Business Sustainability Toolkit

Financial stability and Business Sustainability

Introduction

Most firms have had a tough time since the start of the recession and the finances of many are fragile. Several have gone into administration and many more across the UK are said to be in difficulty.

Profitability has reduced since 2008 and most firms have depleted reserves. The real issue is not profit, however, but cash and this is made more acute by a greater realisation on the part of most banks that solicitors are not necessarily the “safe bet” they were once presumed to be. They are often not as willing to lend as freely as they once did.

Indeed, part of the problem is that historically some banks lent too freely to law firms, often funding not just the overdraft and loans to the firm, but also Professional Practice Finance Loans to incoming partners. In effect, they were funding both sides of the balance sheet. Perhaps they were attracted by the sizeable client accounts law firms could bring, perhaps law firms were simply viewed as good quality clients, however the result is that now, if a firm gets into difficulty, the banks can be very exposed – more exposed than might initially be indicated by the firm’s balance sheet.

Those banks, which were previously content to lend to solicitors without a proper assessment of all the factors looked at in other sectors, have now changed their parameters. Firms should expect banks to form a judgement of the lending risk informed by a critical review of up-to-date financial information and an assessment of management and leadership. Lenders will also be more likely to seek ongoing financial data to monitor performance, and for term lending they may introduce covenants based around financial performance. This is just ‘business as usual’ when lending to most SMEs, but for some law firms it may seem like a different regime.

There are many reasons firms need to improve their financial stability and make their businesses more sustainable. It is in the interest of:

- The partners who own the firms, who not only depend on the practice for an income but who are likely to be personally liable if things go wrong;
- Their staff, whose livelihoods depend on the firm’s survival and success;
- Their clients, who shouldn’t have to suffer in terms of service or financially as a result of avoidable firm failures;
- The profession as a whole as firm failures damage the solicitor brand and reputation of us all.

Life has been tough in recent years, and even if economic conditions improve, we will continue to see greater competition once alternative business structures become a reality and firms undertaking legal aid face yet more cuts, in particular those that offer criminal legal aid. Firms need greater financial resilience in order to withstand further blows.

These Guidance Notes are intended to be a valuable and confidential method of allowing partners to assess and improve their firm's financial standing. They replace earlier advice on capital adequacy published by the Law Society of Scotland several years ago which detailed two ratios, a partnership solvency test and a measure of profitability. The former compared partner capital with the firm's total gross assets, including property and other fixed assets. The latter expressed the firm's profits as a percentage of fees. Some accountants may well still use these ratios. If you use them in your firm and find them helpful, you should continue to do so, however the new ratios outlined below are considered to be more relevant in today's more challenging environment.

Structure

This toolkit has four parts:

- **A self-diagnostic** – to help you assess the financial process risks in your firm (available on our website)
- This guide, which starts with information on the key benchmarks to consider (click here)
- A Financial Stability Self Diagnosis tool, which allows you to assess your firm's financial stability – this requires your firm's latest annual or management accounts (available on our website)
- A worked example of the Financial Stability Self Diagnosis (available on our website)

We have also included guidance on:

- Guidance on partner capital and drawings
- Ten Practical steps to improve financial stability
- Some tips on getting paid
- The characteristics of really well run firm- a banker's view

Acknowledgements:

We are grateful to Andrew Otterburn, of Otterburn Legal Consulting for his work developing these materials, and to the others who assisted him, notably:

James Oliver and Scott Foster of Royal Bank of Scotland

Alasdair Swan of Bank of Scotland

Shirley McIntosh and Steve Carter of Baker Tilly, Chartered Accountants

Benchmarks to help you assess your firm's financial stability

Over the years accountants have developed various measures to assess a firm's financial stability and these ratios are still used today. They consider:

- Whether a firm is solvent
- Whether its capital reserves are adequate
- Profitability

The various ratios used are applied across a range of business sectors and are not specific to law firms. Despite being difficult to apply to the legal sector, they are regularly used by banks when making lending decisions.

Due to the change in the lending environment since the start of the recession, the ratios of bank borrowing relative to money provided by the partners has become an important issue. Many firms have been, and still are, far too dependent on bank funding and have inadequate capital invested by their partners.

