BACK TO BASICS

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Cashflow

This is the second in our series of Back to Basics pullouts, which look at law firm management issues from first principles. This article covers cashflow from three angles: projection (by Robert Banner); cash collection (Barry Wilkinson); and cashflow for legal aid lawyers (Helen Broughton).

1 CASHFLOW PROJECTION

The ability to project cashflow is one of the most important aspects of any future planning. All firms, irrespective of size, should have accurate cashflow projections to enable them to monitor their financial performance in this volatile market. Firms should be aware of, at the very least, the monthly peaks and troughs of cashflow throughout a financial year, to enable them to plan properly.

Many books and articles have been written on cashflow projections. Only a brief summary can be given in the space allowed and only one way of preparing cashflow projection can be explored. There are many other ways, including covering more than one year, or more than one area of the business.

In conjunction with the article, I have also prepared four sample schedules, all of which are based around an entirely fictitious 'case study' firm. They are designed to illustrate cashflow projection techniques, not to reflect any particular firm's financial performance. This supplementary content is available to download from the Law Management Section website at tinyurl.com/cko63ac.

Fees rendered projections

The first stage of cashflow projection is ascertaining what fees the firm expects to render during the financial year.

The majority of any firm's income will be fees rendered to clients. To create a projected fees rendered schedule, consideration has to be given to the expected performance of all the firm's fee-earners on an individual basis. To achieve the most accurate projection, fee-earner performances for the previous two to three years should be considered. Projections should then be made on a monthly basis, based on that historical information. In addition, any potential changes to a fee-earner's fee-earning ability during a financial year should be borne in mind. Two very relevant current examples are the changes in legal aid availability affecting family departments, and the changes to the costs regime affecting personal injury departments. The effect of these changes on fee-earners' ability to earn fees should be assessed as accurately as possible and then fed into the fees rendered schedule.

Regard must also be had to the fact that some fee-earners render fees more consistently throughout a financial year than others. For example, private client fee-earners tend to be more consistent than those working in personal injury. The latter often settle long outstanding cases which include work-in-progress (WIP) from previous financial years; this means that they may render substantial fees in one month, but then go several months rendering only low levels of fees.

Another important factor is whether there will be any changes to the structure or number of the firm's fee-earners during any financial year. Will some fee-earners leave or retire, or will new fee-earners join? In the former case, provision has to be made for WIP subsequent to the fee-earners' departure; in the latter case, provision has to be made for any new fee-earner taking some months to achieve full fee-earning capacity.

See tinyurl.com/cko63ac for a sample projected fees rendered schedule based on the fictitious case study firm.

Projected expenditure

Having assessed what fees a firm is likely to render during a financial year, an assessment then has to be made as to how much the firm will spend in that year. Projected expenditure, like projected fees, should be considered on a monthly basis.

By far the largest percentage of any firm's expenditure will relate to wages. Wages therefore need to be considered in as much detail as possible. If projected wages are accurate, it is more likely that the projected expenditure schedule as a whole will be accurate.

To calculate projected wages, gross wages must be taken into account, together with employers' national insurance contribution. Thought then needs to be given as to whether any members of staff will leave or join the firm during the financial year. Changes to working practices also need to be considered. For example, there may

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be some major IT spend which ultimately leads to a reduction in staff levels.

Wage rises and / or bonuses should also be part of the thought process.

Having dealt with projected wages, consideration then needs to be given to the firm's remaining expenditure. This can be broken down in many ways. One way is to divide the remaining expenditure into four: office; house; financial; and miscellaneous.

Office expenditure will include items of expenditure necessary to run the business, such as expenditure on the firm's library (whether hard copy or online), postage, telephone, stationery, marketing, publicity and IT.

House expenditure will include items of expenditure on premises, such as rent, rates, electricity, insurance and repairs.

Financial expenditure will include accountants' fees, practising certificate (PC) fees, professional indemnity insurance (PII) premiums and excess payments, and recruitment agency fees.

Miscellaneous expenditure will include items such as training, entertainment, subscriptions and sundries.

This is just one example of how to break down other expenditure. There are many other options which may be appropriate, depending on the firm; the most important point is that any schedule dealing with projected expenditure must capture *all* projected expenditure.

To create the most accurate schedule, expenditure for the last two to three years should be considered. The firm will then need to decide whether any changes will be made for the forthcoming year, based on that historical information.

