Small wonder

Peter Scott examines the financial issues small firms face in the long tail of the pandemic

At the beginning of 2020, no law firms could have foreseen the coronavirus (COVID-19) pandemic. In the second quarter of 2020 the UK entered into a recession, and law firms are not immune from recessions. We read daily in the press of even some of the largest and financially most robust law firms continuing to take steps to conserve cash and manage profitability, as demand for services fell in the early stages of the pandemic in March and April. At the other end of the size spectrum, how are small firms doing, and what does the future hold for those firms?

I define 'small firm' by two criteria: the number of partners and revenue. In a September 2018 *Legal Compliance* article, I defined a mid-size firm as being within the 5–20 partner range and with revenues of £5m-£20m, and accordingly for this article I am discussing firms of 1–4 partners and with revenue of up to £5m. In England and Wales there are 8,765 law firms of 4 or fewer partners and they account for 86% of all firms.

The liquidity of many small firms, even in more prosperous times, is not good because managing working capital is often not a priority or they lack the knowledge and resources to do so. It only takes a few months of poor billings for cashflow to dry up and potentially tip a firm over the edge. It is for that reason that all law firms should regularly (that is, at least every week) stress test cashflow forecasts to obtain as realistic a view as possible of their future liquidity. However, I still come across small law firms which do not prepare cashflow projections!

Resource issue

Many small firms lack the appropriate level of internal financial management and expertise. However, small firms will often try to justify this by the 'we can't afford it' argument. My response to that is always 'you cannot afford not to'. While small firms may be able to keep a clean sheet in relation to compliance with the SRA Accounts Rules, the financial management required to ensure survival in the circumstances of the pandemic is wholly different and requires different expertise.

We are presently in a 'phoney war' in that under the government's actions to support business, VAT payments due before 30 June 2020 do not need to be made until 31 March 2021 and self-assessment payments on account due on 31 July 2020 do not need to be made until 31 January 2021, with the option of making smaller payments until March 2022, without interest. Further support is also available through the Coronavirus Business Interruption Loan Scheme – with 3-6 year facilities, where the government guarantees 80% of the finance to the lender and pays interest and any fees for the first 12 months; the Coronavirus Future Fund match-funding for innovation companies, and other measures such as furlough which will end on 31 October.

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Problems ahead?

No doubt many small firms have taken advantage of these measures but are they storing up potentially terminal liquidity problems? In particular, how will they deal with the looming challenge of the furlough scheme coming to an end if workloads do not show reasonable prospects of returning to pre-COVID 19 levels? And how many will need to consider how to provide for a more resilient working capital base than the often 'hand to mouth' cashflows experienced by some firms?

Since March, COVID-19 has put significant strain on firms of every type and size, with banks requiring cashflow forecast scenarios, nervous partners, socially distant management meetings and cashflows under pressure. As a banker said to me recently: 'We are not prepared to lend to firms unless they can show they will have a viable business at the end of this. We cannot save them all.'

While scenario-planning for a post-COVID future needs to be done, the urgent issue is still cashflow – the life blood of any firm's survival. The crisis has accelerated trends which were already under way, and unless small

firms adapt to the 'new normal' to meet the challenges of the future and take advantage of opportunities, then they will not in their present shape survive. These pressures all demand higher financial performance and, as a result, small firms must manage their finances ever more efficiently to:

- manage working capital as a priority ('cash is king')
- ensure financial stability and viability and the management of risk
- understand what banks are looking for to support law firms, and
- educate partners and fee earners on how to manage clients and their practices differently to improve cash generation and profitability.

These require high-quality financial management and expertise, which are often in short supply at small firms. Financial management in a law firm is an essential element of managing risk, and the need to prioritise risk management applies equally to small firms as to all other law firms, but they do not have the same resources. The 'we can't afford it' argument to justify not putting in place effective risk management is invalid. Given the uncertain economic outlook, small firms cannot afford to settle for second best in relation to financial management resource, but that does not mean they need to recruit full-time finance directors. There are various ways in which small firms can gain access to high-quality financial expertise. For example, I know two small firms that for one day a week each use the services of an experienced finance consultant to ensure they financially manage their respective firms in an optimal manner, to drive cashflow and profitability. Outsourcing of financial management can be an appropriate and cost-effective solution for small firms.

