Taking control of the finances

Where media league tables categorise firms by profit and loss, it is hardly surprising that law firms can obsess over their latest figures. But only by getting the core management and partner behaviours right, will firms really enjoy financial success. By Peter Scott

Managing the financial well-being of a law firm tends to be not so much about figures, but more about managing people to get the best out of them.

For law firms, in the environment in which they now and will in the future have to exist, this becomes ever more critical.

The manner in which partners manage the financial aspects of their practices tends to be a reflection of how they operate generally as partners. On closer examination, partners' financial management is often likely to reveal more fundamental underperformance problems, because financial results are merely the tip of an iceberg – the part that can be seen, in contrast to the underlying causes of such results. Deal effectively with these underlying issues and financial performance will tend to look after itself.

Firms must decipher the core issues, agree how they should be tackled and by whom, and every law firm needs to take control of how it manages its finances.

Those who manage law firms will often say it is an uphill struggle to persuade partners to behave in a manner conducive to achieving good financial results. Crack this problem and many things will fall into place.

How many managing partners, when struggling to bring financial discipline to a partnership, have been firmly told: "You can't tell me to do that – I own this firm as muchas you do."

That being the case, financial management of a law firm tends not to be about 'telling' partners what to do, but more about 'taking them with you', by showing them that better results can be achieved by behaving and doing things differently.

To achieve this requires a fundamental shift in behaviour on the part of some partners.

At the outset, focus on obtaining buy-in to 'partner accountability', ideally evidenced by a written undertaking to be given by each partner, whereby each undertakes to support in the fullest way possible:

* Those mandated with the onerous task of managing the firm;

* Other partners in the firm as they endeavour to carry out their respective roles in the firm;

* The implementation of all decisions made by the partnership.

Achieve this and many more decisions are likely to be implemented with beneficial results. I suggest obtaining a written undertaking because not only will it focus the mind but also lawyers tend to have greater respect for the written word. If, when presented with the above, which I regard as a very reasonable undertaking from a partner, an individual refuses to sign, then a different conversation may need to take place.

We also need to consider who should be responsible for financial management? The answer many will give is 'the finance director', but while there are many excellent

finance directors in law firms, experience tends to show that a finance director cannot do it alone; he or she will need to be part of a larger team.
Others would advocate with some justification, that financial management should be a primary role of a managing partner. It is for this reason that a managing partner not only needs people and communication skills, but also a strong financial understanding of the business.

Depending upon the size and nature of a firm, financial management may need to be delegated down to those managing various groups in the firm who together may make up a core management team. However, with delegation comes responsibility and those appointed to manage need to accept that responsibility and accountability for the financial results of their groups. Unless responsibility for financial performance is pushed down in a corporate manner to 'line managers', it is unlikely that a managing partner and finance director alone can succeed in their tasks.

Some firms delegate down even further, making each individual lawyer (whether partner or not) responsible for the financial management of their work. It is often said that it is important to do this so that younger lawyers gain experience in financial management. In practice, however, what often happens is that partners will abdicate their financial-management responsibilities to assistants instead of managing their teams as they should themselves.

If a firm is to be successful financially, then it needs to be actively managed by those most capable of doing so, and individual partners should not be left to financially manage their practices on their own. They need to be helped, directed and cajoled. Additionally, some areas of financial management may need to be taken out of their hands entirely if desired results are to be achieved.

Active financial management may also require that sanctions are agreed for non performance. Sanctions are increasingly being seen, even in a strong partnership culture, to be necessary to ensure partners do what they are paid to do. As a managing partner I was only given formal authority to do one thing – to stop a partner's monthly drawings if it was shown that a partner had processed a bill, but had not delivered it to the client within a reasonable period. Apparently in many firms this was and still is a problem.

Within a few months of being given that authority I had to stop a partner's drawings. The deal I agreed was that as soon as the bill was paid he would get his drawings – the bill was delivered and payment was received within seven days. Sanctions that hit the pocket can work well – unless your partners have become too financially comfortable.

Before leaving the discussion as to who should deal with financial management, it is worth mentioning another technique to achieve results – the task force.

When it comes to 'making it happen' it is important to harness the power of the team. Having a loyal and able team to handle the implementation of changes regarding how a firm is financially managed, can mean the difference between success and failure. Some firms adopt the 'task force' approach, putting together a hand-picked team, under a strong and purposeful leader, which is given the mandate to 'go do'. If a task force, supported by a groundswell of opinion across a firm, goes about its job with vigour and an almost ruthless missionary zeal, then in relation to achieving financial results, such a task force can be highly successful. However, it will need to be ruthless in order to overcome reactionary internal forces holding back a firm, using language such as: "This train is about to leave the station, but you still have a chance to jump aboard." The choice for a partner is clear – jump aboard or be left behind.

Turning to how 'getting the best out of people' can be applied to improving financial results, we need firstly to look at cash management, because 'cash is king', and then we will look at profitability issues. There is, however, one discipline that is crucial to both – the need for clear financial reporting.

Too many firms are guilty of what I call 'financial information overload'. Some finance directors produce spreadsheets that make partners' eyes glaze over with the result that reports get binned. What is required is clear information to enable every part of a firm to be 'best managed', highlighting critical areas of performance, actions that need to be taken and the degree of urgency required. Anything more is overkill and becomes counter productive. Above all, keep it simple.

Cash management

Cash management, to accelerate cash flow, reduce debt and partner investment, and to put cash more quickly into the pockets of partners or for investment, is fundamental to building a law firm.

In order to decide what actions may need to be taken to accelerate cash flow, it is critical to first carry out a detailed analysis of a firm's work and business. The results of such analysis will dictate the steps that will need to be taken to resolve issues that the analysis will have revealed. This may lead, for example, to the conclusion that part of the business, however seemingly profitable, should be dropped because it will always be a severe drain on cash.

