Sting in the tail

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

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Since the beginning of the coronavirus (COVID-19) pandemic there have been remarkable highs and lows in the financial fortunes of many law firms in the UK. In April 2020 I wrote in an article in the Law Society's Risk and Compliance e-newsletter on the need for law firms to prioritise collection and conservation of cash, at a time when one banker told me, "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."

How times change. Most law firms have survived the pandemic and many law firms are turning down certain types of work because they are so busy and others (mainly the larger firms) are achieving record levels of profitability. This can, however, create a climate of complacency and in some firms it has already done so (crisis – what crisis?) which is dangerous and presents a serious risk issue. It would be a mistake to believe the legal world will necessarily revert back to its pre-COVID-19 days any time soon.

Capital requirements

Growth in business as firms recover from COVID-19 will create a greater working capital requirement but this is unlikely to be met by higher banking facilities, as it seems lenders continue to be cautious during these (still) uncertain times. Ironically, therefore, an improvement in business conditions may push some firms closer to solvency problems. For many firms, a recovery may not mean a return to 'the good old days' but instead, there will be the need to provide for a more resilient working capital base in place of 'hand to mouth' cashflows, which is likely to mean lower drawings, more capital required to be injected into or retained in a firm and much tighter 'lock up' management.

Moreover, there are some additional financial clouds on the horizon for law firms and their cashflows, which will mean that even tighter levels of lock up management are likely to be required for the foreseeable future including the following:

1. The buoyant market created in conveyancing for law firms by the Stamp Duty Land Tax (SDLT) ended on 30 September 2021 and many commentators consider that the number of conveyancing transactions are likely to fall substantially, which is likely to impact on the income and cash flows of those law firms heavily reliant on conveyancing.
2. As the Law Society *Gazette* reported on 13 August 2021 (tinyurl.com/axh2r8wh), HMRC has issued consultation proposals (the consultation deadline for responses was 31 August 2021) relating to the reform of 'basis periods' for the taxable profits of sole traders and partnerships (and all unincorporated entities with trading income) within the self-assessment regime. The consultation proposes that changes are implemented from the 2022/23 tax year (although the Treasury has announced a postponement for a further year) and involve moving from the 'current year' basis to a 'tax year' basis, so that profits will be calculated for the tax year rather than the period of a firm's accounting year. This could (depending upon the accounting date of the firm) bring up to two year's profits into charge for the year, with firms with 30 April year ends (as many have) being particularly impacted. Consequently, there should be an urgent imperative for firms to take advice quickly to ascertain the impact of the proposed changes on their cashflow.

Cashflows and funding

The factors mentioned above should require law firms to urgently take a serious look, not only at their short term cashflows, but more particularly at their medium- and longer- term funding needs. At the same time, weak management of financial performance in a firm will need to be addressed to avoid serious consequences in the future.

During the early days of COVID-19, I saw many firm managers really getting to grips with their cashflow issues but I fear that much of that urgency has now disappeared as levels of work have increased. However, the funding of working capital (particularly as work levels remain high and the need for recruitment grows) should still be a priority and the good financial practices developed and applied at the height of the pandemic, should now be continued if longer term liquidity is to be secured.

So, what enhanced financial measures and management disciplines should now be put in place to secure longer term financial stability?

Stress-test cashflow projections

As law firms face an uncertain future, banks will continue to expect to see stress-tested cash flow projections when considering requests for credit. The provision of up-to-date cashflow projections which are regularly stress-tested against a number of 'what if' scenarios is likely to increase the credibility of, and build confidence in, a firm's financial management.

The ability of a firm to ensure its cashflow is secure, that it can stay within its credit facilities and will be able to trade solvently and profitably will also provide comfort to partners when being asked to contribute further capital or to leave profits in the firm. Otherwise, if such comfort is not given, then the perception is likely to be that such capital will just be 'good money after bad' and will disappear into a 'black hole'.

