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Successful profit distribution policies require cash management discipline

Last week a firm announced it intends to move to a single profit distribution each year, instead of its current quarterly system. While the internal reasoning in that firm is unknown to me, it does raise questions as to whether a move to a single annual distribution is necessarily a wise or a desirable one.

Paying out profits to partners has for long been a perennial problem for many firms. Come the year – end, healthy profits are shown to have been made – on paper at least, and in the accounts partners' current accounts and tax reserves are credited with each partner's share of profit after deducting drawings on account received during the previous 12 months (NB – current accounts and tax reserves are usually just 'paper accounts' and not cash which is ring fenced). There is elation all around, until the first pay – out is due (often on a quarterly or six – monthly basis), when the firm realises it does not have enough cash for the distribution. Partner morale falls into a deep abyss. That scenario plays out very frequently and can lead to the build – up of large current account balances, which means that partners may be leaving their profits at risk for the future if a firm experiences a cash crisis. **However, partners' current accounts should not exist to support financial indiscipline and under-performance.**

This is why prudent but sensible profit distribution policies should be put in place which not only pay out profits as quickly as possible to ensure that current accounts are not allowed to reach levels when they are put at risk and when the only practical thing to do is to convert them into fixed capital, but also to help nurture good financial disciplines designed to drive strong cash flow.

It is a well tried and tested tenet of law firm management that if a managing partner wants to keep partners happy then the profits must keep regularly flowing. Many years ago when I was a managing partner, I put in place an approach quite different to the quarterly / six monthly / or whenever they could be afforded basis for profit distributions.

We introduced a distribution policy which required (subject to available cash flow) all profit from the previous year to be paid out over the next 12 months by 12 equal monthly instalments.

We treated our partners as though they were third party creditors and therefore ***they had to be paid on time***. That meant that partners had to sign up to new financial disciplines if they were to receive their monthly profit distributions, and on the whole they did. The policy worked well and, in addition to satisfactorily managing the working capital needs of the business, we never missed a month's profit distribution. Monthly distributions are still my preferred approach because of the financial disciplines required to achieve them. The amounts are smaller and more manageable and the risk of failing to meet a distribution (which can damage partner morale) is less. The risks associated however with a once a year pay – out (or even a six monthly pay – out) are far higher.

I recently carried out a small survey with several accountants who act for law firms and their experience is that generally they do not see any specific trends in profit distributions. Instead, they see distributions by their clients being usually driven by the availability of cash, rather than as an incentive to collect cash in order to make the distributions as per a set timetable. **However, they commented that having a disciplined approach to distributions means firms can be better focused on the need for good cash management so that distributions can be made when promised.**

Collecting sufficient cash to both meet the working capital needs of a firm and paying out profits from past years on time to partners does require a different approach to financial discipline.

Hand in hand with a continuous education of partners and other fee earners and the formulation of credit policies to suit the needs of a changing business, an urgency to both bill and to collect bills has to become instilled into the collective mindset of partners. Increasingly, firms are also concluding that there is likely to be the need for ***sanctions policies*** linked to cash generation targets, to penalise partners through their drawings and/or profit distributions.

Putting in place cash generation targets for each partner or group as part of a cash generation plan can be a particularly successful tool in reducing lock up days.
A cash generation plan is not difficult to implement and can involve, for example –

- Developing rolling forward cash-position goals built around a minimum acceptable cash balance at the bank and the cash needed to cover all outgoings for say the next three months (including the cash to pay partners' drawings and profit distributions in accordance with an agreed profit distribution policy);

- Agreeing realistic **weekly** work in progress / billing targets by each partner / group based on aged work in progress and planned to keep work in progress within agreed parameters to generate cash to meet future major outgoings;

- Agreeing **weekly** cash-collection targets with each partner / group, based on aged debtors. These targets do however need to be realistic and achievable otherwise they lose credibility with partners;

- Making payments to partners dependent on meeting agreed cash collection targets. **Weekly** reports to partners of performance against targets will help to raise real – time awareness amongst the partners of how a firm is performing and payments to partners can be accelerated or delayed depending upon whether targets are met. This can be linked to overall collections or to individual / group collections. In a number of firms **sanctions policies** for unpaid debtors which penalise partners through their drawings and / or profit distributions have been particularly successful tools in reducing debtor days and ensuring profit distributions to partners are made on a timely basis.

- Firms need to support a cash-generation plan with sufficient resource to ensure that partners are provided with the information and help they need to collect cash and to ensure that the absence of such resource cannot be used as an excuse for inaction.

Being required to contribute additional capital to a firm, or having to retain large current account balances, should not be seen as acceptable alternatives to adopting more effective cash management disciplines to ensure that a firm operates with no more working capital than is prudently required and is able to pay its partners the profits they have earned.

Changing the attitudes of partners in their approach to billing and cash collection should be a key element of a firm's strategy, enabling it to focus its borrowing capability on projects for the long – term benefit of the practice rather than to meet day to day needs. If successful, growth can be financed without the need to increase borrowing, to make cash calls or to delay distributions to partners.

However to do so and if cash management is to improve, a far more business - oriented 'culture' needs to be built into law firms. Unlike a crisis which can force partners to change, just offering promises to partners of profit distributions at potentially irregular intervals in the future (particularly if they can live comfortably on their monthly drawings), will often not achieve its objective to drive stronger cash flow.

On the other hand, putting in place a prudent and sensible profit distribution policy, linked to a cash generation plan and supported by sanctions can be a start to building that more business - like culture – and is likely to both drive stronger cash flow and enable the profits to keep flowing to partners.