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Briefing Note – September 2011

Financial management has just become regulated!

With the introduction of Outcomes Focused Regulation (OFR) on 6 October 2011, the manner in which law firms financially manage themselves will become regulated and subject to compliance obligations in the new SRA Handbook. No longer will financial management in law firms just be about running profitable and sound businesses. However, having said that, many already successful law firms are viewing compliance with OFR not as a burden but as an opportunity to become even more successful and profitable. That is clearly a sensible approach to take.

As to how law firms will be subject to greater compliance in respect of their financial management is illustrated by one of the 'outcomes' in **Chapter 7 of the new Code (Management of your business)**:

- **Outcome O(7.4) – *you must maintain systems and controls for monitoring the financial stability of your firm ……..and take steps to address issues identified***

That is something which, quite apart from their compliance obligations, law firms should in any event always be doing as part of good business practice. Certainly in the future, those law firms which currently do not make financial management a priority will have to manage themselves very differently if they are to achieve this and other 'outcomes' required by the new Code. Another example is in **Chapter 10 of the new Code (You and your regulator):**

- **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.*** (Note the use of the term '*indicators*').

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, including -

- **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*** (Note the use of the words "*may not be*").

How many law firms over the past three years have not experienced such problems? That very broad and imprecise wording will require active and continuous monitoring by law firms of their financial stability and viability and I would suggest, the laying of an **'audit trail'** by firms in order to be able to demonstrate compliance.

In view of the greater emphasis there will now be on law firms achieving financial management 'outcomes' such as referred to above as part of their compliance obligations, I set out in this month's Briefing Note some steps law firms can take to enhance their financial management and performance.

If you have any questions regarding financial management and performance or any aspects of OFR, please do not hesitate to call me. In particular if you would like a commentary on the responsibilities of the COLP, please click on the following link - http://www.peterscottconsult.co.uk/articles/COLP-article.pdf

Take financial management to another level

Sound financial management is necessary to underpin the success of any law firm. Without it, any firm can fail, or at the very least be at risk in the future of not complying with outcomes in the new SRA Code which will come into effect on 6 October 2011. What are some of the *building blocks* for enhanced financial performance which need to be put in place to provide that solid foundation for financial stability? Here are some thoughts.

1. Identify who in the firm should have responsibility for financial management

Given the challenging pressures already on law firms, in addition to the new compliance obligations, it is clear that financial management, if it is truly to underpin competitive success, should be seen not only as the domain of a finance director.

Financial management needs to be seen as something intrinsic and inseparable from everything else that requires to be managed in a law firm and should not be seen as a separate discipline isolated from other aspects of law firm 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 a firm being aligned to achieve the firm's objectives. Financial performance can be seen as the result of how well people in the business are being managed.

It follows as a result of the greater competitive pressures on law firms and the new compliance requirements, that not only will ever-higher levels of financial expertise become necessary in law firms, but given the need to align financial management with getting the best out of people, that every lawyer will have a greater part to play in financially managing their clients, their colleagues and themselves. Increasingly managing partners are making it their business to ensure that they can more than hold their own with their finance directors on financial matters.

This is a necessary development, given the need on the part of those with management responsibilities within a firm to successfully manage the business. They will need to have a total grasp of cutting-edge financial management techniques and to understand which *levers* to pull to drive any desired people behaviour and financial results.

At the same time there is likely to be a need to resource the finance function more appropriately and adequately

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, particularly as compliance requirements become more stringent.

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

What should our FD be doing?

Do we need to replace our credit controllers with revenue managers to drive the management of both work in progress and debtors in order to accelerate cash generation at an earlier stage?

Should we employ receivables managers to drive credit control?

Paying for a high quality FD and other well trained professional financial staff is likely to make far more economic sense than having a partner ‘play at’ being a finance partner, which is common in many firms. Instead, employ an FD who understands what is needed to be done to get the firm into good financial shape and who can command sufficient trust and respect of partners to enable him or her to get the job done.

However, for performance management (including financial performance) to be successful, performance needs to be accurately measured, assessed and reported on.

2. Review 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 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. 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.

In particular, if decisions need to be made regarding the future of a firm then they should only be based upon known facts and not on assumptions.

Financial Analysis

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?

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 to then find solutions to the problems, then that firm will need to build such capability or look outside for external help.

Financial reporting

Many firms still continue to provide their partners and other fee earners with over complicated and lengthy financial reports, which contain just ‘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.

On the other hand, throwing financial reports at partners (even clear and informative reports) is unlikely to be an effective way of improving performance (especially financial performance) if there is no explanation of what the reports mean and no indication of what people are supposed to do with them.

There needs to be more emphasis placed on financial education and training for people at all levels in firms, to help them to better manage all aspects of their financial performance, and as a consequence improve a firm’s overall financial results.

3. Financial education

Recently a fee earner in a law firm said to me

“I don’t have a clue about the financial reports I receive!”