It is very useful, therefore, to understand the ratios developed by the banks to assess the credit worthiness of their customers because these are calculations a bank manager is likely use with respect to your firm. The ratios are a very good starting point when assessing a firm's financial health, and are in many ways more useful than traditional accounting measures. Generally most banks will be interested in three key areas:

- The firm's viability
- The quality of the management team
- The bank's security

Financial Stability Ratios

This section illustrates six important financial stability ratios that you should calculate at least once a year, more often if necessary. The trend of the business measured consistently and regularly can be a powerful management tool. It would be useful to calculate these ratios for the previous two years to establish any trends and they could also be calculated quarterly or half-yearly to measure the rate of improvement and decline – you will need to extract a balance sheet from your firm's management accounts and make sure it includes realistic values in areas like work in progress. A better judgement of the firm's financial health can be made when the following checks are carried out regularly:

1. **Borrowings (non-property) : partner capital**
2. **Borrowings (non-property) : unfunded capital**
3. **Cash flow available for debt servicing (CFAFDS)**
4. **Solvency – the "Quick" ratio**
5. **Ratio of profits : drawings – the "make & take" ratio**
6. **Profit per equity partner**

1. Borrowings (non-property) : partner capital

This key ratio compares the capital the partners have invested in the firm with bank borrowings. The partners should have at least as much invested as the bank, and ideally they should have significantly more invested than the bank.

How do you calculate this?

You will need the year end accounts produced by your accountants. This will show bank borrowing and also the partner capital invested in the firm – which may be split into current accounts and capital accounts – you should take the total.

The following is an example of a **firm with two partners**:

Table 1 Borrowings : partner capital

Office account		-50,000
Bank loans		-75,000
Total (non-property) borrowings		-125,000
Partner capital		
Partner 1	50,000	
Partner 2 (newly appointed)	50,000	
		100,000
Ratio		125%
What might a bank want?[1]		**100% or less**

The firm in this example has relatively little partner capital compared to the amount invested by the bank – over time the partners would need to either increase the amount of their capital in the firm, reduce their borrowings, or probably a combination of the two.

Action needed?

If you have less capital invested than the bank it is a cause for concern – you should always have more capital invested – so that in the event of a change in bank lending policy you are not exposed. It can take time to change this and will be achieved by a combination of capital injection, reduced drawings, higher profitability and better billing and cash collection.

[1] The indications in this section of what a bank might look for are based on one bank's opinion – other banks might take a different view. Also the ratios a bank might expect could be influenced by the size of the firm – a firm with a high proportion of equity partners might have different ratios to a larger firm.

2. Borrowings (non-property) : unfunded capital

The first ratio looks at borrowings shown on the balance sheet. However, many firms (larger firms in particular) have "off balance sheet" borrowings in the form of Professional Practice Finance Loans, and in some cases, these loans are substantial. Most partners appointed in the last ten years are likely to have one of these loans.

Taking the example firm, whereas Partner 1 has been with the firm for many years and has built up his capital, the new partner was given a Professional Practice Finance Loan to fund her capital of £50,000. This loan is secured on the assets of the partnership and is interest only with the capital being re-payable when she leaves the firm.

How do you calculate this?

The calculation is the same as shown in Table 1 except you also need to take into account any Professional Practice Finance Loans the partners have. These are not included in the firm's balance sheet – you will have to ask each partner for the balance.

Your bank will be very interested in the firm's "unfunded" or "free" capital relative to borrowings as illustrated in Table 2:

Table 2 Borrowings : unfunded capital

Office account		-50,000
Bank loans		-75,000
Total (non-property) borrowings		-125,000
Professional practice finance loan		-50,000
Total borrowings		-175,000
Partner capital		
Partner 1	50,000	
Partner 2 (newly appointed)	50,000	
	100,000	
Less Professional practice finance loan	50,000	
Unfunded capital		50,000
Ratio		350%
What might a Bank want?		**175% or less**

The unfunded capital ratio will be difficult for most firms to change, at least in the short term, due to the scale of change needed and the fact that these are long term loans – however, your bank will be aware of it and it will influence their view of you.

Action needed?

Most new partners have been given these loans in recent years on an interest only basis. These will often be younger partners in their 20's or 30's who will be unlikely to be easily able to replace them with their own capital. The problem with such loans is that they assume there will be an easy way of repaying them on retirement, and that may not necessarily be the case. There could be much sense in partners repaying elements of the capital over time or at the very least making provision for its repayment and this may well require an adjustment in profit shares.

It is possible that the banks will move towards making loans for future partners on a repayment basis, thereby avoiding potential problems when a partner leaves or retires.

3. Cash flow available for debt servicing (CFAFDS)

Banks are obviously very keen to ensure their customers are generating sufficient cash to service any debts they have – and this is something with which the partners need to be concerned. CFAFDS will be new to most solicitors, but it is an expression well understood by bankers.

How do you calculate this?

