



Dos and don'ts for today's compensation plans

Don't panic!  
How to be ready for an IRS audit

Is the Netflix model the next big thing in law firm billing?

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# LAW FIRM MANAGEMENT

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# Dos and don'ts for today's compensation plans

The past decade has brought sweeping change to the legal industry, from the influx of Millennials into law firms to growing competition from alternative legal services providers. Yet many firms have clung to compensation plans first devised years ago, in a very different climate.

Even firms that have been stubbornly holding out in hopes the pendulum might swing back are beginning to recognize that they need to adapt their plans to today's realities. Keeping some critical dos and don'ts in mind can help ease the transition.

## NEED FOR CHANGE

Rainmaking and billable hours have long been the cornerstones of law firm compensation. But this approach now is counterproductive in many ways. Prioritizing new clients and billables can lead law firms to incentivize attorney behaviors that may undermine client satisfaction, efficiency — and even attorneys' health.

*Traditional plans generally focus on hours billed, ignoring actual collections.*

For example, traditional compensation plans encourage attorneys to rack up as much billable time on a matter as possible, with little to no reward for results. Clients, on the other hand, want to achieve certain outcomes as quickly and affordably as possible and are increasingly requesting some form of value-based pricing. Similarly, traditional plans put greater emphasis on landing clients than on serving them.

In addition, these plans emphasize personal success over firm success, providing little reason to devote time to management, client relationships,



**Dos**



**Don'ts**

marketing, associate development and other non-billable activities. They also discourage any type of work-life balance, something younger attorneys in particular crave these days. And they make partners reluctant to assign work to associates.

## GUIDING PRINCIPLES

Designing a new compensation plan that's better suited to the current legal landscape is no small feat. You should find it easier, though, if you keep in mind the following elements to do:

**Incorporate both objective and subjective components.** No one is suggesting law firms completely abandon consideration of objective measures such as hours billed when calculating compensation. But also weight some subjective factors such as client satisfaction, technological competence, community activity and associate mentoring.

**Go one step at a time.** It's not realistic or wise to completely overhaul your compensation system in one fell swoop. By changing two or three elements at a time, you minimize the disruption and have more time to obtain buy-in. For example, establish a hard ceiling on the number of annual billed hours for which an attorney will be rewarded (with a lower limit for partners).

**Think about retention.** Younger generations generally are more comfortable switching jobs than their older colleagues. To keep these attorneys on

## WHAT DOES THE RESEARCH SAY?

A recent study backs up the notion that providing greater incentives for leadership activities and weaker incentives for billable hours can pay off for law firms. The study, published in the journal *Industrial and Labor Relations Review*, looked at an international law firm that shifted from an “eat what you kill” approach for team leaders.

The firm changed its compensation plan so that leaders can address a “multitasking problem”: The leaders were focusing on billable hours and spending insufficient time on nonbillable activities to build the firm. The plan incorporated leadership activities such as cross-selling, mentoring and management activities.

After the new plan was implemented, team leaders increased their nonbillable hours — with no change in total hours worked — and shifted billable hours to their associates. The leaders’ “personal profits” (the revenue generated by each lawyer less the compensation the firm pays the lawyer) were unchanged, while the associates’ personal profits jumped significantly.



board, make it worthwhile for partners to train and otherwise help develop them.

### PRACTICES TO AVOID

Of course, for every “do,” there’s a *don’t*:

#### **Rely on a pure individual performance**

**approach.** Firms that compensate attorneys based solely on their own production prioritize individual performance over collaboration and firm performance. Think about basing, for example, only 10% of compensation on an individual’s work, with 40% based on practice group performance and 50% on overall firm performance. You may find that your younger attorneys in particular prefer collaboration to competition.

**Reward partners by bumping them up the pay tiers.** Avoid mechanically moving partners

up the pay scale. Instead, reward them with bonuses. If a partner’s productivity drops off in future years, you can withhold bonuses, rather than being stuck paying them at that higher rate.

