

# Navigating stormy seas: financial difficulty in law firms

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## Executive summary

In the SRA's Risk Outlook, launched in July 2013, financial difficulty was identified as a significant current risk to the regulatory objectives<sup>1</sup>. There is a difference between firms facing tough operating conditions, but managing this situation well, and firms that are in the same situation but not managing the associated risks effectively.

It is the latter group that we need to engage constructively with to ensure that risks to clients and the public interest are controlled. This paper sets out the approach we have taken to dealing with this risk amongst the firms we regulate and highlights key lessons learnt from this experience.

### Targeting our resources

To allow us to take a proportionate and risk-based approach, we undertook a substantial data collection exercise to allow us to understand better the risks posed by the financial position of law firms:

- we requested data from over 2,000 firms, based on criteria relating to the probability and impact of financial difficulty. We did not have specific concerns about the financial position of these firms, but required more information to allow us to assess levels of risk
- we asked for a range of information covering debt, use of overdraft facilities and levels of profit, loss and partner drawings
- an analysis of this information indicated that around
  - 5 percent of firms in this group present a high risk of financial difficulty
  - 50 percent were assessed as presenting a low risk
  - the remainder of firms fell somewhere in between these two positions
- where risk was assessed as high we have engaged urgently, often by a firm visit, with a view to validate this assessment and to understand how risk is being managed

- other firms will receive different levels of engagement, including telephone discussions, future information requests or simply a reminder of their obligation to notify us if their situation worsens

This type of data collection and analysis is critical for us to assess risk and manage it effectively. This highlights the importance of firms co-operating with requests for regulatory information.

### Engagement and controls

Our engagement with firms has highlighted a range of poor practices associated with higher risk of financial difficulty, including:

- inability to measure or control financial performance
- excessive use of borrowing and debt
- excessive partner drawings and remuneration in relation to profit and revenue
- over dominant senior partners or managers
- lack of transparency on financial performance amongst appropriate levels of management
- inappropriate use of client account
- weak process for collecting on bills for completed work
- inadequate planning and due diligence for diversification of legal practice or acquisitions of other firms
- narrow focus on a single type of legal work

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1. <http://www.sra.org.uk/sra/strategy.page>

We make a distinction between firms that have entered financial difficulty and taken a positive approach to dealing with it, and firms that have attempted to ignore or conceal their situation or have taken a reckless approach and worsened the financial situation through poor financial or business management. Resultant enforcement action will be taken where there is evidence of a lack of integrity in the conduct of firms faced with financial difficulty.

Where firms have engaged with us early on, and held a constructive dialogue, we have seen more positive outcomes. For example, some firms have improved their financial position by adopting better business practices.

## Background

We know that financial difficulty is a widespread issue, and many law firms are faced with a challenging operating environment. Many of these firms are dealing with these challenges and managing these risks effectively. Some are not. Our objective is to identify and engage with firms where financial difficulty is presenting a real risk to that firm's clients or the wider public interest.

This paper sets out:

- how we have taken a risk-based approach to managing financial difficulty in the firms we regulate
- what we have found from engaging with these firms



## Targeting our resources

We are using a risk-based approach to deploy our resources to deal with financial difficulty. Our aim is to enter a close and continuous engagement with firms in financial difficulty. To do this, we have used indicators and analysis of information to allow us to target our resources at the firms that present the greatest risks to the regulatory objectives.

### Data collection

We rely on access to the right types of information to allow us to operate risk-based, outcomes-focused regulation. The information we collect from firms during the Practising Certificate Renewals Exercise is not sufficient for us to identify which firms face financial difficulty, and often annual accountants reports do not provide an up-to-date picture of firm's current financial position. We needed additional data in order to construct better indicators.

