

Financial Management and Control

It is not now sufficient to regard a legal firm as only a professional practice. It is also a business and has to be run as such. This means that controls on operating the business have to be put into place and, so far as its financial management is concerned, this means that reliable and accurate budgeting and reporting systems should be installed. This is not as daunting as it may sound. Depending upon the size of the business it is necessary only to calculate, or estimate, sources and amounts of income and categories and amounts of expenditure expected to arise during the firm's financial period and to compare actual results with those estimates on a regular basis, preferably monthly, but at least quarterly. The other essential forecast is of estimated cash flow (which your bank manager will want to see anyway) and again actual cash usage can be compared with that estimate to show how the firm is doing and whether there is going to be a cash crisis at any point in the forecast period.

In practical terms, about three or four months before the start of a financial period, the proprietor or partners of the firm should sit down and draw up the budget for the period, taking into account all known or anticipated factors likely to affect the figures for both income and expenditure. For example, on the income side a new competitor firm may be opening which might have a damaging effect on fee-earning capability and, on the expenditure side, a rent review may be due which would almost certainly result in an increase in costs. Figures should be arrived at for most, if not all, of the undernoted items of income and expenditure.

(a) Income

Fees (analysed as appropriate)

Commissions

Interest

Any other income

(b) Expenditure

Purchased Services (e.g. sub-contracted work, law accountants' fees etc)

Staff Costs (salaries, national insurance, pensions, travelling expenses, personal accident and other insurances etc)

Premises Costs (rent or loan interest, rates, repairs, heat and light, cleaning etc)

Office Running Costs (leasing, repairs, renewals and maintenance of furnishings and equipment, stationery, telephones and postages etc)

Motor Expenses (leasing, petrol and oil, repairs, licences, insurance, Class 1A national insurance and VAT on private running)

Insurances (Professional Indemnity Insurance, Fire, Consequential Loss, Public Liability and Employers Liability etc)

Education and Training Costs (Courses, libraries etc)

Promotional Costs (Advertising, functions, literature, entertaining etc)

Other Expenses, such as professional fees and subscriptions, bank charges, client balance write-offs, client claims etc.

Overdraft Interest

Depreciation of Owned Fixed Assets

Once the budget has been drawn up and agreed the cash flow forecast should be dealt with. This covers not only the revenue items in the budget but also capital and other items such as purchases of fixed assets, income tax, VAT and proprietor's or partners' drawings.

The budget and cash flow forecast will, in themselves, provide information as to whether problems are likely to arise as regards either profitability or cash sufficiency. However, even if both seem satisfactory, it is only by regularly measuring actual results against these forecasts that the true performance of the business can be gauged. To extract these results from the ledgers can be a time-consuming task, particularly if the records are not computerised, but it has to be done, and frequently. It is very easy for things to go wrong and, because, e.g. the client debtors (i.e. unpaid fees rendered [and outlays] and work-in-progress) are decreasing, for the impending problems not to be seen. It is impossible to over-emphasise the vital necessity of keeping a close eye on the firm's performance if disaster is to be avoided.

Work-in-progress should be properly recorded and accounted for as it is a vital element in the effective management of the firm.

Assuming that the reporting of profitability and cash movement is accurate and reliable, there are other indicators which assist in determining the efficiency of the business, for example: -

1. Aged lists of the client debtors, to highlight where action has to be taken to pursue payment. An indication of how long it is taking for fees to be paid can be obtained by dividing the total client debtors by the amount of the average month's fees rendered.
2. An analysis of time records, if any, showing the time taken by fee earners to generate fees for matters dealt with. How long it takes before a fee is rendered is shown by dividing the total work-in-progress (for the firm or for partners etc.) at charge / feeing rates by the average month's fees rendered. If hourly cost rates are incorporated, a comparison with the fees charged will indicate matter profitability.
3. An analysis of key ratios should be agreed with your accountants. The relevant ratios will vary according to the type, size and geographic location of each firm. As a guide, however, the following targets might be relevant to the average firm: -

- (a) Staff costs to fees rendered, less than 40%
 - (b) Other costs broken down into suitable groups to fees rendered such as proportion of Professional Indemnity Insurance, less than 2½%, proportion of marketing / practice development costs, less than 2%.
 - (c) Profits earned to fees rendered, excess of 30%.
 - (d) Value of the firm's investment in clients i.e. unpaid fees rendered
 - (e) Numbers of qualified staff to partners (this is dependent on the individual firm), two to one.
 - (f) Numbers of partners plus qualified staff to support staff, two to one.
 - (g) Number of new clients and new matters taken on (subjective to the
 - (h) If possible, the targets for the foregoing ratios should be compared with the ratios of other similar firms (if these can be obtained) or with average figures which are published from time to time. Over a period comparisons with your own figures will be useful indicators
4. Periodical balance sheets for the business showing its total asset value and sources of financing.
 5. How individual fee earners are performing against fee targets set. Depending upon the size of the firm, fee targets that are realistic can be set by, for instance, estimating the anticipated expenditure for the year ahead, adding to this the Partners' realistic targeted profit to give the total turnover target; estimating how many hours fee earners will put in per annum and what proportion of these might be chargeable; then using the estimated chargeable hours and the fee that might be charged per fee earner to set fee targets per individual fee earner which together total the targeted fee income for the firm. Whether or not the targets are achieved, if properly calculated it will be difficult for individuals to dispute their validity and a comparison with fees earned against the targets will provide useful information on the profitability or otherwise of both individual fee earners and different work types. This system will work best when accurate time recording is completed by all fee earners.

All of these reports help to build up a picture of the health of the business and, over a period, will create a historical perspective for the better evaluation of the data being produced.

It is important to set up the systems to provide information about the business but it is essential to examine the information, interpret the message that is being provided and to take the action needed which the interpretation indicates.