PETER SCOTT CONSULTING

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My top ten tips for improving financial performance in 2017

1. Train your people to understand finance

The need to understand finance does not just rest with those in management positions or with a finance team. That need extends to all lawyers in a firm who will need to play a more effective part in financially managing clients, colleagues and themselves.

The FD of a successful law firm suggested recently that in many firms he knew (including in his own) there is a *financial education gap* in the sense that there is often a lack of understanding about basic financial matters such as ***how law firms make profit*** **and** ***how to generate cash faster*****.**

Just 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. As a senior associate in one firm said to me

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

It is not sufficient to just tell people that they must do certain things and meet certain targets without it ever being explained to them ***why*** they should be doing those things and the benefits which will flow if they do so.

As a result of this lack of financial knowledge the profitability and cash flows in many firms are far worse than they should be. How much better off would firms be if partners and other fee earners were taught basic financial skills to enable them to better evaluate financial reports and to manage their practices in a way which will enhance a firm's financial performance?

If law firms are to achieve this, at the same time as helping their people to manage their ***continuing competence***, there needs to be more emphasis placed on financial education, training and support for people at all levels in firms. Increasingly progressive law firms are tailoring internal programmes designed to educate partners and others to understand the financial dynamics of their firms.

Although the benefits which will accrue to a firm and its people from improving their financial performance should be self - evident, to achieve buy-in (from partners in particular) to financial training, it will often be necessary to make a strong business case showing the benefits which will accrue.

Financial training should not be seen in isolation from other areas of learning and development and a financial skills programme may need to run alongside other development programmes covering people management, management of client relationships, team working, leadership and business development.

2. Invest in quality financial resource

As law firms continue to grow into businesses of significant size and complexity, there is a corresponding need for enhanced financial management expertise.

It may not be palatable to some partners to see ever more so called 'non fee - earning admin staff' being taken on, but it can be a serious mistake to starve a finance function of essential and good quality people.

If financial performance is to be enhanced then a firm will need to analyse what it is going to require in terms of professional financial resource and to then set about putting that resource to work in the most effective manner.

What kind of FD do we need? See http://www.peterscottconsult.co.uk/briefings/Sept2012.pdf

Do we currently have the right calibre of finance professionals?

Do we need to replace our credit controllers with revenue managers to drive the management of work in progress as well as debtors in order to accelerate cash generation?

Paying for a high quality FD and other well trained and experienced professional financial staff is likely to not only make financial sense but increasingly, banks are recommending that law firms change those heading the finance function to more suitably qualified, experienced and credible professionals.

3. Measure and analyse your financial performance

Financial measurement and analysis is the key to improving financial performance because diagnosis of problems will point to solutions. In particular, if decisions need to be made about the future of a firm then they should be based on facts rather than assumptions.

The purpose of financial measurement and analysis should be to obtain clear and accurate knowledge about what is happening or will happen in the business. Measurement and analysis of every aspect of the operation of a firm will be needed before decisions are made and actions taken.

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 group or partner in our firm is making?

Will this group or partner ever be capable of being profitable? If not, then why do we keep them?

How profitable / loss making are some of our clients?

Which parts of our firm generate good cash flow / haemorrhage cash at an alarming rate?

How much working capital do we really need in our firm?

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

4. Report on what really matters for your business

"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

That quote certainly applies to financial reporting in many law firms which continue to provide their partners and other fee earners with over – complicated and lengthy financial reports which often only contain 'raw data' as opposed to high quality financial information which can be understood and then acted upon. Reports come to be regarded by partners as useless and as a result are often ignored and 'binned'.

If a firm can identify from the financial analysis of its business the **key performance indicators** that it will need to best manage the finances of the firm and then translate these into clear and understandable reports, preferably using graphs and ideally on just one page and on a frequency (probably daily or weekly depending upon the report) sufficient to tell those in the firm what is happening, then that is likely to be a huge step forward.

Firms can test the effectiveness of their existing financial reports by asking questions such as:

Why do we produce this report?

Does it tell us what we need to know about our business?

Does this report indicate what action we now need to take?

What does this report NOT tell us about our business?

Do we ever use this report? – If not, then why produce it?