For example, the cost of stamps has increased significantly, and it would therefore be tempting to increase the cost of postage for the forthcoming year. However, a much more vigorous policy relating to the use of emails as opposed to letters could be implemented, generating a saving equivalent in percentage terms to the increase in the cost of stamps; the postage projection could therefore stay at the same level as for previous financial years.

Firms should also ask if there will be any unusually large items of expenditure during the financial year in question, such as making a one-off item of IT expenditure on digital dictation, with a view to ultimately reducing staff levels – this is shown in the sample schedule available from the Section website.

Remember some items of expenditure do not occur every month. For example, PII premiums, unless paid monthly under a finance agreement, are paid in one month a year, as are PC renewal fees. Rental payments and some other payments are normally made quarterly.

See tinyurl.com/cko63ac for a sample projected expenditure schedule based on the fictitious case study firm.

Cashflow projection schedule

Once calculations have been made as to the firm's projected fees and expenditure, these two projections, together with other cashflow factors, must be blended together to form the final cashflow projections for the financial year.

The final cashflow projection schedule will include projected income received and details of expenditure, so as to give a running monthly total throughout the year of the firm's cashflow position.

The majority of income received will relate to fees received. This will not equate to the fees rendered figures contained in the projected fees rendered schedule. This is because not all fees rendered will be recovered during a financial year; some will be written off and the payment of other fees will be delayed. It is therefore suggested that fees rendered are reduced by 2.5 % - 7.5 %, depending on the firm's cashflow collection procedures, to make an accurate estimate as to fees received in any financial year. For the purpose of the sample cashflow projection schedule on the Section website, a reduction of 5 % has been used.

In addition to income received, there will be other sources of income such as bank interest received, which is paid on a quarterly basis, and VAT received, being 20 % of expected fees received.

With regard to expenditure, the projected expenses calculations are transferred directly into the final cashflow projection schedule. There will also be other outgoings, which can include VAT on expenses, client interest, disbursements, payments to partners / directors, VAT on fees delivered less input VAT on expenditure, and tax. The calculation with regard to disbursements depends on whether the firm is expanding or contracting. In the former case, it is likely there will be more disbursements outstanding at any given time; in the latter, there should be fewer disbursements outstanding. With regard to payments of tax, a partnership example is given in the sample schedule, whereby two monthly payments are made, one in January and one in July. Payments differ for limited liability partnerships and limited companies.

Once again, income received and expenditure should be calculated on a monthly basis. The sample cashflow schedule commences with a monthly balance brought forward to the beginning of April 2013. The difference between total income received and total expenditure is then worked in and added to the opening balance, to give the final monthly cashflow position on the bottom line of the schedule. The same calculations need to be made on a monthly basis, so that the firm's cashflow position is known for each month of the financial year.

One important benefit of the schedule will be showing you the projected worst and best cashflow months, which can help a firm to decide when to make additional items of expenditure, and how to negotiate overdrafts with the bank.

See tinyurl.com/cko63ac for a sample projected cashflow schedule based on the fictitious case study firm.

Monitoring

Cashflow projections are only of practical use if they are monitored, preferably on a monthly basis. Each individual item in the final projected cashflow schedule should be considered and compared with the actual figure for the month, and any variations noted. The schedule can be amended as the financial year progresses, but some firms prefer not to do so, as they can then judge the firm's performance at the year end by comparing the original projections with the actual figures.

One of the most important reasons to monitor cashflow projections is to enable financial adjustments to be made where

Knowing your worst and best cashflow months will help you decide when to make additional items of expenditure and how to negotiate overdrafts appropriate. If, for example, more income is being received, or expenditure is less than anticipated, then consideration can be given to making additional investments on behalf of the firm, or increasing partner / director withdrawals. Conversely, if less income is received or more expenditure is incurred than anticipated, then consideration should be given to making appropriate savings. These financial adjustments are much easier to make on a regular basis during a financial year than at the year end, when more drastic measures may be necessary.

See tinyurl.com/cko63ac for a sample monitoring schedule based on the fictitious case study firm.

2 CASH COLLECTION

Cash collection is arguably the most important task in any business – as the saying goes, profit is an opinion, cash is reality. Businesses do not die because of lack of profit, they die because of lack of cash, so strong cashflow is necessary to ensure survival. The stronger the cashflow, the greater the freedom of choice the practice owners have in developing their business. Conversely, it is hard to concentrate on the 'real work' of the practice when time and attention is devoted to chasing the money.

