The Law Society

The Law Society's Law Management Section

Financial Benchmarking Survey 2018

In association with Hazlewoods LLP

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Foreword

I am very pleased that one of my first tasks as the incoming chair of the Law Management Section is to write the foreword for the 2018 Financial Benchmarking Survey.

LMS's survey is targeted at mid-stream practices, giving invaluable financial comparisons for firms to benchmark against.

The survey this year is bigger than ever, encompassing statistics from over 160 law firms, ranging from those with a turnover of below £1m to those with turnover in excess of £10m.

The format has been improved this year to give a more up to date look and feel to the survey results, without losing any of the detailed analysis.

The results of the survey allow firms to benchmark their performance against other similar firms on a completely confidential basis. By benchmarking in this way, firms are then able to analyse where they can look to make improvements, which will have a direct effect on their profitability.

A huge thank you to Jon Cartwright, Andy Harris and everyone at the accountancy practice Hazlewoods for their hard work in pulling together and compiling all of the survey results. Thanks also to Andrew Otterburn for his efforts throughout the year.

More thanks go to Lloyds Bank Commercial Banking for their sponsorship of the survey, and to Paul McCluskey from Lloyds for his support and encouragement throughout the year.

Final thanks go to all who have taken the time to participate in the survey, which makes this report possible. I hope that you find this year's survey useful in improving the profitability of your practice. Please keep a look out for the survey later in the year so that you can include your statistics in next year's report.

PS if you are not already a Law Management Section member then now is a good time to join – see page 2 for details.

Ann Harrison
Chair, Law Management Section Committee
Chairwoman, Stephensons Solicitors LLP
March 2018

About the Law Management Section

The Law Management Section (LMS) is the community for partners, leaders and practice managers in legal businesses. Established in 1998, the Section provides law firm managers with support, advice and opportunities to network and share best practice with peers.

It provides practical guidance, information and support on the full range of practice management disciplines, including HR, finance, marketing, IT, business development, client care, quality and risk.

The comprehensive range of services and benefits includes:

- *Managing for Success* quarterly magazine;
- regular Law Management e-newsletter;
- website featuring news and events, members-only discussion forum, downloadable documents and suggested links;
- national and regional events programme covering all management disciplines;
- the LMS Financial Benchmarking Survey;
- toolkits on internet policies, mergers, legal aid, risk management, HR and business development;
- networking opportunities;
- representation on the Council of the Law Society; and
- discounts on a range of events, texts and training packages.

Membership is open to solicitors; those concerned or involved in the management of a legal practice / department (whether as HR, IT or marketing manager); or those habitually or frequently involved in the supply of services to legal practices which relate to the financing or management of such practices.

New Corporate Membership

Individual membership costs £199, but you can now take advantage of even greater savings with our new corporate membership deal. For only £200 more than the cost for an individual member, your firm can nominate up to six individuals in their organization who will all receive the full benefits of being a member of the Law Management Section. If you wish to have seven or more memberships, the cost will be £399 plus £60 per person for each additional member over six.

For more information, visit

http://communities.lawsociety.org.uk/law-management
email: MSadmin@lawsociety.org.uk
telephone: 0207 320 5804

About Hazlewoods LLP

The LMS Financial Benchmarking Survey is written and produced by the Legal Team of Hazlewoods LLP.

Hazlewoods is a Top 30 accountancy practice with a niche specialism in advising the legal profession, and we have a dedicated team of 27 individuals who focus only on this. We are retained by over 135 practices countrywide on a recurring basis and advise at least 30 others each year on projects such as practice strategy, mergers, de-mergers, structure advice and implementation, external equity investment, breaking away from larger firms, dealings with the SRA, and imaginative but mainstream tax planning. The scope of our service goes far beyond the normal compliance based services provided by the majority of other accountancy practices, and we have a tremendous range of contacts in the sector. See more at **www.hazlewoods.co.uk/sectors/legal-accountants.aspx**

This is the ninth year that we have compiled the LMS Financial Benchmarking Survey. Should you have questions about anything at all in it, we would be delighted to hear from you (**legal@hazlewoods.co.uk**)

About Lloyds Bank Commercial Banking

I am encouraged by the results which show the sector is resilient and continuing to thrive against a backdrop of challenging headwinds.

The pressure of continued sector reform, coupled with the uncertainty as the UK prepares for Brexit, pose many questions for firms.

However, most pressing issues lie closer to home, with many firms combatting important challenges such as succession planning, viable exit strategies for partners and cybercrime.

To deal with pressures on income, it is crucial that firms keep a tight control on costs and work with fee earners to improve their time recording, billing and cash collection. Results from this year's survey indicate firms are having some success with this.

Almost all types of work are experiencing growth and this is again evidenced by the eight consecutive year of improvement.

Encouraging too is the reduction in lock-up, however I am still concerned by the number of firms across the sector that continue to allow partners' drawings to exceed profits. Succession is a major issue and this practice not only weakens the financial strength of the firm - thus potentially discouraging a prospective investor - but it also means practices are less likely to be able to sustain a healthy future. I encourage all managing partners to take a hard stance against this culture.

At Lloyds Bank Commercial Banking, we work closely with solicitors to provide funding and support that meets the specific needs of their businesses. Our specialist managers are Lexcel-trained; understand practice management standards; and know the opportunities and threats that face the profession.

They are also trained in the SRA Accounts Rules to ensure we complete the housekeeping processes correctly.

We are proud to have been voted 'Bank of the Year' by Finance Directors in the FDs' Excellence Awards for 13 consecutive years. Our 'through the cycle' approach to lending has allowed us to continue to support viable firms through difficult times. Since 2011, we have grown net lending to SMEs by 31 per cent while the market has contracted by 11 per cent.

Lloyds Bank Commercial Banking is proud to sponsor the Annual LMS Financial Benchmarking Survey. It is the most in-depth of its kind and an invaluable tool for law firm owners and managers to understand best practice and to make the right business decisions. I am certain that firms who seek out and use external comparators will continue to be successful, irrespective of new market entrants.

Paul McCluskey
UK Head of Professional Practices, SME Banking
Lloyds Bank Commercial Banking

www.lloydsbank.com/solicitors

Lexcel
Legal Practice Quality Mark
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THE FDs' EXCELLENCE AWARDS
2005 - 2017
BUSINESS BANK OF THE YEAR

Introduction

Subscribers to The Law Society's Law Management Section (LMS) represent law practices up and down the country. For the past 17 years, LMS produced the annual LMS Financial Benchmarking Survey with the active participation of that membership.

This is the 17th year of the LMS Survey. The survey is widely regarded as one of the leading annual health check reports for mid-sized practices.

All legal practices are welcome to participate in the survey. We recognise that it takes effort to compile all of the data necessary to participate in it, and therefore questionnaires were once again emailed to members in Excel format, allowing them to be completed as quickly and easily as possible.

As in previous years, participants were asked to provide two years' data, i.e. the most recent accounting period and the previous one. This has allowed us to compare two years' results on a true like for like basis.

Many of the charts throughout this report include the results for two accounting years. Most charts includes three figures for each turnover band; the lower quartile, median and upper quartile. The results for 2017 are shown as columns and figures, and the like-for-like results for 2016 are shown as a dash (i.e. -).

In a small number of instances, participants were not able to provide us with full comparative data. Where necessary we have taken account of this in the statistics quoted.

For ease, throughout this report we refer to the owners of the practices as Equity Partners.

As in previous years, our report focuses on three basic performance measures: income, profitability, and working capital.

We would like to thank all practices that took the time to complete and return the questionnaires, and we hope that you find the report both interesting and useful in your practice.

The Law Society | Law Management

Key headlines in this year's survey (explanations for all of these will follow later):

£227,738
17%
median equity partner capital

5.3%
median practice fee income

median fee income per equity partner
£683,746

150
-5 days
year end lock up

median cost of employed fee earner
£40,304
£40,516 2016

5.5:1
fee earners to partners

0.56:1
secretaries per fee earner

median spend on non-salary overheads
£35,816 (2016)
£35,304 (2017)

median 'super profit'
2016 £58,078
2017 £66,584

- Median equity partner capital (combined total of capital account, current account and tax reserves) increased by 17% to £227,738.
- Median practice fee income increased by 5.3%.
- Median fee income per equity partner of £683,746 (2016: £629,847).
- Total year end lock up days (WIP and debtors together) fell by 5 days to 150 days (2016: 155 days).
- The median cost of an employed fee earner, including fixed share partners and notional salaries for equity partners, was £48,787 per fee earner, compared to £47,744 in 2016.
- The ratio of fee earners to partners remained steady, at 5.5 to 1.
- The number of secretaries per fee earner increased very slightly, to 0.56 to 1. (2016: 0.54 to 1) The number of all other support staff per fee earner remained the same, at 0.37 to 1.
- The median spend on non-salary overheads per fee earner was £35,304 compared with £35,816 in 2016, and as a proportion of fee income non-salary overheads dropped slightly, to 30.6% (2016: 31.7%)
- 15% of participants reported partners' total drawings (including income tax) exceeding profits in both 2017 and 2016, compared to 9% last year.

Median net profit per equity partner (before notional salary) has increased again, up from £151,712 in 2016 to £162,161 this year – a rise of 6.9%. Both the 2016 and the 2017 numbers are all taken from the practices taking part in this year's survey, so it is a true like for like comparison. This is the eighth consecutive increase.

When we adjust these figures to include a cost for equity partners, and also notional interest on partner capital, the median 'super-profit' for the year was £66,584, compared to £58,078 in 2016. 18% of participants reported a 'super-loss' for the year.

Once again, it is pleasing to see that this was a strong year for the majority of practices taking part in the survey.

3. Participants

169 practices from across England and Wales, employing 12,500 people, took part in this year's survey. The fee income of all participants totals £948m - an average of £5.6m per practice - with combined net profits of £225m.

As in last year's report, we have categorised practices based on turnover. The turnover bands, and number of participants in each band, are as follows:

Turnover band	Number of participating practices
< £1million	27
£1million - £2million	19
£2million - £5million	57
£5million - £10million	41
> £10million	25
Total	**169**

Just over three quarters of participants traded as either a limited liability partnership or limited company. This is significantly higher than, and in different proportions to, the percentages for the legal sector as a whole – according to SRA statistics, 44% of practices were operating as a limited company, and 15% were operating as a limited liability partnership at 31 December 2017.

The SRA's statistics show that the number of limited companies has increased by 721 in the last two years, with very little change in the total number of practices.

Table 3.1: Accounting year end of participating practices

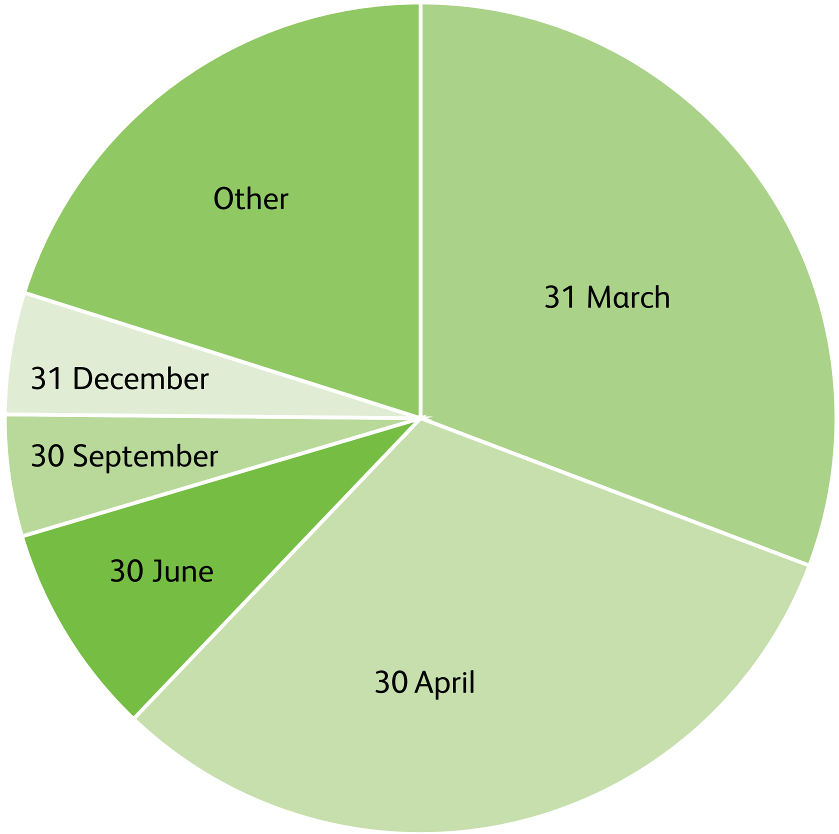
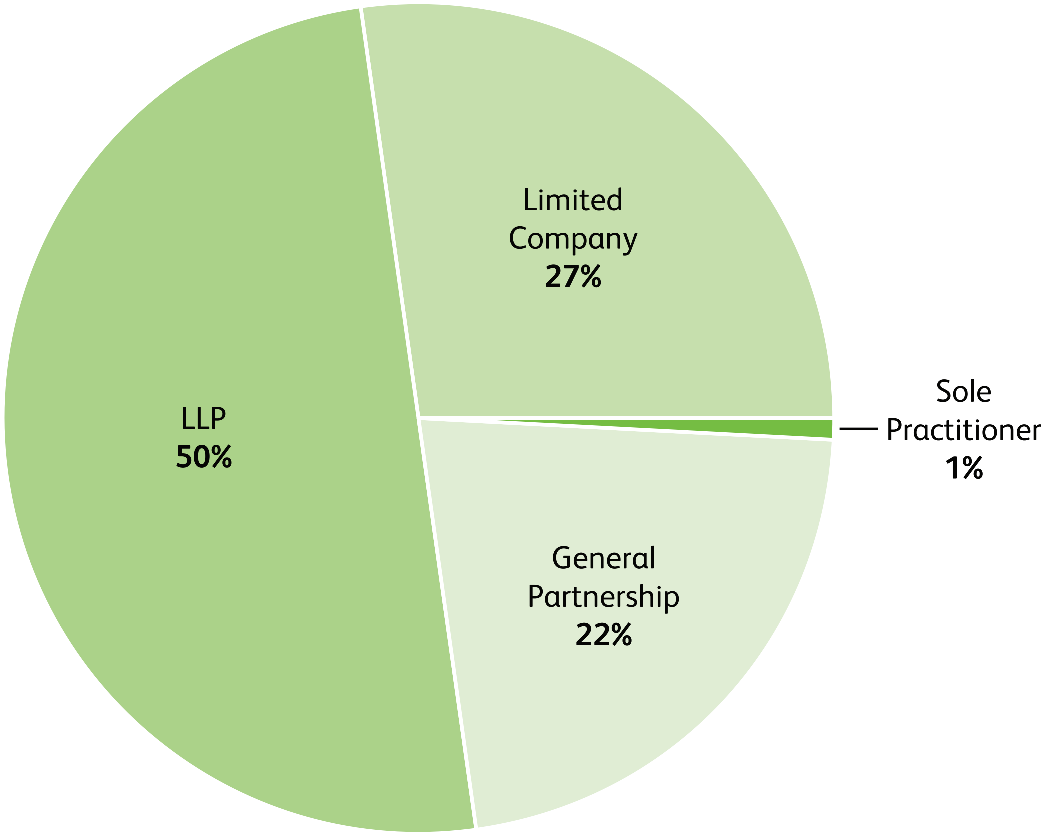
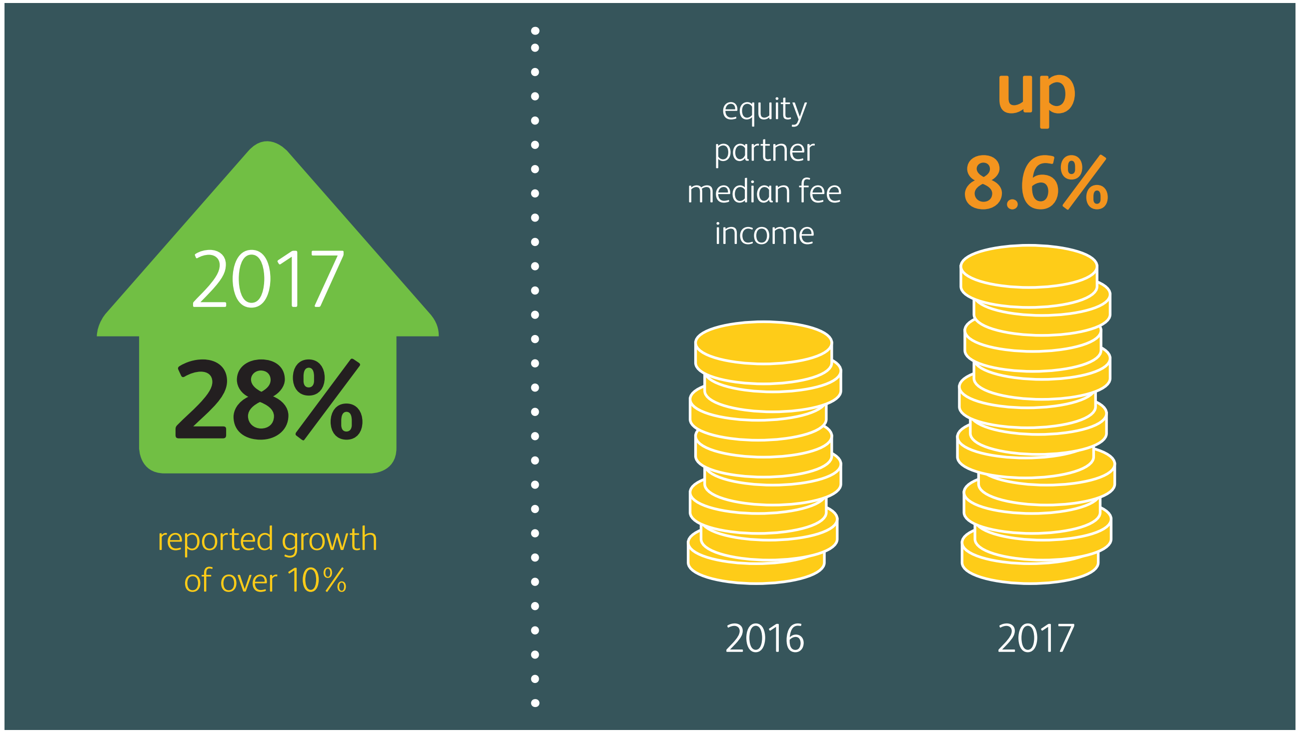


Table 3.2: Structure of participating practices



4. Fee income

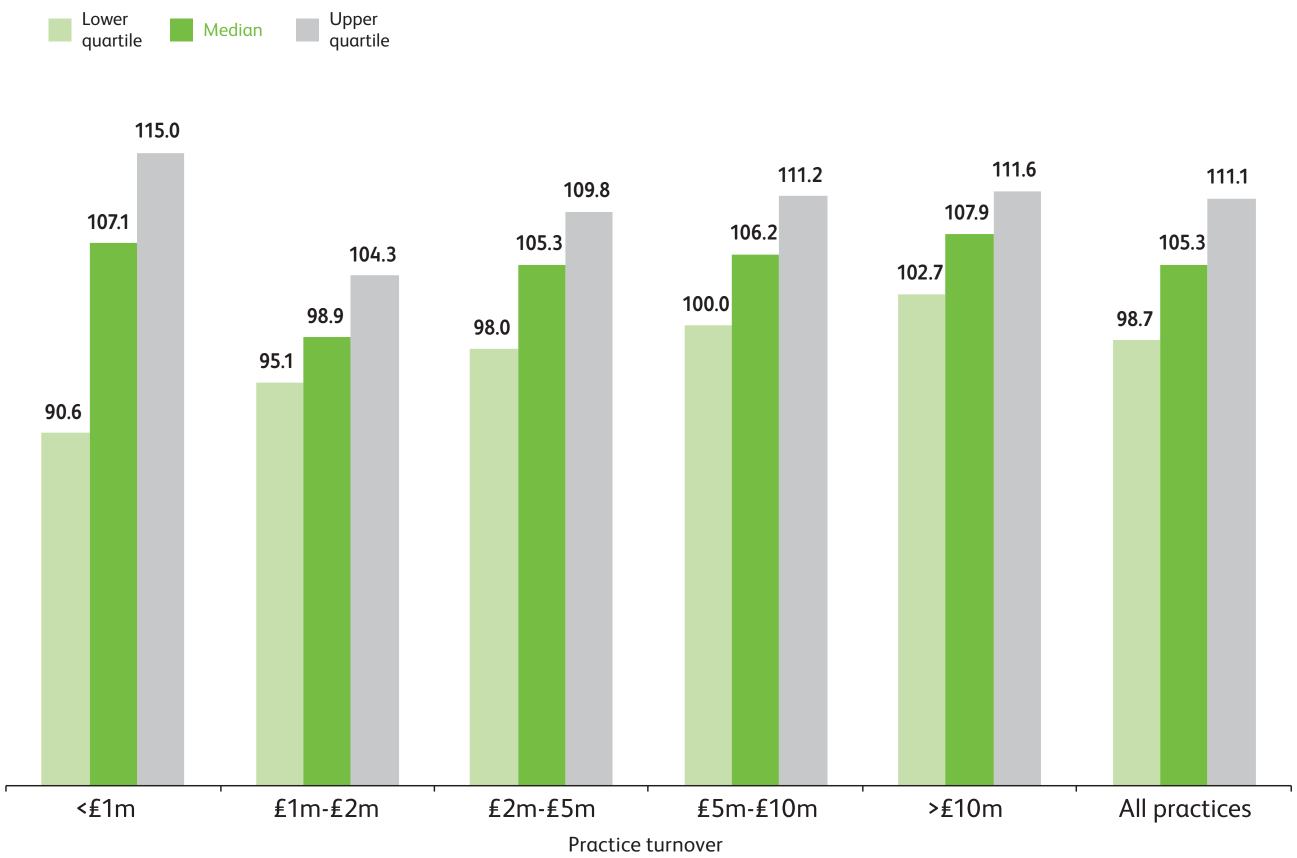
We start our analysis by reviewing income growth. We have measured income performance by equity partner, by individual fee earner and by specialism. We reveal the effects on revenue from changing the gearing in a practice; that is the ratio of fee earners to equity partners. At the end of the section we look to see which specialisms are outperforming the others.



