Financial stability for law firms

What are the signs?
Strategy and planning
Cashflow, profitability and financial reviews
Is incorporation the way to go?
Considering a merger?

A White Paper

A Member of MHA

Broomfield Alexander professional advisors

About Seamus

Seamus Gates has over 25 years experience as a chartered accountant and has been a Director at Broomfield & Alexander since 2000.

Seamus heads up the firm's Professional Practices service and has developed a designated team to deliver a high quality service to legal practices.

Seamus is part of the Professional Practices team at MHA, an association of nine independent accountancy firms across the UK who collectively look after over 150 legal firms and over 500 partners.

About MHA

MHA is a UK wide association of progressive and respected accountancy and business advisory firms.

Each MHA firm offers a broad range of services including accountancy, tax and corporate finance as well as sector specialisms.

- 45 nationwide offices
- National access, local insight
- Combined turnover of £102m
- 150 legal firm clients
- 500 individual partner clients
- Award winning teams

Why 'financial stability' is the number one priority for law firms

There has perhaps never been a more challenging era for law firms to be operating in, and yet one with so many opportunities for legal businesses to flourish.

If you survey the UK legal sector, there are some excellent examples of law firms mixing strong financial management with innovation and creativity to build successful businesses, many of them benefiting from the external investment that the Legal Services Act has allowed. These are the ones that planned early and got their house in order at the beginning.

There are also many firms heading for potential oblivion, having responded too slowly to the monumental changes that have taken place in the legal sector over the last few years. These firms have limited options for securing their financial future and for many it will already be too late.

There are many more legal practices caught somewhere in the middle of these two ends of the spectrum, still adapting to the changes and trying to chart their path to financial stability.

That is the purpose of this series of articles – to look at how law firms can put themselves on a firmer financial footing, something the SRA believes should be the main priority of all law firms at this moment in time.

Hopefully, this series of articles will provide a useful overview of how this can be achieved and some thoughts on what your firm's next steps should be.

Please don't hesitate to contact me if you would like to discuss any of these issues in more detail.

Best regards,

Seamus Gates
Seamus.gates@broomfield.co.uk

Financial stability for law firms:

What are the warning signs?

A constantly evolving legal services sector, combined with tough economic conditions paints an unsettling picture for many practices.

The gravity of the situation is underscored by the SRA's confirmation that it has placed 160 firms under intensive supervision, following concerns about their financial positions.

Against this backdrop of uncertainty, it has never been more important to be aware of the financial danger signs, while recognising the importance of sound financial governance, strong cash management and effective business strategy.

Many law firms run their finances effectively, but the SRA believes some are still too focused on work volume rather than profitability.

The good, the bad, and the best way forward

The number of different business models means the way firms handle their finances will vary enormously.

Poor behaviours

• Amounts of drawings exceeding net profit levels.
• High borrowing to net asset ratios.
• Increasing indebtedness by maintaining drawings levels.
• Firms controlled by an 'inner circle' of senior management.
• Key financial information not shared with 'rank and file' partners.
• Payments made to partners irrespective of cash in the bank and all net profits drawn, with no 'reserve capital pot'.
• Short-term borrowings to fund partners' tax bills and VAT receipts used as 'cash received', resulting in further borrowings to fund VAT due to HMRC.

Good behaviours

• All partners regularly receive full financial information including office account bank balances.
• Drawings are linked to cash collection targets and do not exceed net profits.
• Provision is made to fund partners' tax from income received.
• A capital element is retained from profit, and a capital reserve account built up.
• Premises costs are contained.
• Profitability levels are tested and unprofitable work is dropped.

However, the basics of solid financial management remain the same and the SRA's Risk Index sets out lists of good behaviours to aim for and poor ones to avoid.

How Lexcel drives better financial management

If your practice is struggling with financial management, you may want to consider accreditation – the Law Society's practice management standard – which can strengthen your firm's finances in a number of ways.

The process of gaining the accreditation in itself means firms become more profit conscious, proactive, and risk aware. Lexcel provides professionals in law firms with a management framework that drives operational efficiencies, effective risk management, and cost reductions, all of which should result in greater profitability.

Additional benefits include better customer service, which means higher client retention rates, increased success in tenders, improved marketability, and more effective risk management which leads to fewer claims and lower insurance premiums.