Most cash collection problems are not actually collection problems at all – they are self-inflicted wounds. When cash is not flowing, it is usually the result of an absence of credit policy, poor process or a weak culture. When writing *Cash Management For Law Firms* (Ark Group, 2009), I interviewed several finance directors of large firms and they were unanimous that culture is more important than process. Many firms ignore culture and leap straight to looking at process, and as a result, fail to enforce the terms of trade. This is often because the fee-earners are rewarded for, and focus on, purely fee-earning tasks, rather than facing any penalties for failure to collect the cash; they can therefore argue that they have more 'important' things to do.

So where should you start to improve your collections? In my firm's seminars and workshops, we focus attention on the five-step practice pipeline: getting the client; getting the instructions; doing the work; billing the work; and collecting the fees. If your collections are poor, you need to look further up your pipeline – to the client.

Successful collection depends on being treated as the final part of an integrated process of servicing each client. The keys are simple: select good clients, do a good job, stick to terms, and communicate regularly.

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Categorising late payers

Your list of unpaid bills can be one of the best quality control tools you possess. All you need to do is systematically go through the list and ask why each bill has not been paid (or even better, set up a reason code system). You should obviously ask the person responsible for collection, whether fee-earner or credit controller, but even more importantly, you need to ask the client. This may be difficult to achieve, because fee-earners may lack the skills or confidence, feel it's unethical or unprofessional, worry that they will upset the client, or not even actually know the payment terms they agreed to. But fee-earners must not forget that they are in a commercial transaction, where both parties have rights and responsibilities. Lack of confidence – acting like a servant who has to plead for their reward – is responsible for a great deal of outstanding bills.

Once you know the reasons for the payment delay, you can split clients into two groups: those who can't pay and those who won't. There is arguably, however, a third, where the error may lie with you. Large businesses, including the Legal Services Commission (LSC), often operate IT systems matching to set criteria on their purchase / payment processing system, which often have no leeway. An invoice is either right, in which case it will get processed on terms as recorded on the system, or wrong, in which case it will be rejected. In supplying these organisations, it is your responsibility to ensure that your invoice exactly matches the agreement. We have found repeatedly that half of LSC overdue payments have been due to processing errors by our clients.

Collection

If the client won't pay, you need to pursue collection of the fees. To do this, you need to probe more deeply and keep asking why. It usually involves some form of dissatisfaction with your service – perhaps with the result, the time taken, or the way you spoke to them, or more often, that the fee has exceeded expectations and been an unpleasant surprise. These are all management issues, and you have to solve the root cause, not the symptom. Collection needs to be an essentially friendly process, where you encourage your 'good client' to fulfil their part of the bargain, once you have fulfilled yours. If they still don't pay, they are no longer a good client, and you will need to move to the other option: recovery. But you should only do this if you have exhausted all options available in the collection phase.

Recovery

If the client can't pay, your only option is to protect your position and pursue recovery, which means litigation. However, if you want to retain the client, you must not start with a litigious recovery approach – treat the client the way that you would expect to be treated if you were a client of another business.

If you have a few 'can't pay' clients, you may need to amend your client selection process. Why did you take on the client in the first place if you knew they might not pay? And if you didn't know, why not? Did you do any credit checking? Why did you not take cash on account?

The alternative may be that you let the matter run away with you. Often, even where precautions are taken at the outset, once the matter is in full flow (especially in litigation departments), the financial discipline is overtaken by desire to do the work.

Implementing new systems

To make your collection processes more effective, you need to ensure that collection is monitored and is part of the reward / sanction system for your staff.

I recently met a large accountancy practice which holds its partners to account for their debtors – any bills unpaid after 90 days are deducted pound for pound from that partner's drawings. You may not wish to go that far. But do not allow your fee-earners to abdicate responsibility and let down your collector and your partners. In the end, there is nothing more important than getting paid for doing a good job.

3 CASHFLOW FOR LEGAL AID LAWYERS

It is easy to list the problems in preparing accurate cashflow for legal aid lawyers; it is harder to give solutions, particularly as none of us has a crystal ball. However, with such narrow margins – for family legal aid, between entry-level at £86, and £600 where there is a significant family dispute and some substantive negotiation – it is essential to make every penny count.