**Overlook realization.** Traditional plans generally focus on hours billed, ignoring actual collections. As a result, they may compensate attorneys for billings that are never realized and eventually written off, thereby encouraging attorneys to overbill, and potentially alienate, clients.

### TRANSPARENCY MATTERS

Regardless of the approach you ultimately adopt, it’s essential that you be transparent about how compensation decisions are made. Make sure everyone knows which factors play a role — and why. •

# Don't panic!

## HOW TO BE READY FOR AN IRS AUDIT

No one likes to receive a notice from the IRS that they're being audited. And that includes law firms. But if you do receive a notice from the IRS, don't panic. The best defense is to be prepared.

### HOW YOUR FIRM IS SELECTED

The IRS trains examiners to specialize in particular market segments through its Market Segment Specialization Program. This means that examiners assigned to your case are familiar with legal industry issues, practices and terminology. Typically as they've audited firms, they've honed their skills and will know which questions to ask and records to examine to expedite the audit process.

To identify potential tax issues, the IRS uses the discriminant index function (DIF) point system. Activities such as handling large amounts of cash can raise a firm's DIF score — and its odds of being audited. And some specialties attract more attention than others. Real estate lawyers, for example, are a common IRS target because they may take a property interest in a transaction and fail to report it.

### WHAT TO DO TO PREPARE

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

Maintaining good records is also critical. Examiners tend to be 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.



The IRS will look at each partner's partnership or limited liability company (LLC) interests or stock received in lieu of cash for services provided. To avoid potential problems, be sure your firm's attorneys document and report such transactions.

### WHEN THE AUDIT OCCURS

The first step you should take if you do receive an audit letter from the IRS is to 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 to clarify a detail. If you delay your response or ignore the IRS, it may raise suspicions about your intentions.

What if the IRS asks 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.

One of the most important things you can do when the IRS comes calling is to remain professional throughout the entire process. If a dispute arises and you're unhappy with the result, have your accountant, who is more likely to approach the situation with a cooler head, handle it. If necessary, your accountant can request a meeting with the auditor's supervisor or a district supervisor.

Avoiding litigation is your best course of action. However, if needed, you can file an appeal with

the IRS's local appeals office. Note, however, that the IRS wins the majority of these cases. And appealing a court decision typically costs more than paying the tax.

### **DON'T GET HURT**

The odds of getting audited were less than 1% for fiscal year 2017 (the last numbers available). So while the chances are slim you'll be one of the unlucky ones, it pays to be prepared. And remember, most likely the IRS is looking to clarify a discrepancy and doesn't intend a protracted audit. •

## Is the Netflix model the next big thing in law firm billing?

More law firms are beginning to reconsider their billing practices, whether in response to client demands, stagnant revenues or other factors. Although alternative fee arrangements such as flat fees, contingent fees and blended rates have topped the list of options for some time, a new approach slowly is gaining ground — subscription-based legal services. Is this something your firm should consider?

### **THE CASE FOR SUBSCRIPTIONS**

Chances are, your clients already are familiar and comfortable with subscription models. Everything from music, TV shows and movies to food, gym memberships, pet supplies and clothing are available on a monthly fee basis. And it's not just consumer-oriented products that have gone this route. Think about software as a service (SaaS), cloud storage and office products. Those, too, can be billed on an automatic, recurring basis.

There are many potential benefits of a subscription model for law firms. It provides predictable costs



for clients, eliminating the possibility of sticker shock or collection issues. And it provides a steady revenue stream and cash flow stability for the firm.

Unlike hourly billing, which discourages clients from reaching out until something has gone wrong, the subscription model helps clients avoid "crisis mode." When clients don't fear getting nickel-and-dimed for every contact with their attorney, they're more likely to be proactive about seeking advice.

This strengthens client relationships and boosts client satisfaction.

The subscription model also is scalable in a way hourly billing isn't. After all, no matter how much you improve efficiency, you can bill for only so many hours in a day. While hourly billing can incentivize inefficiency, a subscription model discourages it. Greater efficiency means you can serve more clients, generating more monthly fees, with little if any change in overhead.

