

## Financial health checks

13/01/2016

**Practice Management analysis: How can law firms effectively monitor the financial health of their organisation? Peter Scott, principal of Peter Scott Consulting and former managing partner of Evershed's London and European offices, and Andy Poole, legal sector partner at Armstrong Watson, consider how to give your organisation a financial health check.**

### **How crucial is it for firms to have good systems in place to monitor and maintain their financial stability?**

Unless firms have systems in place to enable them to monitor what is happening in their businesses and to forecast what will happen—and then to provide clear information to those involved in managing the business as to the actions they will need to take—then a firm will be at risk of financial failure.

It is not only crucial for firms to have good systems in place to maintain their financial stability, but also for them to maximise their financial performance because what gets measured gets improved. The need to improve performance is exacerbated when firms are faced with potential financial instability, but it is the same factors that need to be improved to make a good firm even better. By recognising and then having good systems to measure appropriate performance indicators, firms will give themselves the best chance of prospering.

### **In your experience, how adequate are the financial monitoring systems you see used in most firms? How much do they vary?**

Systems do not exist in a vacuum. Failure to adequately monitor and assess the financial performance of a law firm is usually because of failures by people in the business, rather than the IT systems used by firms. Effective financial monitoring depends on having appropriately experienced people using such systems to add value to their law firm.

Many firms continue to produce reports containing just 'raw data' rather than good quality financial information which can be understood and acted upon. When we review typical law firm management information packs, it can take an age to read through them, let alone understand and act upon them. When there is financial information overload, there is only one result—it gets 'binned'.

Too often we see inadequate capture and analysis of relevant financial information relating to fundamental aspects of the financial wellbeing of a firm, including:

- o the working capital needs of a firm
- o the cash generative parts of a firm and those which are burning cash
- o the profitable/loss making parts of a firm
- o which clients are profitable/loss making

If law firms want fee earners to change behaviour to maximise financial performance, the information provided needs to be in a format that they can use and understand. It needs to be simple, to the point, accurate, and within the control of those receiving the reports.

If financial performance is to be maximised, all fee earners need to understand:

- o the reasons why certain indicators are being measured—ie why they are important
- o what those indicators mean, and
- o how they can improve those indicators by adjusting their behaviours and interaction with clients

### **What are some of the key components of a system to determine the financial stability and health of a firm?**

When looking to determine whether a firm has its financial performance under control, there are various tell-tale signs. Firms able to determine their financial position, performance and future performance are more than likely to be performing better than firms not able to determine and demonstrate those things.

Firms that routinely produce, use and test the following are better able to demonstrate such financial control:

- o relevant and easy to use key performance indicators circulated to management and fee earners on a regular basis (see below)
- o 13-week cash flow forecasts—updated weekly
- o three-year fully integrated forecasts updated monthly with variance analysis to cover:
  - o profit and loss
  - o balance sheet
  - o cash flow, and
  - o funds flow

Firms should also produce a profit and loss account that analyses the contribution of offices/service lines and crucially, a balance sheet. However, many firms concentrate on fee income and profits and take their eye off the balance sheet, which is an important control in so many ways, and firms that do not produce one at least on a monthly basis are cause for worry.

### **What are the key indicators that you are looking to identify in health checks and what can they reveal about a firm?**

As people businesses, law firms should be relatively simple to run. To generate profits, people need to be kept busy, they need to convert how busy they are into fees, and expenses need to be controlled. While it is easier to control expenses than to control people, it is the people factors that will have the greatest impact on profitability and so firms should concentrate their reporting on those people factors.

As well as generating profits, law firms need to generate sufficient cash in order to meet liabilities as they fall due. As firms grow, the cash requirement grows and it becomes more important than ever to monitor cash flow indicators.

The relevant factors to be monitored in each firm will vary depending on specific circumstances, but subject to that, key performance indicators should include:

- o utilisation rates
- o recovery rates
- o work in progress days
- o debtor days
- o new matter starts

The level of information and indicators covered should be appropriate to different categories of users and based on what is within their control. The simpler the information provided, the more regularly it can be provided.

### **What are the common failures and misconceptions firms display in this area?**

When performing health checks, information request lists are provided. Well-run firms monitoring 'what matters' provide that information easily and quickly. In firms that are less well run (often the struggling ones), that information either takes a long time to be produced, or is not accurate or available at all.

We then work with firms to help them:

- o obtain the information on which to make business decisions
- o become self-sustainable in terms of their ongoing information recording and management, and
- o use financial information to perform better

### **The Solicitors Regulation Authority (SRA) risk outlook for 2015/16 does not include financial stability as an issue. What is your reaction to that?**

We were surprised that 'financial stability' is no longer, in the view of the SRA, a 'high priority risk', given that financial stability has never been as important for law firms as now, in view of the changes in personal injury and legal aid. In our view, sound financial management is intrinsic to everything that needs managing in a law firm, including risk and compliance. Moreover, financial difficulty is a serious risk on at least three levels:

- o the risk of a firm failing financially (firms are continuing to fail)
- o an underlying cause of other risks, including misuse of client monies
- o a factor contributing to inadequate risk management

For these reasons, it is unclear why the SRA have not continued to treat it as a high priority risk. Perhaps they consider we are over the worst, in which case perhaps they should now focus on law firms 'improving their financial performance'.

### **What is your advice to firms who want to improve their financial stability?**

In addition to carrying out financial health checks as referred to above, firms should:

- o be clear who should have responsibility for financial management and then make sure those people are able to do the job well—ideally there should be an effective working partnership between a finance director, and a managing partner who understands finance
- o review financial systems and reporting to obtain clear and accurate financial information about the business and then to be able to provide clear information to those involved in the business as to what they will need to do on the basis of that information
- o put in place a financial training programme so that partners and fee earners 'understand finance' and are able to improve the firm's financial performance
- o take 'control' of cash management by ensuring that every stage of the cash generation process (including taking instructions, managing work in progress and managing debtors) is tightly managed until the cash is received
- o drive up revenue by focusing on those factors which are the 'drivers' of profitability, including:
  - o pricing work 'for profit'
  - o capturing all matter related time
  - o maximising the realisation level of work in progress into bills (recovery)
  - o structuring each team in a firm for maximum efficiency and profitability to ensure that appropriate levels of expertise (and cost) are matched to levels of the work (leverage/delegation)

- focusing investment on profitable areas of work and eliminating those practice areas which are either losing money or failing to achieve the required margin
- controlling overheads so as to run on 'lean burn' by applying 'zero based budgeting' techniques to test every item of overhead on a regular basis—'Is this overhead necessary for the efficient and profitable operation of our firm or can we do without it/use it less?'

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