Effective management of cashflow can also help you keep your bank on side in leaner times, thereby giving you a chance to survive through this year of change. For instance, in my experience, the legal aid coffers seem to run out every February and March, and despite section 6.5 of the contract that says payment should be made within 28 days of a valid claim being made, payments often dry up. If you have spreadsheets showing the amount of work in the pipeline and the money that is payable by the LSC for completed work, then your bank will hopefully be reassured that your systems are working and you are managing your contract.

My area of expertise is family and some civil work. I therefore cannot comment on crime contracts, save to say that, unless you do it in quantity, and preferably with specialised contracts, then you should probably give up. The pending competitive tendering round will turn what was once a cottage industry into large factory units, and work in any other guise will not be financially possible.

My colleague Robert has explained how to put a cashflow projection together. The starting point is the estimate of fees that you will be claiming for the following year. However, this is very complicated to predict in legal aid, as firms are now going through the transition to the 2013 contract, where legal aid is only given if it relates to children public law matters or where domestic violence can be proved by reference to a very specific list of documents.

In practice, if you are starting with a clean sheet to do your cashflow projection for this financial year, then for the CW1 (controlled work 1) contract, I suggest the following steps.

First, count how many CW1 files you have open. They will surely finish over the next six months. They will return between £86 and £600 unless exceptional. I would suggest an average of £250 for each opened file, to be claimed over the next six months and averaged out accordingly. However, only you know the type of cases you have and if that figure is appropriate. Each fee-earner should be able to estimate what those files are worth.

Second, estimate the number of cases under the new 2013 contracts. Case starts appear reduced around the country to approximately 60 for each office. That will average out at five new cases a month, and again at that same average cost. However, note that this allocation includes the new service level of giving advice with mediation, so the average may be a little higher, particularly if you draft a court agreement.

I urge all firms to keep an eye on their claims. Many firms have had audits recently because of failures in assessing the financial eligibility of clients, and also the over-claiming on level 2 for both children and finance. The auditors have the power to stop your monthly payments, so make sure that there are no 'surprises' in your cabinets and that supervisors check financial eligibility and the claim made, both in respect of whether it is a significant dispute and whether it justifies level 2. Otherwise, the cashflow will take a hit when the payments stop – or worse still, when the recoups are made. And if you don't claim every CW1, the LSC may then do a reconciliation exercise to stop payment to your account, on the basis that you have not claimed enough.

Most practices dealing with legal aid family work depend on certificated cases. Robert says that, in order for you to do your cashflow projections, you have to consider the effect that legal aid changes are going to have upon fee-earners' ability to earn fees. But how can you ascertain this accurately? Most practices will set their cashflow based on historical performance, taking into account monthly variations but also looking at their business plan to see where work is going to come from. This is no different for legal aid practices – they must forecast cashflow based on current workload, historical patterns and their business plan. You may, for instance, be running a new office in order to benefit from a new contract, or investing heavily in an internet offering to encourage privately paid work to fill the void left by the new eligibility rules.

If you have spreadsheets showing the amount of work in the pipeline and the money that is payable by the LSC for completed work, then your bank will hopefully be reassured

These steps will help you make annual projections, but legal aid firms will need to take other steps to generate monthly forecasts, and also to achieve effective collection, the importance of which is discussed by Barry above. I suggest three steps for legal aid firms, as follows.

First, enter diary dates as soon as a certificate is granted, and make your first claim for costs on the three-month anniversary; the second, say, six months after that; and then the third claim and others in subsequent years, as provided for in section 6.22 of the 2010 contract. You can only claim 75% of your possible cost, so there will always be a balancing sum due at the end, but again you must ensure that supervisors agree the costs claimed, so that no fee-earners are over-inflating their current situation. If you do your own advocacy, then that balancing sum may be a little more than otherwise, as the new advocates' rates are generally better for solicitor advocates than the previous schemes.

Second, ensure that each fee-earner, on opening a case, gives an estimate of what the likely fee income is going to be, including whether the work is fixed-fee and whether it's going to become exceptional. This information could be kept on a spreadsheet, covering all the open files, which could then be given to the person in the firm responsible for cashflow projection and management.

Third, as soon as the case is finished, send it to be billed. This should be done either by an in-house team or by an experienced costs draughtsman. Enter this information on a claim spreadsheet so the person responsible for cashflow projection and management knows what has been claimed.