### FIRST STEPS

The subscription model isn't appropriate for every kind of matter — for example, litigation. If your firm is interested in trying a subscription approach, it must determine the scope of the services included. You might want to restrict subscription services to those related to a certain niche, such as small businesses or IP licensing. This will allow you to develop an in-depth understanding of the services your clients are likely to need and better target pricing.

Or you might offer different pricing tiers, with a lower fee for routine services only, such as document preparation or review, and a higher fee for unlimited phone calls and advice. The less expensive plans initially will produce less revenue, but they give you the opportunity to get your foot in

the door with start-ups and other clients that may bump up to pricier plans down the road.

Expect to make some substantial investments in software upfront. Technology is the key to maximizing the efficiency that powers the subscription model. Investments in software for website management, document management, client intake and similar template forms, along with billing and other task automation, can free up significant time and capacity.

### BEYOND LEGAL SERVICES

You also need to think about other value you can bundle into a subscription package. To prevent clients from treating their plans like an HBO subscription, regularly canceling and re-upping depending on their interests or needs, require a minimum subscription commitment — say 12 months.

Include some type of additional membership benefit such as “hot topic” video presentations or monthly Skype conferences with your attorneys, so subscribers feel they're getting something for their money even if they don't need any services in a particular month. This may also reduce the risk of violating ethical rules prohibiting attorneys from charging unreasonable fees. The “next big thing” just may be your billing. •

## Study spotlights opportunities for small law firms

A new study from the Thomson Reuters Legal Executive Institute (LEI) suggests that many law firms with one to 29 attorneys are too fixed on the status quo. The *2019 State of U.S. Small Law Firms* finds these firms are well aware that they face numerous challenges, but that not many have taken concrete steps to address them.

According to LEI, this provides valuable opportunities to “first movers” willing to take the lead.

Any attempt to innovate, it says, will set small firms apart from other firms that stay mired in the same place.

### COMMON CHALLENGES

The study found that one of the most common challenges for small firms is the acquisition of new client business. Every law firm segment surveyed (solo, two to six attorneys, seven to



10 attorneys and 11 to 29 attorneys) identified this as their primary “significant challenge.” That’s not much of a surprise — they all need a steady stream of business.

A large percentage of each segment also expressed at least moderate concern about:

- The amount of time required for administrative tasks,
- Controlling costs,
- Staying abreast of developing technologies,
- A lack of internal efficiency,
- Keeping up with competitors,
- Getting paid, and
- Clients demanding “more for less.”

In the three years LEI has conducted this study, the same issues consistently have been identified as the greatest challenges for small law firms — with relatively small numbers of firms taking proactive steps to deal with them.

### **ACTIONS TO CONSIDER**

For those firms that *are* re-examining their businesses, technology is often the first place they look. LEI considers this encouraging, as

technology lies near the root of any solution to most of their concerns.

Which technologies are hot? The surveyed firms are investing in staple technologies like time and billing, conflict checking, case/matter management and financial/accounting tools. Document drafting and document management tools become much less common in firms with fewer than 11 attorneys. These technologies would go a long way toward accomplishing goals such as improving internal efficiency and client service delivery.

Other reported changes can improve firm efficiency, too. Those include changing staffing ratios, shifting work to those with lower billable rates, and mapping and refining practice workflows.

*Many firms that have focused on becoming more efficient have seen positive performance outcomes.*

Many firms that have focused on becoming more efficient have seen positive performance outcomes. In fact, solo firms reported that greater efficiency was the single most important factor driving positive outcomes. For the other segments, focusing on client relationships and business development was identified as the single most important factor driving positive outcomes.

### **ACT NOW**

Law firms that are happy maintaining the status quo risk falling behind in an ever-evolving legal arena. It’s time for small firms to shift from awareness of challenges to actions that help them to seize opportunities. •



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