# PETER SCOTT CONSULTING

# Briefing Note – April 2013

### Developing more effective financial management

Following the introduction of Outcomes Focused Regulation on 6 October 2011, financial management has been subject to the compliance obligations of the SRA Handbook. Financial management in law firms is now no longer just about running profitable and cash generative businesses. Finance directors (as well as COLPs and COFAs) will now need to also ensure that their firms are meeting their compliance obligations in terms of financial stability.

On the other hand, financially sound firms are viewing achievement of financial outcomes not as a burden, but as an opportunity to become even more financially well managed. That is clearly a sensible approach to take.

Financial management is made a specific compliance obligation by virtue of Outcome O(7.4) in the Code of Conduct which provides that you must -

'maintain systems and controls for monitoring the **financial stability** of your firm ……..and take steps to address issues identified'

Examples of how a firm may be able to achieve this outcome are set out in the indicative behaviours in Chapter 7 of the Code:

**Indicative behaviour IB (7.2)** – controlling budgets, expenditure and cash flow

**Indicative behaviour IB (7.3)** – identifying and monitoring financial, operational and business continuity risks including complaints, credit risks and exposure, claims under legislation relating to matters such as data protection, IT failures and abuses, and damage to offices

The idea of putting a firm's financial position on a solid footing, as stability requires, is something which, quite apart from compliance obligations, law firms should always be doing as part of good business practice. In the future, those firms which currently do not make financial stability their priority will have to manage themselves differently if they are to achieve this outcome and other related outcomes of  the Code, including the following:

**Outcome O (10.3)** - you must report to the SRA promptly any material changes to relevant information about you, including **serious financial difficulty**…

*"Serious financial difficulty"* is not defined but some indications of SRA thinking are contained in **Indicative behaviour IB (10.3)** which provides that acting in the following way *may tend to show* that you have achieved outcomes in Chapter 10 –

"Notifying the SRA promptly of any indicators of serious financial difficulty, such as inability to pay your professional indemnity insurance premium, or rent or salaries or breach of bank covenants"

And this is backed up by other Indicative Behaviours which provide that acting in certain ways may also tend to show that you have achieved outcomes in Chapter 10 of the Code of Conduct, including -

**Indicative behaviour IB (10.2)** – actively monitoring your financial stability and viability in order to identify and mitigate any risks to the public.

**Indicative behaviour IB(10.4)** – notifying the SRA promptly when you become aware that your business may not be financially viable to continue trading as a going concern, for example because of difficult trading conditions, poor cash flow, increasing overheads, loss of managers or employees and / or loss of sources of revenue.

**Indicative Behaviour IB(10.5)** - notifying the SRA of any serious issues identified as a result of monitoring referred to in IB(10.1) and IB(10.2) above, and producing a plan for remedying issues that have been identified;

Given tough economic conditions, these compliance obligations make sense. Sound financial management is necessary to underpin the financial stability of all law firms. Without it, any firm can fail. What are some of the building blocks for financial stability which can be put in place to provide that solid foundation?

**1.Decide who should have responsibility for financial management**

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.

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. **Maintaining financial stability should be seen as the consequence of how people in the business are being managed.**

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

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 a finance function as competitive pressures grow and compliance become more stringent.

To enhance its financial performance and stability, a firm will need to analyse what it is going to need in terms of professional resource and then put that resource to work. For example:

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

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 a finance partner. Instead, firms should employ finance directors who understand what is needed to be done to get a firm into financial shape and who can command sufficient trust and respect of partners to enable him or her to get the job done.

## 2. Review financial measurement and reporting

In order to be able to *'maintain systems and controls to monitor financial stability and to take steps to address issues identified'* as required by Outcome O (7.3), financial performance needs to be capable of being accurately measured, assessed and reported on.

### Measure what matters

The purpose of financial measurement and reporting should be to obtain clear and accurate knowledge of what is happening / will happen in a 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, including financial performance. Without accurate measurement no valid analysis of financial stability will be possible and without such

analysis, appropriate solutions cannot be devised and / or remedial action taken. Decisions should only be taken based upon known facts and not on assumptions. For example:

*Do we measure the financial performance of each part of our firm? If not, how should we go about it?*
*Which parts of our firm generate good cash flow / soak up cash?*
*How much working capital do we really need in our firm?*
*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?*

Such financial measurement is likely to reveal a picture of a firm which may surprise and concern some partners. The next step is to decide to do something about it and then to implement solutions. However, if a firm does not have the internal capability to measure and analyse its financial performance in this way and to find solutions, then that firm will need to recruit such capability or to look outside for external help.

**Get your financial reports into shape**

*"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

Financial reports are a vital part of having effective systems and controls in place to help drive financial stability, but many firms still continue to produce over complicated and often useless financial reports, which 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 are often 'binned'.