From your firm's annual accounts simply take the overall profit before tax and add back interest paid and depreciation. The amount of loan repayments should be apparent from the balance sheet and the partner drawings will be in a note to the accounts. Partner drawings comprise monthly drawings and payment of income tax (if the firm is a sole practitioner or partnership).

This concept is illustrated in Table 3 which indicates that the example firm is not generating sufficient cash to service its debts. Crucially, the calculation depends not just on a firm's profitability but also the level of partner drawings. If drawings had been £20,000 less (or profits £20,000 more) there would not have been a problem. The firm will gradually start running out cash.

Table 3 Cash flow available for debt servicing

Fees		450,000
Staff salaries		157,500
Overheads	160,000	
Add back depreciation (not a cash item)	-2,500	
Add back interest	-10,000	147,500
Net profit before drawings, interest and depreciation		145,000
Partner drawings		140,000
Cash flow available for debt servicing		**5,000**
Interest (say)		10,000
Annual loan repayments (say)		15,000
Surplus / (deficit)		-20,000

Action needed?

This is an important ratio. Your firm has to generate sufficient cash to service its debts. This can be addressed by improving profits however that may not be easy and may take time, so initially the solution will be for the partners to reduce their drawings. There is further guidance on drawings at www.lawscot.org.uk/business-sustainability.

In the example, we have added back depreciation, as this is not a "cash item" but an accounting adjustment. The cash impact of any capital expenditure is felt at the time of purchase (if it is bought outright) or when monthly payments are made if it is bought on finance. Depreciation is merely an accounting device to adjust the firm's profits over the life of an asset.

It is not a cash item, so has been added back, however, depreciation has the effect of building a cash reserve towards an asset's replacement. If it is being utilised to fund drawings and loan repayments it will not be available when the asset is replaced. Ideally you need to generate sufficient cash **in addition** to any depreciation.

4. Solvency – the "Quick" ratio

The "Quick" ratio compares a firm's current assets with its current liabilities and assesses broadly whether it is able to meet its liabilities.

How do you calculate this?

All of the figures you will need are in the balance sheet in your firm's annual accounts. The calculation compares the firm's current assets (debtors, work in progress and cash) with its current liabilities (overdraft, short term loans, VAT, PAYE, trade creditors, etc).

Depending on the nature of your work, you will probably not include the full value of work in progress in this calculation because some work can take months to be paid.

The calculations below also include an allowance for partner income tax due within the next six months because that is also a liability the firm will need to fund. It is not technically a liability of the firm (it is a personal liability of each partner). However, in practice most firms will pay it on behalf of the partners, having previously retained part of partner profits for this purpose.

Table 4 illustrates the calculation and shows a healthy position, primarily because of the firm's work in progress:

Table 4 Current assets : Current liabilities (incl. WIP)

	£
Current assets	
Debtors	100,000
Work in progress/accrued income	150,000
Total	250,000
Current liabilities:	
Overdraft	50,000
VAT/PAYE	45,000
Partner income tax	25,000
Creditors	40,000
Total	160,000
Quick ratio	**1.6**

Accrued income

If your firm is an LLP, "work in progress" will be shown in your accounts under two headings – work in progress and accrued income:

- **Work in progress** is in respect of time where there is no contractual right to bill the matter at the balance sheet date. It is valued at cost and should be excluded from this calculation as it is unlikely to be paid any time soon;

- **Accrued income** is time where the matter has reached a point where there is a contractual right to the income. It is valued at selling price and is similar to a debtor. However, the fact that it is included as income for accounts purposes does not necessarily mean it is going to be paid in the next 3 or 4 months. If it was in respect of, say, an executry, it would be reasonable to include it in full, but if it was in respect of a litigation matter payment may be many months off. You should take a view on what proportion of the accrued income is going to be paid soon and include that.

If your firm is a partnership or if you are a sole principal your accounts may also include a line for accrued income, however many will simply show a single figure for work in progress. All firms are required to recognise accrued income for tax purposes although partnerships and sole principals are not required to include it in their annual accounts. The accounts of most smaller partnerships will simply include a single line for work in progress.

Table 5 repeats the calculation but includes just part of the WIP because the partners estimate 25% might be billed and paid reasonably quickly:

Table 5 Current assets : Current liabilities (reduced WIP)

			£
Current assets			
Debtors			100,000
Work in progress/accrued income	150,000	25%	37,500
Total			137,500
Current liabilities:			
Overdraft			50,000
VAT/PAYE			45,000
Partner income tax			25,000
Creditors			40,000
Total			160,000
Quick ratio			**0.9**

This provides a more realistic assessment and indicates that the firm is (almost) able to cover its short-term liabilities. This calculation is prudent but is also a reasonable reflection of the firm's true position.

