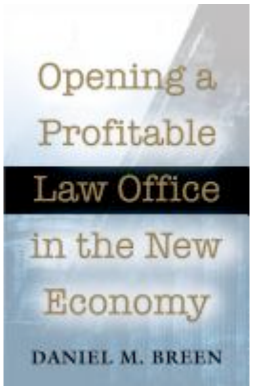
Opening a Profitable Law Office in the New Economy

DANIEL M. BREEN



How to Open a Profitable Law Office in the New Economy is a practical guide available for lawyers who are interested in learning more about opening a practice. Daniel M. Breen walks through the fundamentals of law office ownership in way that is both approachable and insightful. You will learn about the necessary building blocks of getting an office up, running, and making money.

How to Open a Profitable Law Office in the New Economy

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Daniel M. Breen

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Chapter V
Financial Management

Cash Flow is King

There is a good reason that the cliché of cash flow royalty exists – because it is absolutely true. No single aspect of your business is as important as cash flow, both for better and for worse. Cash flow is the most important factor that you need to address when deciding how you are going to open up shop. Recognize, that as with any business, cash flow is going to be unpredictable, and possibly, not all that good, particularly right out of the gates. While an undesirable cash flow situation in the infantile and even early stages of your practice might have no determinative bearing on whether you will have a successful and lucrative business over the long term, a cash flow problem will create short term issues that will become your number one priority and might cut you off at the knees before you even begin rolling. So be prepared to deal with it.

There is a cost to both living and doing business. You first need to know what that cost is and ensure that you are going to be able to pay for that cost for at least a period of a few months into the future. Know exactly what your monthly nut is and just how you are going to cover it.

Just in case this is not clear, let's take a minute to talk about the difference between cash flow and other value metrics of your business. Say you practice plaintiff litigation like me. You sign up a client who suffered horrific injuries when the CEO of a large corporation ran your client down while your client was crossing the street in a crosswalk. Such a case will ultimately generate significant revenue. Such a case will also require a great deal of work and upfront costs. Depending on the nature of your client's injuries you will need to hire experts to explain exactly what happened to her. You might need to hire an economist to explain the lost earning potential that your client suffered and the value of medical care and treatment that your client will require for the rest of her life. From a business standpoint, there is good value to such a case, but it may not generate revenue for years. For the period of time that the case does not generate revenue, you have a piece of valuable business, but money in the bank value business is not. I am quite certain your landlord will not let you apply Enron's mark to market theory to cover your rental payments. Unless you have other income streams, whether they be in the form of a mature pipeline of contingent fee business, retainer work that you are being paid for, or money saved up from other big wins to hold you over, you have a cash flow problem.

Financial Organization Principles

There are different ideas of what it means to be organized. Everyone has a little bit of method to his or her madness. Some people can operate in a scattered environment better than others. Some people need stacks of paper. Some people need paperless. Some people's creative juices are constrained in too organized of an environment. Regardless of your style in other aspects of your business, you need to organize your finances and organize them carefully. While the health or your business will feel a cash flow pinch, should you have a higher level financial issue, financial organization is paramount to (1) avoiding the frequency of any higher level financial issues, and (2) digging your way out of any such financial issues. Thankfully, financial organization is not difficult, it just requires some attention. Aside from the business necessity of organized finances, some studies have demonstrated that sound financial organizing habits are more important to long term wealth creation than a high income.

General Principles

- Cash coming into your business needs to exceed cash going out. A simple and obvious concept yes, but trust me, the simpler the approach that you take to finances, the better off you will be. This parlays nicely into our next principle, which is…

- It is easier to control cash going out than cash coming in. When push comes to shove, you have much more control over what you spend money on, but there are a lot of factors that go into the income that you generate, many of which you cannot neatly manipulate. Control your overhead with diligence from the start. It is very easy to spend more money as your office grows. Going the other direction is challenging.

- Keep good track of your transactions. You do not need to understand everything about how taxes or accounting work. At the higher levels of taxes and accounting, you might have a hard time really 'getting it' much in the same way your clients do not understand the law the way that you do. Just keep good track of all of your business related transactions and you will have the building blocks that you need to understand the health of your business and how much you need to pay in taxes. Even if all you do is send those building blocks to an accountant, you will be ahead of the game if those building blocks are catalogued.

