

# Law Firm Revenue Growth: Warning Signs for a Potential Crisis

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**SUMMARY** This article discusses the negative impacts of false revenue growth in law firms and provides steps to reduce it. False revenue growth can have devastating consequences, such as slowing production and affecting financial goals. To mitigate these effects, law firms should review their revenue metrics and compare current figures to previous years, develop an action plan for improving profitability metrics, investigate process improvement initiatives, and track resources used per partner. Establishing accountability and monitoring financial performance can also help law firms manage false revenue growth. Law firms can avoid many negative consequences of false revenue growth with the right approach and proactive measures.

## QUESTIONS ANSWERED IN THIS ARTICLE

### *What is false revenue growth?*

False revenue growth occurs when a firm recognizes revenue that has yet to be earned or collected and inflates its profits.

### *How can law firms identify warning signs of looming false revenue growth?*

Law firms should monitor the "months of fees" equivalent by summing the accounts receivable and work-in-progress inventories at year-end and dividing the sum by one month's worth of revenue. If this number decreases by 0.4-0.6 months, this may indicate a potential issue with false revenue growth.

### *What steps can be taken to reduce the negative effects of false revenue growth?*

Steps that can be taken to reduce the negative effects of false revenue growth include reviewing revenue growth metrics, developing an action plan for improving profitability metrics, investigating new process improvement initiatives, eliminating unprofitable tasks, and creating a dashboard monitoring progress towards goals.

### *What should firms consider when evaluating cost savings associated with process improvement initiatives?*

When evaluating cost savings associated with process improvement initiatives, firms should consider the resources used per partner and any potential short or long-term implications of implementing new processes.

### *How can law firms monitor their overall financial performance?*

Law firms can monitor their overall financial performance by establishing accountability for all partners to adhere to financial objectives, tracking and comparing resources used per partner, evaluating the cost savings associated with process improvement initiatives, and creating a dashboard monitoring progress towards goals.

There have been a lot of discussions lately about law firm revenue growth. Most firms are seeing some level of growth, but there are warning signs that this may not be sustainable. In this article, we'll take a look at the role of billings and collections in false revenue growth, and what law firms can do to avoid a potential crisis.

## Understanding False Revenue Growth in Law Firms

For managers and administrators, false revenue growth in law firms has become a pressing issue. As it is increasingly difficult to measure true law firm profitability, false revenue profits can skew yearly averages and mask potential problems from the surface. To define false revenue growth, it is essential to understand how law firms measure profit. Most law firms track average annual law firm profitability through billing and collections. Billing quantifies the financial performance of legal services over a certain period, while collections measure how many billed fees were collected within a particular time frame. When law firms use these metrics to calculate average annual law firm profitability or project future earnings, they are relying on false revenue growth when billing results need to be properly reconciled with collections data. This unsustainable practice can lead to troubling outcomes like understaffing, low morale, and misallocation of funds - none of which [benefit law firms](#) in terms of long-term business purposes and business profitability.

# The Role of Billings and Collections in False Revenue Growth

In the [legal industry](#), billings and collections' role can significantly affect false revenue growth. Companies tend to raise costs, increase work costs, charge higher rates, and pressure clients to pay faster to inflate their total revenue figures. Unfortunately, costs associated with such actions tend to outweigh the gains obtained from increased payments in cash or credit. Higher costs lead to increased costs of goods sold, which leads to reduced average annual profitability growth. This undermines the overall demand for legal services due to reduced capital inflows or investments from clients or investors expecting returns on their investments. Understanding how billings and collections impact false revenue growth is one crucial insight that firms must understand if they hope to continue to compete effectively in the competitive legal industry.

To ensure a [successful law firm](#), it is important to analyze the trends of total billable hours and legal staff over time. By comparing the two data sets, we can identify if the growth rate for total billable hours is higher than that of total legal staff. This outcome would lead to increased average utilization rates. If this trend is reversed, then the average utilization will decrease. Additionally, it is important to track the percentage of partners who bill below certain hours and ensure this peak is not within the first two bands (under 1,400 or 1,401-1,500 hours). If so, firms should honestly assess each partner's contributions over the past two to three years. Ignoring this vital information can be done when the firm's economic climate is strong, but it should not be evaded in times of crisis. Finally, if a partner's contributions do not meet expectations, they may benefit from finding another law firm during good times rather than bad.