Action needed?

This is another important ratio. It needs to be at least 1.0 and something higher, like 1.3 would be even better. If it is below 1 it is an indication the firm is insolvent and that action is needed to strengthen its balance sheet – probably by the partners injecting more capital. You will need to obtain advice from your accountants and there may be legal implications if you are trading as a company.

5. Ratio of profits : drawings – the “make & take” ratio

Most of the ratios discussed so far concern to the levels of borrowing relative to partner capital and the main way this can be improved is often to leave more profit within the firm by reducing partner drawings. This ratio compares drawings with profits and is illustrated in tables 6a and 6b, which relate to the small firm illustrated already and also show a larger firm with 20 partners:

How do you calculate this?

Simply take the profits available for the partners as shown in the accounts and compare this to total drawings in the accounts. This will comprise monthly drawings and payments of income tax.

Table 6a "Make & Take" ratio - accounts basis - 2 partner firm

	£ Accounts basis
Fees	400,000
Opening work in progress/accrued income	-100,000
Closing work in progress/accrued income	150,000
Income	450,000
Staff salaries and overheads	317,500
Net profit per accounts	**132,500**
Monthly drawings	79,500
Partner income tax	53,000
Total drawings	**132,500**
"Make & Take" ratio	100%

Table 6b "Make & Take" ratio - accounts basis - 20 partner firm

	£ Accounts basis
Fees	10,500,000
Opening work in progress/accrued income	-2,000,000
Closing work in progress/accrued income	2,500,000
Income	11,000,000
Staff salaries and overheads	8,000,000
Net profit per accounts	**3,000,000**
Monthly drawings	1,800,000
Partner income tax	1,200,000
Total drawings	**3,000,000**
"Make & Take" ratio	100%

The calculations for both firms appears to indicate all is well – drawings do not exceed the profits being generated.

The "Make & Take" ratio illustrated above is a useful starting point, however "profit" is not the same as cash. Because a firm's profits are affected by changes in debtors and work in progress, the profits shown in a firm's accounts may be very different to the cash in the bank.

In the 20 partner firm, the apparent profits shown in the accounts are £3m however part of these profits (£1/2m) are due to an increase in work in progress. The "cash profit" actually available for the partners to draw is £2.5m. The position of the two partner firm is even worse – profits as shown in the accounts are £132,000, however £50,000 of this relates to an increase in work in progress and may take months to be translated into cash in the bank. Tables 7a and 7b show the cash position:

How do you calculate this?

To calculate the "cash" profit, take the profits figure as shown in the accounts and adjust it for any increase/decrease in work in progress. If debtors have changed significantly you could include that movement as well as that also affects the cash available, however you must avoid the calculations becoming over complicated.

Table 7a "Make & Take" ratio - cash basis - 2 partner firm

	£ Accounts basis	£ Cash basis
Fees	400,000	400,000
Opening work in progress /accrued income	-100,000	-100,000
Closing work in progress /accrued income	150,000	150,000
Income	450,000	450,000
Staff salaries and overheads	317,500	317,500
Net profit per accounts	132,500	132,500
Adjust for WIP movement (paper profit)		-50,000
Cash profit		82,500
Monthly drawings	79,500	79,500
Partner income tax	53,000	53,000
Total drawings	132,500	132,500
"Make & Take" ratio	100%	161%

Table 7b "Make & Take" ratio - cash basis - 20 partner firm

	£ Accounts basis	£ Cash basis
Fees	10,500,000	10,500,000
Opening work in progress /accrued income	-2,000,000	-2,000,000
Closing work in progress /accrued income	2,500,000	2,500,000
Income	11,000,000	11,000,000
Staff salaries and overheads	8,000,000	8,000,000
Net profit per accounts	3,000,000	3,000,000
Adjust for WIP movement (paper profit)		-500,000
Cash profit		2,500,000
Monthly drawings	1,800,000	1,800,000
Partner income tax	1,200,000	1,200,000
Total drawings	3,000,000	3,000,000
"Make & Take" ratio	100%	120%

