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CASH IS KING

Barry Wilkinson explains why improving cash flow is crucial for PI firms

Accountants measure performance using three financial statements: the profit and loss account, the balance sheet, and the cash flow statement. Law firms have been accustomed to focusing on the P&L, and paid little attention to the other two.

Recent law firm collapses have included some substantial personal injury firms, and this has not only affected confidence within the sector, but it has also changed lender sentiment. So it is becoming harder for PI firms to fund their businesses in the way that they have done historically. Some of the failed firms - whilst heavily indebted - have nonetheless been said to be profitable. Their collapse brings home the message long recognised in other sectors, that businesses do not fail for lack of profit, they fail for lack of cash; or, as the Americans say, 'profit is an opinion, cash is reality'.

For the last 10 years, PI has been a high-margin business - and as such, it has been comparatively easy to fund very large working capital requirements in a way that few other business sectors could have done to the same extent. But the squeeze on the PI sector from all directions means that PI firms will, in future, have to be managed much more like conventional businesses. As Charles Handy's Sigmoid Curve explains, all business models have a natural life cycle, and there comes a point where change is required to prevent decline setting in. For many PI firms, what made them successful in the past will not make them successful in the future, and could indeed bring about their downfall.

Overcoming this will require a range of changes - to performance measures, to mindsets, to reward systems, and potentially to people - but above all, it requires a change in priorities, to focus on cash flow above profit. In most other areas of the legal profession it is possible to put in quick fixes which can transform the cash flow and borrowings within 90 days. This is rarely the case in PI, where it can take much longer to implement worthwhile change - but the results can be far more impressive.

The lock-up issue

The annual financial benchmarking survey by the Law Society's Law Management Section shows that the average level of lock-up in medium-sized law firms is 181 days, but for PI firms, it is 478 days. What this means is that, from the point of taking an instruction, it takes most firms six months to receive the cash, whereas for a PI firm, it takes an average of 16 months. So while in other types of law firm, partners need to find £500,000 of funding for every £1m of turnover, in a PI firm, they need to find £1.4m.

Businesses do not fail for lack of profit, they fail for lack of cash

The success of the sector in recent years has meant that many firms have been able to do this by a combination of retained profits and external funding. Both of these will be far more difficult in future. It is often assumed that little can be done to change the funding requirement, because 'that's the way it is in PI'.

One of the reasons that PI firms have historically paid little attention to the balance sheet (high lock-up and slow cash flow) is that it has actually been beneficial to do so. In most areas of business life, stocks and work in

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progress deteriorate in value as time passes. The opposite has often been the case in PI; the longer you could run a file, the more money you could make from it. But the introduction of the Road Traffic Accident portal and the Jackson reforms fundamentally change this. In a world of fixed (or predictive) fees, the crucial thing is to get to the point of collecting those fees as quickly as possible, and at the least possible cost. Lawyers are accustomed to measuring time in six-minute units. In future, they will have to think of *time lapsed*, ie. the number of days taken from instruction to cash.

If the number of days of lock-up is to reduce, the number of days taken on every file must be reduced by proactive management. This means that, for every fixed (or predictive) fee file, there must be relentless focus on taking days out of its cycle.

Categorisation and standards

Fortunately, it is possible to categorise different kinds of PI work by looking at the type of claim (RTA, employer's liability etc), and the value of the damages claimed, which determine both the relevant court track (and thus broad timetable), and the amount of fees available.

Once you know the type of claim and the value of damages sought, you can set management standards or targets for three things: time taken (units/hours), estimated fee income (profit costs plus success fees) and, crucially, time elapsed. For lower-value cases, experience and statistical regularity come into play. For higher value cases, this depends on the skill and experience of the fee earner, and we are regularly told that it is not possible to estimate the high-value claims. But when it comes down to a case-by-case review, it is amazing how many fee-earners can tell you, 'that case will be worth £50,000, but it will take another two years before we can settle'.

While in many cases the level of fees may be externally determined, the time taken is largely a management issue.

Some years ago, we created a simple summary of the main processes involved in a fast-track road traffic accident claim with one of our clients. They estimated how much time (units) would be required for each of the stages, which we checked against the matters database. We also asked them to estimate how long it would take to move from one stage of the process to the next. In total, they had identified 25 stages of the process, and in most cases the gap was said to be 'seven to 14 days'. From the point of view of profitability, it matters little whether the gap was seven days or 14 days. From the point of view of lock-up and cash flow, it is absolutely fundamental. Processing 25 stages and allowing a 14-day gap between each stage takes six full months longer than ensuring the gaps are only seven days each. That extra six months means that for every £1m turnover, the firm would have to find £500,000 of extra funding.