- Be aggressive, but do not screw around with your taxes. Do not pay a dime more than you owe, because taxes are a significant expense, but do not play games in trying to pay less than what you owe. IRS issues are a nightmare and the IRS has a lot of power. Screw up on other things with your practice and often the worst case scenario is that you might get sued. As bad a lawsuit be, running afoul of IRS laws is a crime.

- Budget. Even if you don't or can't stick to it 100% of the time, have a framework to shoot for.

- There are a lot of other things to know, but focus on these simple basics for now. We are lawyers after all, not mathematicians.

Software

Many specialized software options exist, and there is no one size fits all solution. What works for you will depend on the nature of your practice and personal preference. Because the options are vast, we will only run through a few here.

Excel

Its elegance lies in in its adaptability and simplicity. Yes, there are more comprehensive tools available, but if you are looking for the best one size fits all solution, excel is the way to go. Although excel is not specifically tailored to do accounting in ways that other accounting programs are, its lack of being tailored to do anything other than organize numbers frees you to handle such organization as you see fit.

Cloud Based Accounting

Cloud based case management has recently become a significant player in the case management market. Accounting is part of their suite of products. As a point of transparency, I have never used such software in my firm. That said, I am familiar with it, but not in the way that someone who has struggled with its nuances is. Certainly one of the best options for such software would seem to be the 'one stop shop' that exists. All of the information for every case is in one place. A could based accounting system as part of a cloud based case management system would prevent looking for your pleadings in one folder, entering case notes elsewhere and balancing the trust account somewhere else.

General Accounting Software

Accounting specific software is also readily available. The quantity of options renders this decision to one that can largely be made on personal preference, nature of your practice, size of your firm, and financial complexity desired. Quicken seems to be the most common option, but that does not necessarily make it the best. If you are on your own, the tools available within these programs will certainly be more than you need or can use.

Regardless of which software options that you use, I cannot stress the following underlying principles enough. Keep your data backed up. Organize your data. Categorize your expenses and revenues. As long as your information is organized, even if your understanding of technical financial principles is limited, you will be able to productively consult a professional who can make sense of your transactions.

It is important that you develop a separate system to organize your trust account, in addition to how you handle general business accounting. Aside from being sound practice, it is ethically required and the consequence of a trust accounting mistake, at least in Illinois, is an automatic letter generated to the ARDC. Such a letter is certainly something to avoid at all costs.

Trust accounting is notable, not because it is difficult or terribly complicated. In fact it is neither. Rather, the ethical importance of trust accounting means that you need to pay close attention to eliminate the possibility of any mistakes. Separately handling trust accounting from general accounting and regularly reconciling the trust account to ensure accuracy is ethically necessary, along with being a sound practice. The ARDC has a number of helpful resources on its website to assist with any ethical questions related to trust account management.

Accounting Principles

You are not an accountant and should certainly seek professional assistance, particularly for tax preparation purposes. That said, understanding that the money going into and out of your business is the very blood pumping through the veins of your office is important to understand. Such an understanding might be the difference between foreseeing a financial problem and allowing yourself the ability to make appropriate strategic adjustments to avoid a real catastrophe or on the other hand, allowing the same problem to sneak up from behind your back because you do not understand the financial health of your practice.

Cash Flow
Cash flow is the movement of money into or out of a business. In the short term, it is the most important financial metric. It is usually measured during a specific, limited period of time. It is a snapshot of what is going in and what is going out.

Accounts Payable
Accounts payable is money owed by a business to its suppliers. It is money that will go out, but has not left yet.

Accounts Receivable
Accounts receivable is money owed to a business by customers/clients. It is money that will (or at least should) come in, but has not been received yet.

Balance Sheet
A balance sheet is a summary of the financial balances of a business at a point in time. It categorizes all of the assets, all of the liabilities and any ownership equity. It applies to a single point in time only.

Asset
An asset is any economic resource owned by the business. Assets represent cash or the value of ownership that can be converted into cash. Because many small law firms do not need much in the way of equipment, it is likely that most of the firm's assets will be cash.

