numbers that identify your anticipated expenses and revenue as well as when those two streams will generate their activity. When is the bill due and when does your next case settle? In which months will cash be short?

This Hazard usually expresses itself in three ways:

1) An inability to estimate the firm's monthly expenditures and revenue
2) An inability to determine if the level of expenditures is met by the level of revenue
3) An inability to determine the sources and timing of revenue

In all these cases a firm without a cash-flow forecast is steering blind on the hope of profitability. A forecast, on the other hand, will give you time to see potential problems and give you the opportunity to manage them before they become a nightmare. Once created, the forecast should be reviewed and revised at least once a quarter.

If you'd like to see a sample cash-flow forecast, you can ask your accountant or see the general form at the end of this article.

Hazard #2: Overstating revenue and being too aggressive on its timing

If you do generate a cash-flow forecast, overstated revenue that is not realized will have significant impact on the firm as expenditures are typically aligned with expected revenue streams. If revenue falls short of forecast, the firm has invariably expended resources in excess of the realized revenue – but it's too late at that point. The money has been spent, only it never came in.

Aggressive timing of receipt demonstrates the same effect as overstated revenue; however, when coupled with overstated revenue, it compounds the detrimental effect on the firm's financial and working capital health exponentially. A practice, which may not realize its cash situation, is at a serious shortfall until an overdraft from the bank appears, and by that point, it's too late. Be prudent in your forecasting, be conservative, cautious and practically-minded. Ending up with more cash then you anticipated is far better than the opposite scenario.

Hazard #3: Not having a dedicated financial officer

If you don't have a financial officer, or if you use an "office manager" who is



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Sample Cash-Flow Forecast – General Form

	Month 1	Month 2	Month 3	Month 4	Month 5
Income					
Esti. Gross Fees Rec'd	110.00	85.00	245.00	0.00	50.00
Total Inflow					
Expenses					
Case Costs					
Advanced	15.00	15.00	20.00	10.00	20.00
Referral Fees	15.00	10.00	0.00	0.00	15.00
Operations					
Salaries					
Employees	25.00	25.00	25.00	25.00	25.00
Partner A	15.00	11.00	15.00	15.00	12.00
Partner B	15.00	11.00	15.00	15.00	12.00
Payroll Taxes	2.25	1.65	2.25	2.25	1.80
Benefits	5.50	7.50	9.50	10.50	11.50
General & Admin					
Rent	4.50	4.50	4.50	4.50	4.50
Communication	1.00	1.00	1.00	1.00	1.00
FF&E	1.00	1.00	1.00	1.00	1.00
Office	0.15	0.15	0.15	0.15	0.15
Line of Credit	0.00	0.00	0.00	0.00	0.00
principal	2.00	2.00	2.00	2.00	2.00
interest	0.20	0.20	0.20	0.20	0.20
Marketing	0.50	0.50	1.00	0.50	1.00
Legal & Professional	1.00	1.00	1.00	1.00	1.00
Misc.					
Total Outflow	103.10	91.50	97.60	88.10	108.15
Net Cash Flow	6.90	-6.50	147.40	-88.10	-58.15
Cum Cash Flow	6.90	0.40	147.80	59.70	1.55

unqualified to truly manage the finances of the firm and its relationship with capital sources, you are asking for trouble. If your firm is simply too small for a full- or part-time chief financial officer, consider budgeting for your CPA to spend time with you each month on developing, implementing and managing the financial planning and reporting tools you need to succeed. It's not something an accountant can do once a year at tax time.

Even if you can access your numbers easily, do you really know how they tie into your financial future beyond what your bookkeeper tells you? Can you, at a glance, know whether a current financial crisis is seasonal, managerial, brief or long – do you know where things could be tighter or if they are as tight as they can go? Without a dedicated and qualified financial officer (in whatever capacity he/she works for the firm), your practice lacks the ability to generate an insightful financial forecast.

For example, typically in the situation where you lack a clear financial picture of the firm's liabilities and obligations, the payables are not aged to determine the appropriate timing of payment and to maximize trade credit.

Additionally, as most firms utilize cash basis accounting, the firm does not have a clear picture as to the extent of their contingent and/or deferred liabilities that are not represented on the payables. If all these terms give you a headache, that's also a sign you may need someone "qualified" to look at this picture.

Additionally, the firm may lack the understanding of how to leverage assets to finance growth or be aware of capital resources available for financing its capital needs (such as private lines of credit for litigation expenses or monetizing a fee lien from a client who won a money judgment on appeal). Historically, the sudden drop in operating capital has been covered by going into the partners' pockets and asking for contributions from them. This isn't the best strategy.

Lastly, if someone isn't focused on it, the firm will miss opportunities to reduce expenses such as renegotiating

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rent, reducing partner draws, modifying staff size, or cutting back on entertainment, subscriptions, advertising and the like.

Hazard #4: Underestimating operating expenses

Not all expenditures or funds for unexpected events such as contingent liabilities are considered when preparing a budget. In other words, you plan for typical expenses but not atypical – like the need for an additional employee, an unexpected expert, or capital expenditures for the replacement of a broken copier for which you didn't plan. It would be wise to create an emergency fund for these unfortunate surprises and to factor that into the cash-flow forecast – including identifying where you will find the additional capital to cover it (e.g. revenue, lines of credit, reducing expenses, etc.).

Hazard#5: Failing to match the partners' draws against actual revenue

Partners are accustomed to their lifestyles, and that expense often trumps the financial needs of the firm, leading to loss of productivity, digging into partners' pockets to cover shortfalls, and increased expenses to regain the momentum prior to cutbacks. Examining how the partner's draw affects cash flow for the practice is essential, not only to maintaining stability for the practice, but also for maintaining the partner's draw – or his/her expected draw. Cash flow forecasts allow the partner(s) to also see how their draws affect the firm's financial picture and opens a more rational discussion – one hopes – about how to ensure partner satisfaction and overall firm growth.

Hazard #6: Failing to have clear fee-sharing arrangements

When you fail to write clear fee-sharing agreements between all of the firms involved in contingency cases, it can result in the firm paying higher referral fees and receiving lower than anticipated revenue. Negotiations erupt over percentages of proceeds, and a situation that can be easily prevented before it occurs is now costing additional resources from the firm's coffers.

The fee-sharing arrangements – how much, when it will be paid, what work is to be done – can first of all be more accurately considered in light of a current financial forecast. You can assess what effect a fee arrangement will have and when.

Secondly, looking at the financial arrangements prior to accepting a referral establishes clarity of expectations because you have a contract. This gives your practice the ability to pinpoint this relationship's effect on your cash flow, rather than relying on assumptions that turn out to be liabilities when you anticipated revenue. Make your contracts clear and clarify your financial future.

Conclusion

Individually, each of these six hazards is enough to drag your firm down financially; collectively, they can sink even the most brilliant trial lawyer's ship. You went into law to practice it – addressing these hazards before you run aground on them will help you be more profitable and suffer fewer sleepless nights.


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