At every level in law firms, sometimes from very senior partners to trainees and newly qualified lawyers, there is a lack of understanding about basic financial matters.

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 knowledge 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 evaluate financial reports and to know what to do to enhance financial performance?

Financial skills and knowledge in a law firm can often be assessed by the ability of partners and other fee earners to answer questions such as some of these set out below:

- *How can I improve profitability?*
- *How can I grow revenue?*
- *How can I price my work profitably?*
- *How do I control overheads?*
- *How should I manage working capital*
- *Why should I fully record matter-related hours?*
- *What are the key performance indicators I need, to most effectively manage my practice*
- *What are the financial ‘benchmarks’ I should be working to?*
- *How do I know if my clients are profitable?*
- *Do we know how much profit / loss our part of the firm is making?*
- *Is our part of the firm generating good cash flow or is it soaking up cash?*
- *Which ‘financial levers’ do I need to operate, to achieve any desired result?*

Whilst these and other questions are often heard being asked in law firms, satisfactory answers are often not provided and it would seem that few firms tailor internal programmes designed to educate partners and other fee earners to understand the financial dynamics of their firms.

In order to obtain buy-in to a financial education programme, it is vital to involve in its design and implementation everyone who is likely to be affected, including partners and other fee earners as well as the finance professionals in the firm. Above all, it is usually sensible to ensure that a managing partner and other senior persons in the firm who have 'clout', agree to 'sponsor' and put their full weight and authority behind a programme.

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. Programmes to enhance financial performance can take a number of forms and should always be tailored to the needs of a firm. For example:

- in the case of partners who are managing departments or groups within a firm, coaching either in small groups or on a one to one basis is likely to be most effective;
- on the other hand, for partners and fee earners at other levels, courses designed to meet their needs and the needs of the firm may be the most effective means to enhance their understanding of how the firm should be run and to improve their financial management skills.

Whatever type of programme or forum is chosen, it is important to ensure that each programme is user friendly and will relate to each participant's daily work so that the knowledge and skills obtained can then be put to immediate and 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 now compliance risks.

Every firm will have its own perceptions of its needs and where the hurdles in the way of financial efficiency lie and will therefore wish to tailor its education programme to deal with these. This is the crucial stage at which, as already emphasised, input from those at all levels within a firm will be required if financial education is to be converted into measurable gains.

4. Take control of your cash management

As always, cash is king.

Partners in many firms probably have far too much capital tied up in their firms (or are now being asked to inject even more) and which would not be needed if cash management was being driven as it should be.

What is your firm's working capital requirement?

Firms need to calculate their working capital requirement (given the nature of their business), based on the amount needed to finance 'best practice levels' of work in progress, debtors and unbilled and unpaid disbursements, and develop a plan to achieve that target.

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 new Code as a possible indicator of serious financial difficulty which might require 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?

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

Are we able to repay capital to partners when they retire?

What is our debt / equity ratio?

Analysis of every part of a firm as earlier described will reveal where the cash blockages exist and where some decisive actions will require to be taken.

Given that the purpose of cash management is to generate cash, then firms can take control of the process and implement cash generation plans built around realistic and achievable cash collection targets for groups / partners. Such targets can be realistically based on levels of aged debtors and aged work in progress (the billing of which will be needed to feed debtors) and can be linked to distributions of profit (or payments of drawings) to partners. This will begin to test the partners' 'hunger'. However, such cash collection targets will have no credibility and will not work unless the targets themselves are seen to be reasonable and achievable.

5. Make higher profitability your strategic aim

Turn your strategic planning process on its head and consider the following as an objective:

'Next year ***we are going to*** *achieve PEP of £[ ]';* and

'Every decision we make will be considered and judged in the light of how and whether it assists / detracts from achieving the above objective"

This bottom line driven approach to strategic planning will bring into clear focus the plans (or lack of plans) of each part of a firm and will provide a much needed financial benchmark for testing strategic initiatives.

To counter arguments that this is too 'short term-ist', longer term development plans can be built into the approach.

6. Drive up revenue

How can a firm build the 'top line' to generate substantially more profit?
One way of course is to win more business (and in particular more profitable business), whether from existing or new clients, using existing resources and within the parameters of existing overhead levels. However, a new, 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.

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

- price work;
- record matter-related time; and
- realise (recover) work in progress.

7. Price your work for profit

It is often forgotten that pricing is one of the most fundamental elements of profitability.

Pricing needs to be controlled at the very outset of every matter. In difficult economic times where levels of instructions may be light, work in some firms seems to be taken on at prices which can never make a profit (or worse, can only lose money). There often appear to be no effective controls over partners and fee earners taking on work at prices which bear no relationship to the cost of doing the work and the need to make a healthy profit margin. Work sometimes seems to be taken on just to stay busy without regard to the financial consequences. This is why the *full* 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 or method of pricing for that job?

To what extent do firms analyse their markets to discover market rates for particular types of work to help them to charge the best price the market is prepared to pay?