Liability
A liability is the business' obligation arising from past transactions or events that may result in the transfer or use of assets in the future. Another way to think about a liability is an

account payable that has not come due just yet. Some examples include:

- Any type of borrowing from people or banks for improving a business or personal income that is payable during short or long time;
- A duty or responsibility to others that entails settlement by future transfer or use of assets, provision or services, or other transaction yielding an economic benefit, at a specified or determinable date, on occurrence of a specified event, or on demand;
- A duty or responsibility that obligates the entity to another, leaving it little or no discretion to avoid settlement,
- A transaction of event obligating the entity that has already occurred.

Gross Revenue
Gross revenue is the total income the business receives in a given period.

Net Income (Profit)
Net income is the gross revenue minus the cost of doing business. Such costs include obvious things like, rent, vendor fees, and taxes. These costs also include less obvious things like depreciation and interest. We will talk about taxes in a bit, but remember that in order to minimize your tax liability (which can be a huge cost), it is better to incur as many necessary expenses as business (rather than personal) expenses as practical. Attention to funneling appropriate costs through the business will save you a great deal of money in the long run

Control Overhead

Another practice that will save you money in the long run is control of your overhead. It is much easier to control what goes out that what comes in. Similarly, it is easier to avoid incurring a cost, whether a subscription fee, a product, or a service, than it is to try to cut costs by ceasing the use of whatever bell or whistle that you bought. Be as diligent as you can about controlling overhead.

Some costs that might make sense to avoid at the outset of your practice include pricey software and advertising. Not only are these costs not necessary in the eating and breathing sense of your business, but you do not want to throw down for a software package or spend money on advertising until you have had the opportunity to get your feet under you. You also want to give yourself and your firm time to develop a business strategy and spend money in ways that are consistent with that strategy.

You will also find that with a little bit of time and ingenuity, you will be able to MacGyver free software to fulfill the needs of many of the more expensive software options. If you are at a loss on where to start with this, just know that as long as you have a little bit of patience and take the time to read the help section, Microsoft Excel can accomplish a great deal of your backend needs as a small office practitioner.

How to Practice Financial Management

As with many things in life, understanding the principles of finance and accounting can be considerably different than putting it in practice. How do you make sure due attention is paid to your financial situation when you are not a financial professional and do not have the resources to bring one on?

How do you carve out time to inspect your financial situation (and really know what you are looking at) when you have a full caseload to look at or are out trying to hustle up new business?

Dedicate Time Regularly

At least once a month, set aside dedicated time to look at the firm finances. Use this dedicated time to pay the bills that have accumulated over the past month, send out bills on billable cases, take a draw (if appropriate), reconcile accounts, and ensure that all of your clients are paid up. Certainly there are many ways to go about this, but from my experience, a dedicated block of time to conduct financial assessment once a month has been irreplaceable for me. Also use this as an opportunity to look forward at the financial health of your firm.

Budget

Make a budget. You may not stick to it and you will definitely have to modify it. You may have to modify it substantially, but make sure this is at the top of your mind. If you were like me when you started out, in that you started a one person law office the distinction between your personal and professional life will be blurred. Make sure your budget not only contemplates the business expenses that you plan to incur, but is also realistic about your personal expenses as well. At the end of the day, the same green money is leaving your pocket to go elsewhere, whether that elsewhere be a new printer for the office, entry fee for a triathlon, or a round of Jameson shots.

Also look at your revenues and, be realistic about what you are working with, and set some rules for yourself. You will probably want to set up a few different bank accounts. Start saving. Recognize that these rules will be broken. Sometimes, as in the case of a spike in revenues, they will be broken in a good way. Other times, the well might be low and you will just have to do what you have to do to make it through the month.

Taxes

One of the benefits to being in business for yourself is that you can strategize to minimize your tax liabilities. Certainly you need to be smart about this, but there are many more options available to business owners than to employees. Be sure to keep track of your expenses and note anything that is business related. An easy way to do this is to have a dedicated account, credit card, or debit card that you only use for business purposes. This way, come tax time, you will not be left sifting through a shoebox of receipts trying to remember which expenses were and were not business related.

The IRS, at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Deducting-Business-Expenses, defines a business expense as follows: "To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensible to be considered necessary."

It is important to separate business expenses from the following expenses:

- The expenses used to figure the costs of goods sold,
- Capital Expenses, and
- Personal Expenses.