Key points are:

- 70% of the participants in the survey reported growth in 2017, with 28% seeing growth of over 10%.
- Median fee income has increased for the eighth consecutive year. The last four years have each seen increases of more than 5%, so when compared with RPI inflation (currently at 2.7%), practices are experiencing strong growth in real terms.
- A median fee income per equity partner of £683,746 compared to £629,847 in 2016.
- In general, most work types are experiencing growth. There remains stiff competition in residential conveyancing, with participants from the South East in particular reporting a drop in residential property work. Our analysis also shows a drop in income from personal injury, which is no surprise, given the ongoing changes to the personal injury sector.

Table 4.1: Fee income as a percentage of previous year's fee income (%)



Median increases in fee income

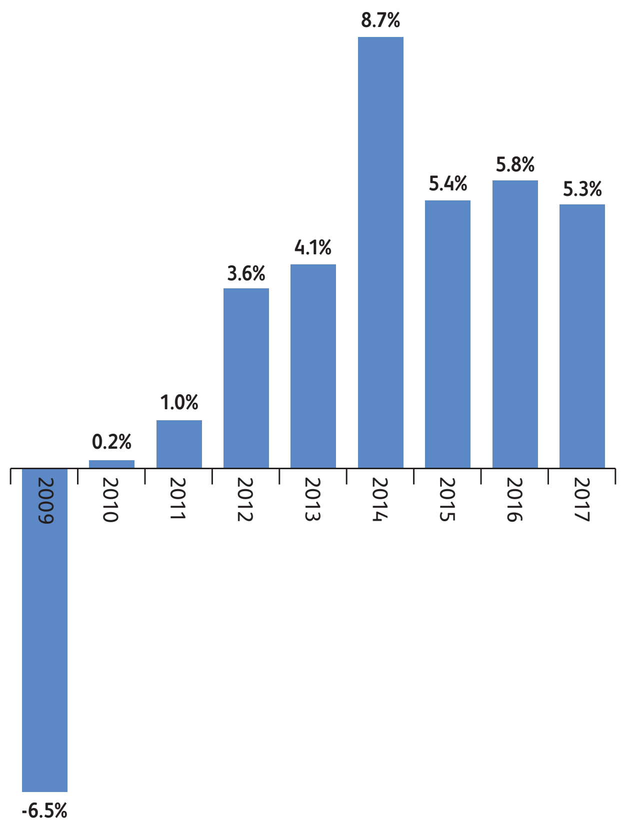
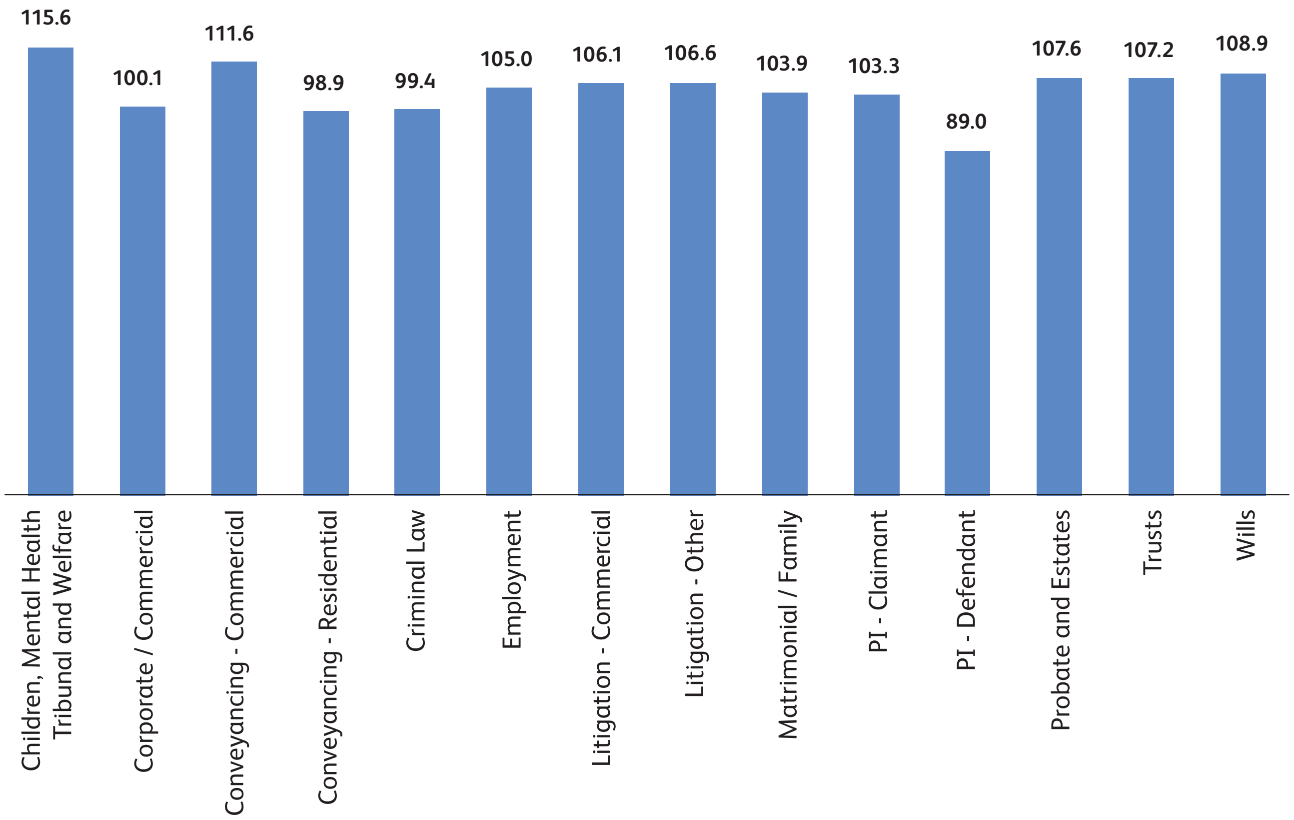


Table 4.2: Fee income as a percentage of previous year's fee income by specialism (%) (median figure only)



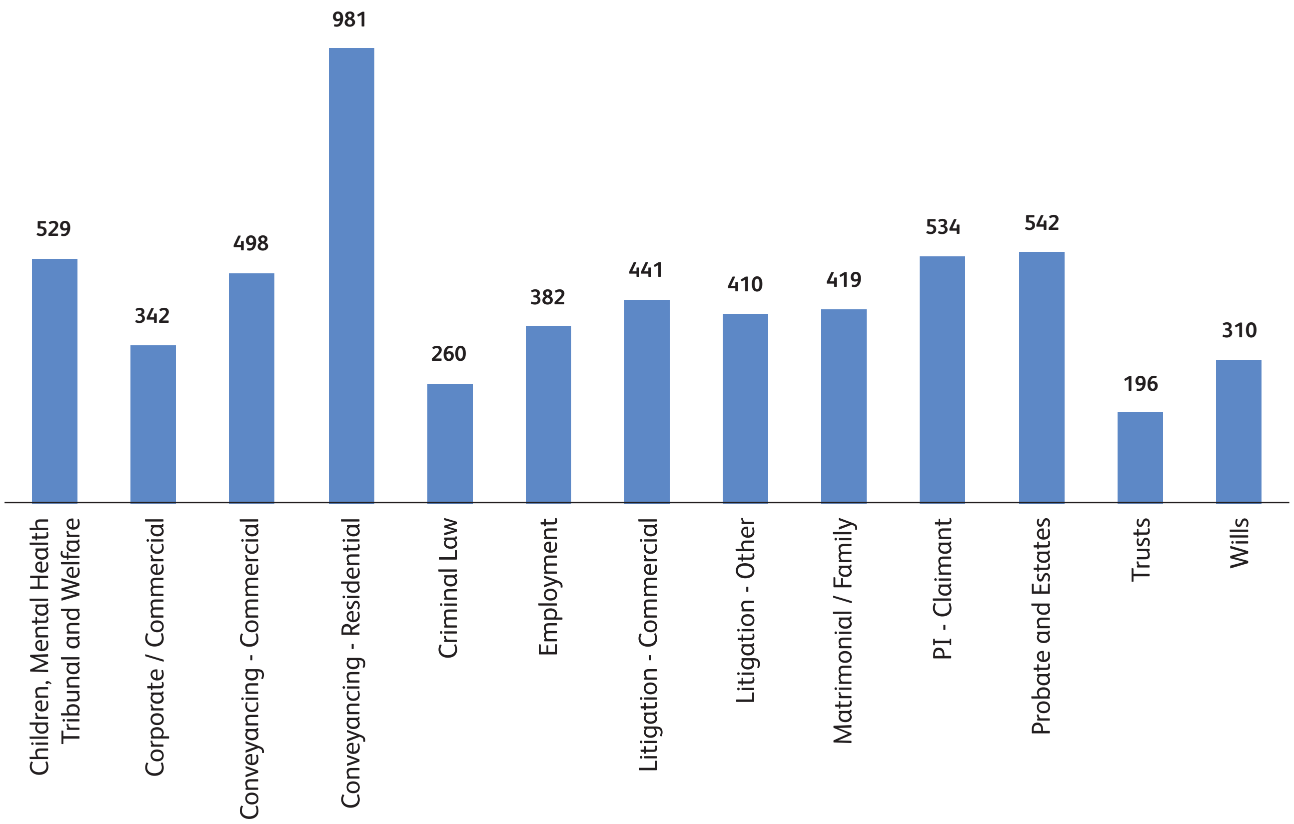
Equity partner performance

The majority of participants in the survey reported minimal change to the number of partners between 2016, and 2017. The total number of equity partners increased by just 0.6%, from 1,073 to 1,080.

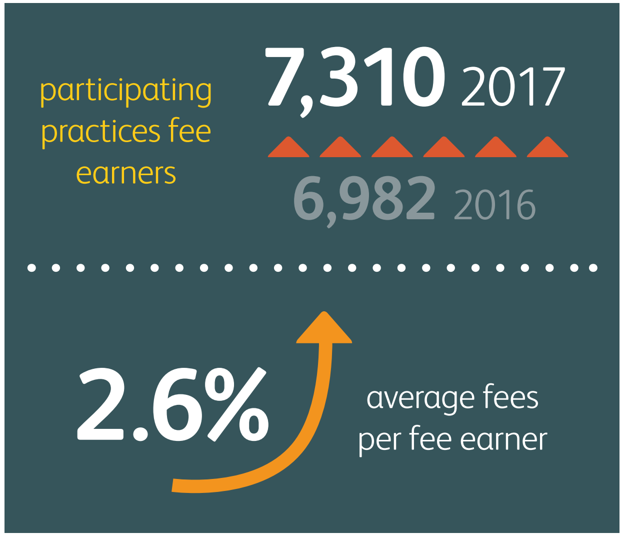
For most practices, the growth shown in Table 4.1 on page 11 has resulted from increased fee income per equity partner, rather than an increase in partner numbers. All but the smallest practices show a rise in fee income per equity partner, with a median growth of 8.6%.

Table 4.3: Fee income per equity partner (£'000)

Table 4.4: Fee income per equity partner by specialism (£'000) (median figure only)



Income by individual fee earner



Key points are:

- Average fees per fee earner were £118,637, compared to £115,602 in 2016, a growth of 2.6%.
- The growth in average fees per fee earner is good news. It shows that new fee earners recruited during the year are being productive and generating chargeable work in line with their peers. Existing fee earners are recovering more of their chargeable time, or have been able to increase their chargeable rates.

Table 4.5: Fee income per fee earner (£'000)

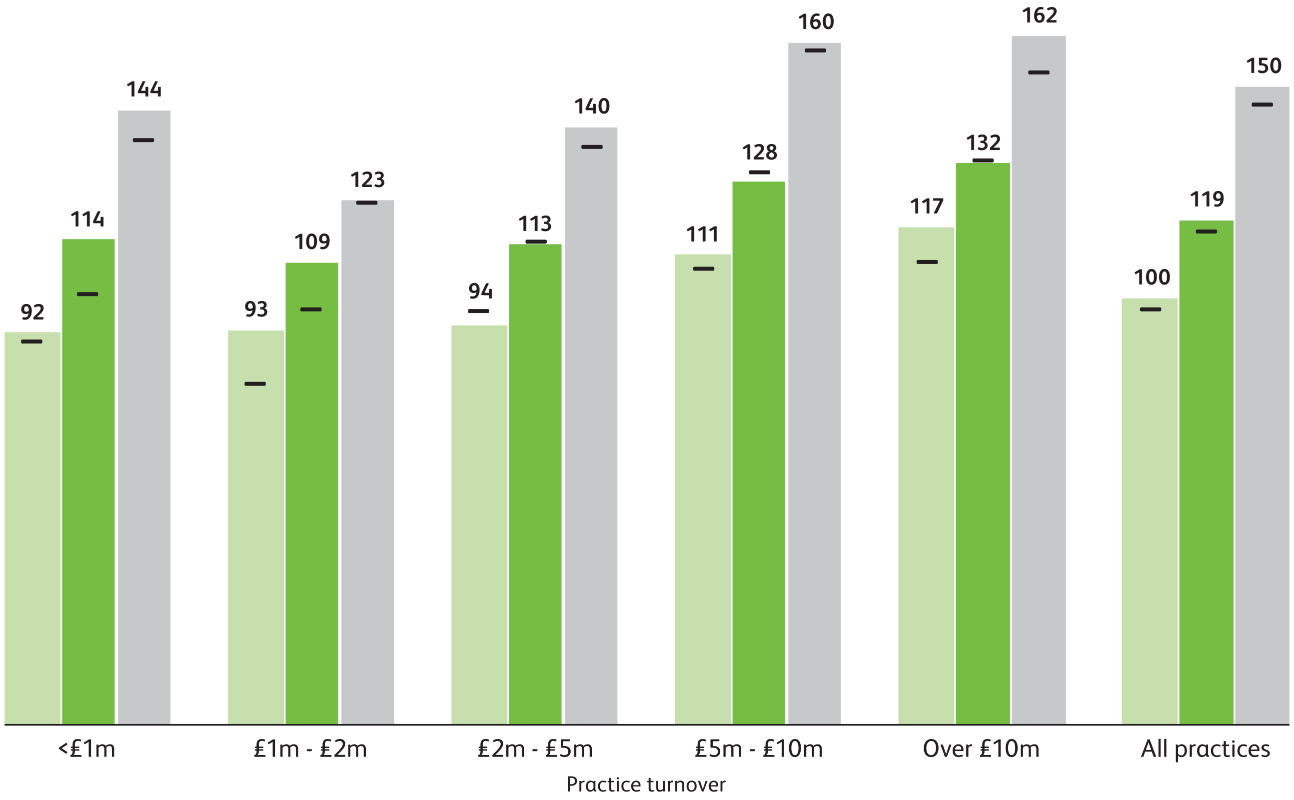
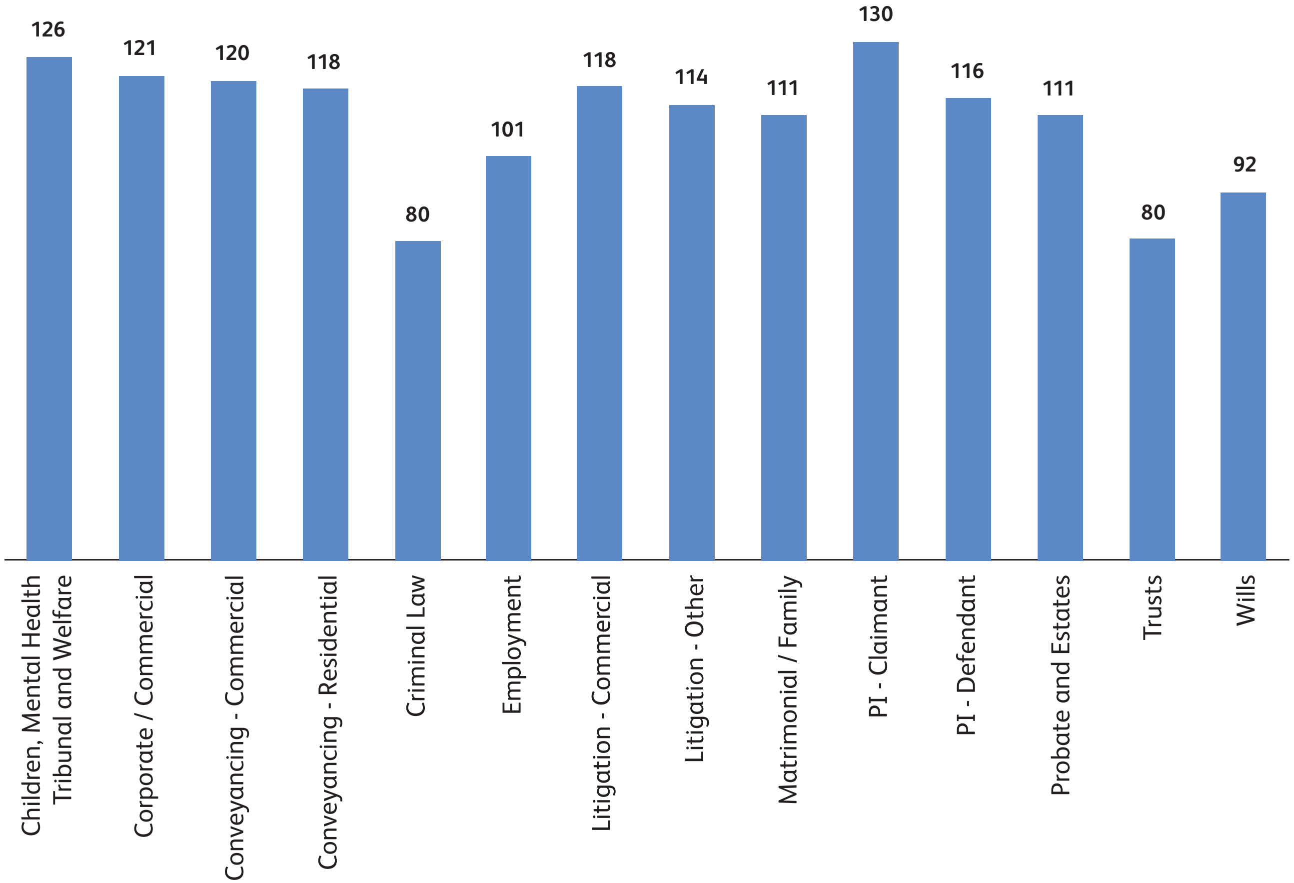


Table 4.6: Fee income per fee earner by specialism (£'000) (median figure only)



Fee earner gearing

Fee earner gearing (the ratio of fee earners to equity partners) is a key indicator, not only as an absolute measure, but also as a trend over time. In improving economic conditions, the ratio of fee earners to equity partners tends to increase as practices grow, with the opposite happening in times of recession.

This is certainly true in our surveys. Back in 2009, when we first carried out the LMS survey, the median ratio was 4:1, and the general economic climate was fairly bleak. Practices took steps to contain overheads. Since then, we have seen a steady rise in fee income, and the gearing ratio has gradually crept up to 5.5:1.