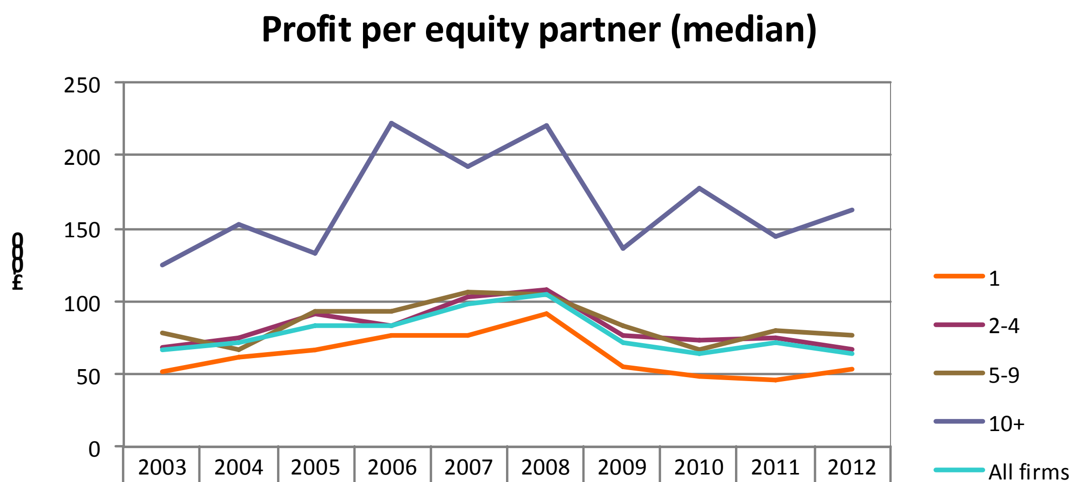
Action needed?

Unless the firm has substantial cash balances, or bank agreement has been obtained, drawings should **not** exceed profits, so this ratio should always be less than 100%. If the firm has to fund any loan repayments the drawings need to take account of this.

Because the accounts profit takes account of changes in work in progress the apparent profit might not actually be available to take – it is a paper profit and may take several months to actually be translated into cash – so drawings should be constrained to the actual cash likely to be available. This is often a difficult figure to predict, but as a rule of thumb drawings might be restricted to 75% of profits. This also leaves some headroom for funding working capital.

6. Profit per equity partner

Each year the Law Society publishes the Cost of Time Survey which reports the profitability of firms across the country. It is very useful to compare the profitability of your firm with these published figures and consider whether your firm has performed as well as you might have expected? The profitability of firms in recent years is shown in the chart:



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1	51	62	67	77	77	92	55	49	46	53
2-4	68	75	91	83	103	108	77	74	75	67
5-9	78	66	93	93	107	105	84	66	80	76
10+	125	152	133	223	192	221	136	178	144	163
All firms	67	71	83	83	98	104	72	64	71	64

The chart of profit per equity partner is before any allowance for equity partner notional salaries.

How do you calculate this?

The figures you will need will be shown in the profit and loss account in your firm's annual accounts. Simply take the total profits and divide by the number of equity partners. If your firm is a limited company you will need to add back any directors' remuneration to the profit figure.

Table 8 Profit per equity partner

	£
Income (fees + change in work in progress)	450,000
Staff salaries	157,500
Overheads (including interest and depreciation)	160,000
Net profit	132,500
Profit per partner	66,250

This firm achieved profits very close to the median for firms of its size. This is the **average** profit per **equity** partner:

- the two partners may not share profits equally – the senior partner may take a higher share, so this is purely the average;
- it is after allowance for the salaries of any salaried partners, who will be included in staff salaries

In order to understand why your firm is doing well (or not so well) you will need to analyse the figures in more detail. The annual Cost of Time Report contains a range of key benchmarks you may want to look at together with a pro-forma for you to calculate these benchmarks for your own firm.

Guidance on partner capital and drawings

Partner capital

Partner capital is used to fund:

- Long-term assets such as offices and IT
- A firm's working capital – its work in progress and debtors

Broadly the partners might contribute 10-30% of the cost of long-term assets and should borrow **on a long-term basis** to fund the rest (i.e. it would not be funded out of the overdraft). They would normally contribute at least 50% of the firm's working capital with the balance being provided through the firm's overdraft.

It is very important that partners **do** invest sufficient in their firm. It is also very important that they **make provision for partner tax**, ideally by a monthly transfer to a separate deposit account. Many smaller firms do very little tax planning and the actual tax bill in January can come as a shock. To quote one tax partner, "Lawyers are amongst the worst at leaving their tax returns to the last minute and then complaining about their unexpected tax bill".

Firms should be wary of advice that they should not have too much money that has been taxed tied up in their firm as it is not an efficient use of money. Some accountants may also try to devise complex ways of minimising the tax their clients pay. Paying too much tax is not the number one problem for most firms. It is very important to have sufficient partner capital invested and remarkably easy for firms to get into difficulty if too little partner capital is retained in the firm.