5. Performance manage your people

Ensuring that a firm's people are highly trained and motivated is critical to building high financial performance. However their financial performance cannot be left to chance – it will need to be **actively managed** and people will need to know –

- The key areas in which their financial performance will be measured;
- Their performance goals pertaining to each area;
- How their performance rates in relation to those goals; and
- How performance will be rewarded.

To discover how just much more profit and cash can be generated, a firm should carry out a **performance audit** to find out how its people, its support systems and structures are performing. The focus of the performance audit should be on those factors which can most strongly improve profitability and cash flow.

Once the findings from a performance audit have been analysed the next stage should involve a firm helping its people to maximise their potential in relation to their financial management and ensuring that all a firm's structures, systems and support processes are directed at improving that financial performance.

Supporting a firm's people to help them achieve higher performance in financial management should be just one part of an on-going performance management programme designed to be an investment in the long term future of a firm and to make continuous improvement to establish a firm's competitive edge.

If progress is to be made in financial performance, firms and their people need to adopt a positive and open-minded approach, learning from how other, perhaps more financially successful firms do things, rather than continuing to operate as they always have, or instead of accepting that there is always a reason why something cannot be done *("Yes, but…..").*

Performance management is likely to bring to the surface many of the underlying hurdles to change that may be preventing firms from being more financially successful. Ultimately it is a question of whether people are prepared to be managed.

6. Put in place a cash generation plan linked to sanctions

As always, cash is king and so firms need to ***take control*** of their cash management

Partners in many firms have far too much cash tied up in their firms which would not be needed if cash management was being driven as it should be.

Begin by setting work in progress targets for all partners and other fee earners calculated by reference to what is the realistic maximum amount of work in progress that should be carried for any particular practice area given the nature of its work.

Implementing work in progress targets in this way should over a period of time progressively reduce work in progress and help to drive increased billings, adding to a firm's debtors which in turn will need to be subject to enhanced management.

Given that the purpose of cash management is to generate cash, then firms should take control of the process and implement cash generation plans built around realistic and achievable cash collection targets for groups / partners, which are arrived at based on current and prospective billings and aged debtors. Consistent achievement of targets can then be linked to payment of monthly drawings or distributions of profit to partners. This will begin to test partners' 'hunger'.

To keep the cash flowing at an accelerated rate, cash collection targets for each department and / partner should be **weekly** and should be updated weekly.

7. Price and manage work for profit

It is often forgotten that pricing is a fundamental element and driver of profitability.

Clients are increasingly knowledgeable and sophisticated nowadays when buying legal services and understand the value or 'worth' ***to them*** of their lawyers' services as well as being knowledgeable about the cost bases of law firms. Accordingly they require those services to be priced on a basis which is in their eyes ‘value for money’ relative to the results a firm achieves for them; and they will require their chosen law firm to do this ‘better’ than its competitor law firms.

Pricing needs to be controlled at the very outset of every matter. However, some firms seem to have no effective controls over partners taking on work at prices which bear no relationship to the cost of doing the work, the need to make a healthy profit margin or to the market place. Work in many firms seems to be taken on at prices which can never make money (or worse, can only lose money). This is why the recording of matter related - time (see below) as a management tool to indicate the cost of doing work is so important. Unless a firm knows how much a job will cost to be done, how can it safely quote a price for that job?

Given that clients now increasingly require fixed prices and the SRA Code of Conduct requires that clients are given at the outset the best possible estimate of how much a job will cost them, it is essential that firms are able to:

- Scope work
- Analyse the risks involved in doing the work and
- Budget that work to make a profit
- Manage the work to bring the job in on budget

Managing work for profit will involve:

- Resourcing the matter in the most appropriate and cost effect manner
- Monitoring progress financially, for which a firm will need clear and accurate financial information
- Managing performance of the people working on a job
- Communicating effectively throughout with the client

These are ***project management skills*** which most lawyers have not been trained to do but will need to be developed if work is to be turned into maximum profit. This again emphasises the need for more financial training.

8. Fully capture matter related time

Partners and other fee earners may appear to be busy and putting in long hours yet this may not be reflected in their level of financial contribution. How productive are they?

How are they using their time?

A performance audit should begin by looking at each partner, fee earner and group in a firm to ascertain the utilisation of their time by comparing their recorded matter-related hours with the hours available to them, in order to identify on what else they are spending their time and whether this is efficient and profitable use of their time.