In our calculations we have included equity partners in the number of fee earners (unless they are non-lawyer managers). For example, if a practice comprises two equity partners and three other fee earners then the ratio is 2.5:1 (i.e. five divided by two).

As shown on the chart overleaf, fee earner gearing can vary significantly by work type. Residential conveyancing teams in particular often have a higher than average ratio, whereas the ratio tends to be lower in areas such as employment and litigation.

Table 4.7: Number of fee earners per equity partner

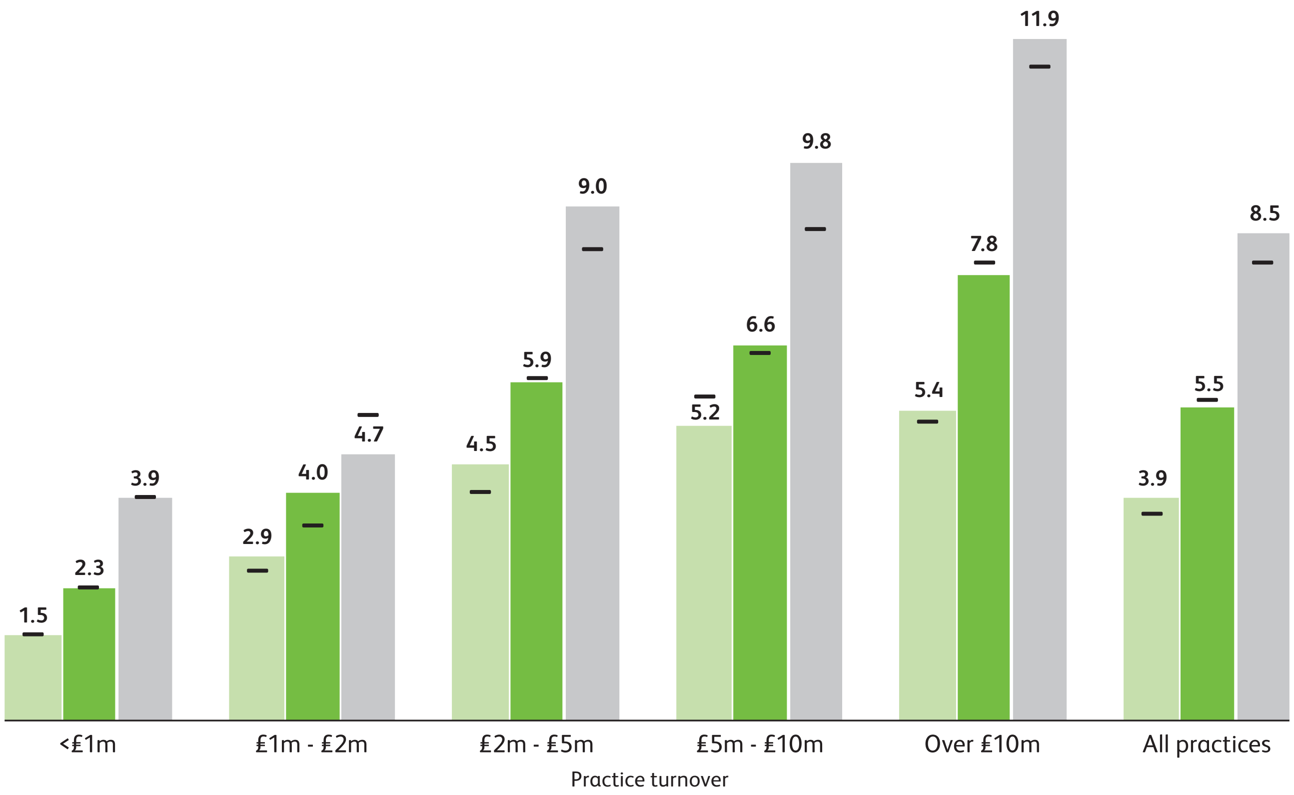
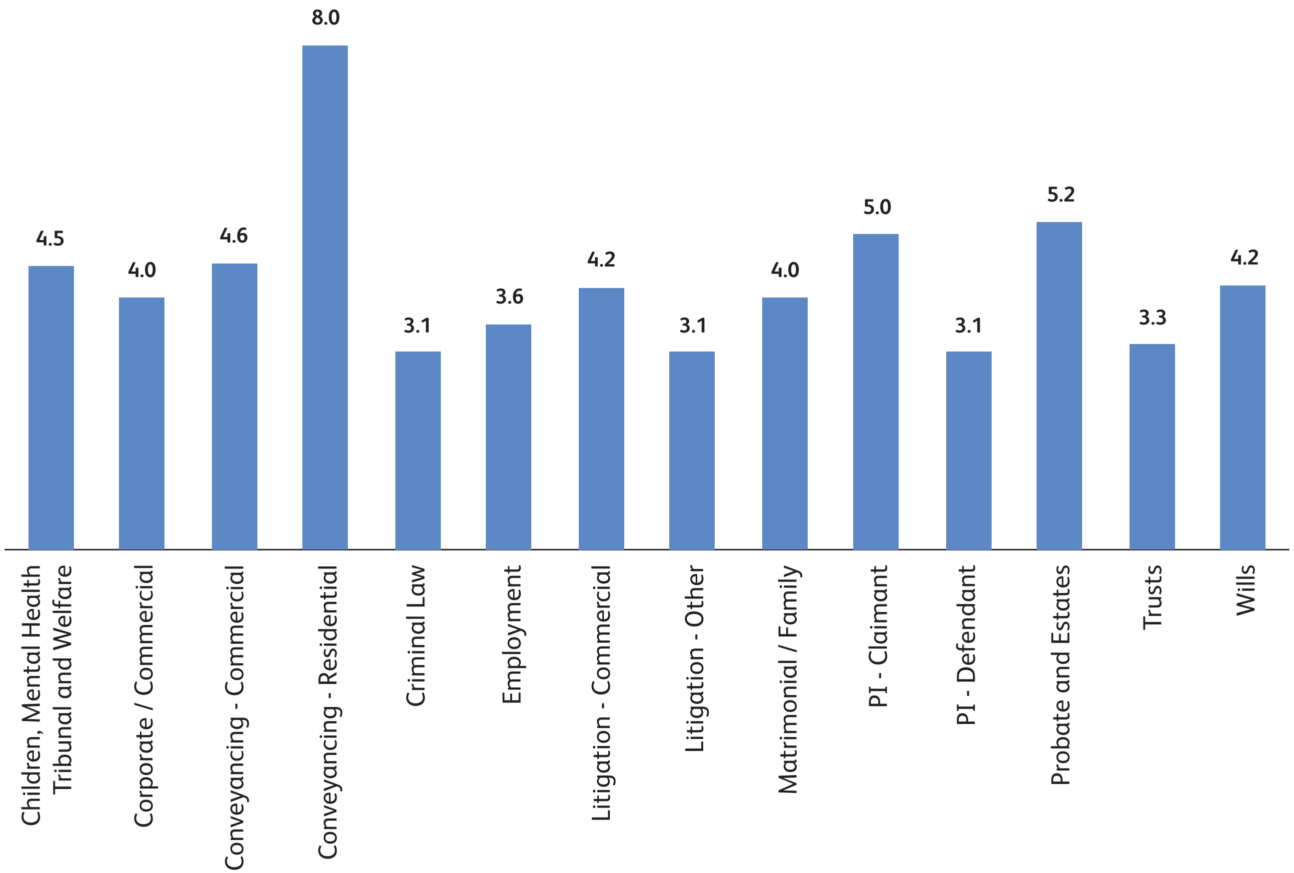


Table 4.8: Number of fee earners per equity partner by specialism (median figure only)



Fee earners

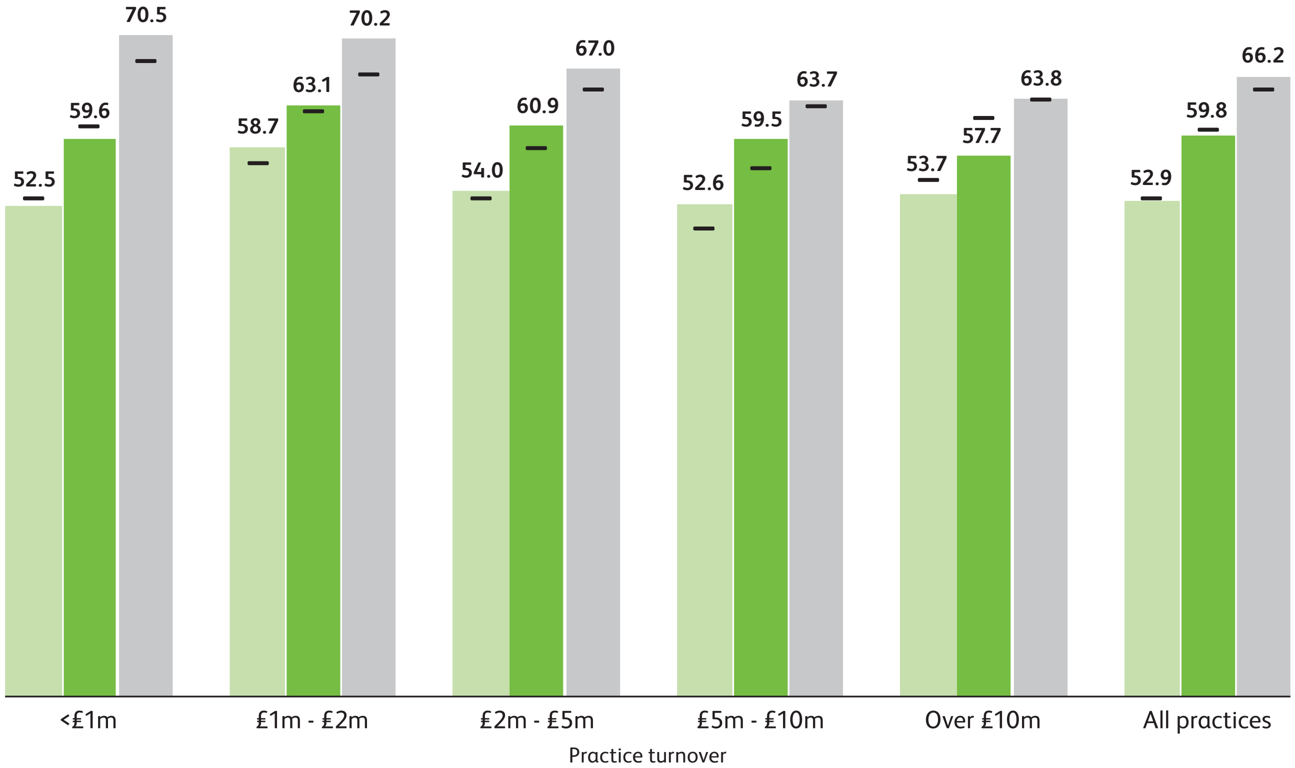
People represent the primary cost of all legal practices. The total costs are broken down into three principal categories:

- Equity partners
- Fee earners
- Support staff

In Table 5.1 we compare the total cost of employing people against fee income. This includes notional salaries for equity partners, which we have again set at a level of the highest employed fee earner's salary for the size of practice, plus 10%.

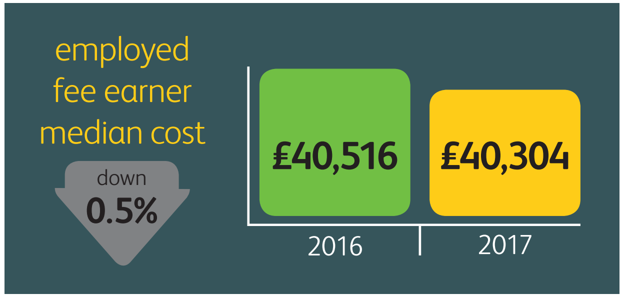
The median 2017 total is 59.8%, compared to 60.4% in 2016. The consistency in margin indicates that staff costs are rising in line with fee income. More people are being recruited, and salaries are rising, but fees are increasing to cover the additional cost.

Table 5.1: Total salary costs, including notional salaries, as a percentage of fee income (%)



Employment costs – employed fee earners

Having established the contribution margin on salaries, we can now look in more detail at how much practices are actually spending on their employees. In Table 5.2 we include salaries, fixed share partners, consultants, temporary staff and all usual payroll and pension costs. However, no redundancy or recruitment costs are included here, or any notional salaries for equity partners.



Key findings are:

- Expenditure on fee earners as a percentage of fee income shows little movement year on year for most practices. If anything, there is a slight fall, which is an indication that wherever possible costs are being contained, either by employing lower grades of staff or replacing expensive contractors with permanent employees.
- The average fee earner cost is not consistent across practice size, and rises in line with practice revenues. Practices with the highest fee income are generally employing more expensive staff

Table 5.2: Expenditure on employed fee earners as a percentage of fee income (%)

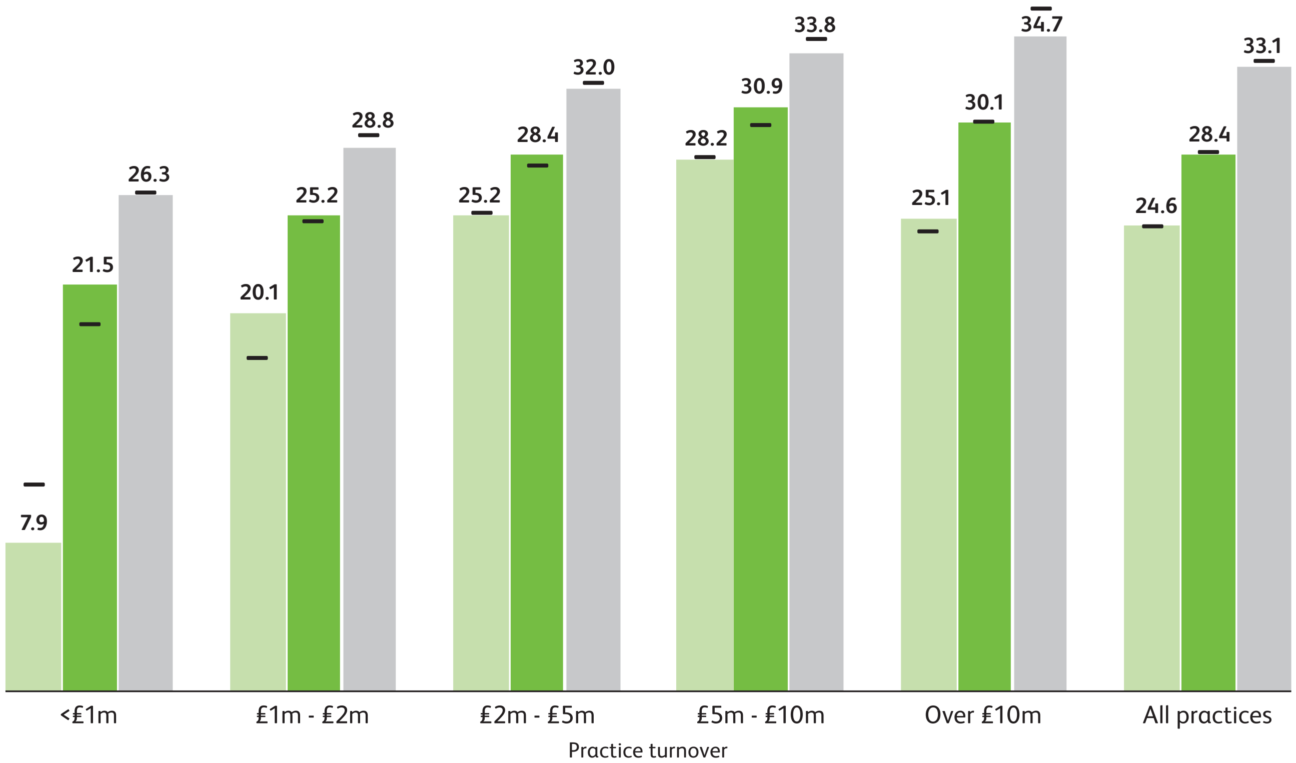
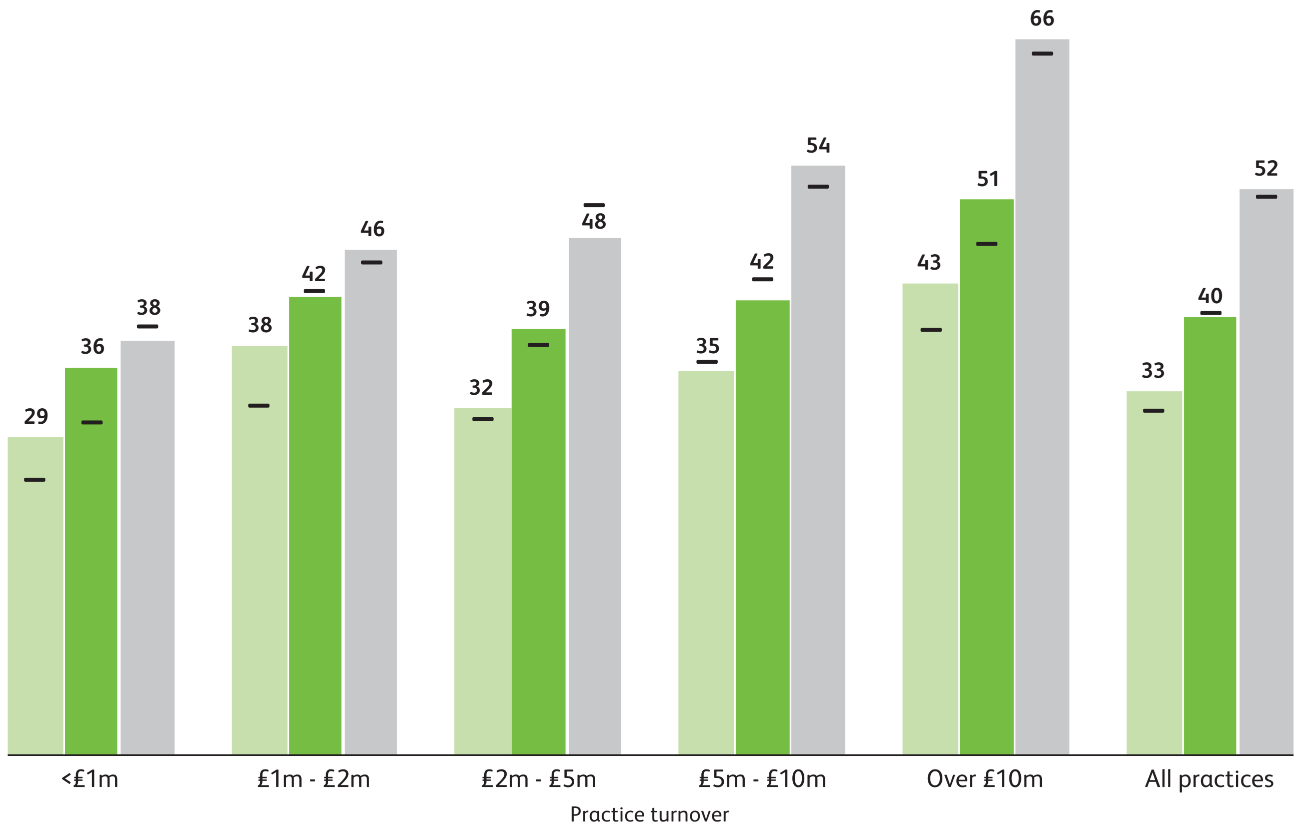


Table 5.3: Cost per employed fee earner (excluding notional salaries for equity partners) (£'000)



Employment costs – all fee earners, including equity partners

Building on the results in Table 5.3, we now show the cost per fee earner, including a notional salary cost for equity partners. This graph shows the "true" cost of a fee earner in the practice, combining employee salaries, fixed share partners, consultants, temporary staff and normal payroll and pension costs, and a notional cost for the equity partners.

Notional salaries are based on the highest fee earner salary for the turnover band, plus an extra 10% to compensate for extra responsibility, risk, etc.

Unlike the previous table, when equity partners are included the median 'true' cost of a fee earner increases to £48,787, up from £47,744 in 2016 – a 2.2% increase. This suggests the highest earners in the practice are costing more in 2017 than they did in 2016.

Notional salary rates are shown below Table 6.4.