It is quite easy (at least in theory) to set the working capital a firm needs. Let's take the example of a new firm with two partners, one fee earner and two secretaries:

Budget for year one	£
Partners @ £50,000 drawings and allowance for tax each	100,000
Employed solicitor	40,000
Secretaries @ £15,000 each	30,000
Cashier	20,000
	190,000
NIC and pension contributions (say 15%)	13,500
	203,500
Rent, and other overheads	156,500
	360,000
Per month	30,000
The firm has to bill £30,000 a month to break even	

Scenario 1

Assume the firm undertakes mainly residential conveyancing and matters are typically billed and paid on completion within (for simplicity) four weeks. Cash flow for the first six months is summarised below. It is assumed that:

- work is billed at the end of the month and paid immediately on completion
- that there is no opening bank balance
- that at this early stage the firm is just billing the £30,000 a month to break even

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Brought forward	0	-30,000	-30,000	-30,000	-30,000	-30,000
Payments	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000
Income		30,000	30,000	30,000	30,000	30,000
Carried forward	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000

The two partners need to provide working capital of £30,000 because at any one time one month's salaries and overheads have to be funded. Assuming there will be slippage they could assume a need to fund £50,000 of which half would come from the bank and half from themselves.

Scenario 2

The table below looks at the same firm but assumes a longer billing cycle, and that it takes three months to be paid. No cash comes in until month 4 and indicates funding is needed of at least £90,000. They might work on the basis that they were going to need to fund, say, £120,000, and once again half would come from the partners.

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Brought forward	0	-30,000	-60,000	-90,000	-90,000	-90,000
Payments	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000
Income				30,000	30,000	30,000
Carried forward	-30,000	-60,000	-90,000	-90,000	-90,000	-90,000

These are **very** simple illustrations, however, the principle is that the partners need to ensure there is enough cash available to pay the firm's salaries and overheads, and that it should be broadly possible to predict the money that will be paid out and the income coming in. They need to fund the difference.

Tax on accrued income

It is important to understand that because the tax partners pay is based on a full valuation of accrued income that tax will have to be funded, even though the firm may not actually have been paid by the client. The work is taxable regardless of whether the firm has received the cash, so not only is it necessary to fund the actual monthly expenses such as salaries, overheads and drawings, but also make provision for the business tax that will become due.

Drawings

The general rule for determining drawings is that drawings should not exceed profits, however, as discussed earlier in this guide:

- allowance must be made for loan repayments;
- profit is not the same as **cash in the bank** because part of a firm's profits may have been created by a change in work in progress. They are paper profits – not cash that is available for drawings.

Table 9 (below) illustrates three options for the drawings of the 20 partner example firm discussed earlier.

The firm fully accounts for work in progress in its accounts as it is an LLP so its accounts are prepared strictly in accordance with UK GAAP. The budget for the coming year predicts an increase in WIP of £500k. It also assumes loan repayments of £500k. The table indicates three possible scenarios for the level of drawings the partners could take:

Column 1 indicates expected profits of £3m. After making allowance for partner tax at, say, 40% so long as partner drawings do not exceed £1.8m over the year or £150,000 a month, their capital accounts will be maintained as drawings will not exceed profits;

<u>Column 2</u> makes allowance for the £500k in loan repayments that will have to be paid during the year, and indicates that if the partners were to draw at that level they would exceed the cash available. The partners need to restrict their drawings to £1.3m or £108,000 a month in order to allow for these loan repayments;

<u>Column 3</u> makes allowance for the impact of the change in WIP on profits - of the £3m profit, part is due to the increase in WIP and is a paper profit. It may take months to be paid. Partner drawings will need to reflect this as well and the actual cash that is likely to be available for drawings is just £800,000 – and this is less than 1/3 the total that might have been taken.

Table 9 Drawings - Example - 20 partner firm

	£	£	£
Fees	10,500,000	10,500,000	10,500,000
Opening work in progress	-2,000,000	-2,000,000	-2,000,000
Closing work in progress	2,500,000	2,500,000	2,500,000
Income	11,000,000	11,000,000	11,000,000
Staff salaries and overheads	8,000,000	8,000,000	8,000,000
Net profit per accounts	3,000,000	3,000,000	3,000,000
Allow for tax (say 40%)	1,200,000	1,200,000	1,200,000
Available after tax to draw	1,800,000	1,800,000	1,800,000
Loan repayments		500,000	500,000
Available after loan repayments			1,300,000
Adjust for WIP movement			500,000
Cash available			800,000
Available to draw	1,800,000	1,300,000	500,000
Per month	150,000	108,333	41,667
Per partner	7,500	5,417	2,083

So the issue of drawings is complex, and in many ways is not helped by the basis of preparing accounts, especially for an LLP, which, in an attempt to show a “true” position actually produce figures that are far removed from the real cash position.

