Financial stability

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Financial stability is a current topic of concern as law firms continue to fail and the SRA announces it has identified at least 1,200 firms with evidence of financial difficulty after it carried out a mass survey of at-risk sectors

Poor financial performance in law firms is just the 'tip of the iceberg' and should not come as a surprise to anyone, in that it is the visible result of the inability or unwillingness by the owners of law firms to adequately manage 'as businesses' the totality of their practices. It is a disease that has been endemic for years in large swathes of the profession in the UK. These inadequacies have always been present but it is only now, with the 'perfect storm' of a difficult economy combining with government legislation which has impacted adversely on certain sectors of the legal profession, that they are showing up in the form of increasing financial failures.

Meanwhile the Solicitors Regulation Authority (SRA) as the regulator has to try to get to grips with the problem to protect clients and the wider public interest. However, the SRA cannot provide financial advice to law firms, nor is it equipped to do so. It is only law firms themselves that can get themselves out of trouble, otherwise many more will fall by the wayside.

Poor financial performance in law firms is the 'tip of the iceberg'

Principle 8 from the SRA Handbook requires law firms to 'run your business or carry out your role in the business effectively and in accordance with proper governance and sound financial and risk management principles'.

It is the first words of principle 8 which are important – 'run your business … effectively'. In the context of financial stability, if a law firm fails then that is likely to be an indication that the business has not been run effectively and that there has been a breach of principle 8.

I asked myself what immediate steps I would now take, if I were still a managing partner running a law firm, to run the business effectively so as to ensure financial stability. Here are a few thoughts to get started.

1. Challenge everything about your firm

To run a financially successful law firm requires that every aspect of the firm is working productively and in unison. The challenging managing partner will question everything about the firm:

- Why do we still do things in this inefficient way?
- Why do we accept this level of underperformance and poor client service?
- Why are we still in this unprofitable area of work which is devouring cash at a fast rate of knots?

These and many more searching questions will need to be asked before any progress can be made. In particular, being uncompetitive is at the core of many firms' financial problems.

Everyman's Dictionary of Economics by A Seldon and F G Pennance (1964) stated that 'competition' is said to be a process by which:

- 'services that people are not prepared to pay for';
- 'high cost methods of production'; and
- 'inefficient organisations'

are 'weeded out and opportunity is given for new services, methods and organisations to be tried'.

That could be a description of many parts of the legal profession today. Every law firm should consider on a regular basis whether it is making the right strategic moves to enable it to be competitive in its markets and ask questions such as:

- What kind of law firm do we realistically want to be?
- Which (six) changes would make the greatest difference to our law firm?

Having arrived at answers to questions such as these, a firm will then need to take steps to implement the changes necessary to get the business right because, as Jack Welch (the US management guru) once famously, said: 'Change before you have to.'

Survival strategies are now urgently necessary in the case of those firms which are 'at risk' from market forces and new competitors with deep pockets that are now coming into their markets and threatening to destroy their businesses. Only those law firms which are able to develop their businesses in ways that enable them to gain a competitive advantage and outperform their rivals will survive.

2. Ensure you have 'accountability'

Law firms will not achieve sustainable financial success unless every owner is prepared to adhere to the following: 'We have no room for those who put their personal agenda ahead of the interests of the clients or the office.' (D Maister, *Practice What You Preach: What Managers Must Do to Create a High Achievement Culture*, 2012).

Being accountable in this sense is not universally accepted by partners in many firms but, unless owners of law firms are prepared to be managed and to behave in a way that will enable their firm to achieve its objectives, then it and they will suffer. The roles of the compliance officers for legal practice (COLP) and for finance and administration (COFA) bring these issues into perspective because, unless everyone in a law firm is prepared to comply, then the COLP and COFA will not be able to satisfactorily perform their roles and they and everyone else in the firm will be at risk. This applies as much as to managing financial risks as to any other type of risk. Non-compliance by partners with a firm's reasonable requirements as to financial management cannot be accepted in these tougher times. Zero tolerance has to be the new mantra for law firms in relation to compliance.

3. Plug your 'financial education gap'

A finance director of a highly successful law firm suggested to me recently that in many law firms (including his own) there is a financial education gap.

He meant by this that at every level in his firm (and in his view across the whole spectrum of UK law firms), from newly qualified lawyers to very senior partners, there is a lack of understanding about some basic financial matters such as 'how law firms make money' and 'what they need to do to generate cash faster'.

This was illustrated very clearly when recently a senior associate in a firm said to me: 'I don't have a clue about the financial reports I receive!'