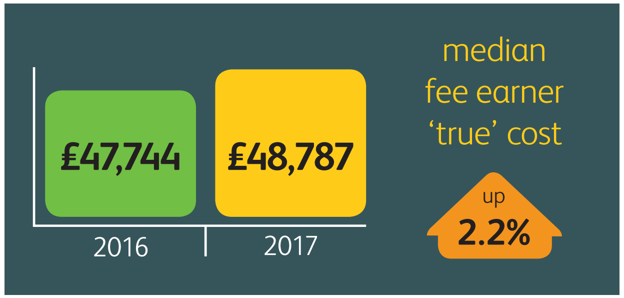
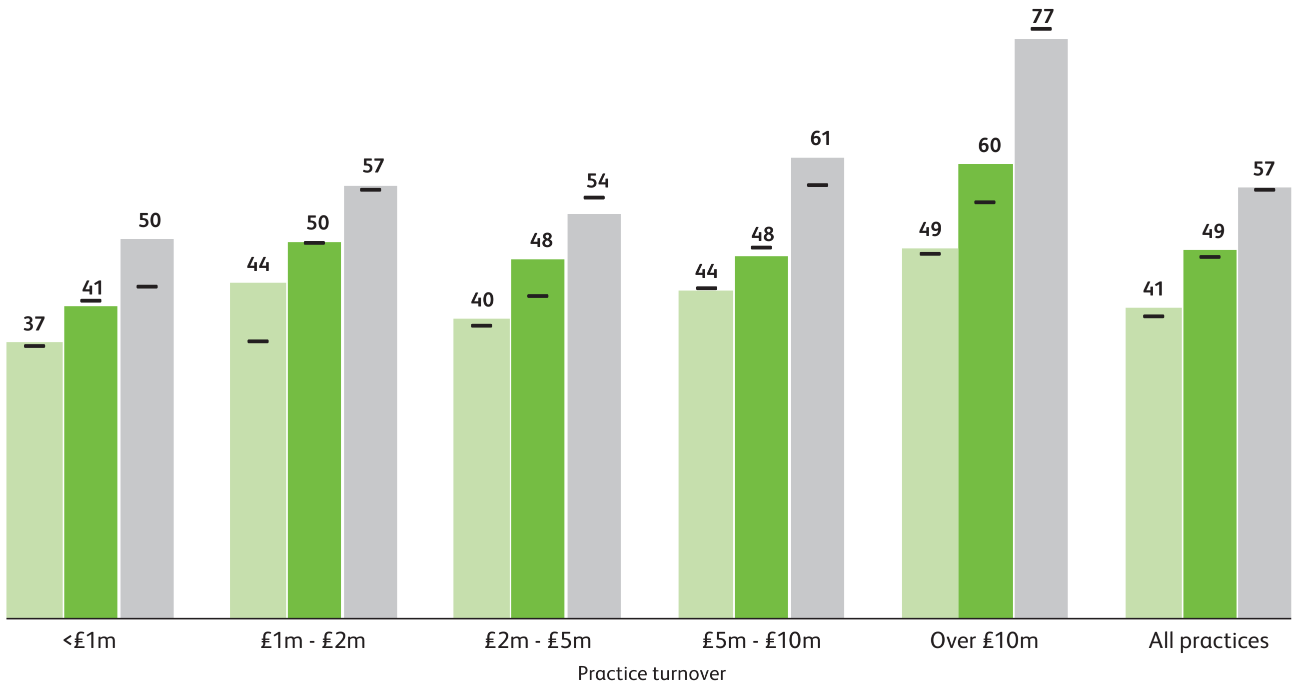
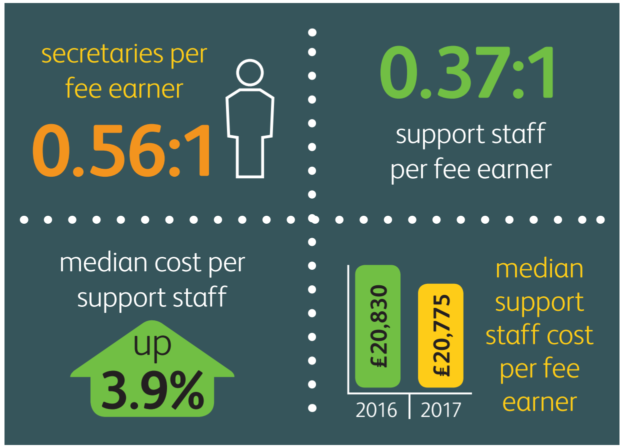


Table 5.4: Cost per fee earner (including notional salaries for equity partners) (£'000)



Employment costs - support staff

In terms of actual head count, the total number of people employed in a non-fee earning capacity by practices in our survey was 3,659 in 2017, compared to 3,504 in 2016. That's a rise of 1.9%.



Within that total we looked in more detail at their specific roles and discovered the following statistics:

- The number of secretaries per fee earner increased very slightly, from 0.54 to 1 to 0.56 to 1. However, a decade ago the same ratio was 0.77 secretaries per fee earner.
- The number of other support staff per fee earner (accounts, administration, marketing, receptionists, IT, etc.) remained unchanged at 0.37 to 1.
- The median cost per member of support staff (excluding secretaries) increased from £22,231 in 2016 to £23,090 – an increase of 3.9%.
- The median support staff cost per fee earner, including secretarial support, was £20,830 in 2016, compared to £20,775 in 2017 – a drop of 0.3%.

Table 5.5: Expenditure on support staff as a percentage of fee income

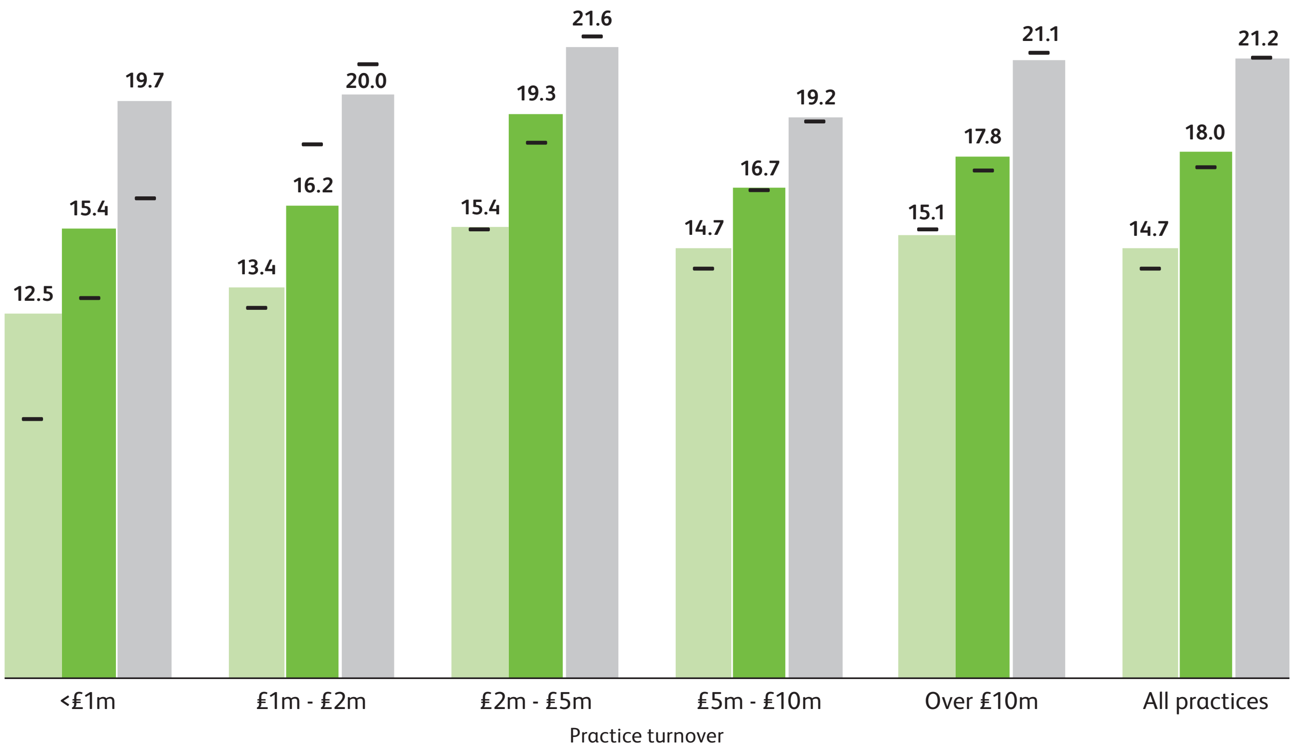


Table 5.6: Cost per support staff member

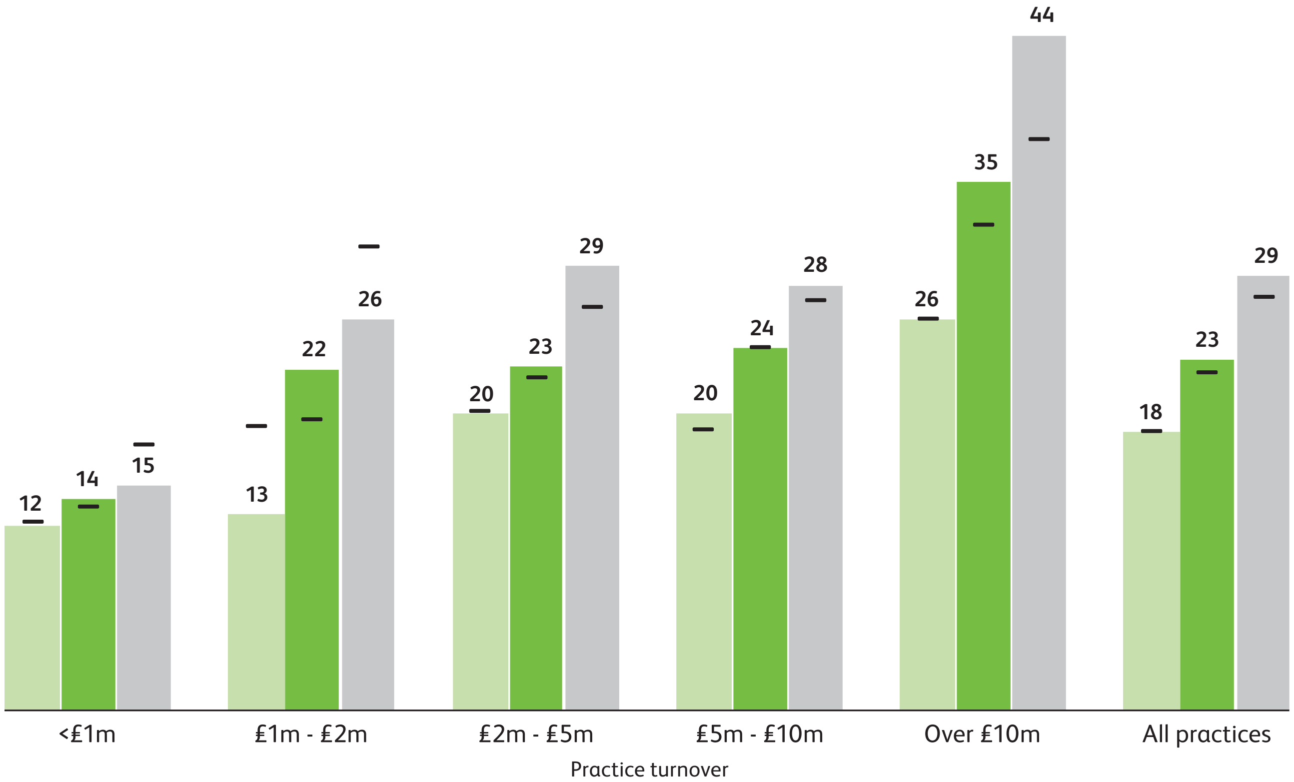


Table 5.7: Number of secretaries per fee earner

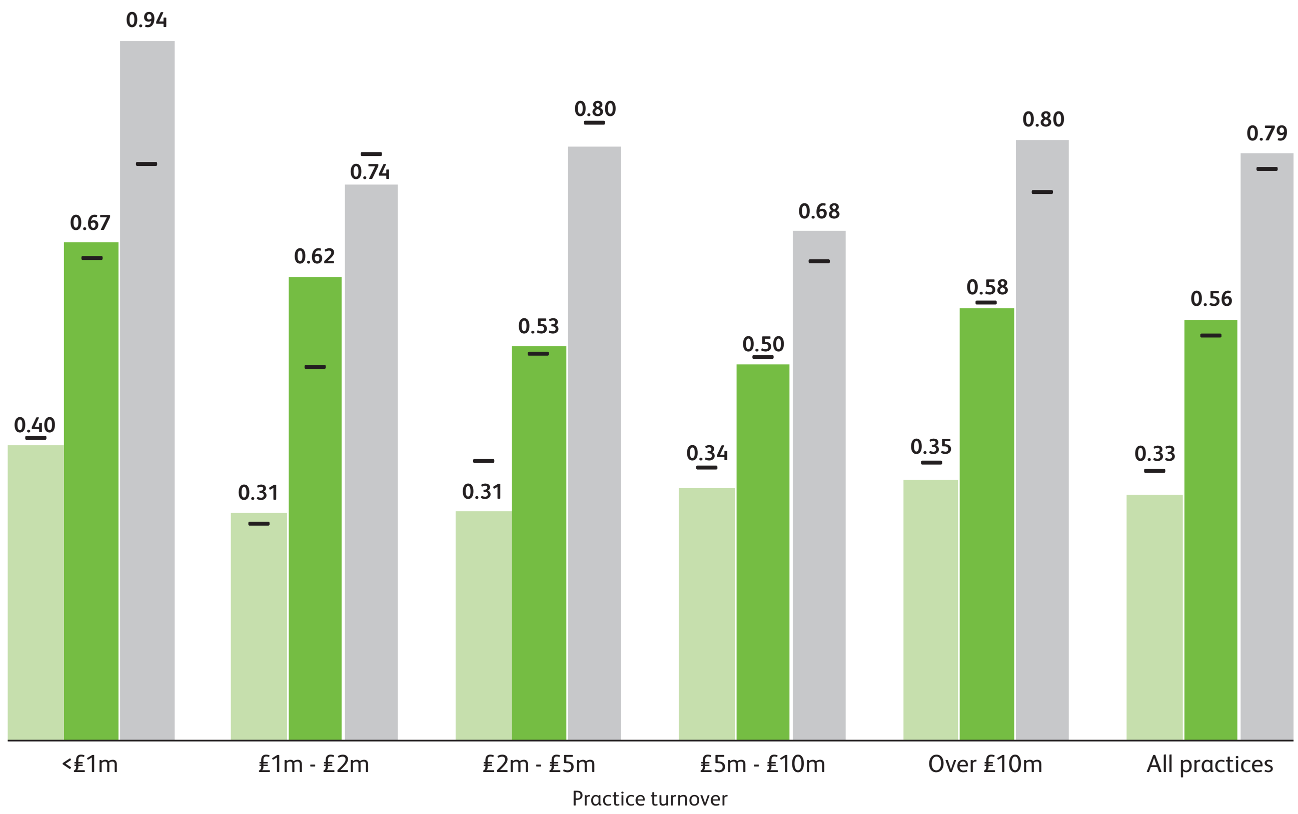


Table 5.8: Number of other support staff per fee earner

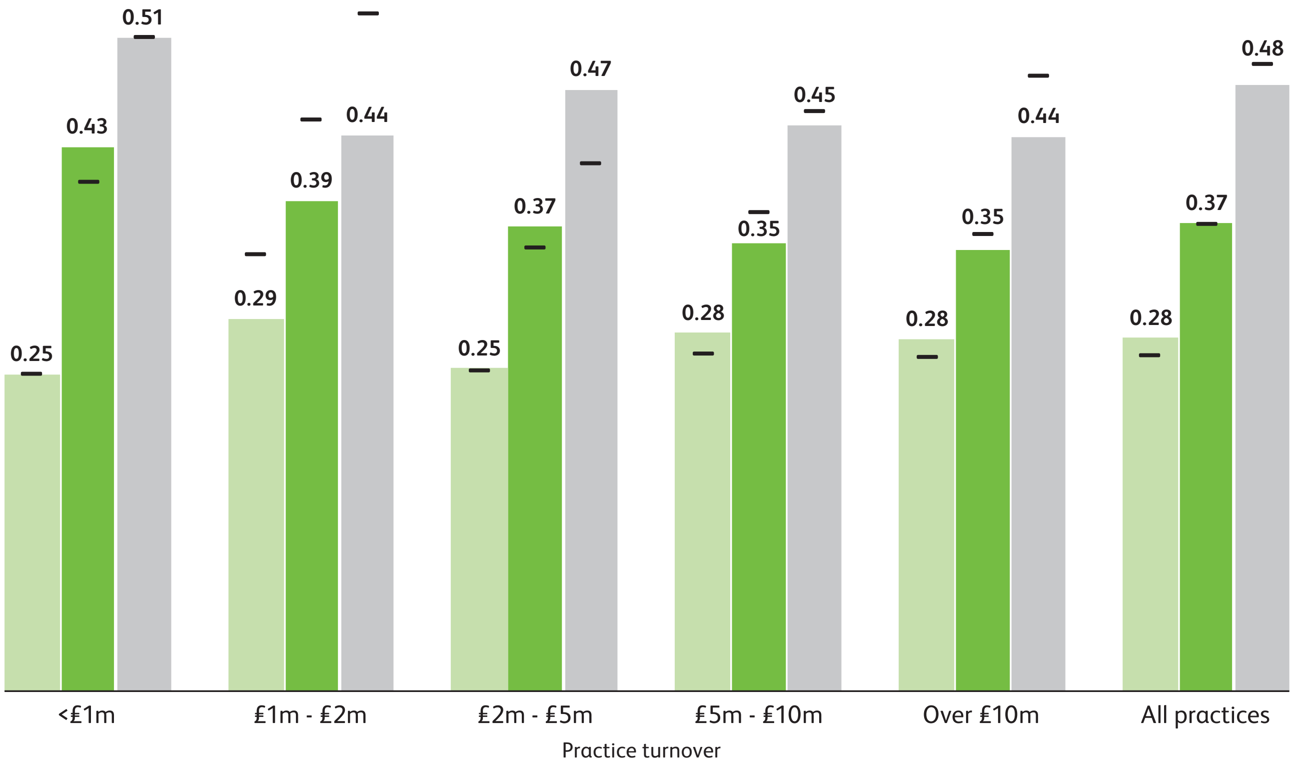
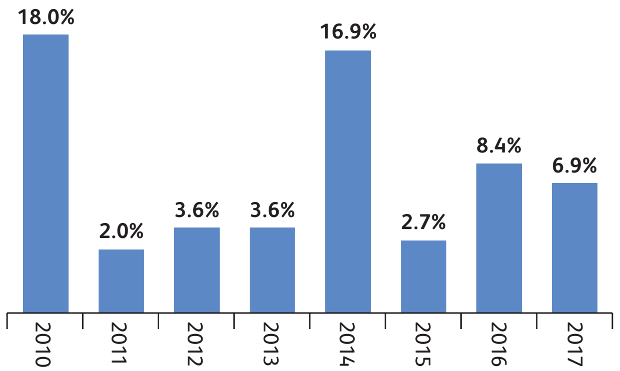


Table 5.9: Cost of support staff per fee earner (£'000)

Profitability

Profit per equity partner (PEP) has grown steadily since 2010, as shown in the graph below.

Median increases in PEP

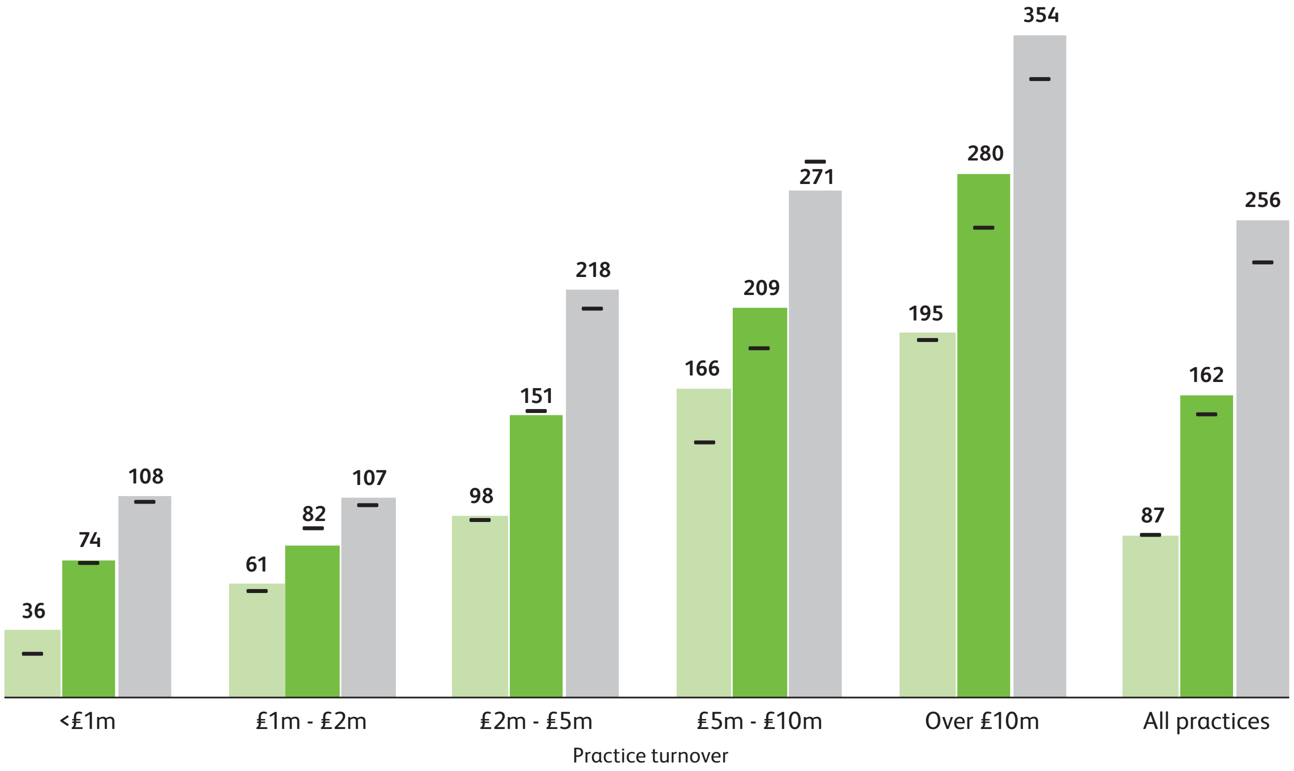


The trend continued in 2017, as median profits per partner have increased by 6.9%, from £151,712 to £162,161.