Certainly, business expenses include things like office supplies, advertising, and rent. Business expenses can (but do not necessarily) also include less obvious costs like health insurance, a home office deduction if you work from home, mileage, money spent entertaining or networking with clients, potential clients, and referral sources.

As to how to practically pay taxes, the downside to the tax benefits that you can take advantage of as a business owner are countered by the fact that your filings are a bit more involved than simply filing a W2 before April 15 of each year. For starters, you need to pay quarterly estimated taxes each quarter to both the IRS and the state. Your quarterly estimated tax payment is determined using the following calculation:

(Gross revenue – Business Expenses)*applicable tax rate, which is laid out as such:

Schedule X — Single

If taxable income is over	But not over	The tax is:	of the amount over
$0	$9,075	10%	$0
$9,075	$36,900	$907.50 + 15%	$9,075
$36,900	$89,350	$5,081.25 + 25%	$36,900
$89,350	$186,350	$18,193.75 + 28%	$89,350
$186,350	$405,100	$45,353.75 + 33%	$186,350
$405,100	$406,750	$117,541.25 + 35%	$405,100
$406,750	no limit	$118,118.75 + 39.6%	$406,750

Schedule Y-1 — Married filing Jointly or Qualifying Widow(er)

If taxable income is over	But not over	The tax is:	of the amount over
$0	$18,150	10%	$0
$18,150	$73,800	$1,815.00 + 15%	$18,150

$73,800	$148,850	$10,162.50 + 25%	$73,800
$148,850	$226,850	$28,925.00 + 28%	$148,850
$226,850	$405,100	$50,765.00 + 33%	$226,850
$405,100	$457,600	$109,587.50 + 35%	$405,100
$457,600	no limit	$127,962.50 + 39.6%	$457,600

Schedule Y-2 — Married Filing Separately

If taxable income is over	But not over	The tax is:	of the amount over
$0	$9,075	10%	$0
$9,075	$36,900	$907.50 + 15%	$9,075
$36,900	$74,425	$5,081.25 + 25%	$36,900
$74,425	$113,425	$14,462.50 + 28%	$74,425
$113,425	$202,550	$25,382.50 + 33%	$113,425
$202,550	$228,800	$54,793.75 + 35%	$202,550
$228,800	no limit	$63,981.25 + 39.6%	$228,800

Schedule Z — Head of Household

If taxable income is over	But not over	The tax is:	of the amount over
$0	$12,950	10%	$0
$12,950	$49,400	$1,295.00 + 15%	$12,950
$49,400	$127,550	$6,762.50 + 25%	$49,400
$127,550	$206,600	$26,300.00 + 28%	$127,550
$206,600	$405,100	$48,434.00 + 33%	$206,600
$405,100	$432,200	$113,939.00 + 35%	$405,100

$432,200	no limit	$123,424 .00 + 39.6%	$432,200

Keep in mind that the above numbers are based on estimated annual earnings and that your state also likely has an estimated tax that you are required to pay. I find that the best way to avoid surprises at tax payment time is to create a dedicated tax savings account for tax purposes; each month, on the day I spend managing finances, I transfer a sum into this dedicated tax savings account to make the quarterly payment. For instance, if you are single, and expect to earn between 36.9k and 89.35k per year, your federal tax rate is 25%. Considering that you will also owe a state tax (in Illinois, it is 5.25%), if you set aside 1/3 of gross revenue, you should have more than enough money to pay your estimated taxes at the quarter, once you calculate your business expenses. You might consider investing whatever is left over in a savings or retirement plan.

Paying Yourself

Putting money into your pocket is the most important component of financial management. Unfortunately, despite being the most important aspect, it sometimes falls behind other matters. This is particularly true early on in your practice when revenue and cash flow are not what you want them to be.

Ideally, you can set a base salary for yourself, earn that as a minimum and then pay yourself a draw based on profits. Calculating what you are worth and what you can afford to pay yourself are two different concepts, particularly early on. This being the case, it may make sense to pay yourself exclusively by way of a draw.

How does this work in practice? What kind of bank accounts do you need and how does the money flow through them?

Certainly, there are a few different ways to skin this cat, but if you are looking for a place to start, I would suggest an arrangement similar to the one below.