Certainly the old maxim that drawings must not exceed profits no longer holds true. The new maxim is that they must not exceed **cash profits** and these need to be adjusted for any loan repayments. A rule of thumb might be that drawings should not exceed 75% of profits.

Ten Practical steps to improve financial stability

1. Each firm should appoint one of its partners (or managers) to monitor its financial stability. This person could (but does not have to be) the Cash Room Manager. The person nominated should review the firm's overall financial position – both historically as shown in its annual and management accounts – but perhaps more importantly, projecting forwards, and should report to his/her fellow partners at least quarterly on the firm's financial stability. He/she should ensure the following;

2. A budget should be prepared at the start of each financial year, to include a monthly cash flow forecast. The partner capital required and levels of drawings should be reviewed as part of setting this budget;

3. Management accounts should be prepared at least every three months showing the firm's income, expenditure and profit to date, compared to this budget;

4. Key financial information such as the office account balance, cash collected and fees billed should be circulated to all partners or managers on a weekly (or even daily) basis. Certain information should be provided monthly such as cash collected, fees billed, numbers of new matters opened, amounts owing from clients (debtors), unbilled work in progress, and outlays paid but not yet billed;

5. The partners should ensure their drawings do not exceed the firm's <u>cash</u> profits – in other words be aware how much of your firm's profits are represented by changes in WIP or debtors and are paper profits as opposed to cash in the bank – and make allowance for loan repayments. In other words link your drawings to expected available cash;

6. The cash flow forecast should be updated on at least a quarterly basis. If you are close to your overdraft facility you may find it very useful to prepare a detailed cash plan:

   a. For the next 12 weeks on a weekly basis;

   b. Expenditure is easy to predict. Include salaries, drawings, rent, PAYE, VAT, income tax, etc;

   c. Make a best estimate of the money coming in each week, in particular any significant receipts;

   d. Update weekly for the actual payments and receipts and revise the forecasts.

The advantage of a weekly forecast is that it helps you to manage the cash available, and is likely to improve cash flow (because you will be focused on it and are more likely to chase clients for payment). It also helps confidence with your bank.

7. At least once a year the key ratios outlined in this guide should be calculated and trends considered at a partners' meeting. Consider what can be done to improve them. In particular look at:

a. Total (non property) borrowings : partner capital

b. Total (non property) borrowings : unfunded capital

c. Cash flow available for debt servicing (CFAFDS)

d. The "Quick" ratio

e. Profit per equity partner;

f. The "make & take" ratio.

8. Each month an amount should be transferred to a separate deposit account in respect of VAT so that when this becomes due each quarter the firm already has funds available to pay it. Similarly transfer an amount each month into a deposit account in respect of partner income tax – it means that you have the funds to pay it in January and July;

9. Set up a "sinking fund" – and put money aside for future "knowns and unknowns" – to pay out partners, to pay for property dilapidations, to enable you to move quickly on a deal, to help the firm get through a crisis;

10. Make sure everyone is focussed on billing – that everything that can be billed is billed and that it is then chased and gets paid. Circulate appropriate financial reports to all fee earners and support staff so that everyone understands the importance not just of billing, but also of getting paid.

In April 2013 the Solicitors Regulation Authority[2] published guidance for firms in England & Wales which firms in Scotland may also find helpful. They published the following list of good behaviours to aim for and poor behaviours to avoid:

Poor behaviours

- Drawings exceeding net profits
- High borrowing to net asset ratios
- Increasing firm indebtedness by maintaining drawing levels
- Firms controlled by an "inner circle" of senior management
- Key financial information not shared with "rank and file" partners

[2] Reproduced from the website of the Solicitors Regulation Authority

- Payments made to partners irrespective of "cash at the bank"
- All net profits drawn, no "reserve capital pot" retained
- Short-term borrowings to fund partners' tax bills
- VAT receipts used as "cash received" resulting in further borrowings to fund VAT due to HMRC
- Partners out of touch with office account bank balances
- Heavy dependence on high overdraft borrowings

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 (properly) dropped

Some tips on getting paid

Try to ensure you are paid as quickly as possible after the work has been done:

- Ensure you are clear in your initial engagement letter about likely fees; that you will issue interims; that you will issue your final bill promptly; that you will expect payment within x days;
- If it is a commercial client, check their credit rating. If it is a long standing client check it again as it may have changed from last month;
- Send regular interims – monthly if the matter is significant, quarterly for all other matters. Clients prefer to know where they are, and it avoids surprises at the end, and of course it helps your cash flow;
- Bill promptly at the end of the matter and let the client know it is coming. The fee earner should speak to the client and explain if the bill is different to what has been discussed previously;
- Let your cash room chase for payment. Don't interfere or hamper them;
- Do everything you can to avoid bad debts. Any increase in bad debts will come straight off your bottom line profits.