Having said this, our survey shows that the median net profit margin reported by participating practices has fallen from 24.2% in 2016 to 21.8% in 2017. However, the increase in fee income has largely offset the reduction in net profit margin.

Almost a third of fee income is spent on non-salary overheads. The median amount per fee earner is £35,304, compared to £35,816 in 2016. We have looked in detail at expenditure on specific costs such as professional indemnity insurance cover, marketing and accommodation costs. When expressed as a proportion of income, there has been little variation from 2016. Many practices are focusing on fixed costs, and seem resistant to price increases.

Table 6.1: Profit per equity partner (£'000)



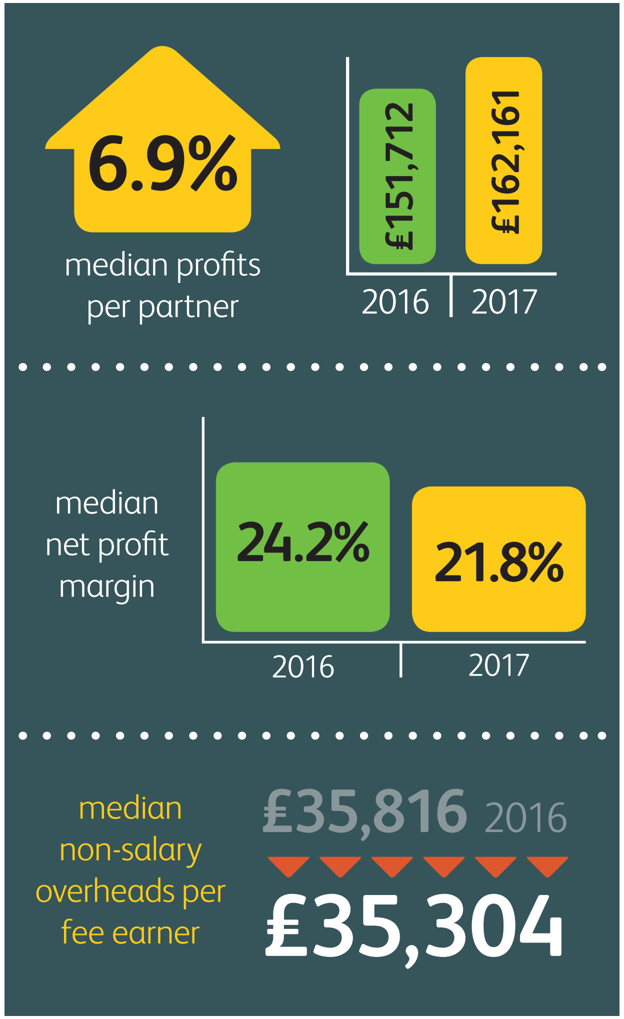


Table 6.2: Profit per fee earner (£'000)

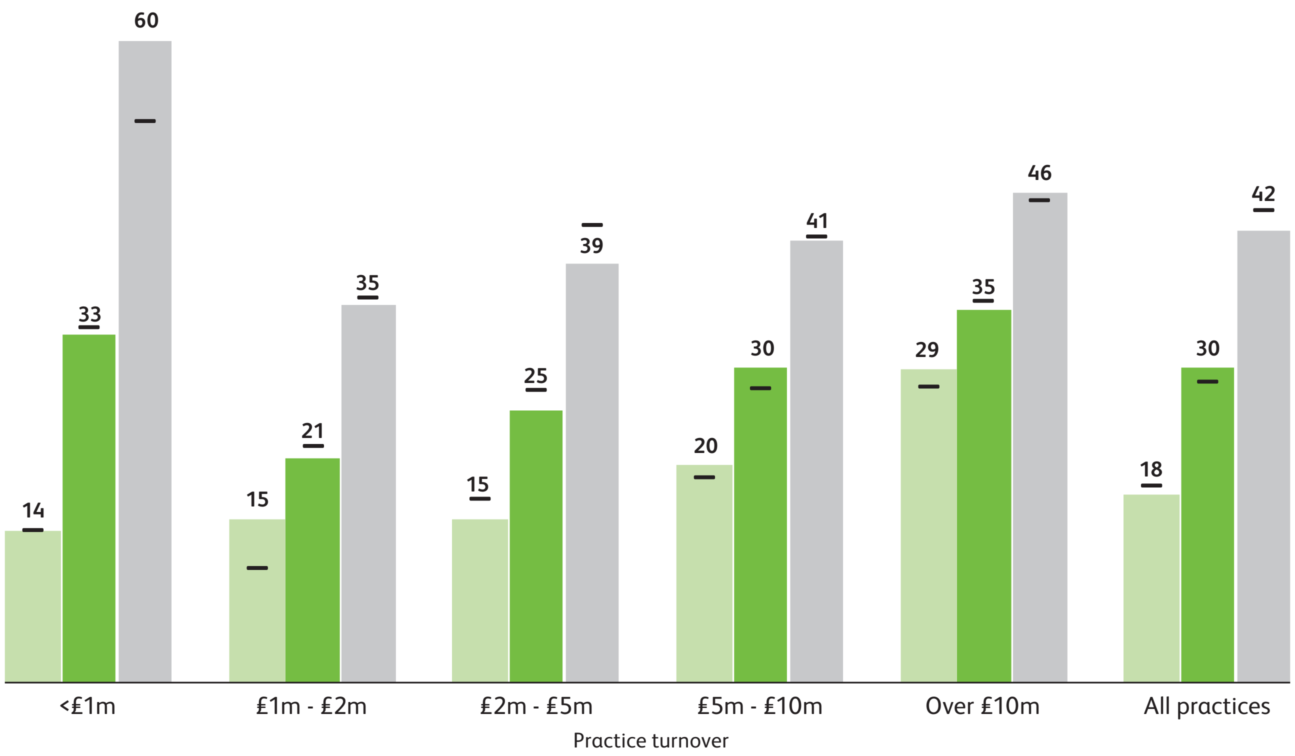
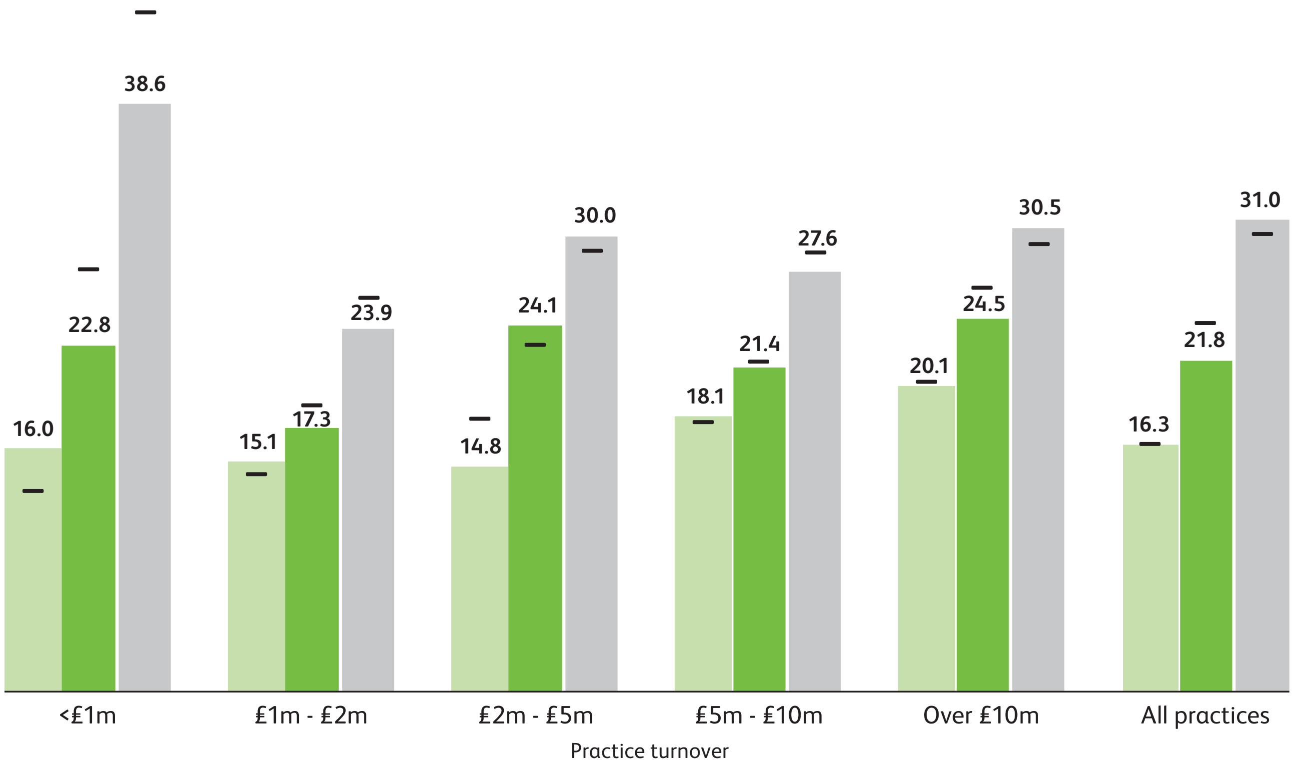


Table 6.3: Profit as a percentage of total income (%)



Profitability – return on investment, i.e. super-profit

As owners of a practice, equity partners expect to be rewarded for the salary equivalent for work that they do, and they also require a return for the capital invested in the practice and an additional “super-profit” for the risk and liabilities of running the practice. We refer to these as notional salary, notional interest and super-profit.

For the purposes of this report, equity partner notional salaries have been calculated based on practices’ highest fee earner salary plus an extra 10% to compensate for their additional responsibility. Notional interest is set at 3% of partner capital.

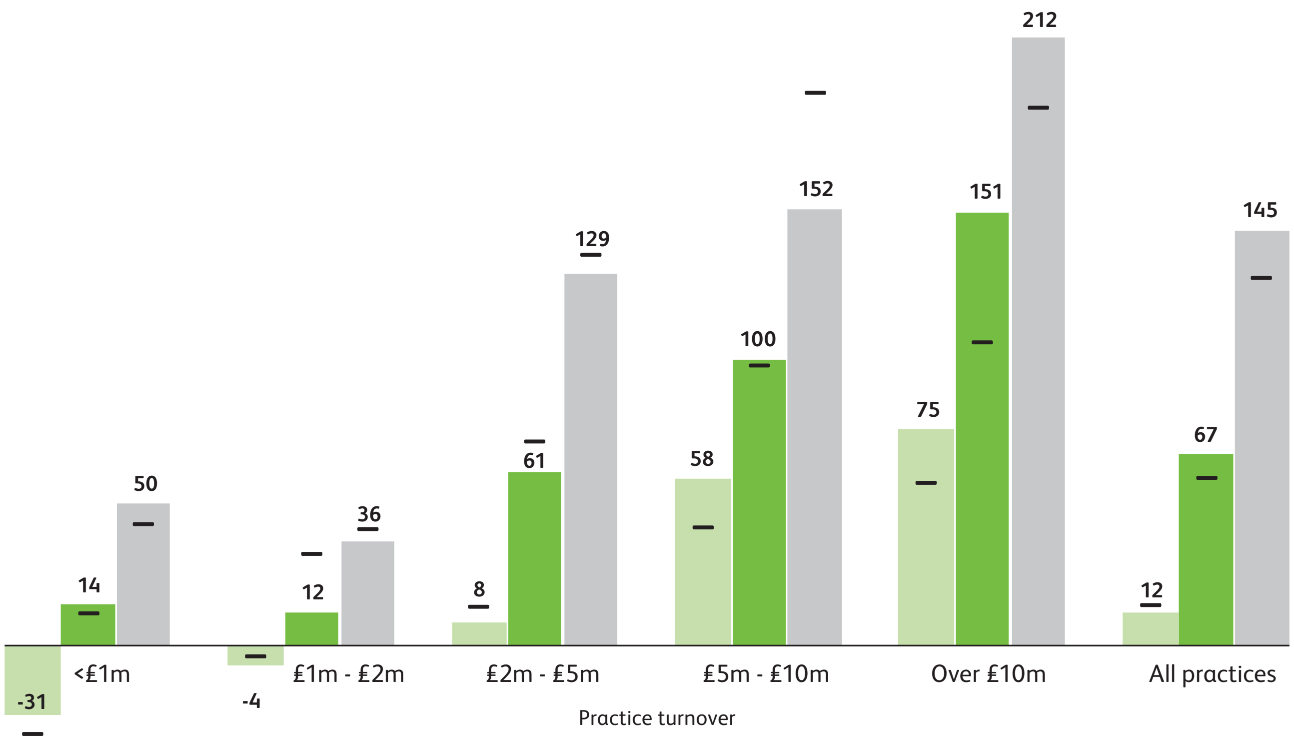
Super-profits are simply the net profit less notional salaries and notional interest.

In Table 6.4 we show the “super-profit” per equity partner. In 2017, the median ‘super profit’ was £66,584, compared to £58,078 in 2016.

The median figure for super-profit as a percentage of total income has fallen slightly, from 9.6% last year to 9.0%.

The notional salaries used for each turnover band are shown below the table on the right. The figures for 2017 are shown above those for 2016. Last year, we commented on the large salary increases experienced by mid-sized practices, necessary to retain senior fee earners. This seems to be a continuing problem in 2017, with median increases in excess of 11% for practices in the £2m - £5m turnover band.

Table 6.4: Super-profit per equity partner (£’000)



Notional salaries

	<£1m	£1m - £2m	£2m - £5m	£5m - £10m	Over £10m	All practices
2017	44	58	85	99	129	87
2016	42	59	76	94	136	80

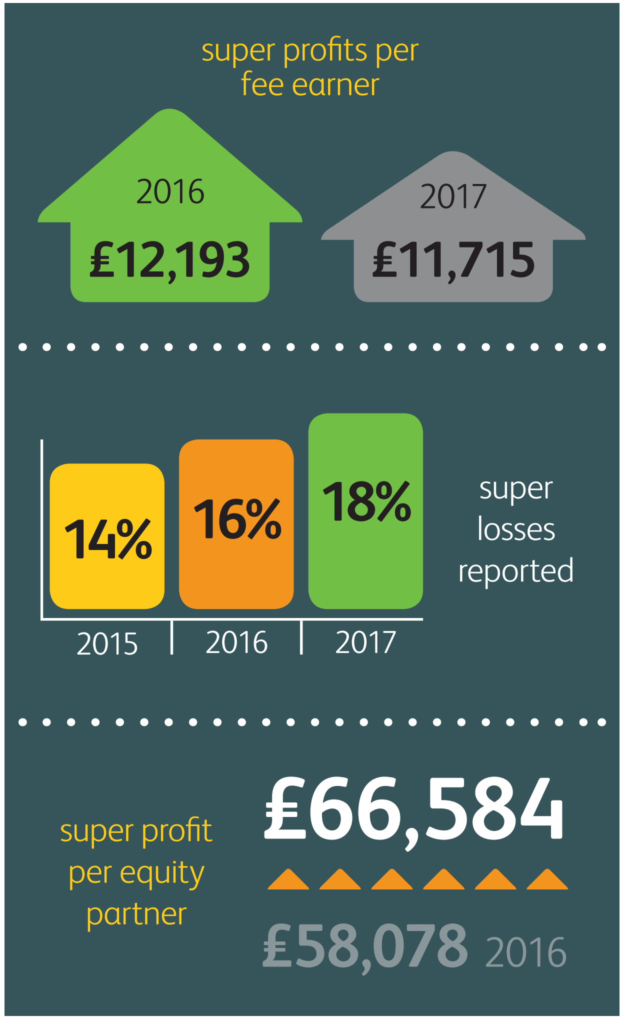


Table 6.5: Super-profit per fee earner (£'000)

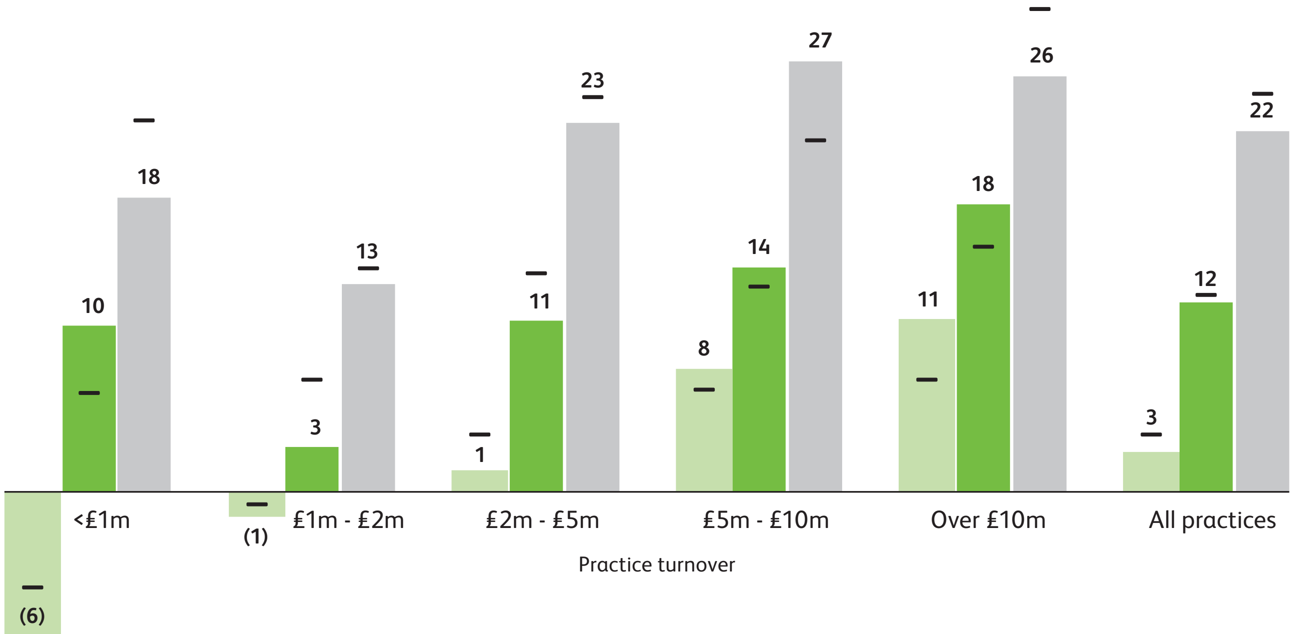


Table 6.6: Super-profit as a percentage of total income (%)

Return on capital employed (ROCE)

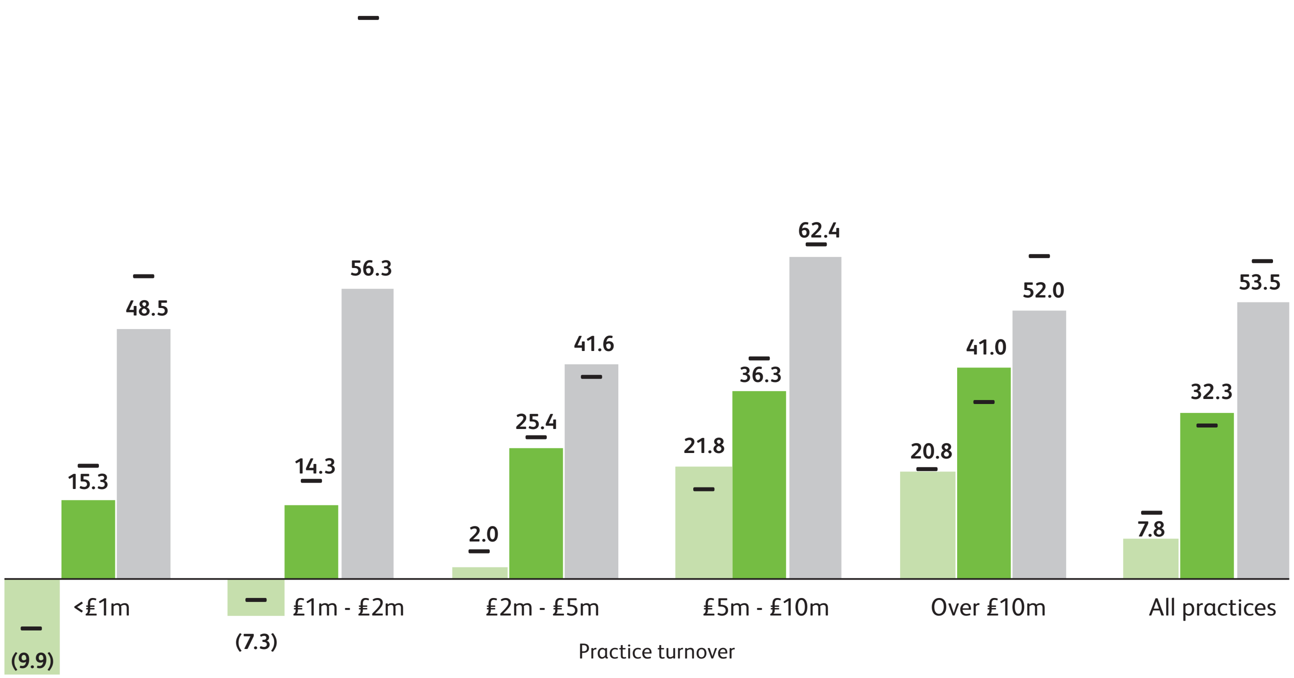
ROCE is a measure of the returns made by a practice on the resources available to it. For a legal practice, ROCE is measured in terms of super-profits as a percentage of partner capital. We use super-profit, as this takes account of notional salaries for partners, and also notional interest on partners' capital.