Throwing financial reports at people (even clear and informative reports) is unlikely to be an effective way of improving financial performance if there is no explanation of what the reports mean or what people are supposed to do with them.

We have probably all come across firms where people are told that they must do certain things and meet certain targets in relation to the financial management of their practices, without it ever being explained to them why they should be doing those things.

There is often a lack of awareness about some of the most basic factors which contribute to good financial management, with the result that the financial performance of many firms is lower than it should be. How much better off would law firms become if their partners and other fee earners were taught financial skills to enable them to, for example, evaluate financial reports and to know which 'levers to pull' to enhance financial performance?

Throwing financial reports at people is unlikely to be an effective way of improving financial performance

Some firms tailor internal programmes designed to educate partners and other fee earners to understand the financial dynamics of their firms. However, as part of achieving buy-in to this, a business case will need to be made showing the benefits which will accrue to the firm from improving the financial performance of its lawyers. That is usually a very easy business case to make.

Educational programmes to enhance financial performance should always be tailored to the needs of the firm and its people but, whatever type of programme is chosen, it is important to ensure that it is user-friendly and will relate to each participant's daily work so that the knowledge and skills obtained can then be put to practical use.

Financial education should not be seen in isolation from other areas of performance development. Financial management is often said to have little to do with figures but everything to do with managing people. Accordingly, a financial skills programme may need to run alongside other development programmes covering business development, team-working and leadership, as well as the management of client relationships and internal office relationships.

4. Invest in quality financial resource

As law firms have grown into significant businesses, this has necessitated enhanced financial management:

- increasingly auditors and banks are recommending a change in finance director to a suitably qualified and credible professional;
- clients are demanding higher levels of service at a lower cost;
- management of firms now requires more and better information about their partners' financial performance; and
- managing partners come under increased pressure to respond to business risks in the most appropriate way.

However, given the challenges facing firms, financial management, if it is to underpin competitive success as well as ensuring financial stability, should be seen not only as the responsibility of a finance director.

Managing partners in particular will need to make it their business to ensure that they can more than hold their own with their finance directors. Gone are the days when a managing partner could say: 'I don't do finance.' This is a necessary development. Those with management responsibilities now need to have a far better understanding of effective financial techniques so they will know which levers to pull to drive any desired behaviour to achieve given financial results.

Financial management needs to be seen as something intrinsic and inseparable from everything else that requires managing in a law firm and not as a separate discipline isolated from other aspects of management. In particular, law firms are 'people businesses' and the success of a law firm will depend upon the attitudes, behaviour and individual performance of the people in the firm being aligned to achieve the firm's objectives.

As a result of the greater competitive pressures on law firms, not only will higher levels of financial expertise become increasingly necessary, but also, given the need to align financial management with getting the best out of people, every lawyer in a firm will need to play a more effective part in better financially managing clients, colleagues and themselves.

At the same time there is likely to be a need to resource the finance function more appropriately. It may not be palatable to some partners to see more 'non fee-earning staff' being recruited, but it can be a serious mistake to under-resource the finance function as competitive pressures grow and compliance becomes more stringent. A firm will need to analyse what it is going to need in terms of professional financial resource by asking some of these questions:

- Who should be responsible for financial performance?
- What should our finance director be doing?
- Do we need to replace our credit controllers with 'revenue managers' to accelerate cash generation? (Revenue managers will tend to be responsible for driving the management of work in progress (WIP) as well as for debtors.)
- Do we currently have the right calibre of finance professionals to ensure our financial stability?

In many of those law firms which already have high quality financial resource available to them, initiatives have been taken by those responsible for the financial function to successfully drive cash management to new levels.

Paying for a high quality finance director and other well-trained finance staff is likely to make far more financial and compliance sense than having a partner 'play at' being the finance partner. Firms should employ a finance director who understands what is needed to be done to get the firm into financial shape and who can command sufficient trust and respect of partners to enable him or her to get the job done.

5. Review your financial measurement and reporting

The purpose of financial measurement and reporting should be to obtain clear and accurate knowledge of what is happening/will happen in the business and to then provide clear information to those involved in managing the business as to what actions they will need to take to maximise performance. Without accurate measurement no valid analysis of performance will be possible and, without such analysis, appropriate solutions cannot be devised and/or remedial action taken.

Decisions to be made regarding the future of a law firm should only be based upon known facts and not on assumptions.

Measure what matters

Analysis of every aspect of the operation of a firm is needed before decisions are made and actions taken. For example:

- Do we measure the financial performance of each part of our firm? If not, how should we go about it?
- Do we know how much profit/loss each part of our firm is making?
- Will this part of our firm ever be capable of being profitable? If not, then why do we keep it?
- How profitable/loss-making are some of our clients?
- Which parts of our firm generate good cash flow/soak up cash at an alarming rate?
- How much working capital do we really need in our firm?