If you would like to discuss a legal practice financial management issue, please call Seamus Gates on 02920 549939 or email seamus.gates@broomfield.co.uk

Financial stability for law firms:

Strategy and business plans

With alternative business structures now a reality, forward-thinking firms are developing business plans and strategies aimed at securing their future success.

A business plan is a crucial development tool – a blueprint for the future, setting out in detail how you will translate your ambitions into reality.

It enables you to harness your energies and resources in a way that drives profitability and operational effectiveness.

Using the Legal Services Act as a financial Springboard

Some law firms have already taken proactive action by launching new services to take advantage of deregulation under the Legal Services Act.

They are using the new regulations as an opportunity to introduce external (non-lawyer) investment and fundraising which allows firms to become more financially focused.

Increased competition will ultimately make the legal profession stronger, but it will also give firms a number of different business model options, including incorporations, joint ventures, mergers, acquisitions, franchises, outsourcing and even shared services. Whichever route you choose, it should be an integral part of a meticulously thought-through strategy.

Developing a business plan to address risk management

Risk management should not be viewed as a one off assignment, but a constantly evolving process, led by a senior person, that perpetually informs your long-term strategy. Successful firms will make risk management one of their top priorities.

A business plan will also analyse where work is going to come from and how you can get more of it.

Look at your referral structure and professional networks and examine who is referring work and why. Ensure you are maximising cross-selling opportunities and make clients aware of other service lines they could benefit from.

Looking ahead strategically to a profitable future

In addition, an effective strategy will consider potential mergers or takeovers. It will explain what sets you apart from your competitors and how you communicate these key selling points to raise bottom line performance.

By setting out the future direction of your firm, you'll be able to focus more effort on the most profitable work streams and vital areas of activity. This will also make it easier for your business development and marketing teams to target work.

If you would like to discuss a legal practice financial management issue, please call Seamus Gates on 02920 549939 or email seamus.gates@broomfield.co.uk

Cashflow, profitability and financial reviews

It has always been essential for any practice to strike a profitable balance between expenditure and fee income.

However, with competition from new legal services providers, it is even more important for traditional firms to deliver financial stability and commercial success.

Overheads must be factored into fees

The basis of any law firm's financial management is the ratio of income to overheads, because profitability and healthy working capital are built on fees billed out.

A great deal of useful financial information comes out of a firm's accounts office, including fees billed and amounts recovered, but there tends to be little detail on overheads, which are often treated as a central expense without being allocated to individual departments.

Financial difficulties develop when departments bill only for their own time and cost their own work without taking account of overheads – as if the rent is paid by an entirely different organisation. The head of department should monitor the total operational cost of the team and make this integral to determining the fee structure.

Fixed fee issues and how to avoid them

Different issues are involved in the integration of overheads into fixed fees (for example, Conveyancing). A simple solution is to reflect overhead expenditure when you quote for work, rather than opting for the lowest possible price.

The problem here is that legal services provided by bulk operators benefit from economies of scale that may make it difficult for traditional practices to compete on fees.

Firms would be well advised to look carefully at their overhead structure to see where costs can be reduced. Some services can be sold as a 'loss leader' if you are confident that you can sell other profitable services to your client, but this has to be monitored extremely closely to ensure there is a strong enough business case for doing so.

How strong risk management translates into commercial success

With traditional law firms facing the challenges of the Legal Services Act under outcomes-focused regulation (OFR) the need for good risk management is greater than ever.

Firms are responsible for meeting requirements set out in the SRA Handbook and operating effective risk management systems.

Once again, a great starting point is the Law Society's Lexcel Practice Management Standard, which provides professionals in law firms with a management framework to drive operational efficiencies, effective risk management, cost reductions, and greater profitability.

If you would like to discuss a legal practice financial management issue, please call Seamus Gates on 02920 549939 or email seamus.gates@broomfield.co.uk

Financial stability for law firms:

Is incorporation the way to go?

The personal tax and pension benefits available to partners and directors under an incorporated business structure are well documented.

However, for the purposes of this article I intend to look at other knock-on benefits for financial stability that make incorporation an attractive proposition.

Limitation of liability

Many businesses have already recognised the key advantage of incorporation – limitation of liability. Partners and sole practitioners carry the financial risks in the practice. In extreme cases of business failure, a limited company or LLP structure will reduce the impact on the individual's personal assets.

