PETER SCOTT CONSULTING

Briefing Note July 2012

Take control of your cash flow

The recent news that another large law firm has been forced into insolvency reflects the fragility of the financial situation in which many firms now find themselves as a consequence of the impact of funding shortages on a legal sector which has mainly been built on borrowed money, and where financial management is too often weak and not up to the task in hand. The insolvency of a large firm grabs the headlines, but it is happening to firms of all types and sizes across the spectrum of the legal sector. The trend of law firms failing is likely to accelerate unless those responsible for managing their firms take control of their cash management to meet working capital needs.

In many cases, not only have firms used borrowed money to finance their working capital but to add to the potential fragility of their financial situation, their partners have also borrowed 100% of their capital to invest in their firms. This worked for firms in the good times. However this financing model, faced with a recession where there is less work and clients take longer to pay their bills, the ready supply of easy and cheap credit being cut off and weak internal management of financial performance, has been brought to a painful and abrupt end.

There is now a need to build real capital in law firms to replace the shaky foundations of borrowed money. This is likely to be achieved by a combination of several measures, including the retention of profits, reduction of debt being carried, more stable longer term funding for working capital and stronger internal management of financial performance. It is the last of these elements which is the subject of this Briefing Note because, from observation of law firms over many years, it is clear that in many cases firms are still not optimising their cash generation.

Change the culture

There needs to be built into a firm an enthusiasm to embrace change if cash flow is to be maximised. 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 with achieving the firm’s objectives. Outstanding financial performance requires a

continuous investment in people, services and resources if attitudes are to change and new working practices (often using new technology) are to be implemented in order to re-engineer the way working capital is managed. However, innovation is not just about technology – it is often about doing a few simple things better.

Financial results should be seen as the consequence of how people in the business are being managed. Financial performance should not be seen 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.

Every lawyer should have a greater part to play in better financially managing clients, colleagues and themselves. In particular, managing partners 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"*

Some firms which have been particularly successful at cash management, from the outset embarked on major initiatives to raise the awareness of partners and other fee earners of the importance on the part of individuals to follow 'best practice' financial disciplines related to cash management. Firms have launched extensive education programmes in an effort to help partners and fee earners develop a keen culture of financial awareness relating to providing credit to clients and re-educate those in the business as to what is required to maximise cash flow.

Education as to ***'why'*** best practice financial disciplines should be followed is often one of the key elements in successfully implementing more effective cash management.

Invest in high quality financial expertise

A recession and the credit crunch have thrown the spotlight on those who are supposedly managing the finances of their law firms and shown that many are not of sufficient calibre. The quality of the financial management in many law firms must be improved if more firms are not to find themselves in financial difficulties. Investing in the best possible financial management resource is a necessity. If firms are not able to afford the best then they need to be considering other ways to provide what is needed, including possible outsourcing of the function or consolidation between firms to enable them to afford the higher standard of

financial management expertise necessary to now meet the greater financial challenges firms face.

In many of those law firms which already have high quality financial resource available to them, initiatives have been taken by those responsible for the financial function to successfully drive cash management to new levels. For example, some of the procedures and systems firms and their finance professionals have introduced include:

- Establishing financially prudent policies (for example in relation to profit distribution) so that firms only commit to borrow for purposes of investment rather than consumption;
- Appointing experienced receivables managers to drive the credit control focus;
- Having centralised credit control teams, to build relationships with all a firm's clients – independent of partner relationships – and to take primary responsibility for the collection of all bills;
- Developing sophisticated credit control software to build credit profiles for clients and more effectively manage debtor levels;
- Putting in place regular WIP reviews, combined with WIP targets and the establishing of a culture of monthly / interim billing;
- Introducing agreed automated credit control procedures involving staged reminders and telephone chasers;
- Putting in place intranet - based reporting systems highlighting problem WIP and debtors, internal credit ratings and high risk clients.

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, including financial stability. Without accurate measurement no valid analysis of financial performance 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, in relation to cash management:

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

How much less working capital would we need if we did a few simple things better?