COVID-19 has created a need for enhanced financial management expertise. It may not be palatable to some partners to take on 'more non-fee-earning admin staff', but it can be a serious mistake to starve a finance function of essential and good-quality people. Good financial performance means a firm must analyse what is required in terms of resource and to then put that resource to work in the most effective and financially productive manner. Otherwise, small firms will continue to be at risk of financial underperformance, potentially leading to failure.

Paying for a high-quality finance professional not only makes financial sense but, increasingly, banks are recommending that law firm customers change those heading the finance function for more suitably qualified, experienced and credible professionals.

Financial pressures, together with succession issues and doubts about future economic viability are driving the momentum for increasing consolidation between small law firms. As financial pressures increase and as the benefits of scale begin to be understood by small law firms, then increasingly they will look to mergers and acquisitions as a route to a more stable financial future.

Financial education and reporting

Another issue in smaller firms is a lack of understanding among partners and other fee-earners about the steps needed to drive stronger cashflow and generate profits. Such matters can be addressed by educating partners and fee-earners by providing them with the tools to do the job. A fee-earner once said to me: 'I don't have a clue about the financial reports I receive.' How many partners and other fee-earners in small firms (and in larger firms) might say the same?

Financial reports are intended to enable decision-makers to take appropriate action in relation to clients and their matters. If lawyers are not trained to understand the reports they receive, or if the reports are not providing the relevant information, financial performance will suffer.

Work smarter, not harder

Small firms that are not well-managed financially are both failing to drive up revenue and drive down costs. As a result margins can be severely squeezed. Not only is a degree of central control and direction needed to focus on the 'profitability drivers', but also ensuring partners understand what they are required to do (or not to do) is vital, including:

- carrying out unprofitable work;
- working for clients who will only ever lose a firm money;
- addressing a lack of lawyer resource at the right levels leading to insufficient leverage and delegation (more senior partners doing work which should be delegated);
- 'throwing away' profit by:
  - under-pricing work (how many lawyers know their market 'worth'?)
  - under-recording of matter-related hours (both deliberately and unknowingly)
  - under-recovery of recorded matter-related time when billing (the easiest way to lose profit)

The impact of these can mean triple discounting, but if each of these can be improved by just a small degree, profitability can escalate.

- lack of tight control over overheads (how many firms apply a zero-based budgeting approach which requires an organisation to regularly test whether it needs every item of overhead?)

Be prepared to be managed

There are simple techniques which can substantially increase profitability without having to work any harder, but they can be difficult to achieve in small firms because of an anti-management culture, unless:

a) those who have responsibility for managing a firm have the appropriate knowledge, determination, and courage to take control; and
b) the principle of 'accountability' is accepted by all partners, which will in particular involve an agreement to support all partnership decisions which are made, and to support those trying to manage the firm, as well as accepting financial disciplines and a willingness to be managed.

If small law firms can get to grips with these issues, then many of their financial objectives will be easier to achieve.

Regulation

During the pandemic little has been said about law firms' regulatory obligations. Paragraph 2.4 of the SRA Code of Conduct for Firms provides that 'you actively monitor your financial stability and business viability. Once you are aware that you will cease to operate, you effect the orderly wind-down of your activities'.

The SRA Risk Outlook for 2019/20 published in October 2019 sets out what the SRA regarded as key risks and challenges faced by the profession:

- anti-money laundering
- client money
- diversity in the profession
- information and cyber security
- integrity and ethics
- investment schemes
- managing claims
- meeting legal needs
- standards of service

Even though the outlook was published before COVID-19 struck, it is worth asking whether the SRA is looking at these risk areas with a sufficient focus on financial risk.

Financial stability should always be a priority risk issue and as such perhaps a 'standing item' in the SRA's Risk Outlook.