- Business Accounts
  - Operating – This is your day to day account. Revenues hit here first. Bills and vendors get paid from here. You will want to float a healthy minimum balance in this account.
  - Trust – No need to go over the trust account again. Remember that it is best setup and managed separately from any other business or personal activity.
  - Savings/investment – Obviously, this is where you sock money away for things like equipment purchases, marketing campaigns or events, or any other irregular projects that your heart might desire or your business strategy dictates. The more important question is how the money gets here. Again, many ways to do this, but you might consider doing something like the following. As you know from our discussion of taxes above, when you reconcile your accounts, you should put away a percentage of your revenues for your quarterly estimated tax payments. Put a little bit more than you will need here. One easy way to do this is to disregard business expenses and assume all revenues are profit. Save that money away to pay taxes. This way, when you calculate the actual quarterly profit, the actual amount should be smaller than you saved. That leftover balance stays in savings.

- Personal
  - Personal Operating – Your personal business is yours and is separate and distinct from any business considerations, but how you handle it is important because if you are not astute here, it will overflow onto your business and have business implications. What goes into your personal operating account depends entirely on what you can pay yourself.
  - Savings – These next two accounts are more important because they are the easiest ones to neglect. The lack of immediate practical necessity makes it that much more important that you are diligent about putting money away into your personal savings. Everyone's particular situation will dictate different needs, but it might be wise to consider, in some structure, setting up a short term savings plan and a long term nest egg. The short term savings is similar to your office savings/investment account. This is money that you save, but with the intention of investing into personal items. This might include a down payment on a house, purchase of a new vehicle, new piece of furniture, or even a vacation. As far as getting money in here, there are many ways to do this. You might consider a monthly bill that you pay to yourself. Even if it is something small, such as an amount under $100, it will add up quickly, and getting into the habit of doing this is sound practice for when you are eventually able to deposit more substantial sums into your personal savings accounts. The other way to

accumulate savings is to use the overestimated quarterly estimated tax payment example from above and choose a fixed percentage of the overage in advance that you will deposit into your personal savings account.

- Long Term/Retirement Savings – This is rather self explanatory. Make sure you are diligent about shoring up your finances for when you might want to stop working or spend a lot of money on something fun later in your life.

Pricing Your Services

In order to charge money, you have to earn money, and in order to earn money, you have to decide how much you are going to charge for your services. Be warned that, as a new and inexperienced lawyer, this is one of the more difficult things that you will have to do. Certainly clients do not expect you to have an answer about everything. Largely, it is ok to tell a client that you will need time to conduct some research so that you can get back to them with a reasoned and accurate response. One instance in which I do not believe this to be the case, however, is how much you charge for your services. Unless you are being retained for a complex matter and there are a number of unknowns about the case, you should have answers here. Know how much you will charge for so-called commoditized areas of law, or at least the fee structure within which you will structure your services.

If you choose to charge hourly, you should be able to communicate to a client how much they might expect to spend to accomplish their goals with your office. Even if your answer is dependent on a number of variables, such as the reasonableness of your opponent, communicate this. If you choose to charge hourly, it is important to note how much longer it will take you to do things right out of the gates. Keep in mind that when you are building things for the first time, it will take you longer, sometimes significantly longer to do so. It is neither good for business nor fair to your client to charge someone for hours spent pouring through templates for a simple will or basic contract. In that same vein however, do not undercut your services. Doing so is also neither fair to you, nor is it a sound business practice. Consumers of any product subscribe to the belief that you get what you pay for, so do not charge bargain basement prices for your legal services.

If determining the price of your services and knowing what that price will be offhand sounds difficult, that is because it is, particularly early on. Asking people for money is not easy. So how do you build the confidence and background to navigate money conversations in a savvy way? Talk to other, more experienced lawyers that you know and ask how they price their services. Ask them how you think you should price your services. Reach out to hypothetical potential clients and find out from them what they expect to be charged, how they are charged, and how they might like to be charged differently. In reaching out to potential clients be sure that you are careful to follow ethical protocol when doing so. Talk to former professors and classmates. Ultimately, accumulate information from wherever you can. This will ultimately allow you to build a knowledge base upon which you can confidently price your services.

