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Keeping watch: why sound financial management remains a priority

Predictions of a better economic outlook should not stop firms designing and implementing rigorous accounting and management systems, says **Tony Harvey**

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In December 2012, against the backdrop of the new regulatory regime based on outcomes focused risk-based regulation, the Solicitors Regulation Authority published its Regulatory Risk Framework together with a Regulatory Risk Index categorising the risks to the SRA's regulatory objectives. These included, in particular, protecting the public interest and clients of legal services. This was followed, in July 2013 by the SRA's first - to become annual - Risk Outlook, assessing the most significant current, emerging and potential risks that law firms will have to manage.

Key to those current risks is financial difficulty. Law firm financial stability has perhaps never before been such a topical issue, with many high-profile failures driven by unprecedented economic and commercial pressures causing shockwaves on both primary lenders and secondary lenders, and insurers.

> **"In the struggle for survival many firms may justify questionable financial behaviours, convincing themselves that they are short term exigencies**

By autumn 2013, the SRA had contacted over 2,000 firms asking for key financial information and set up a dedicated web-page for firms setting out good and bad behaviours (an addition to Chapter 7 of the Handbook on-line). The regulator published its findings in November 2013 in Navigating Stormy Seas: financial difficulty in law firms. Its analysis indicated that five per cent of firms in the survey present a high risk of financial instability, 50 per cent were low risk, and the remainder fell somewhere between the two. It is important that COLPs and COFAs are aware of these SRA initiatives.

Management weaknesses

The SRA believes that financial difficulty presents the most significant current risk. More generically, using features identified by John Argenti in "Corporate Planning and Corporate Collapse" (Long Range Planning, Vol.9, Issue 6 (1976)), key "at risk" characteristics include weaknesses in management, accounting and change handling.

Management weaknesses found in recent law firm failures range from unfocused, unstructured or inexperienced management and governance systems to rigid management with extreme 'command and control' - where power is concentrated in the hands of an unaccountable few and key financial information is not shared. Poor management expertise at owner, director and manager level – with a lack of transparent, reported management information – is also identified as an indicator of potential financial instability.

Accounting weaknesses can arise from poor

systems and lack of sound financial management. Systemic failures range from a lack of financial planning and forecasting, with poor updating on income and overheads, to a failure to control debtors. The danger signs are obvious: in the struggle for survival many firms may justify questionable financial behaviours, convincing themselves that they are short term exigencies. These include borrowing to pay VAT, ever escalating, professional indemnity premiums, even salaries. Failure to make provision for, or delaying payments of, VAT or PAYE or using VAT as cash revenue are signs of distress. Overdrawing is also a problem. Drawings are frequently based on over-optimistic revenue and profit expectations, often well in excess of net profit or real cash collection. Perhaps, at the most heinous end of the scale is client account abuse. The deep dive into client account to prop up office account is an obvious temptation in hard times. Drawing up ghost bills to allow transfers from client to office account and even double set accounting (one for the firm and one for HMRC and the regulator) are all extreme examples.

Failures in cash flow intelligence, such as forecasting, budgetary and costs control and understanding and controlling WIP, are a frequent cause of financial trauma. As are over commitment to high fixed costs, such as expensive premises, and paying for unviable expenses – like partners' cars.

Viability risk

The SRA has also identified poor change handling and change management as an issue. The legal services market is changing and this is unavoidable. With the introduction of alternative business structures and virtual firms the traditional law firm business model is being challenged. It is a surprising statistic that of the 11,000 law firms authorised by the SRA, 57 per cent are sole practitioners or traditional (non-LLP) partnerships. A frequent and long-standing problem for the financial stability of many law firms is a simple inability to understand the profit generated by different types of work. Firms hold on to work – often unsure whether the work makes a profit at all. This reluctance to analyse profitability for different work types and let go of unprofitable (particularly long standing) work presents a real challenge. It amounts to poor change handling.

Clearly, the risk of insolvency can be assessed on the basis of the usual 'light at the end of the tunnel' tests, but what of non-insolvency events? These can include anything that puts the viability of the practice at risk, such as the loss of a major client or work type or fee earner or team, not having cash to meet liabilities as they fall due, a major creditor petition or any other material risk to continuing to trade.

I asked the SRA what this meant in terms of a COLP and COFA report, and its answer was that missing an HMRC payment, entering a 'time to pay' arrangement, short-term borrowing to pay day to day operational costs and exceeding the bank overdraft limit or breaching bank covenants are all reportable events.

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Searching questions

It is clear that appropriate financial awareness at director, owner and manager level is key to success, as is a high-quality finance director (or equivalent). Appreciation of business context is also important. Ask some searching questions: What is your business model? Do you understand the profit generated by your different work types? Should you dump unprofitable work types? Have you critically assessed your market and market changes?

Management transparency is important if a business is to thrive. Information on all financial matters should be shared with partners and managers. Firms should ensure that they do not suffer from an over-dominant individual (e.g. senior partner or chief executive) and, fundamentally, the firm must have appropriate and robust financial management information and systems. To this end, forecasting of income and overheads must be regularly reviewed. Cash flow control is, of course, crucial to good accounting behaviours. Sound and detailed forecasting is important to ensuring that the pinch points in cash flow (VAT, tax, rent) do not come as a surprise. This is not just a problem for small firms – many large firms and companies run out of cash because of poor cash flow analysis.

Drawings should be carefully controlled and restricted only within net profit and cash collected thresholds. Active control of debtors, at the start of the relationship, during the relationship and at the end of it is extremely important in troubled times when, all too frequently, a debt due to the firm becomes an uncollectable bad debt. Perhaps strategies to reward cash collected not time recorded or billed will assist with financial stability as will the careful control and regular billing of WIP.

The SRA is particularly keen to see honest engagement with external stakeholders. Engage with your bank, HMRC, first and second tier lenders, landlords (Cobbetts' failure left total unsecured debts of more than £91m, more than £75m of which was owed to landlords), insurers and regulators. And do this early. Delaying engagement with or actively misleading stakeholders is a sure sign of 'head in the sand' or over-optimistic management failure.

Finally, financial instability can arise from poor succession planning where firms are simply not able to recover from the unplanned withdrawal of key people. It is food for thought that 85 per cent of firms have less than four partners with an average age of 59.

Planning for the upturn

There is some good news. The UK legal services market is estimated to be worth between £27 and £29bn annually. Growth forecasts are becoming healthier and there is growing business confidence. Huge sums sit on corporate balance sheets ready to be invested and we are seeing higher transaction volume in the housing market.

But the predictions in some quarters of a 3 per cent growth for the UK economy in 2014 comes with a health warning – many businesses fail on the economic upswing. While they have been fire-fighting during the recession they may have lost key staff and skills and unplanned for growth can stress the resources of the firm. Many fail in the recovery phase because they expand too rapidly and simply run out of cash. Insolvency practitioners advise that firms should audit their key staff resources and measure new matter starts - per fee earner, per department - daily or monthly to assess the trend.

Plan for growth sensibly, revisit your financial management, risk register and business model and engage honestly with stakeholders, including regulators, and, perhaps, you can look forward to a more stable future and continue to serve clients' interests through a share of one of the biggest markets in the UK. **SJ**

Strategies to reward cash collected not time recorded or billed will assist with financial stability