Central to cash management should be the development of a 'cash generation plan', to focus (in order of priority) on:

* Partner accountability (as discussed earlier);
* Forward cash-position goals;
* Billing targets by partner/group;
* Cash-collection targets by partner/group.

A simple cash-generation plan can be developed as follows:

* Set a minimum acceptable cash balance for your firm at the bank;
* Each month on a rolling basis calculate the cash needed to cover all outgoings for the next three months (including partners' drawings and distributions);
* Calculate and broadcast weekly cash-collection targets for the firm, divided between each group/individual based upon aged debtors and work in progress. Leaving this for periods of longer than a week risks losing control of the cash-collection process;
* Report and publish weekly on cash collection;
* Plan billing targets to generate cash to meet major outgoings;
* Recognise the consequences of deviations – for example, +/- £50k per week = +/- £650k per quarter;
* Make payments to partners dependent on cash collection. This can be linked to overall collections or to individual/group collections. More firms are using this sanction to action partners to collect cash owing;
* Publish 'lock-up' tables to 'name and shame' those who are not performing. Peer pressure can be a powerful weapon.

A cash-generation plan needs to be supported by sufficient back-up resource to ensure that partners are provided with the information and help they need to perform, so the absence of such resource cannot be used as an excuse. Employing 'revenue managers' within a firm (if the firm is large enough, at least one for each group in the firm) to drive billing and cash collection, working side by side with partners, can work well. Revenue managers look after both work in progress (WIP) and debtors, and should ideally report (and be seen to report) directly to the managing partner. And they need to be given authority to work effectively.

Ultimately, if partners do not respond to the help and resource provided, then there is always the 'star chamber' approach used by many firms to good effect whereby partners are required individually to account for their lack of financial management.

Whatever techniques are used to accelerate cash flow, it is important to provide partners with realistic and achievable targets, otherwise it will be difficult to subsequently criticise and/or impose sanctions for failure to perform.

Before leaving cash management there is one matter to keep in mind – partners' capital should not be used to subsidise financial underperformance.

It is dangerous to regard the level of partners' equity capital as insufficient for working-capital purposes, unless and until a cash-generation plan can realistically extract no further cash from the system. Until then, a firm should work at running its business on the minimum amount of working capital prudently required. The most efficient firms are constantly reducing their lock-up days by robustly taking control of their internal processes to manage down their WIP and debtors. To do otherwise is merely to provide free credit to clients. And we must not forget that lock up is also a risk issue.

Improving profitability

Flabby firms are failing to drive up revenue and drive down costs. Margins are being squeezed. As when trying to accelerate cash flow, improving profitability is about working smarter – not harder. Again, analysis of the business, as with cash management, is key to success, focusing in particular on:

* Work types;
* Client types;
* Leverage/delegation;
* Pricing;
* Chargeable hours;
* Recovery rate;
* Overheads.

I put overheads last, not because they are unimportant, but because a firm's major outgoings are often not possible to reduce quickly. On the other hand, focusing on the other profitability factors to build the top line can improve profitability to a greater extent and more quickly.

Such analysis can reveal a great deal about a firm. For example, do you know how much profit each part of your firm is making or how much it is losing? You need to know this if you are to make sensible decisions about the future of the firm.

Do you know how much of your turnover and profit/loss is represented by the bottom ten or 20 per cent of your clients (by billings).Take the case of the firm I came across where the bottom 50 per cent of its clients (by billings) represented just six per cent of turnover. A large percentage of that firm's resource was being devoted to generating just six per cent of revenue. Half of the firm's clients were generating a substantial loss for the firm.

Just as pricing is a key factor, so is capturing chargeable time in a business that is time based. Firms admit to losing large amounts of profit by a mix of under-recording of time and over manning. If someone is in the office for between eight and ten hours each day, but they are only recording five hours of chargeable time, what are they doing for the rest of the time?

The answer often lies hidden in non-chargeable time codes, which are often dustbins to pad out the day, unless of course someone actually has real non-chargeable duties to perform, to which discounts against chargeable hours targets can be given. Why have non-chargeable codes? Do away with them and there is then nowhere to hide.

And then there is writing off chargeable time when billing a matter – expressed as the amount recovered as a percentage of time recorded – the recovery rate.

This is likely to be the single most important factor affecting profitability in many firms. Take a firm with recorded chargeable hours of £10m pa. Just five per cent of that, if written off, will amount to £500,000. More likely, the write-off will be ten per cent or more. What is required is a write-off policy with teeth.

How much does your firm write off?

Try this simple exercise in your firm:

* If you were to increase your charge-out rates by say just £10 per hour across the firm (probably an imperceptible increase); and
* Each fee earner recorded and recovered an additional 30 minutes chargeable time per day (most people 'lose' that amount by forgetting what they have been doing); and
* You were to halve the amount of recorded time you write off…
* How much more profit would you make?

Even if you were only able to see your way to partly achieving some of these objectives, you may still be shocked as to how much profit you have been throwing away.

In an article of this length it is only possible to scratch the surface of many of these issues, all of which justify more detailed examination if you are to build a more cash-generative and profitable firm.

However, while the above are easy to advocate, they can be very difficult to achieve in practice, unless accountability on the part of partners is accepted – and that will involve financial discipline and a willingness to be managed.

Above all, to succeed will require strong leadership on the part of those running a firm involving:

* Determination and courage to challenge accepted ways of doing things;
* Ability to find solutions to a firm's financial problems;
* Communication of those solutions to partners in a way that will inspire them to comply;
* Taking control of the internal processes involved to achieve desired objectives.

These are just some of the challenges for the leaders of today's law firm.

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