The legal recruitment market is currently very buoyant, and so providing financial comfort to a partner who may be fearful of financial meltdown in his or her firm and is seeking pastures new, may just persuade that partner to stay. The ability of a law firm to retain the best talent is crucial to survival, and to prevent the rapid withdrawals of partners, which can lead to a rapid collapse.

> *Complacency on the part of partners and those who are managing law firms is the greatest threat to achieving much needed changes required to create business-oriented cultures and enhanced financial performance*

Provide more stable funding structures

Historically, law firms have been largely built on borrowed money. The traditional partnership structure has meant that profits have each year been paid out in full and capital for the firm has often been provided by partners taking out personal loans. The financial crisis of 2008/9 and the subsequent recession had an impact on the continued viability of this model but it still persists in many firms, which continue to be heavily under-capitalised, with very little margin for safety if, for example, a client fails owing large amounts to the firm. Accordingly, following the pandemic, law firms should now be planning to de-risk by creating more stable funding structures, ideally with real capital, not borrowed money. This may well mean retaining more profits within firms rather than distributing them in the form of drawings or profit distributions with a view to improving liquidity and rebalancing their debt / equity ratios. This would increase stability and firms would be better able to withstand turbulent times.

This may also lead to more law firms seeking external investment. However, external investors will not countenance weak financial management and will impose stringent financial disciplines on firms. They will bring with them their own cultures and management techniques which they have developed in the 'shareholder value' environment of the large-scale corporate, and they will seek returns greater than are being generated. Current financial management expertise in many law firms is unlikely to be good enough to deal with this.

Ensure 'accountability' for better financial management

Law firms are 'people businesses' and every aspect of a firm's performance (including financial) depends on the attitudes, behaviour and performance of individuals being aligned with the clear objectives of the business. Financial results are a direct consequence of how well the people in the business – and the expectations of clients – are managed. Financial management is an intrinsic and inseparable part of the overall management of the business and as the drivers of change increasingly take hold, ever higher levels of financial expertise will become necessary as part of the infrastructure of law firms.

And it follows that not only will the roles of those managing financial performance need to become more extensive and far reaching, but everyone in a law firm will need to have a greater role to play in financially managing their work, their colleagues, their clients – and themselves. Pressure on raising performance levels across a range of work areas, functions and roles is already happening as they feel the heat of competition. Criteria to measure and manage performance needs to be devised and financial measurement criteria have an important part to play.

There are straightforward techniques which can improve liquidity and profitability, but they can be difficult to achieve unless:

- 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; and
- those who have responsibility for managing a firm have the appropriate knowledge, determination, and courage to take control.

Given the pressures on law firms, financial management should be seen as wider than the domain of the finance director. Increasingly, managing partners are now being required to ensure that they can hold their own on financial issues with their finance directors. It is not a question of managing partners trying to do the jobs of their finance directors, but more a case of their needing to have an understanding of what will impact on the financial performance of the firm if they are to successfully manage the whole business. Indeed, management and accountability for financial performance will in reality need to be a partnership between everyone in a law firm.

Prioritise education and training

I often hear from law firms about the obstacles to good cash generation put in their paths by partners and other fee-earners. Why are such 'people obstacles' allowed to exist in law firms and how can they be overcome if firms are to accelerate their cash generation?

Those firms that have been particularly successful in their working capital management tend to have extensive financial education programmes to help partners and other fee-earners to develop a culture of financial awareness and to educate them as to what is required to maximise cash generation.

Change the culture

During the pandemic, partners in law firms were forced to accept changes to working practices but law firms now need to work hard to ensure that such changes are permanently embedded into their organisational culture. Just offering 'carrots' to partners to behave differently will usually achieve little, particularly if they are able to comfortably live off their monthly drawings. Instead, there needs to be an enthusiasm to embrace change – innovation is not just about technology – it is more often about people in a business working differently. Complacency on the part of partners and those who are managing law firms is the greatest threat to achieving much needed changes required to create business-oriented cultures capable of dealing with the challenges which, post-COVID-19, will be facing law firms.