In line with a risk-based approach, we did not seek to obtain data from every single firm. To minimise this burden we used profiling characteristics to select 2,000 firms to request information from. Firms were not asked for information because of any particular concern about their financial situation. It was based on the following characteristics:

- any firm which generates at least 50 percent of its revenue from Legal Aid and at least 50 percent of its turnover from criminal or family law work
- any firm that generates at least 90 percent of its turnover from personal injury work
- any firm who had previously reported to us as having a referral fee arrangement in place
- all firms that assessed as being in the top 500 by impact (based on our risk assessment methodology)<sup>2</sup>

- where our risk profiling suggested firms shared some common characteristics with firms that have experienced financial issues in the past
- any firm we were already engaging with in regards to financial difficulty at the point of selecting the firms, plus continuous additions of any firms we engaged with since.

The 2,000 firms selected were asked to provide the following information<sup>3</sup>:

net profit or loss

total drawings

director remunerations

dividends paid to directors

total borrowings

if the firm is in a 'time to pay' or 'deferral of liabilities' arrangement

whether an agreed overdraft is in place

if an overdraft is in place, and if so, the approved overdraft limit

maximum and minimum account balances over a range of time periods

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2. <http://www.sra.org.uk/sra/strategy/risk-framework/regulatory-risk-framework.page>

3. When choosing the indicators to use, we discussed a range of possible metrics with a number of financial institutions before making the final selection.

## What we found

The financial information we collected was inserted into pre-defined financial formulas and analysed using a combination of academic and qualitative insights<sup>4</sup>. This analysis provided an assessment of the likelihood that the firm is experiencing financial difficulty. This was combined with the existing 'impact' scores for the firms concerned. This allowed us to calculate a 'risk rating' score (i.e. impact x likelihood) for each firm.

We are now considering our next steps in terms of collecting data from a wider selection of firms. This may be necessary because the data collection exercise described above has confirmed our view that financial difficulty is a widespread current risk.

Based on this analysis we found that:

- 5 percent of firms showed a very high risk of being in financial difficulty
- 50 percent of firms showed a low risk of being in financial difficulty
- the remaining firms fell on a spectrum between these two positions, and the level of risk identified will determine our approach to further engagement

## What we are doing with this information

The results of this analysis are being used to direct a proportionate response to the levels of risk we face. This allows us to engage where it is most needed. Broadly, our engagement was decided on the following basis:

- firms that have a low-risk rating are sent an e-mail reminding them of their self-reporting obligations
- firms with a medium-risk rating will be required to re-submit their information for analysis at a to-be-decided point in the future
- firms with a high-risk rating are engaged with by phone or via a face-to-face visit. The firms deemed to present the highest risk were visited first.

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4. With subsequent validation by financial institutions we have been engaging with and by specific case studies of particular firms

## Engagement with firms

We have been engaging with firms, via our supervision function, on the subject of financial difficulty before the data collection exercise began. However, this type of work with firms in financial (and other types of) difficulty is still relatively new. We are still growing our own expertise and confidence to work closely and constructively with firms in financial difficulty, but we are already seeing the benefits of this constructive, and at times pre-emptive, approach. For example:

- clients and the public are better protected, as a result of better risk management over factors that might cause them harm
- firms are taking the necessary steps to avoid regulatory issues, by being encouraged to deal with financial difficulty before the situation deteriorates

There are also other tangible benefits, such as reducing the total intervention costs incurred by those we regulate. This is achieved if firms are able to conduct an orderly wind-down, or better still, resolve their difficulties and build a stronger financial position for themselves.

### Experience of engagement – good and poor practices



Engagement with firms has highlighted many issues about the financial management of firms. In some cases, the behaviour we have seen has simply demonstrated poor management skills. However, we have also seen conduct which has demonstrated dishonesty or a lack of integrity. Where enforcement action is necessary, it will be proportionate to the conduct of those involved.

Firms may enter financial difficulty for a variety of reasons, and it is impossible to identify all of the factors in detail. Below we outline some of the most striking features that we have observed from our recent work.