Financing Options

As a business owner, you will experience ups and downs. This is a good thing, because if you run your business well, you will reap the full benefits of the ups. Unfortunately, you will also have to manage the downs. This might mean forgoing payment to yourself for a short period of time. It also might mean putting money back into your business. Whatever the cause, there is a good chance that at some point within the business lifespan, you will find yourself dealing with the old adage that sometimes you have to spend money to make money. So how do you deal with this proverbial chicken and egg riddle?

Making this an even trickier area than it might otherwise be is the fact that many people come out of law school with more debt than they should have. The existence of debt makes it that much more difficult to get access to credit. Additionally, as a practical matter, when you are trying to get control of your debt, the first step in filling that hole is to 'stop digging.' Nonetheless, investment in the business is crucial, and many entrepreneurs say that their biggest regret is that they did not take expansive risks sooner or more ambitiously. So what do you do if you need money, but do not have it?

Line of Credit

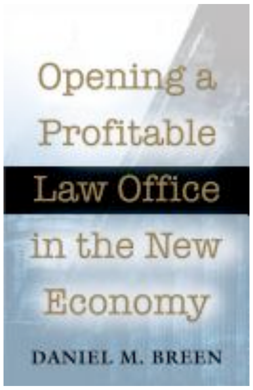
A line of credit is probably the most traditional way to seek financing for a business. Good luck getting one of any significance with any favorable terms if you have student loan debt and lack valuable collateral. Generally, with a line of credit, you will pay interest only on the money actually withdrawn from the line. However, read the fine print carefully. Particularly if you are not a valuable customer of the financial institution from which you obtain the line (i.e. if you are not rich, in which case you might not need the line of credit anyways), you may not receive the most favorable terms. In this case, your line of credit may have monthly withdraw minimums, maintenance fees, etc. If possible, it is better to look elsewhere for money.

Credit Card
Obviously you want to be careful with this one. But a credit card is there if you need it. I would suggest not using the credit card so much as a window to credit, but rather as a cushion to smooth over the occasional anomaly month in which your cash flow is not healthy. This might be as a result of significant, necessary purchases, or an unusual lack of case closures or billable hours. The point here is, go ahead and use it, but have a plan for how you are going to pay the balance within a relatively short period of time. Credit card terms and interest rates are simply too unforgiving to rely on this as your main source of credit.

Student Loans
Student loans are some of the easiest loans to get. The reasons include that they are not dischargeable in bankruptcy and they are federally guaranteed. One way or the other, the lenders know they will be getting paid. I recognize that using student loan funds to help start a business may be frowned upon by some, but it also may be the most effective way to get access to capital. The maximum borrowing limits for student loans are usually a pretty comfortable number, one that you probably would not need to max out on, particularly if you earn any money at all while in school. If you recognize that you will be starting a firm shortly out of school, it may serve you well to take out the max and sock it away so that you will have access to capital when you desperately need it. Additionally, the benefit of this is that if you do not need the money, you can either pay it back right away, or invest it somewhere where your interest rate has a decent chance of exceeding that on your loans.

Student loans are a very tricky area. In one sense because they are guaranteed, but the payback rates can be somewhat forgiving. For more on payback calculations, how income is calculated and what you might be expected to pay if you seek an income based repayment option, please see this link for more:
http://studentaid.ed.gov/repay-loans/understand/plans/income-based.

Business Partners
This may hold more true for contingent fee cases, which often require some level of financing, but can also apply to cases that are bigger than you, your logistical capabilities, or the resources at your disposal. Having a significant case walk through your door is a great thing, but the work level and upfront costs can be problematic if you are not equipped to handle a big case. Certainly a good problem to have, but a problem nonetheless. As a business owner, you need to be opportunistic and figure out a way to make such situations work for you and the client. In the case of financials, this may mean bringing in a deeper pocketed attorney to provide some financial support. Of course this will require a little piece of the action thrown their way, but if planned and handled appropriately, this should be a win-win situation. That said, it is important to stress the significance of carefully planning such an arrangement. Make sure all parties to the arrangement understand how much money will be spent, the case's financial potential and risk, and who will be doing what work. Is this strictly a financial arrangement, or will the lawyers involved be expected to devote some resources and expertise as well? Either way, if handled appropriately, partnering with a trusted resource is probably the most effective way to alleviate financial stresses for individual cases.



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