Where the practice has significant borrowings, the bank will still look at maintaining a high level of security over debts. They may ask for personal guarantees from the partners / directors, so that an individual may not be entirely free from debt security.

But the bank can also take a debenture from the company, which typically gives security over book debts and work in progress. This will reduce the potential liability of the partners / directors in the event of business failure.

Planning and cash flow

The flexibility that a limited company gives is that you are able to plan in advance for a partner / director's taxable income. This is based on the tax efficient remuneration plan, and is completely opposite to the issue that a sole practitioner, partnership or LLP has, whereby the year end accounts must be completed, tax adjustments calculated and taxable profits allocated before an individual is able to do any tax planning.

The spikes of January 31 and July 31 tax payments can also be flattened out of the ongoing cashflow of the practice by moving to a limited company. Corporation tax is payable nine months after the company year-end, but the previously

high tax bills paid by the individuals should be reduced significantly. Again, this puts the business on a much firmer financial footing, as it is normal practice for partner's personal tax liabilities to be paid out of the office bank account.

Separate legal entity

Many partnerships will already have a high value of goodwill in them, and so the trading name of the practice may well be worth protecting by the creation of a company. This will help to stop any other businesses trading off the good name of your practice.

Partnerships and LLPs with a small number of partners and members may be concerned about the continuing existence of the business. Of course a limited company can be run with only one director / shareholder, and so concerns over the future should be resolved. This will also benefit sole practitioner businesses.

Future investment or sale

In the new era of alternative business structures, we must also consider how a limited company is the ideal vehicle to allow for external investment in the practice. You may be able to generate investors willing to put capital into the practice for a return. A corporate structure may be bolted onto another legal practice company or LLP in a merger or consolidation scenario.

Succession planning

In our experience, up and coming fee earners do not always ask to become partners in a practice as they tend to be more risk averse than was the case in earlier years. The limited liability status may calm some of their fears.

There may no longer be the need to 'buy in' to the partnership and so this will remove the issue that younger individuals may have with limited personal capital, with banks making it more difficult to loan on an equity buy in. Limited companies can allow a staged buy in of shares, with the potential support given to new directors of capitalised bonuses, say, rather than having to raise funds privately to buy the shares.

Considering a merger?

Greater competition and major legislative changes mean law firms must ask some big questions – especially whether to consider a merger, or drive organic growth through more effective marketing activity.

Three key drivers of mergers are: retirement and succession planning; the need to diversify; and the wider issue of risk management.

Why shutting up shop is not as simple as it may seem

Retirement costs may make a merger much more sensible, especially at a time when increased competition erodes the value of many traditional practices. Even shutting up shop can come with significant costs, such as making staff redundant, handling dilapidation issues on your building, and taking out run-off insurance cover.

Grooming your firm for a merger is a marathon not a sprint

Traditional high street firms may be attracted to a merger to gain economies of scale and other cost benefits.

The key issue here is making your firm attractive to a potential suitor, which involves careful positioning and preparation. This is not a quick window-dressing exercise, but more akin to training for a marathon – in terms of timescale as well as commitment of resources.

How mergers are identified through the risk management process

Mergers are also driven by the wider issue of risk management, which involves a firm looking long and hard at how it can reduce risk. The process of doing this in itself often suggests the possibility of a merger because firms implement better management practices and make themselves more appealing to other firms.

'Life after Jackson' requires careful planning

The Jackson Reforms may not have had an immediate impact on many practices, but forward-thinking personal injury firms will be busy planning now for when their current workloads run out. Major organisational challenges are involved in deciding how PI firms will structure their business and where their future work will come from.

Pooling resources to bring in business

Many firms may go down the route of joint marketing and advertising panels that see firms pooling their marketing resources to pay a third party to generate business. While this will provide PI firms with legitimately generated work, it will be monitored closely by the authorities for any whiff of referral fee payments.

The risks of going it alone on marketing

Others firms may invest in their own marketing activity – especially website development and social media platforms – to target prospects directly. However, building a brand that enables a firm to self-generate work requires significant management time and resources and should not be undertaken without specialist professional advice.

If you would like to discuss a legal practice financial management issue, please call Seamus Gates on 02920 549939 or email seamus.gates@broomfield.co.uk