There is a particular danger that fee earners under pressure to maximise their fees will take on clients who may not be able to pay. Risk management is an area where many firms are weak – it is good practice:

- To identify a named supervisor for each area of work the firm undertakes;
- To maintain lists of work the firm will and will not undertake, together with the generic risks and causes of claims associated with each area, and make sure this is fully communicated to staff;
- For each fee earner to undertake an opening risk assessment for each new matter against these criteria. Experienced lawyers instinctively do this – and will know when a new client or matter doesn't feel quite right, but a new fee earner who lacks the equivalent experience may not. Require each fee earner to indicate on the file that they have undertaken an opening risk assessment, and that in particular they have considered whether the client will be able to pay.

The characteristics of really well run firm- a banker's view

1. **Strategy /Vision** - Where do the firm/partners want to be in three years' time (position in market place, profitability, breadth of service offering)? What are opportunities for services provided and the best delivery channels? Will they withstand fluctuations in market demand? Willingness of Partners to re-invent historic models.

2. **Structure** - have they got this right? Partnership/LLP/Limited Company or formation of Service Company. Bank Funding – Capital structure appropriate?

3. **Governance Policy** - frequency of meetings - decision makers - Minutes of meetings. In larger firms - board rotation - sub committees for project work. Appointment of Non Exec Directors. Culture/Ethics and Reputation.

4. **Managing People** (morale and incentives) - Key Performance Measures, career progression, retaining trainees, and secondments.

5. **Finance function** - Is it helping us deliver our strategic direction? Role of FD or Cash Room Partner. Will they challenge Partners? - How we go about 'making (cash) versus take (accounting profits)' Audit provider input.

6. **Financial** - 'Keep it simple = easily understood' Management Information - monthly Profit and Loss/Balance Sheet v Budgets (sensitised as to break even and downturn) and Cash Flow (on cash basis) **Credit control** - Fee collection and WIP management (Lock Up Days). WIP write off frequency. Bad and Doubtful Provisioning. Billing – Fixed Fee versus hourly rates?

7. **Cost Control** - Staffing levels (support: Fee Earners), Property Costs, Outsourcing of front end services (cash room?). Capital expenditure - Funding options (Asset Finance, Term Loans) and for e.g. Partner Pay Outs/Tax Funding/Technology. Legal Process Outsourcing (LPOs) In-House Counsel is likely to drive change in Panel work. Larger Firms better placed to commoditise. Creation of separate legal entities for volume work (e.g. PI work).

8. **Technology** - Is Technology being used to maximise cost benefits/streamline activities/enhance investment in different areas of the business? E.g.: Cloud Computing. E-billing. Web development. Full utilisation of existing Client Management systems.

9. **Profit Distribution** - Timing and Retention. Drawings v cash available. Funding of tax- by partners or firm tax reserve.

10. **Equity v fixed Salary** - Partner strategy for Lock Step. Fee earner retention, new arrivals, departures what issues this creates

11. **Client base** - Breadth and Depth of Customer base – do you know what they want you to deliver? Do you understand your 'Will bank'? Over reliance on particular Clients. Diversification and De-Risking strategies. How are clients affected by regulations and general economy (Understanding their Business)? Client inter-action = Customer face to face/Seminars/Podcast Marketing

12. **New business** - Who are the rain makers-Business Development strategy? How do we manage business we are not experts in?

13. **Succession** - merger options - Is merger the best option (not just to scale up Revenues) **–** may give Senior Partners exit option and future career progression for younger partners. Economies of scale. What plans does firm have for trainees/ recruitment/lateral hires? What formula will be used to ascertain value of lateral hires?

14. **Risk management** - People/Partners (leaving). Client Defection and ability to pay. Dependence on dominant clients. Letters of Engagement -Terms and Transparency. Client profitability. PI Claims-history. Complaints -handling. Relationship with Bank. ABS implications.

15. **Credit card payment** – Consider what transactions and clients credit card payment may be appropriate for.

