The Difficulties of Delinquent Accounts in Law Firms

Cash flow is the most important financial variable of businesses of all types and sizes, including law firms. Delinquent accounts can take a large bite from your working capital and impede your ability to pay your own expenses on a timely basis. Law firms, therefore, must ensure that they are paid on a timely basis, or they will face financial problems.

A recent survey by the Commercial Collection Agency Association revealed that the probability of collecting a delinquent account after three months was 73 percent. After six months, the probability drops to 57 percent, and after one year, the probability of collecting is 29 percent. The probability of collecting after one year falls as low as 10 percent. Another way of looking at this is that, after one year, your $10,000 client account receivable is worth $2,900, or 29 percent, based on these statistics.

Between now and Dec. 31, assuming you use a fiscal calendar, you will be attempting to collect on services rendered during the past eight months. Regrettably, you also may have receivables to collect from last year.

Here are some steps you should undertake to prevent financial problems later, assuming that you are rendering your invoices on a monthly basis.

By now, you should have your accounts receivable aging dated Aug. 31, 2001. After the initial shock from reviewing this aging wears off, identify the clients who require your personal attention and those that can be contacted by someone from your accounting department.

You will find that the vast majority of outstanding invoices are either lost or are gathering dust on someone's desk. Thus, a simple telephone call to the client's accounts-payable department will determine whether your invoice is in the queue for payment. If it is not, fax a copy of your invoice to the client's accounts-payable person. Your next phone call should be no later than a couple of days after this contact. Always end each call by receiving a promise and timeline for payment.

If you have a large number of clients and an accounting department that does not have the capacity or experience to make collection calls, then you should think about employing an outside collection agency. These agencies usually come in two forms. One offers a simple letter-writing campaign and is effective for a large population of small accounts. If you choose this kind of collection agency, have it service accounts that are more than 30 days past due. These agencies start off with a customary polite message and then send three or four letters with an increasingly stern message. If you start now, this process should pay dividends over the next two-to-three months.

The next level of collection service sometimes is referred to as hard-core collecting, whereby you engage a professional collector. The collector you choose should have experience in working with law firms and their special considerations regarding client relationships and possible malpractice claims, and in working with partners who are overly protective of their clients.

The accounts you select for this service should be significant in size relative to your firm, be more than 120 days past due or be the ones that have generally ignored prior past-due inquiries.

The collection process should be followed every month, not just when you gear up for year-end financial calculations. If you make formal collection efforts every month, you will find the year-end hurdle much less onerous.

For example, many firms find that December collections represent more than 15 percent of their collections for the entire year. In the mad scramble for cash, firms often will cut deals in order to meet their year-end target. These write-offs are very expensive, and your sophisticated clients have the upper hand in negotiating December collections. They will expect your calls and will anticipate your desperation.

The amount you have invested in accounts receivable should not exceed approximately two months of services, according to national survey data.

You easily can determine this investment by taking your annual fee revenue divided by your accounts receivable balance at any time. For example, let's assume your annual fee revenues are $2 million and your accounts-receivable balance is $500,000. The number of months you have invested in accounts receivable is four, which is $2 million divided by $500,000. Accordingly, you overinvested in accounts receivable by $250,000, thereby creating negative cash flow for you and your firm.

This overinvestment in accounts receivable creates significant cash-flow problems. At the very least, you have an annual carrying cost of $17,500, assuming an interest rate of 7 percent. In addition, you are slowing the firm's ability to meet payroll, pay vendors and minimize short-term financing.

The waiting game is also costly in terms of write-offs. How costly are write-offs? If you settle a $50,000 receivable for $40,000, you are tempted to call this a 20 percent discount. However, if your profit margin is 40 percent, the amount of this discount is actually closer to 50 percent in terms of the loss to your bottom line.

Let's look at this in another way; the amount needed to replace this amount of lost income is $25,000, an amount determined by dividing your write-off by your profit margin.

As you see, this waiting game is quite costly. While the aging process is beneficial for the cheese and wine industries, it is not for your business.