The results show a median ROCE of 32.3% for 2017, compared to 29.4% in 2016. This is excellent news, since capital invested in practices is higher year on year too – see Table 8.5 on page 51.

Practices looking to attract new partners will be more successful with higher levels of ROCE. Potential investors or acquirers will pay more when a practice is achieving ROCE in line with the best performers in their size category.

The chart on this page shows that a number of the smaller practices in the survey experienced a negative ROCE, which is a result of super-losses reported in the previous section.

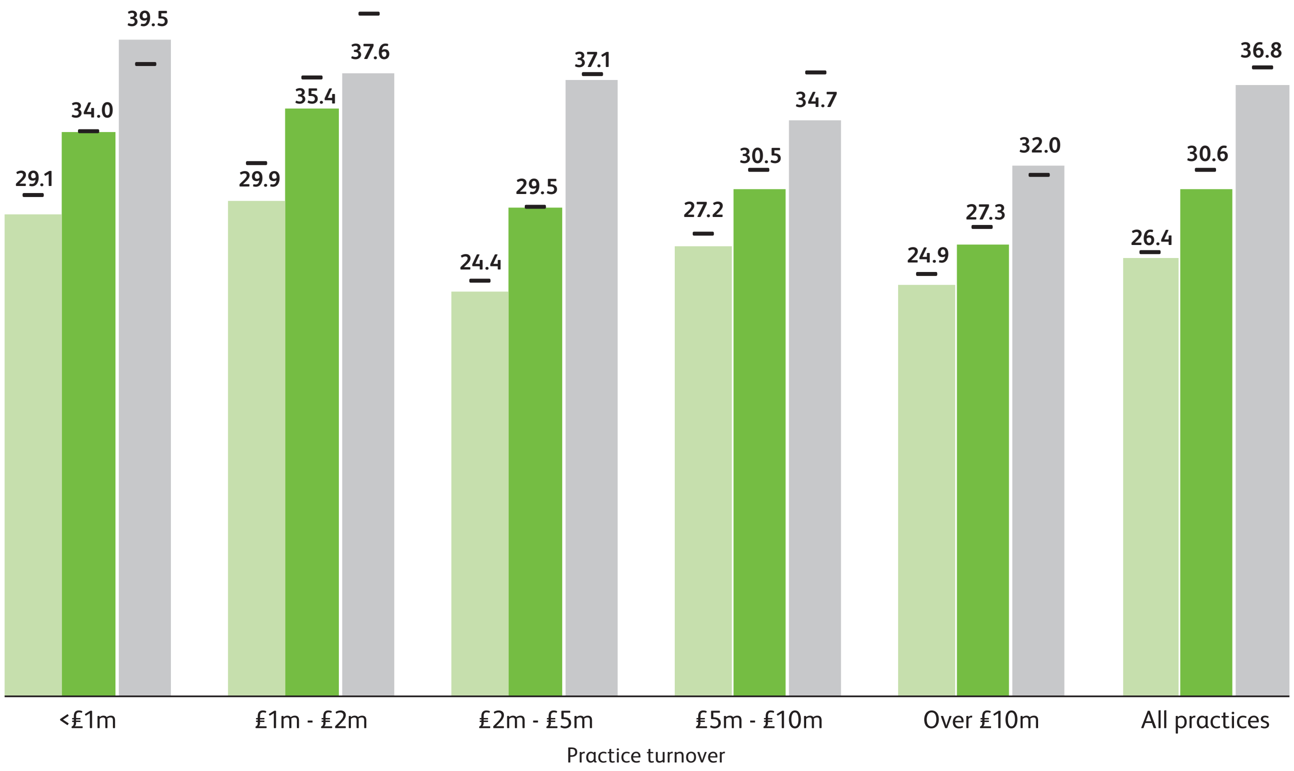
Table 6.7: Return on Capital Employed (super-profit as a percentage of partner capital) (%)



Non salary overheads

The graphs over the new few pages reveal that practices have continued to work hard to control their overheads.

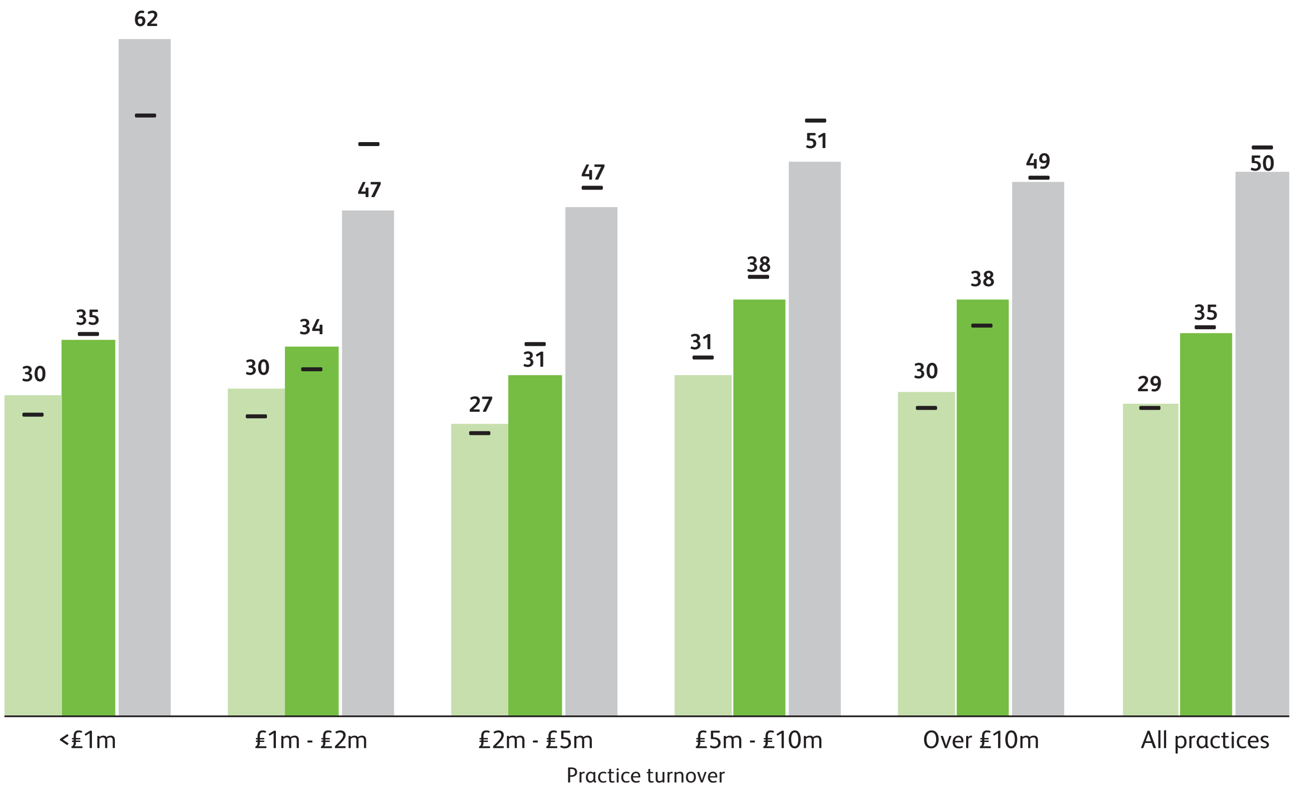
Table 6.8: Non-salary overheads as a percentage of fee income (%)



Non-salary overheads (continued)

These graphs are a valuable reminder of the true cost of fee earners, over and above their salary costs – an overall median of £35,304.

Table 6.9: Non-salary overheads per fee earner (£'000)

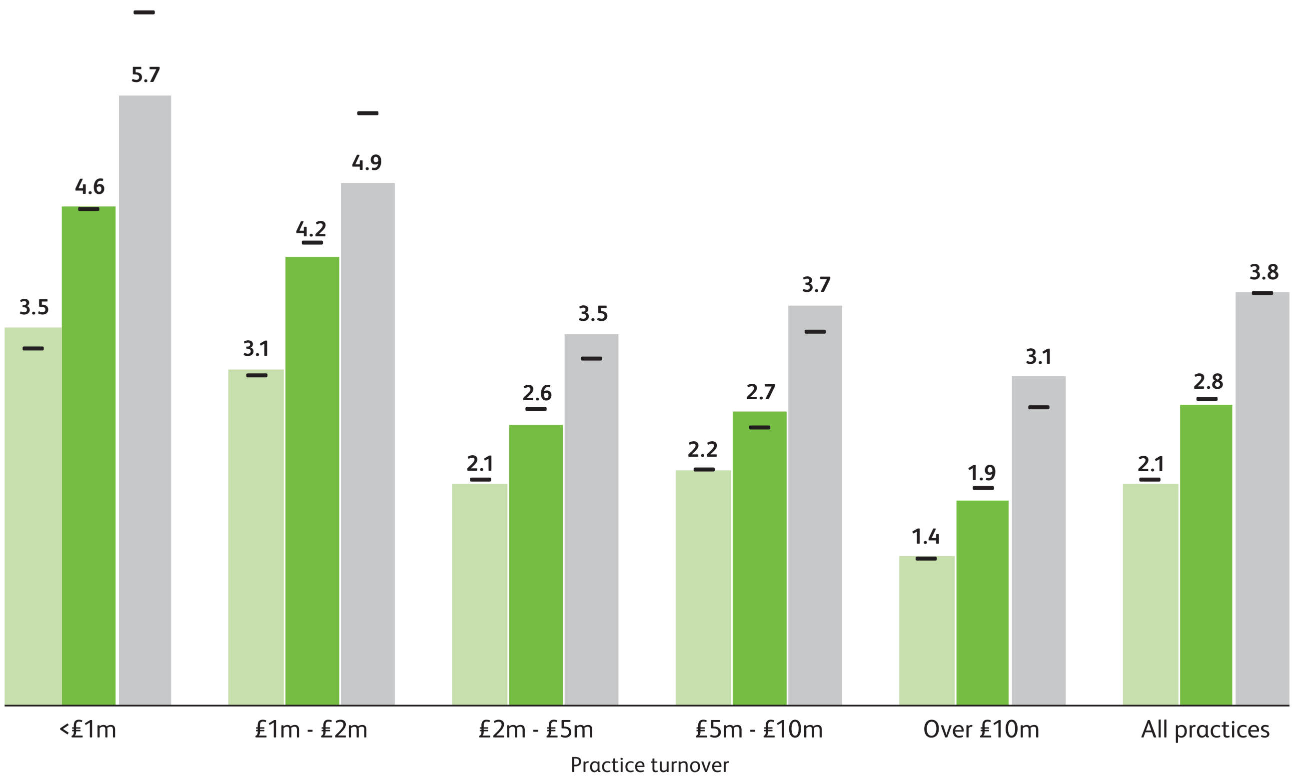


Key variable overheads
Professional indemnity insurance

The figures in the survey principally deal with the renewal on 1 October 2016, so are one year out of date. The results show that the median PI insurance cost per £ of fee income was relatively stable across the board last year – 2.8% of fee income compared to 2.9% in the previous year.

Our experience is that increasing numbers of practices are moving away from the traditional October renewal date, as insurers offer attractive premiums in return for longer terms. 18 months policies are fairly common nowadays.

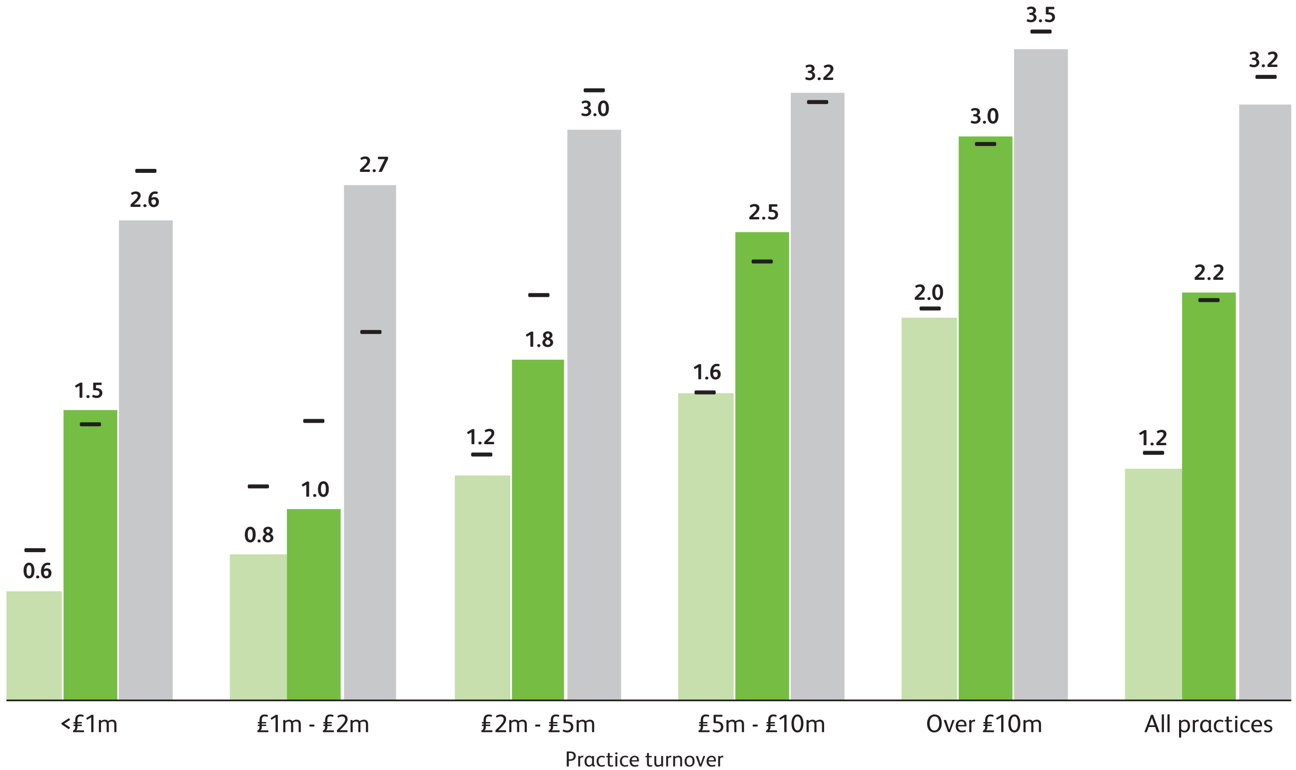
Table 6.10: PI insurance premium expenditure as a percentage of fee income (%)



Marketing costs (including marketing staff costs)

The results here show that direct spending on marketing has been stable across practices of all sizes, with a median spend (including staff costs) of 2.2% of practice fee income, compared to 2.1% last year.

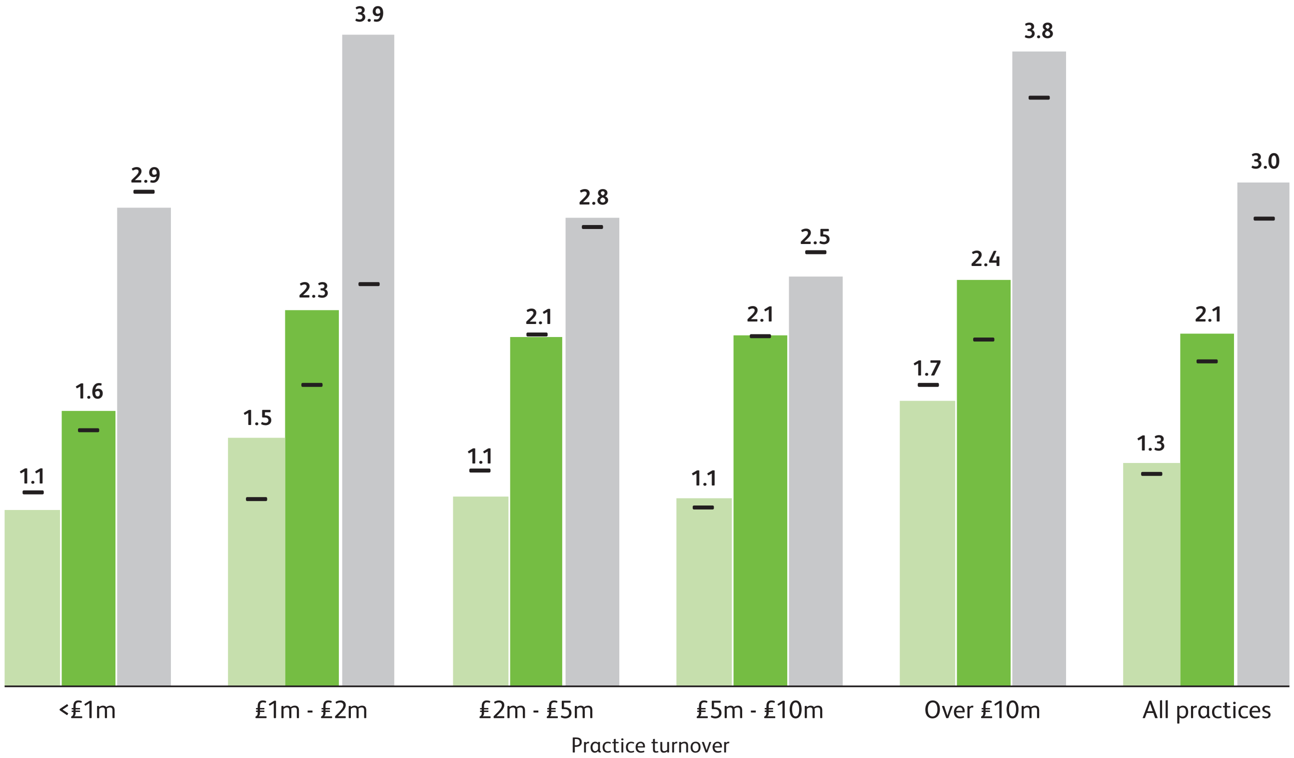
Table 6.11: Marketing expenditure as a percentage of fee income (%)



IT expenditure

The survey shows that expenditure on IT as a percentage of fee income also remained fairly consistent in 2017, at 2.1% of fee income. The expenditure includes the cost of IT support, IT consultants, Cloud-based storage, etc.

Table 6.12: IT expenditure as a percentage of fee income (%)



Accommodation costs

After staff-related costs, accommodation costs are usually the next largest expense for any practice. The results here show a median spend on accommodation costs of 5.7% of fee income, in line with the previous year.

Many practices are paying more than this though, either due to prime locations (e.g. those in city centres or brand new offices) or as a result of surplus office space, or both.