## How To Identify Warning Signs of a Potential Crisis

Law firm leaders must be vigilant about potential warning signs of a financial crisis so that they can take preventative measures in advance. The first nine months of the law firm's fiscal year are incredibly important as they provide law firms with guidance on risk levels and assess whether staffing, [practice area focus](#), and cost have been affected. Ultimately, law firms have a legal and moral responsibility to their clients to ensure their businesses continue to run smoothly and profitably.

To monitor a law firm's overall health, the following should be closely reviewed:

- Analyzing high-volume accounts;

- Measuring matter profitability;

- Understanding their law firms' mix of litigated and transactional matters;

- Assessing practicing law interests regarding pay rates versus certain types of practices;

- Comparing existing costs against income from former years;

- Assigning responsibilities for risk management across departments including finance, operations, and IT;

- Rate possible penalties for engaging in normal business activities such as settlements or investments.

Using these critical steps, law firm leaders can easily identify warning signs before an issue emerges that could affect the long-term success of the law firm.

## Assessing the Impact of Low Billing Rates on Firm Survival

Many firms in danger of failure have difficulty raising their billing rates. This is more reflective of the services they offer and how much these services are worth in the marketplace than it does with their actual billing practices. In a difficult economy, it can become even harder for a firm to raise its billing rates if this has already been met with significant resistance. As a result, they need to keep up with inflation and lose ground compared to the wider market. To get an accurate picture of how this affects them, it helps to look at their average attorney billing rates over the past five years and relevant data from the Consumer Price Index (CPI). Tracking these figures and comparing them to conservative estimates of the market growth rate makes it easy to spot any discrepancies that can then be addressed. If their rates are below both lines, they may need to consider a different focus or new service delivery means to secure their future.

Many businesses that will ultimately experience a financial crisis have seen a recent surge in transforming inventory (accounts receivable and work in progress) into cash. Revenue can increase without an upsurge in production due to the mechanics of modified cash basis accounting used by most law firms for bookkeeping. Revenue is recognized when money is received instead of when services are rendered. If production slows down, this process can lead to an accumulation of inventories that need to be billed or collected in the future. Firms accelerate their billing/collections cycle to avoid this situation and compensate for the lack of production. Although this is an acceptable practice from time to time, it should be monitored closely, as a recurring focus on this process may indicate an underlying problem with diminishing workloads. To estimate the effect of billings/collections activities, calculate the "months of fees" equivalent for inventories by summing the accounts receivable and work-in-progress inventories at year-end and dividing the sum by one month's worth of revenue. A decline of 0.4-0.6 months is significant, and further decreases may indicate that the firm has a larger issue to address.

## Steps to Mitigate the Negative Impact of False Revenue Growth in Law Firms

False revenue growth negatively impacts every business process and financial goal for any size of law firm. Process improvement, focusing on profitability metrics, should be implemented to measure actual profit properly to mitigate these effects. This process can be time-consuming and requires knowledge of the partner's profit efforts to accurately compare the first three quarters to the same period in previous years, such as repeat engagements and resources used per partner. When done correctly, reports can then be delivered that demonstrate accurate compliance with each partner's goals while evaluating cost savings associated with process improvement. By taking these steps, firms can accurately gauge their overall financial performance and agility as they move forward with desired objectives.

The following steps can be taken to reduce the negative effects of false revenue growth in law firms:

- Review revenue growth metrics and identify areas of false revenue growth.
- Compare current revenue growth to the same period in previous years.
- Develop an action plan for improving profitability metrics.
- Investigate new process improvement initiatives that can increase efficiency.
- Identify tasks that are unprofitable or wasteful and eliminate those processes.
- Track and compare resources used per partner to ensure accurate results.
- Evaluate the cost savings associated with process improvement initiatives.
- Create a dashboard monitoring progress towards goals for each partner.
- Establish accountability for all partners to adhere to financial objectives.
- Monitor overall financial performance and adjust accordingly as needed.

## Conclusion

False revenue growth can have devastating consequences for law firms in the short and long term. By understanding the role of billings and collections in false revenue growth and identifying warning signs of a potential crisis, firms can take steps to mitigate the effects of false revenue growth. While some degree of false revenue growth is inevitable in any business, by taking proactive measures to identify and address it, law firms can avoid many negative consequences.