A firm can test the effectiveness of each of its financial reports by asking questions such as:

*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?*
*If not, then why do we produce this report?*
*Do we ever use this report?*
*Which financial reports which should be vital to our business do we not produce?*
*Is our financial reporting preventing us from effectively ensuring our financial stability?*

'Financial information overload' is a hurdle to improving financial stability. Instead, firms should keep financial reporting as simple as possible and focus on producing clear and accurate reports which indicate what needs to be done to achieve financial stability and other objectives.

**3. Financial education and training**

On the other hand, throwing financial reports at partners (even clear and informative reports) is unlikely to be an effective way of improving financial stability if there is no explanation of what the reports mean or what people are supposed to do with them. Recently a fee earner in a firm said to me

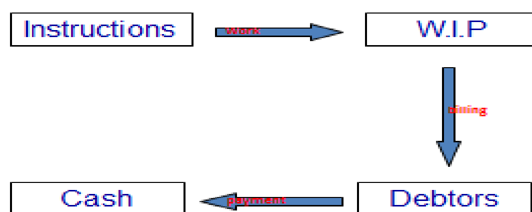
*"I don't have a clue about the financial reports I receive!"*

There is often a lack of knowledge about the basic factors which contribute to good financial management and thus financial stability, with the result that the financial performance of many firms is worse than it should be. How much better off would firms be if partners and other fee earners were taught financial skills to enable them to evaluate financial reports so as to be able to enhance their financial performance?

If law firms are to ensure improved financial performance, then there will need to be more emphasis placed on financial education and training for people at all levels in firms. And as part of achieving buy-in to a financial education programme, a business case will need to be made showing the benefits which will accrue to a firm from improving the financial performance of its lawyers and as a consequence the financial stability of the firm. Compliance requirements should now provide that justification.

**4. Take control of your cash management**

As always 'cash is king' and of paramount importance to maintaining financial stability, as the examples used in the Indicative Behaviours referred to above make clear. It is often helpful to achieve a better understanding of cash management to see the process of generating cash as a flowchart.




**Taking instructions**

The process begins when instructions are taken from clients. If essential matters are not agreed with clients at that stage then it is likely that there will be cash management problems throughout the client relationship, which are likely to then impact on the relationship itself

and on a firm's financial stability. Firms need to have procedures in place requiring partners and other fee earners to, for example:

Carry out client vetting / credit checks (firms are providing clients with free credit, but are not trained or paid to take credit risk)

- Agree credit limits
- Take money on account
- Take funds to cover disbursements
- Agree interim billing / frequency of billing
- Agree payment terms
- Incorporate the above into client engagement letters

Agreeing such matters with clients is covered by some of the Outcomes and Indicative Behaviours in Chapter 1 of the Code of Conduct dealing with client care, but they should in any event be an essential part of best practice if financial stability is to be maintained.

**Managing Work in progress**

Work in progress is a risk factor. Accordingly, managing work in progress will require constant monitoring and setting of work in progress targets, designed to minimise the level of 'work done but not billed' and the risks associated with excess and old work in progress. Putting in place procedures such as the following can better manage work in progress and accelerate cash generation:

- Agree with clients monthly / interim billing
- Agree bills with clients before delivering the bills
- Monitoring aged work in progress
- Consistently meeting realistic and achievable work in progress targets by driving the billing process

**Debtors**

Debtor management requires similar disciplines:

- Monitoring the age profile of debtors

- Reviewing debtors to ascertain whether 100% of debtors will be paid
- Ensuring partners speak to clients regarding payment of bills (it seems that in many firms partners do not like discussing money with clients!)
- Using a firm's credit control systems more effectively
- Putting in place a cash generation plan based on payments to individual partners being linked to their achieving agreed cash collection targets

**5. Working capital**

Partners in many firms have too much capital tied up in their firms (and some are now being asked to inject even more), which would not be needed if cash management was optimised. If firms are to get to grips with financial stability then they should ask questions such as the following:

*What is our firm's current working capital requirement?*
*How much less would our firm's working capital requirement be if we were to be more effective at cash management?*

Firms should calculate their working capital requirements (taking account of the specific nature of their businesses), based on what should be needed to finance 'best practice levels' of work in progress and debtors, and develop plans to achieve those targets. The lower a firm's 'lock up', then the lower its working capital requirement.

Firms can test the effectiveness of their working capital management by asking questions such as:

*Are we able to consistently keep within our banking arrangements?* (Note – breach of bank covenants is mentioned in the Code of Conduct as an indicator of 'serious financial difficulty', requiring reporting to the SRA)

*Is a cash call on partners likely to be required shortly?* (Partners' capital should not be used to support financial underperformance.).

*Are we able to make distributions to partners from last year's profits?* (A sensible 'distribution policy' can help to develop disciplines designed to ensure payment of profits from previous years)

*Will we be able to pay next July's tax bill?*

*Will we be able to repay capital to those partners who are soon to retire?*

*What is our debt / equity ratio?*

Analysis will reveal where the ‘log jams’ exist preventing the acceleration of cash flow and where decisive action will now need to be taken to ensure financial stability.