### Poor financial management – ranging from naïve to reckless

Unsurprisingly, we have found that well-run firms tend to have in post a high-quality financial director or equivalent. The opposite was often true at poorly-run firms. Examples of poor financial management encompass a wide range of practices, including:

- inability to measure and performance manage the financial position of the firm
- over reliance on borrowing and use of overdraft facilities to keep the firm trading
- partner drawings and remuneration being excessive in relation to the firm's profits and cash collection
- over commitment to high fixed costs, such as premises and vehicles
- failure to share financial information outside of a small group of senior partners or managers

We have also seen poor practice in the management of client accounts. For example, some firms have held large amounts of client money in their office account by receiving payments containing both office and client money. This gives rise to various risks, including the temptation to keep the client money in office account for longer than necessary. Better practice is for mixed receipts to be paid first into the client account rather than office account (with the office money then transferred promptly).

### Poor business management

Closely linked to poor financial management are other weaknesses in wider business management. We have encountered several firms trading in a weak financial position as a result of failing to bill, and collect revenue, for completed work. Identifying this issue and rectifying it by introducing efficient invoicing processes has been a major step towards financial stability for firms in this situation.

Many of the firms we have worked with are overly reliant on a single type of legal work. Whilst having a genuine specialism in a particular area of work is a significant business advantage, we have found many firms that have a very narrow focus, but without a unique selling point for their services. This has made these firms vulnerable to changes in demand from clients or to competition from other firms.

Diversification into new areas of work can be part of the solution for firms in this situation. However, it needs careful consideration and preparation. We have seen situations where financial difficulty has been worsened by firms entering new legal markets without a clear business plan or the necessary skills to make this a success.

Similar lessons can be learnt from the experience of firms that have acquired other firms to gain market share or diversify their services. This can be an effective approach if it is well managed. However, acquisitions require both legal and financial due diligence and a well-thought-out business plan to control the associated risks.

### Poor leadership

Our experience of engaging with firms has also highlighted that one individual, or a small group of individuals, can be the main cause of a problem. Over-dominant chief executives or managing partners sometimes cause strategic failure or lead to a refusal to accept how serious a financial situation has become. Firms that have recognised this and dealt with it have sometimes recovered quickly, possibly as a result of regaining the confidence of their funders.

### Failure to work constructively with us

It is very effective for firms to engage constructively with us rather than to adopt defensive tactics or ignore the presence of a problem. Frank and early acknowledgment of errors or misconduct demonstrates an understanding of modern regulatory practice and can substantially mitigate our risk-based concerns.

Many firms are recognising this, which is leading to some positive results. We have found that independent advice on solvency has also been a valuable source of advice for firms in this situation and has encouraged the development of proactive plans to deal with difficulties. Where firms are actively identifying and controlling the risks associated with financial difficulty the need for regulatory action, including intervention, is much reduced.

However, refusal or inability to accept the existence of serious financial and management problems in firms is still common. Firms are failing to deal with the risks to the survival of their own business as well as neglecting to manage risks to clients or the wider public interest. The temptation to be economical with the truth, both to us and their funders, is a very serious risk for firms. In view of the implications for the integrity of those involved.

## Conclusions

The risk of financial difficulty remains high in firms across the legal services market. It is a risk that can be controlled by firms, through effective business and financial management processes, as well as by dealing openly with their regulator.

We have been focused on ensuring that we are clear and open in our rationale and objectives for the financial difficulty data collection exercise, given that it is the first initiative, on this scale, of proactive, detailed information collection from the regulated community.

We have taken a risk-based approach, designed to allow us to target our resources on firms where the risk of financial difficulty is highest and the benefits of constructive engagement are greatest.

We have already started to work with the firms that present the highest level of risk, and will make further contact with other firms who provided information that indicated a lower, but still concerning, level of risk.

As expected, our engagement with firms has highlighted that financial difficulty is highly associated with poor practices in terms of financial and business management. We have also made a distinction between firms that face financial difficulty despite their best efforts to avoid this situation, and those that have behaved recklessly or otherwise conducted themselves in a way that demonstrates a lack of integrity or responsibility towards their regulatory obligations.

We have found that openness and willingness to deal with this risk in a constructive manner is beneficial to the interests of firms themselves, clients and the wider public who depend on strong and well managed law firms to administer justice and uphold the rule of law.