A few practices in the survey pay a reduced rent on their premises, either because the property is owned by the principals of the practice, or because they have managed to negotiate reduced rent with their landlords. Where this is the case, participants have provided us with a current market rental value, so that the results shown are as if on a third party basis.

Table 6.13: Accommodation costs as a percentage of fee income (%)

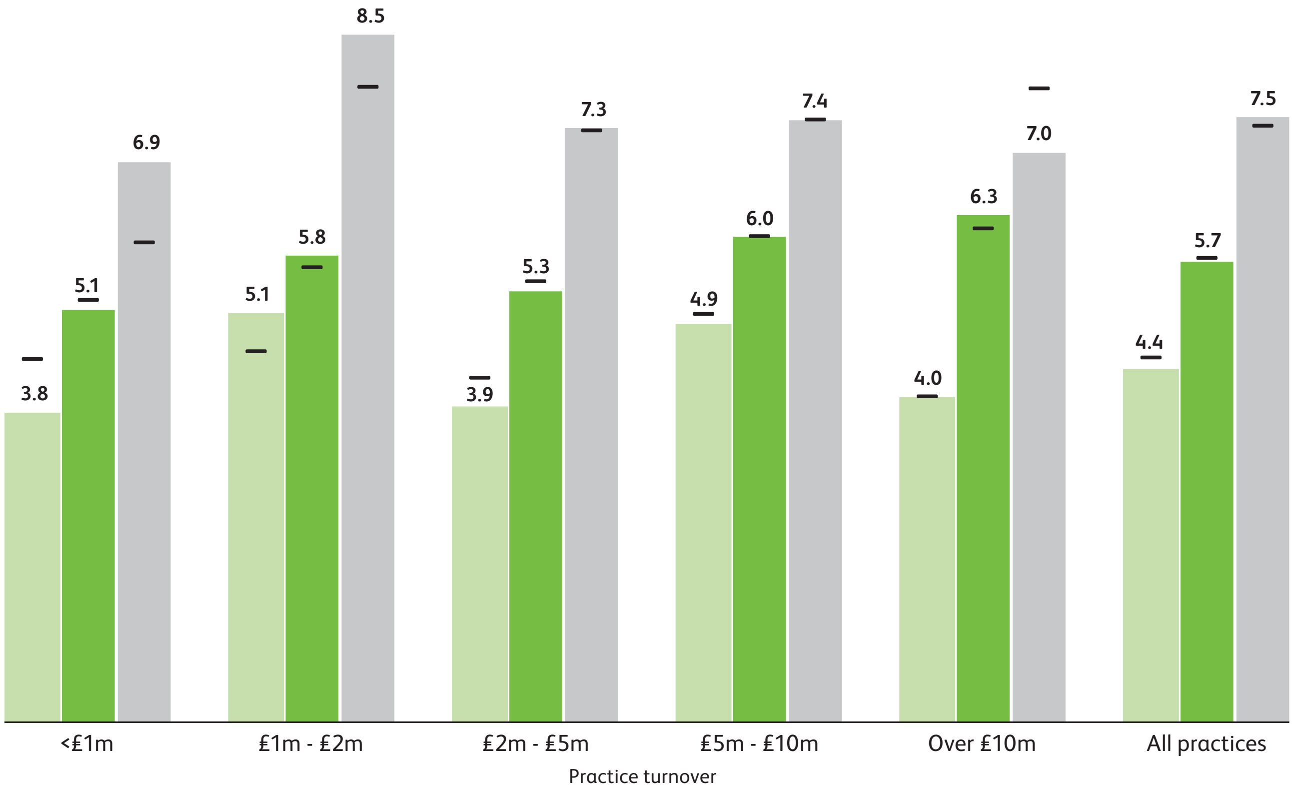
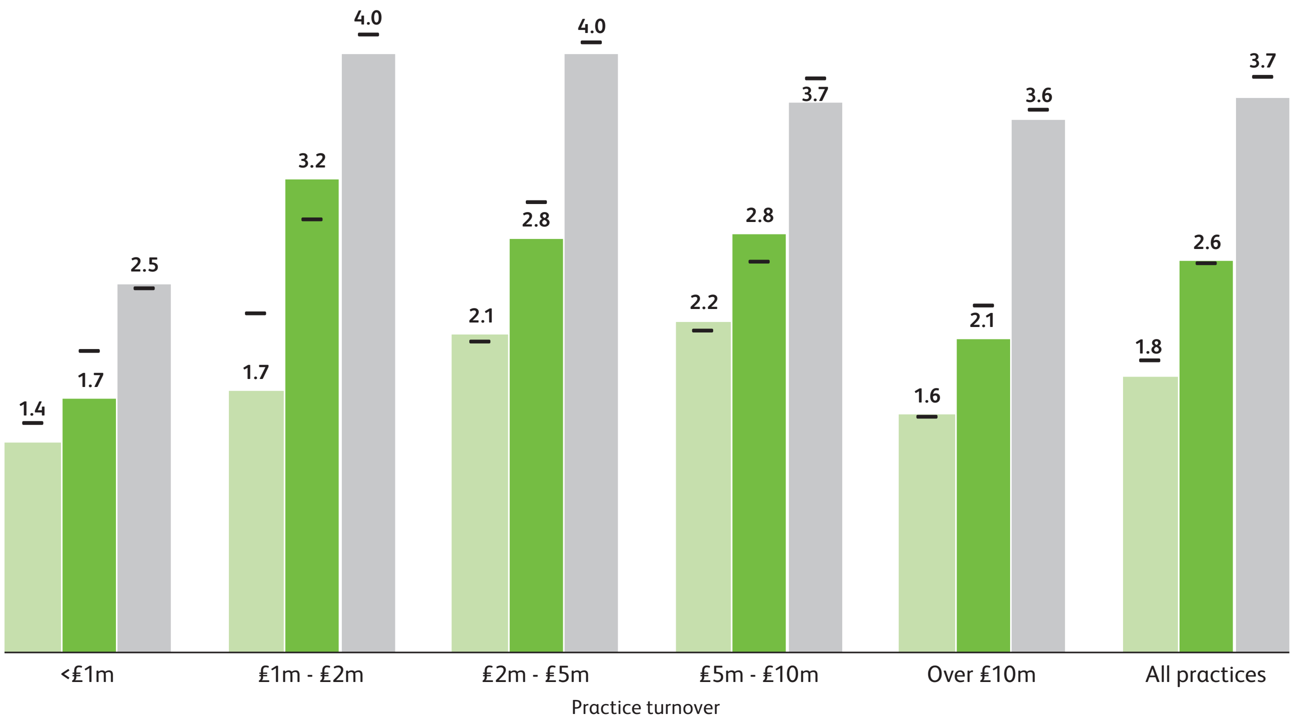


Table 6.14: Premises rental payments as a percentage of fee income (%)

Table 6.15: Other premises costs (rates, light and heat and maintenance) as a percentage of fee income (%)



In this section we examine the characteristics of the more profitable practices that took part in this year's survey, focusing on four key areas:

- Fee earner gearing;
- Fee income per equity partner;
- Total salary costs, including notional salaries for equity partners;
- Non-salary overheads.

The figures shown in the following charts have been calculated by taking the median results for practices in the upper and lower quartiles in terms of profits per equity partner, in each turnover band. The bars on the left of each turnover band are the figures for the most profitable practices, and the bars on the right are for the least profitable practices in the survey. Comparative figures are once again shown as a " - ".

Table 7.1: Fee earner gearing

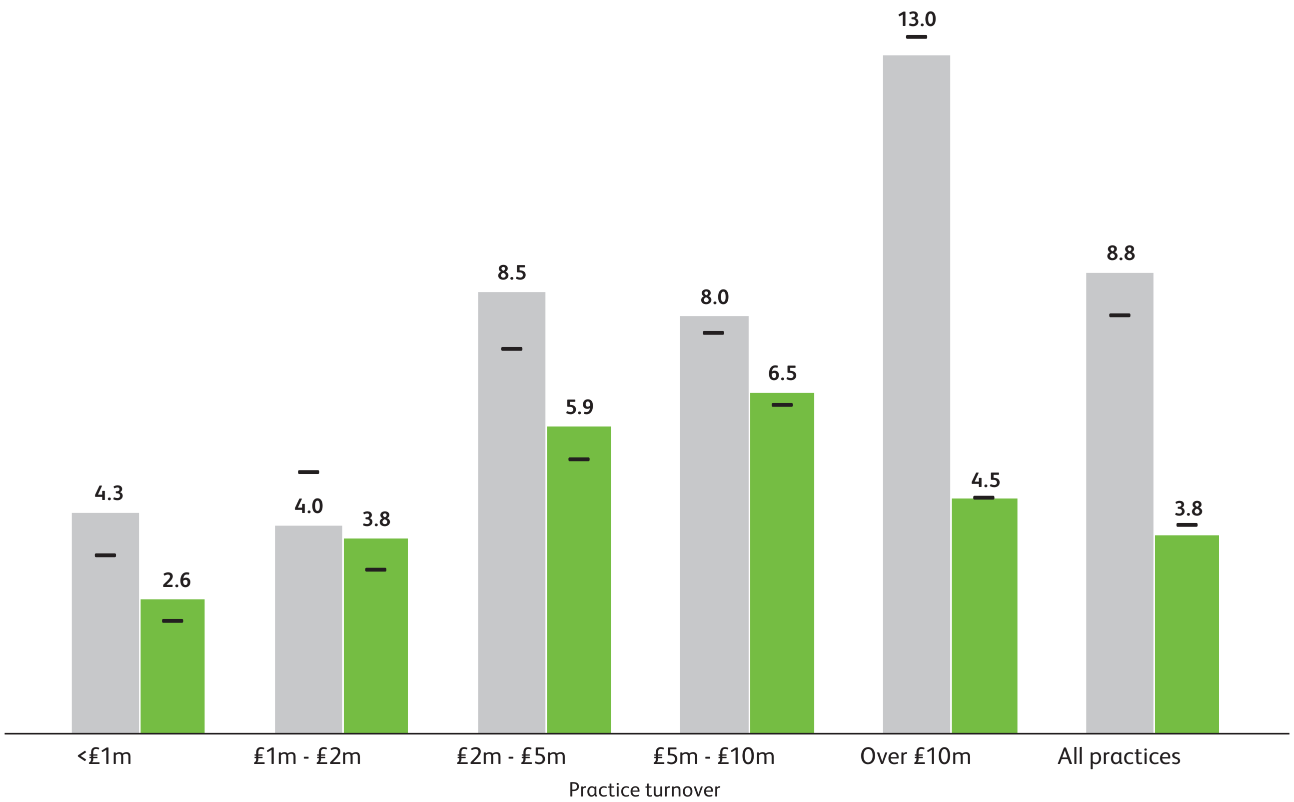


Table 7.2: Fee income per equity partner (£'000)

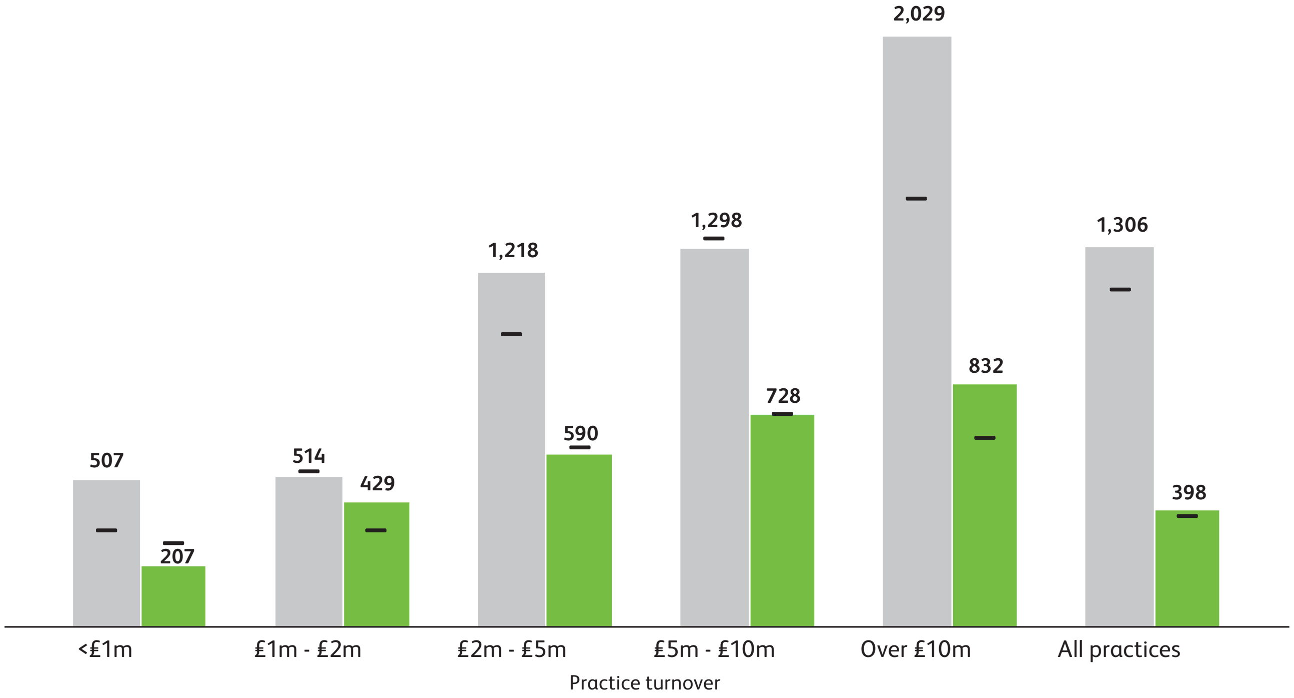
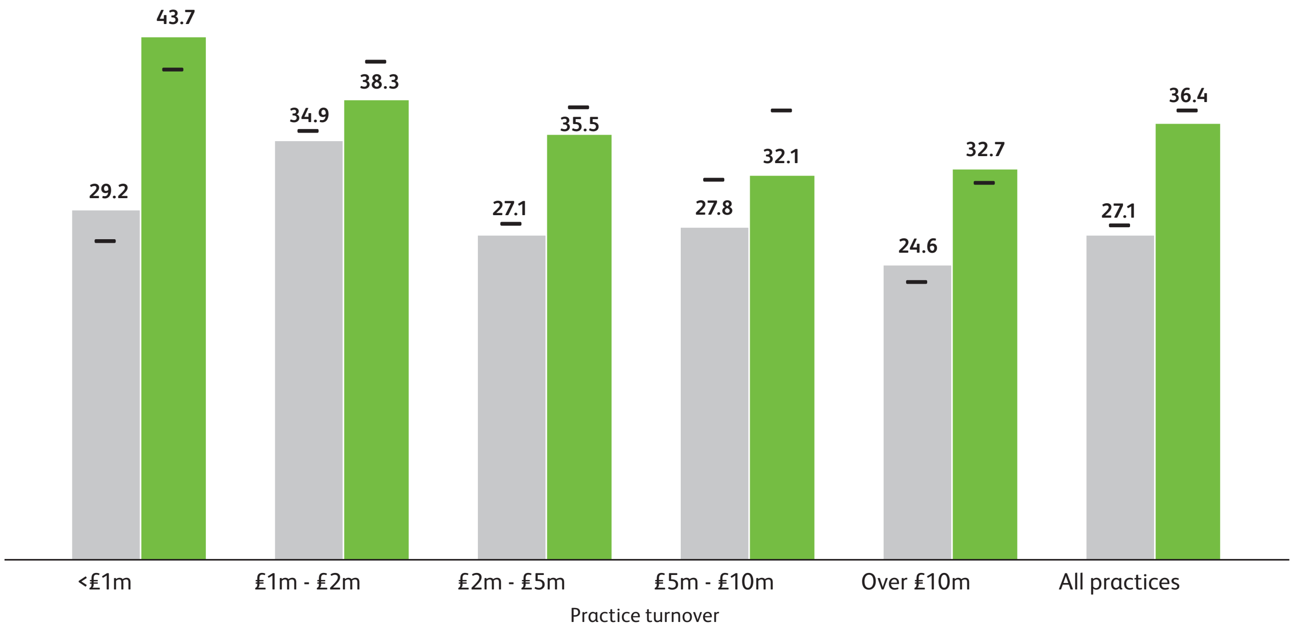


Table 7.3: Total salary costs, including notional salaries, as a percentage of fee income (%)

Table 7.4: Non-salary overheads as a percentage of fee income



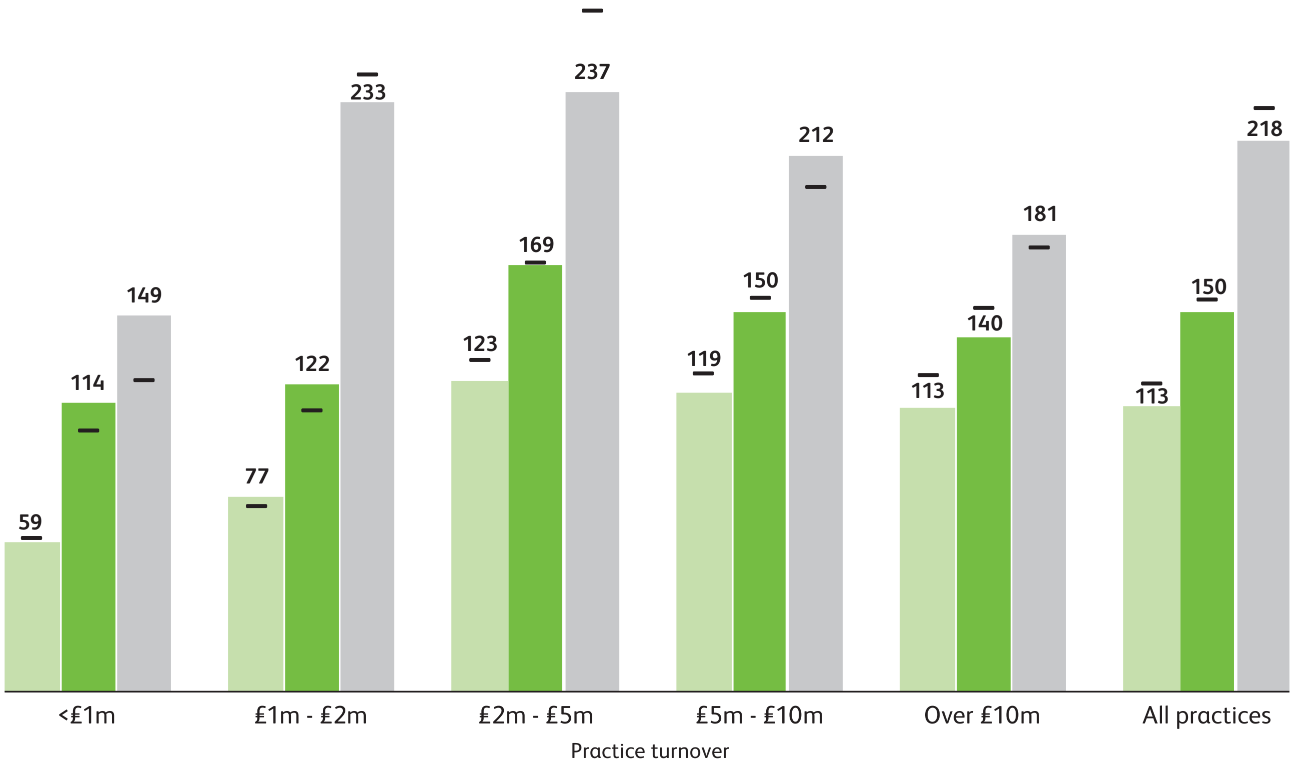
It is always difficult to conclude on trends on working capital management in a survey of legal practices, as lock up varies so dramatically in differing areas of law.

However, the median number of days lock up has fallen by about 3% between 2016 and 2017, and we have seen reductions in debtor days. This is pleasing, as in times of increasing workloads we would expect the actual quantum of debtors to increase. We must remember that our data is collected for balances at the year-end date only, which may not be reflective of a full twelve-month period.

As a matter of general good procedure, practices need to ensure that they continue to focus on reducing lock up where at all possible, as high lock up can not only lead to adverse cash flow issues but often also leads to increased bad debt exposure too.

The country's largest practices' lock up days are below 141 on average, compared to the median of 150 days in this survey.