Who should decide on pricing?

Firms need to lay down pricing parameters within which partners are permitted some freedom to operate; outside of those parameters they should obtain approval of management. In the case of high value or high risk matters, the approval of a managing partner or a group of senior partners should be sought, not only for pricing purposes but equally as importantly, to manage risks.

Education of partners to help them to understand the beneficial financial consequences of just very small incremental pricing improvements is sometimes necessary before they will 'price for profit'.

Even more necessary can sometimes be coaching of partners to assist them to become confident enough to speak to clients about financial matters. Embarrassment about discussing 'money' with clients is still possibly one of the largest hurdles to overcome in many firms if profitability is to be improved.

8. Capture more time

Matter-related hours X charge out rates = input

Input is one of the most basic pieces of financial information required to drive sound financial management and improve profitability.

For example:

'How can we see on a [weekly] basis whether we are 'on budget' as far as input is concerned?

Is the trend line shown by our input going up, going down or is it flat?

How can we have a realistic budget based on a certain number of matter-related hours being recorded per annum by each fee earner or accurately analyse our financial position, when parts of the firm do not see the need to time record?

How can we tell whether our people are sufficiently busy or are overworked?

How can we effectively plan billing and cash flow if we do not have honest and accurate work in progress figures?

Whilst matter-related time should be regarded as only one component in arriving at what is the 'right price' for a job, it is however also an important risk management tool because without recorded matter-related time and accompanying descriptions of work carried out, firms may have very little evidence of what work has been done on a matter.

Some lawyers as well as whole departments in some firms, try to say that time recording is not relevant to their particular work. Recording matter-related hours is a management tool and as such is relevant to **every part of a firm**, but this message is lost on some.

Here are a few suggestions which may help:

- Have an automatic email appear every morning as fee earners log on asking them if they have fully recorded their time from the previous day, or even better, do as some firms do and not permit partners and fee earners to log on unless they have already recorded yesterday’s time!

- Put in place **daily** matter-related hours targets for all fee earners based upon their budgeted hours which are then closely monitored on a weekly basis and are followed by discussions with every partner and fee earner who falls short of target.

- Consider whether so-called “non chargeable codes” are really necessary other than for those who have specific functions to carry out. Non chargeable codes can be a dustbin – if removed, people will have nowhere to hide and matter related time (and profitability) is likely to increase!

  The usual arguments put forward for recording ‘non chargeable time’ are that

  “We need to know how are people are spending their time!”

  Why? Surely it is ‘effective outcomes’ which matter, not inputs.

  Another justification often put forward for the practice is that

  “We want all our people do business development!”

  Again, effective business development can really only be measured by ‘outcomes’ and not by inputs.

How much more profit would your firm make if every fee earner recorded and recovered say, an additional three or four units per day? The amount of additional profit is likely to surprise you and will show you just how much profit you may have been losing over the years.

9. Improve the realisation (recovery) rate

The action which can have the greatest impact on profitability and which often requires the least work and effort is to improve the rate at which you realise (recover) recorded work in progress when a matter is billed. This will require a plan to be implemented to manage the writing off of work in progress, both during the course of work and on billing. Of course, a firm will not be able to accurately or meaningfully calculate its realisation (recovery) rate unless there has first been full capture of matter-related time.

To see the potential impact this can have on profitability, you should ask yourself what a 1% / 5% / 10% improvement on your realisation (recovery) rate would mean for your bottom line.

To improve the realisation (recovery) rate, usually requires firms put in place an effective write off policy. For example, no writing off of work in progress outside of certain parameters should be made without the managing partner's (or equivalent's) written approval. However, partners then begin to 'play the system' by only recording matter-related time which they know for certain they will be able to bill. Accordingly more effort will then need to be put into capturing time! It can sometimes feel as though it is an uphill struggle but with enough determination success can be achieved!

10. 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 somewhere within a firm there will be existing capacity to do the work. 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 lean’?

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 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 firm.

If a firm has during the past few years already taken hard decisions as to overheads so that it is already ‘lean’ and if that level of overheads can be kept constant for the reasonably foreseeable future, then all additional turnover, generated in ways such as are set out above, should be profit.

Finally, get your partners into shape

None of the above basic disciplines will be capable of being implemented unless a firm first gets its partners into shape.

If progress is to be made in relation to financial performance, then firms will need to adopt a more positive and open-minded approach, learning from how other, perhaps more 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…..”).* This approach will bring to the surface many of the underlying hurdles to change which may be preventing a firm from making a great deal more of itself. The crucial question which needs to be asked is:

“Are our partners prepared to be managed?”

If this is an issue in a firm, there is likely to be very little progress made towards resolving that issue unless a firm is prepared to face up to it and to deal with it effectively.

Equally, in terms of regulatory compliance, the jobs of the COLP and the COFA will not be capable of being effectively carried out unless partners accept the need to be accountable and 'zero tolerance' in relation to compliance obligations is applied and accepted.