Do we know which parts of our firm generate good cash flow / soak up cash?

If not, how should we go about measuring the cash generation of each part of our firm?

Which partners / groups are consistently carrying the most 'lock up' (WIP, disbursements and debtors)?

Will we be able to keep within our banking arrangements and not breach our bank covenants?

Will we be able to pay the July / January tax bill?

Will we be able to make profit distributions to partners from last year's profits?

Will we be able to repay our retiring partners their capital when due?

Is a cash call on partners likely to be required shortly?

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

Financial reports are a vital part of having effective systems and controls in place to help drive cash flow.

"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

How 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 are a *“burden not a benefit”* and come to be regarded by partners as useless, are ignored and more often than not, are ‘binned’.

A firm can test the effectiveness of each of its financial reports 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 should we now produce to more effectively manage our cash flow?

‘Financial information overload’ is a hurdle to improving cash flow. 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 better cash management.

Put in place a cash generation plan

If generating cash is to be improved, then developing a cash generation plan can be a useful tool to focus on the hurdles which are often put in the way of effective cash management.

For example:

1. Partner accountability.

How partners financially manage their practices tends to be a reflection of how they behave and perform generally as partners. On close examination, a partner’s financial management will often reveal more fundamental issues of behaviour, attitude and inability to manage client relationships, because financial performance is just the tip of the iceberg – it is the underlying causes that need to be tackled.

Improving cash management in a law firm tends not to be so much about ‘telling’ partners what to do, but more about *‘taking them with you’*, often by showing them that there is

another, better and more innovative (but simple) way of doing things. However, to get all partners going in the same direction may require fundamental shifts in behaviour on the part of some.

At the outset, try to focus on obtaining buy-in to the idea of ‘partner accountability’ evidenced if possible by each partner undertaking in writing **to support**:

- The implementation of all decisions made by the partnership in relation to financial management;
- Those managing the finances of the firm; and
- All other partners in the firm (mutual support is the essence of partnership);

If a firm can achieve this then more decisions are likely to be capable of being implemented. If anyone refuses to go along with this, then a different conversation may need to take place. Indeed, the necessity of taking cash management to a higher level can itself be used as the catalyst for the issue of *who really runs the firm* and whether partners are, when it comes to the crunch, prepared to be managed.

2. 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 partners’ drawings and distributions);
3. Providing realistic WIP / billing targets by partner/group based on aged work in progress and planned to generate cash to meet future major outgoings;
4. Reporting weekly on cash collection and educating partners to understand the consequences of small deviations – for example, +/- £10k per week = +/- £130k per quarter. Leaving the monitoring of cash for periods of longer than a day risks losing control of the cash - collection process.
5. Agreeing cash-collection targets by partner/group, based upon aged debtors which are seen by partners to be reasonable and achievable and are broadcast weekly.
6. Make payments to partners dependent on meeting cash collection targets. Weekly reports to partners of performance against targets should raise real – time awareness of how a firm is performing amongst the partner community 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 a sanctions policy for unpaid debtors which penalises partners through their drawings has been a particularly successful tool in reducing debtor days.

7. 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.

The compliance aspect

Prudent cash management is something every law firm should be doing as a matter of course – it should be obvious and just common sense that a business will fail if the cash runs out. However, we have now reached the point where the profession's regulator considers it necessary to impose cash flow disciplines on law firms. Only those who are not driving their cash flow as they should ought to have anything to fear from this.

Following the introduction of Outcomes Focused Regulation on 6 October 2011, financial management is made a specific compliance obligation by virtue of the following provisions of the Code of Conduct.

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

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 (10.1) – 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.

Law firms have now been put on notice not only by a tough economic outlook but also by their regulator that managing cash flow needs to be a priority. Law firms should heed the well-known words of Jack Welch

"Change before you have to"

If they do not then we are likely to see more law firm failures.

©PETER SCOTT CONSULTING 2012