Are our people fully capturing all their matter-related time?

While matter-related time should be regarded as only one component in arriving at what is the ‘right price’ for a job, it is an important component because apart from anything else, without recorded time and descriptions of the work carried out, a firm may have very little evidence of what work has been carried out on a matter and will be at risk if bills are challenged.

Are the matter related hours targets we have set across the firm realistic? / too high? / too low?

If targets are based on what your people have recorded over the past few years when there was perhaps less work around, then targets are likely to be too low relative to current levels of work and so too easy to achieve. There is also plenty of evidence in law firms that for a variety of reasons not everyone fully records the time spent on client work. People are likely to record just enough to meet their targets.

At the same time embark on an education and training programme, explaining to all partners and fee earners **why** they should fully and honestly record such time. Training for people on how to use a time recording system may also help to capture more time. Combine this approach with close monitoring of recorded time against new higher targets on say, a weekly basis and require those who miss their targets to provide explanations. Low recorded hours can be a symptom of numerous problems which may need to be nipped in the bud if serious consequences are to be avoided.

Also so – called 'non-billable time' codes often tend to become 'dustbins' for people to make up their hours in the day when, for whatever reasons, they cannot or choose not to record time against client matters. If an audit shows that non-billable time is a substantial proportion of total time **(I have sometimes seen ineffective non-billable time as high as 40% of the total)** then a firm's people will be throwing away a great deal of their firm's potential profit.

How much more profit would your firm make if every fee earner recorded and recovered an additional 15 / 30 minutes per day?

The amount of additional profit is likely to surprise you.

9. Manage realisation (recovery)

How much time which should properly have been billed to your clients was written off last year?

The action which can have one of the greatest positive impacts on profitability and which requires the least work and effort is to improve the rate at which you realise (recover) work in progress when a matter is billed. A firm will not of course be able to accurately calculate its true realisation (recovery) rate unless there has first been full capture of matter-related time.

Carry out an exercise to find out the total amount of work in progress your firm wrote off last year

- As a total for the whole firm; and
- For each group / partner / fee earner

The results may surprise you.

For some firms, succeeding in doing this is likely to be the single most important factor to improving profitability. Several years ago I worked with a firm which in its previous financial year had recorded £45M of work in progress but had only billed £40M. When this was pointed out to the partners they were so shocked they immediately agreed to take steps to put in controls to reduce write-offs to no more than half of the previous level.

Bringing home to partners the amount of potential profit they may be losing by not adequately managing the realisation (recovery) rate can often have the desired effect by persuading them to take more seriously both profitably managing work to a price (see 7 above) and the billing process, in order to arrive at the 'right price' for the work without throwing away their profits.

Who is authorised to write off work in progress in your firm?

What is usually required is the implementation of **a write off policy *'with teeth'*** to control the unjustified writing off of recorded time which should properly be billed to clients.

10. Manage overheads – especially your people costs

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

Every individual item of overhead (and particularly the cost of people which is 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 will be surprised to discover just how much unnecessary '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 firm – and it is not difficult to do.

In particular, given that ***people costs*** are usually the single largest item of overhead it is vital to ensure that a firm's people are being efficiently and profitably used.

This will involve looking at 'leverage' (the ratio of equity partners to other fee earners) which is a key element in building greater profitability. Work coming into law firms is continuously being 'commoditised', particularly through the use of technology. It will often require a wide range of expertise and experience to be applied to it and ensuring that work is carried out by those with the appropriate level of expertise and at the most appropriate level of cost is a key to building higher profitability.

To achieve this will require ***effective delegation and supervision,*** which in turn will help to build the use of teams and to better manage risks and compliance. A performance audit will identify which partners are doing work which others should be doing more profitably.

A good performance indicator to measure and test of how profitably a firm or a group is using its people is to look at the '**gross profit'** line (turnover less direct people costs) of the firm / group.

Make improved financial performance a priority in 2017

The process of driving financial disciplines often needs to go hand in hand with overcoming internal hurdles to change.

If progress is to be made in improving financial performance, firms will need to adopt more positive and open-minded approaches, learning from how other, perhaps more financially successful, firms do things, rather than continuing to operate as they always have. Above all, they will need to ask the crucial question:

“Are all our people prepared to be managed for the good of the whole firm?”