**6. Drive up revenue**

The focus of this Briefing Note so far has been on cash management as that is a primary element of financial stability. However, we must not forget the need to drive up revenue to improve profitability and ensure the well - being of a law firm. Unless law firms can build financial stability through both good cash management and by driving profitability then they will not be able to develop in a way which enables them to achieve their objectives.

How can a firm build the ‘top line’ to generate substantially more profit?

One way is to win more profitable business whether from existing or new clients, using existing resources and within the parameters of existing overhead levels. However, a more effective approach to business development and client retention is likely to be first required in many firms if this is to be achieved and this is likely to take time.

An effective way to improve profits in the shorter term is to **‘make the most of what you already have’**, by looking at how you:

- price work (for profit);
- manage work to a price to achieve required margins;
- fully capture all matter-related time; and
- maximise the realisation (recovery) of work in progress on billing.

The above areas are where many law firms haemorrhage profit, firstly by discounting prices, then discounting further by not fully recording all their matter – related time (for many different reasons) and then triple discounting by writing off matter – related time when billing. The cumulative effect on profitability can be a disaster and to illustrate this, try these simple tests on your firms –

**By how much would your revenues increase and your profits grow if you were to increase your charge out rates by say £10 per hour across the board and you recovered that increase when billing?**

**By how much would your revenues grow if each of your fee earners recorded an additional 30 minutes per day? (I am not in any way suggesting that fee earners ‘puff’ their recorded hours but simply fully record all the time they actually spend on clients’ matters)**

**By how much would your revenues increase if you were to reduce by 50% the amount you write off when billing?**

The results may surprise you!

### 7. Control Overheads

If work is increasing, then firms should not immediately seek to take on more overhead by recruiting to cope with it. The likelihood is that within a firm there will be existing capacity to do the work (most firms I have been currently looking at are over – manned). More buoyant market conditions can be a dangerous time if overheads are allowed to spiral 'to meet demand', instead of fully employing existing assets.

How can firms ensure they are running on 'lean - burn'?

Every individual item of overhead (and particularly the people in the business who are usually the single largest expense) needs to be looked at and questions need to be asked such as:

*"Is this overhead really necessary for the efficient and profitable operation of our firm or could we do without it / use it less?"*

*"We know we must have this overhead, but how can we reduce the cost of providing it?"*

Many firms might be surprised to discover just how much unnecessary overhead 'fat' they are carrying. A regular testing of every item of overhead and the price being paid for it should be one of the most basic financial disciplines required to run a profitable (and financially stable) firm.

### 8. Establish an 'audit trail'

Under Outcomes Focused Regulation, it is not sufficient just to be compliant. Firms must go further and be able to demonstrate that they are achieving outcomes and thus meeting the Principles set out in the Handbook, particularly **Principle 8** which provides that you –

**'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'**

How will firms be able to demonstrate if challenged, that they are maintaining financial stability?

Having in place disciplines and procedures as outlined above which are adequately documented can be a starting point. However, controls and procedures which firms put in place can only be tested for their effectiveness by continuous monitoring and as already mentioned, this will require firms to 'measure what matters' and to record outcomes.

If any circumstances arise which could possibly be said to affect the financial stability of a firm, then the firm would be well advised to quickly take advice from its accountants or other financial advisors with a view to establishing the extent of the problem and if possible arriving at a course of action to remedy the difficulty. The advice provided and the actions agreed to be taken on the basis of that advice will need to be carefully recorded in order to be able to justify the firm's conduct, if challenged, and how and why the issues were resolved in the particular manner adopted.

The question is also likely to arise as to whether such financial issues will need to be immediately reported to the SRA, and the COLP and the COFA will need to carefully consider the matter in the light of the notification and reporting outcomes in the Handbook.

For example:

**Outcome O (10.1)** – *you ensure you comply with all the reporting and notification requirements in the Handbook that apply to you.*

**Indicative behaviour IB (10.5)** – *notifying the SRA of any serious issues identified as a result of monitoring referred to in IB (10.1) and IB (10.2) and producing a plan for remedying issues that have been identified*

**9. Get your partners into shape**

Disciplines and procedures need to be adhered to by everyone in a firm and 'zero tolerance' in relation to OFR compliance is now being required by many firms, with sanctions on those who do not comply. However, none of the basic steps outlined above will be capable of being implemented unless a firm first gets its partners into shape and everyone agrees to be 'accountable' by undertaking to be managed and to do whatever is required to be compliant.

The risks to a firm from compliance failure (particularly failure to maintain financial stability) should now provide those 'good' partners in a firm with the justification to say to the mavericks that 'enough is enough' and require them to comply ... or else. If this is not done, then everyone in a firm will be ***at risk***.

This is the real challenge for many law firms if they are to achieve a higher level of financial performance.

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