The converse of this is that many PI firms have an opportunity to dramatically reduce their lock-up, and improve their cash flow by speeding up the cycles of each of their work types. This involves a steady and relentless process of identifying in detail the issues which slow down the cycle, and systematically removing them. Most of these issues are not technical or legal, but are internal management or cultural issues.

The action programme

Our approach is to work with the fee-earning teams to set up process improvement programmes which produce a combination of quick wins, followed by steady, continuous improvement.

Step 1 is to identify all of the work type combinations carried out within the department, and to allocate separate product codes on the IT system.

Step 2 is to identify standards for each of those work types; these cover time - both time elapsed and time taken, and value expected. We define standards as being those levels which should be achieved by a competent fee-earner doing their job in a professional manner. Unlike targets, which are generally imposed from above, we prefer standards to be agreed within the teams. Since it will involve a change in the way people work, we want to get the maximum buy-in from the outset.

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Step 3 is to check the status of all current outstanding files against these newly defined standards. Almost inevitably, we will find that many files are lagging behind, and actually should have been turned into cash some time ago. This starts to give a scale of the potential cash flow opportunity, and focuses attention on those files that can most quickly be finished and billed.

Step 4 is to agree with fee-earners a practical completion timetable for all of their overdue files. In some cases, this may mean transferring files from overloaded fee-earners to those who have got some productive capacity. Given the nature of PI work, this tends to have only a limited impact in the first three months, and a very substantial one in the following three months. The key effect here is to move fee-earners' priorities from dealing with new work to ensuring that all work is completed and billed.

If the case management system can be adapted, we also try to ensure that target dates for all stages in a matter can be programmed in, so that fee-earners are held accountable for keeping matters up-to-date. Once a matter gets behind in time, it can be almost impossible to catch up. We then put in place a system of face-to-face meetings with the manager / partner in charge. The process is very simple; the fee-earner has to explain exactly why any file is running behind its timetable. In the first instance, the list of overdue files can be quite extensive, leading to long meetings. But most people do not like having to explain to their boss why they have not done what had previously been agreed as being entirely reasonable. So very rapidly we find that the overdue list shrinks, and the meetings get shorter- and files get completed and billed, so the cash flows in.

As well as the one-to-one meetings, we ensure that there are team meetings which identify the reasons why files have been running late. It is important that these meetings are not used to apportion blame, but to identify the underlying causes of delay. Once the causes are established, visible corrective actions can be put in place. In our experience, the initial list of causes of delay can also be very long - in some firms, it has been up to 100 different explanations. Very quickly, these causes can be split into two categories: excuses and reasons.

What made PI firms successful in the past will not make them successful in the future

The difference is that responsibility for overcoming the excuses belongs with the fee-earner. Responsibility for overcoming the reasons primarily rests with management - and these could range from IT issues, resourcing issues, design of remuneration systems, allocation to the wrong people, inadequate procedures and so forth. Not all reasons are internal; some of them can relate to the behaviour of the clients, or the courts, or third parties such as medics - but by the same token, just because a reason is external does not mean that nothing can be done about it.

The order book

Once we have the system of standards in place, our file matter list becomes an order book. We can estimate exactly which matters should be completed and billed in which month, and for PI more than any other area of law, this can be for several months into the future. Our approach is to do a medium-term cash flow forecast, based on the order book, every three months (unless the firm is in financial difficulties, in which case we would do it more often). Almost invariably, we find that the firm's first attempt at this will be overoptimistic in respect of timing, but will usually underestimate the true value of the files. After a couple of iterations, forecasting can become surprisingly accurate - and this greatly increases the confidence of lenders. When this approach works at its best, it improves cash flow, reduces borrowings - and then, almost perversely, increases the willingness of lenders to provide funding for future growth.

Creating distinctions

At the heart of this approach to improving cash flow is to create a clear distinction between files which are on a fixed or predictive fee, and those which attract costs on a standard basis.

In fixed-fee files, the emphasis is on getting to the result as quickly as possible, with the minimum amount of inputs. Conversely, the emphasis on standard basis cost files is to earn the optimum fee within a reasonable timeframe. These two situations require diametrically opposed approaches to file management, and it is very rare to find individual fee-earners who are sufficiently schizophrenic to operate the two systems side-by-side. We have found it absolutely vital to have different fee-earners running the low-value files to a rapid conclusion, from those who need to adopt the more considered approach required for the high-value files. Not only does the work require different people, but it also needs different systems; not only customised IT systems, but also modified remuneration systems.

Provided that firms can accommodate these changes, the cash flow profile and funding requirements of PI firms can be changed dramatically. Whilst there are many challenges to the profitability of PI firms as a result of the myriad changes at the moment, those same changes provide a massive opportunity to reduce the financial commitment and risk profile - and if managed properly, can allow firms to make a transition to a wholly different business model. Strange though it may seem, it is almost reaching the situation where low-value PI may have a cash profile not dissimilar to that of residential conveyancing.

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