Financial information overload can be a serious hurdle to improving performance

An example of how important focused financial measurement can be is seen in relation to what is probably one of the most common problems law firms are now experiencing. That is, a downturn in the value of business, caused by fewer instructions or lower prices or both, which will lead to less WIP being available to be billed, leading to less cash being received to pay overheads. Unless this cycle of paying out more cash than is being received is stopped by taking action to cut overheads and generate more revenue, then a firm will at some point run out of cash to enable it to continue in business. This is what is happening to law firms today.

Being able to 'nip this problem in the bud' at the earliest possible moment is crucial. As well as preparing realistic cash-flow projections, monitoring 'input' can provide early warning of problems ahead. An input report showing the value of work being carried out, on at least a weekly, if not a daily basis, will indicate future shortfalls in WIP and eventually in cash, and should be one of the most important measures upon which to report in a law firm.

Such financial analysis is likely to reveal a picture of a firm which may surprise/concern partners. Having analysed a firm in this way, the crucial next step is to decide to do something about it and then implement solutions.

If a firm does not have the internal capability to analyse its financial performance in such a way and then to find solutions to the problems, then that firm will need to build such capability or look outside for external help.

Financial reporting

'Information is a source of learning. But unless it is organised, processed and available to the right people in a format for decision making, it is a burden, not a benefit.' (William Pollard, 19th-century clergyman)

Many firms still continue to provide their partners and other fee earners with over-complicated and lengthy financial reports, which only contain raw data, as opposed to providing good quality financial information which can be understood and acted upon. Such reports come to be regarded by partners as useless, are ignored and more often than not are likely to be 'binned'. If reports are not going to be used, then why produce them?

You can test the effectiveness of each of the financial reports your firm produces by asking questions such as:

- Why do we produce this report?
- Do we ever use this report?
- Does this report tell us what we need to know about what is happening/is likely to happen in our business and indicate what actions we should take?
- Which reports do we not produce and is this preventing us from more effectively driving up performance?

Financial information overload can be a serious hurdle to improving performance management. Instead, firms should ideally keep financial reporting as simple as possible and focus on producing clear and accurate reports which indicate in the chosen area of performance what needs to be done to achieve objectives.

6. Take control of your cash flow

The trend of law firms failing is likely to accelerate unless those responsible for managing their firms take control of their cash management to meet working capital needs.

In many cases, not only have firms used borrowed money to finance their working capital but, to add to the potential fragility of their financial situation, their partners have also borrowed 100 per cent of their capital to invest in their firm. This worked for firms in the good times. However, this financing model, faced with a recession where there has been less work, where clients are taking longer to pay their bills, and where the ready supply of easy and cheap credit has been cut off, exacerbated by weak internal management of financial performance, has been brought to a painful and abrupt end.

Some of the procedures and systems which firms have introduced to accelerate cash generation include:

- establishing financially prudent policies (for example, in relation to profit distribution) so that firms only commit to

borrowing for purposes of investment rather than consumption;
- appointing experienced receivables managers to drive the credit control focus;
- having centralised credit control teams to build relationships with all clients independent of partner relationships – and to take primary responsibility for the collection of all bills;
- developing sophisticated credit control software to build credit profiles for clients and more effectively manage debtor levels;
- putting in place regular WIP reviews, combined with WIP targets and establishing a culture of monthly/interim billing;
- introducing automated credit control procedures involving staged reminders and telephone chasers;
- putting in place intranet-based reporting systems highlighting problem WIP and debtors, internal credit ratings and high-risk clients.

There is now a need to build real capital in law firms to replace the shaky foundations of borrowed money. This is likely to be achieved by a combination of several measures, including the retention of profits, reduction of debt being carried, more stable longer-term funding for working capital and stronger internal management of financial performance.

However, something else will also be necessary.

7. Change the culture

There needs to be built into a firm an enthusiasm to embrace change if cash flow is to be maximised. Law firms are people businesses and the success of a law firm will depend upon the attitudes, behaviour and individual performance of the people in the firm being aligned with achieving the firm's objectives. Outstanding financial performance requires a continuous investment in people, services and resources if attitudes are to change and new working practices (often using new technology) are to be implemented in order to re-engineer the way working capital is managed. However, innovation is not just about technology – it is often about doing a few simple things better.

I would suggest that the lesson many law firms now need to learn is that the sustainable financial stability of their businesses should be seen as the consequence of how well they are managing the people in those businesses.

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