Table 8.1: Total lock up (days)

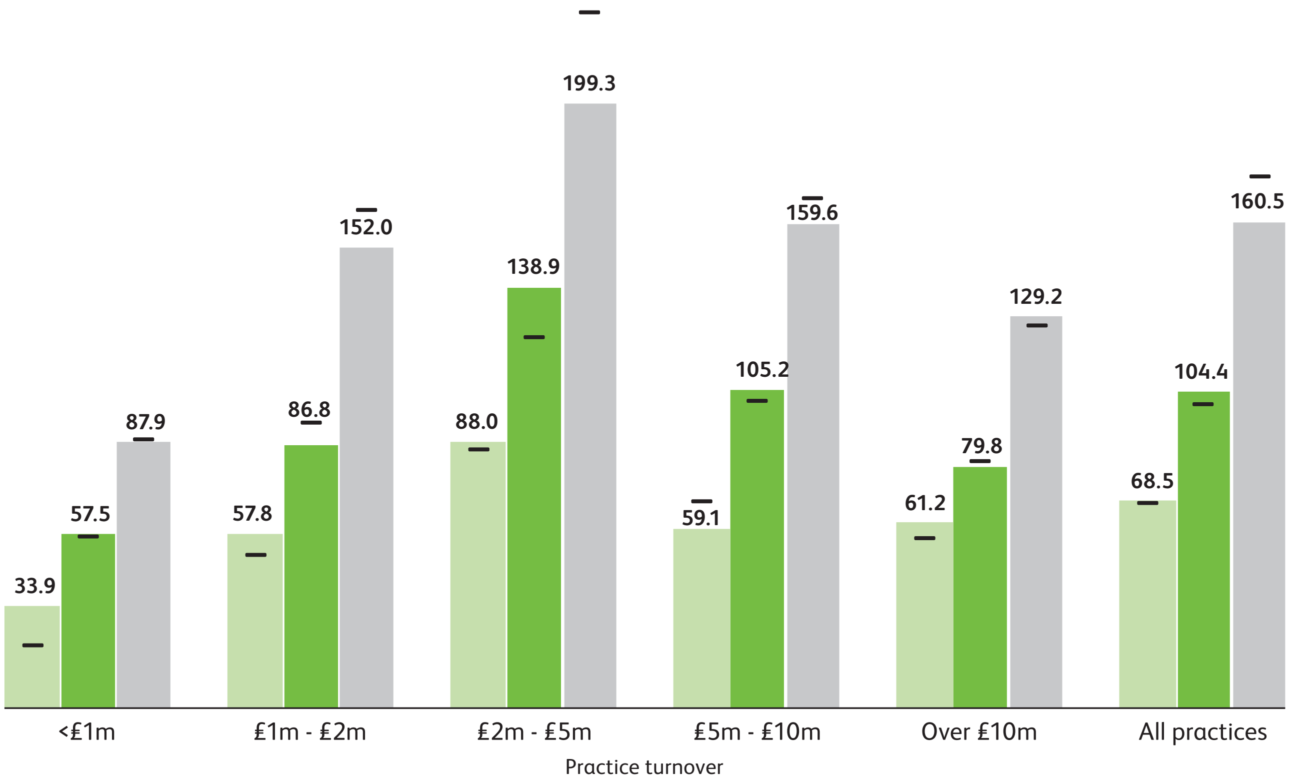


WIP days

WIP days have been calculated based on total WIP per participants' time records as opposed to the figure included in their accounts, as for many practices the figure in the accounts does not include large amounts of contingent WIP.

The survey shows a slight increase in WIP days for most practices, with a median of 104 days, compared to 100 days in 2016.

Table 8.2: WIP days



Debtor days

As per last year, the survey shows very little change in debtor days between 2017 and 2016.

Our own experience is one where:

- Increased effort continues to be directed at pre-billing client communication and cash collection, resulting in fairly quick realisation of current invoices.
- Small changes to standard practice, such as moving away from billing at month-end to billing across the month, and raising bills as soon as the work is complete, can make a big difference to lock-up.
- Practices continue to carry large amounts of unbilled disbursements, and often do not ask for money on account of them, even in areas where you would have thought it was straightforward for them to do so, e.g. property work.

Table 8.3: Debtor days

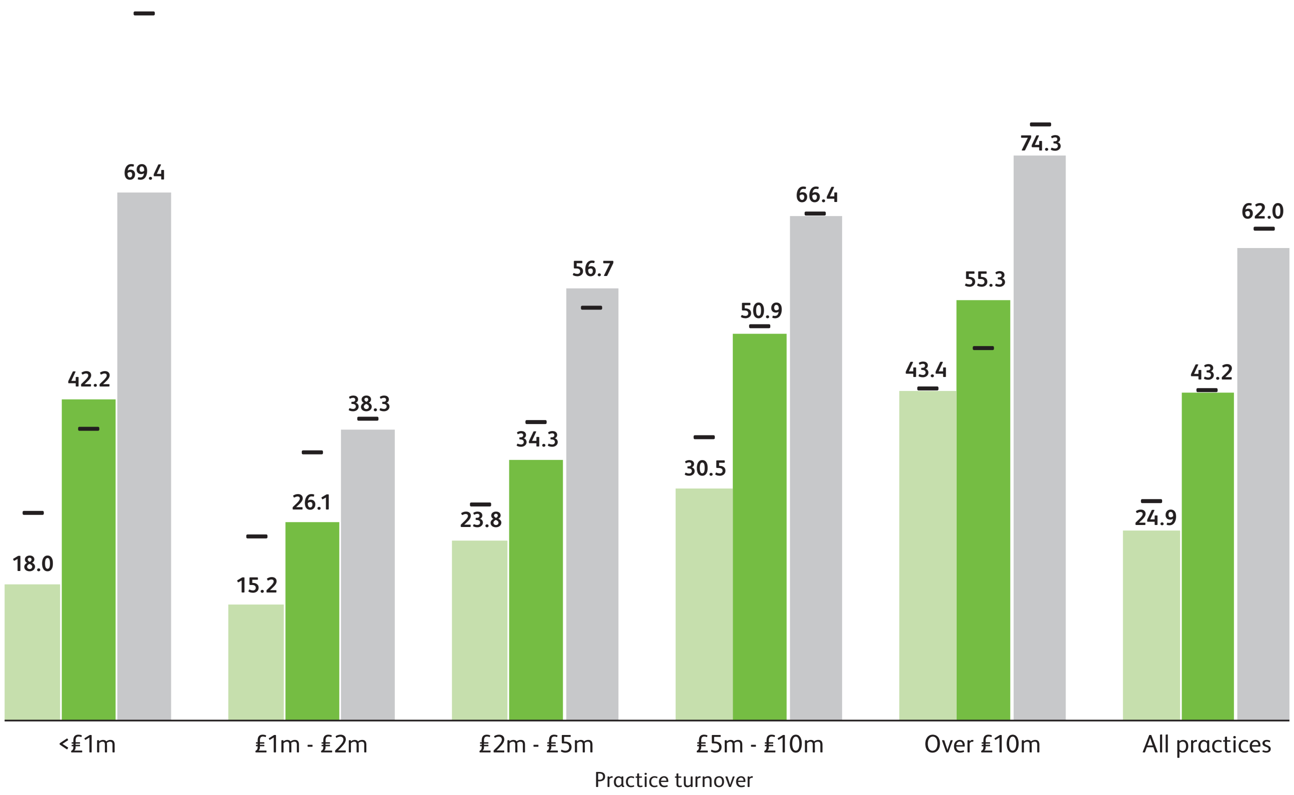
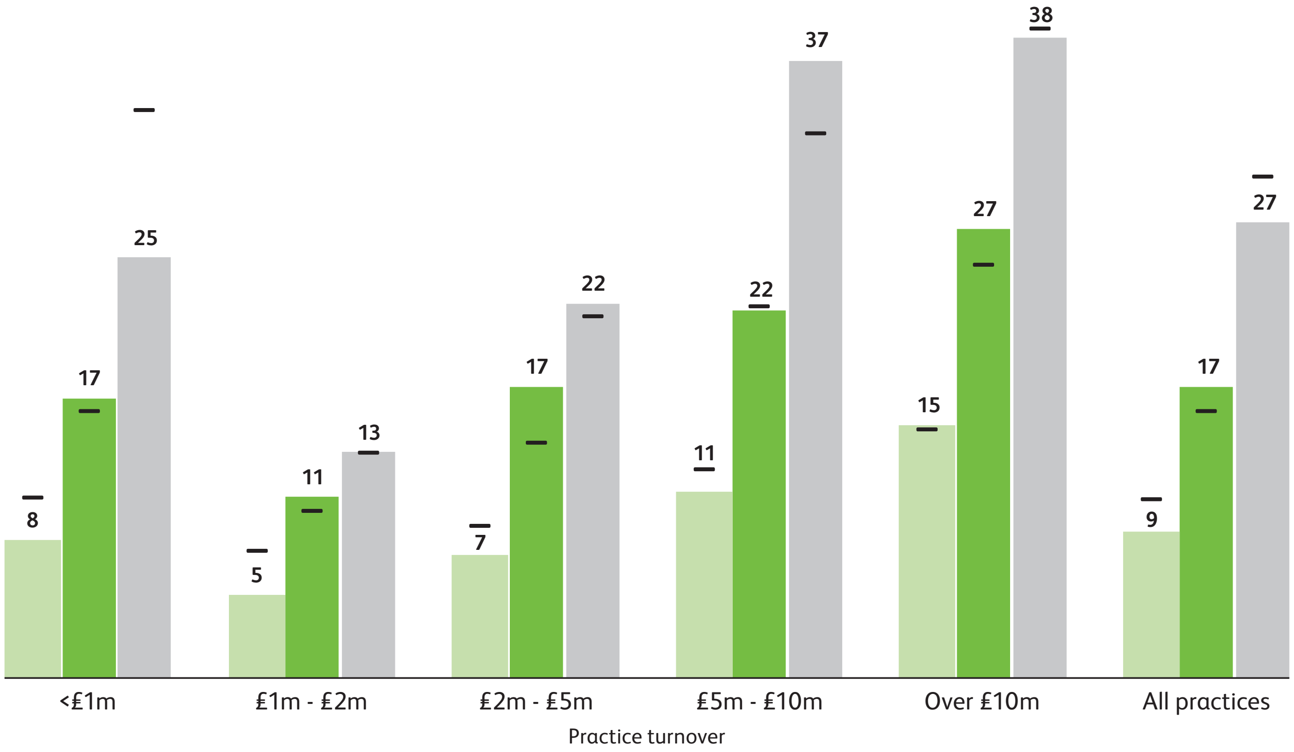


Table 8.4: Debtors per fee earner (£'000)



Working capital – equity partner funding

Equity partner capital in a partnership or LLP is the total combination of capital account, current account and tax reserves. In a limited company, capital comprises share capital and retained profits.

Our survey shows a median 17% increase in partner capital in 2017. This is on top of the 14% increase reported in last year's survey.

Growth in partner capital may be due to one or more of the following strategies for working capital:

- Increasing levels of super profits retained in the practice.
- Higher tax liabilities for the partners and increased undistributed tax reserves.
- A reduction in third party borrowings and bank overdrafts.
- A deliberate effort to retain higher amounts of cash in the practice, perhaps to prepare for potential turbulence caused by Brexit and ongoing changes to the legal profession.

The median balance has increased from £193,876 in 2016 to £227,738.

£227,738

17% median equity partner capital

Table 8.5: Partners' account balances per equity partner (£'000)

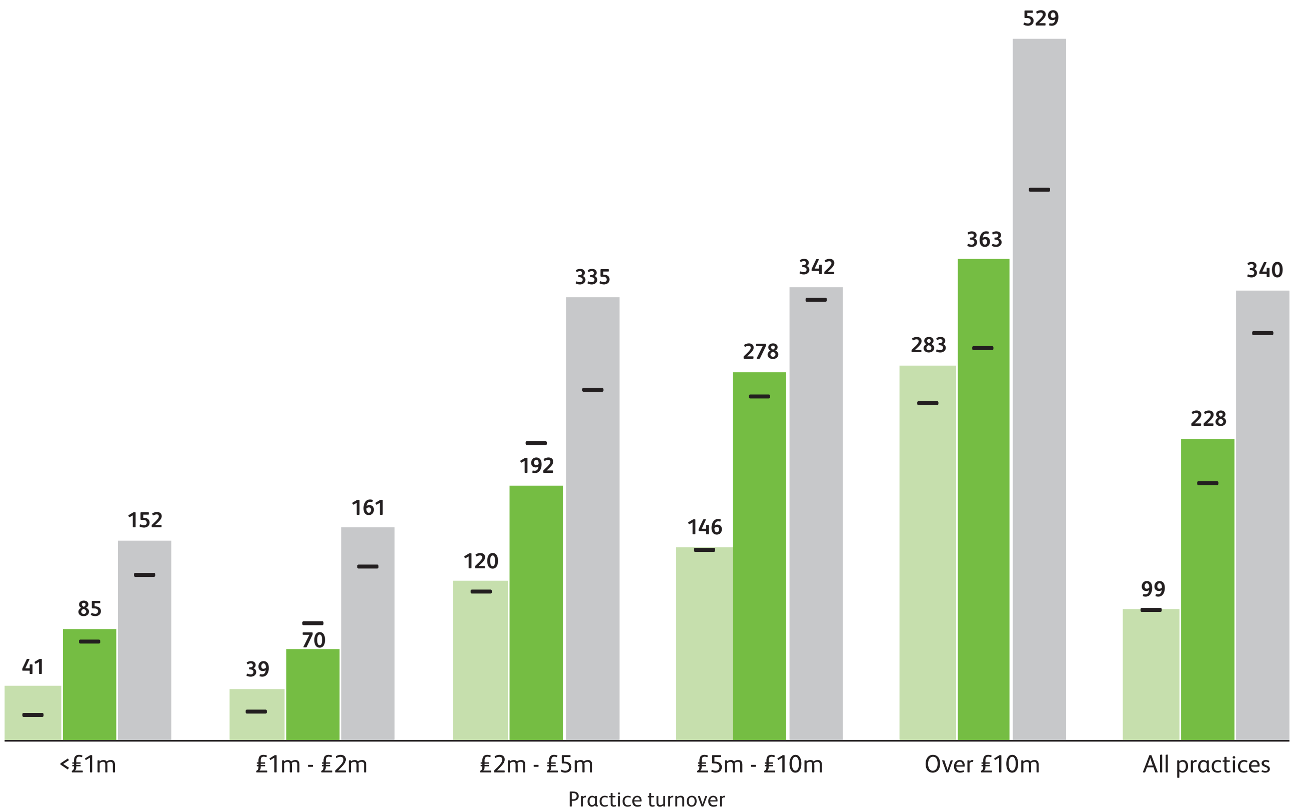


Table 8.6: Total borrowings per equity partner (£'000)

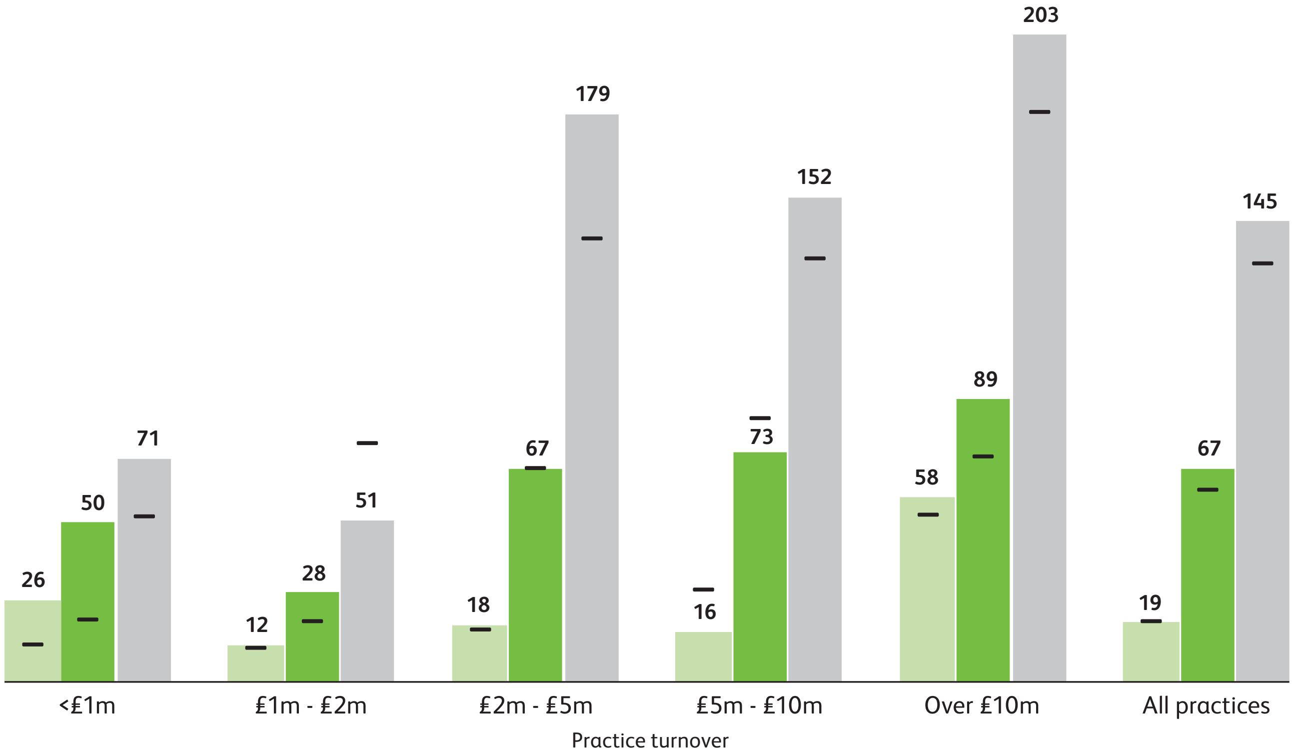


Table 8.7: Bank borrowings per equity partner (£'000)

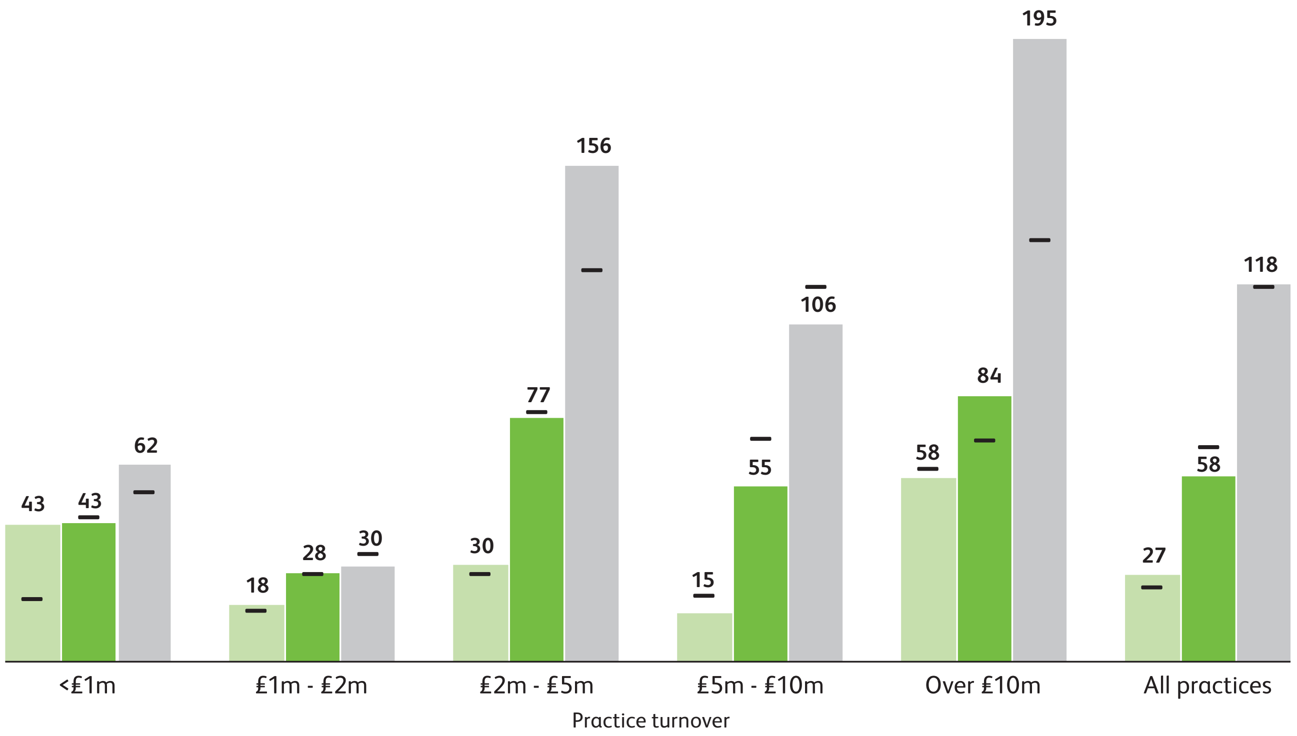


Table 8.8: Other borrowings per equity partner (£'000)

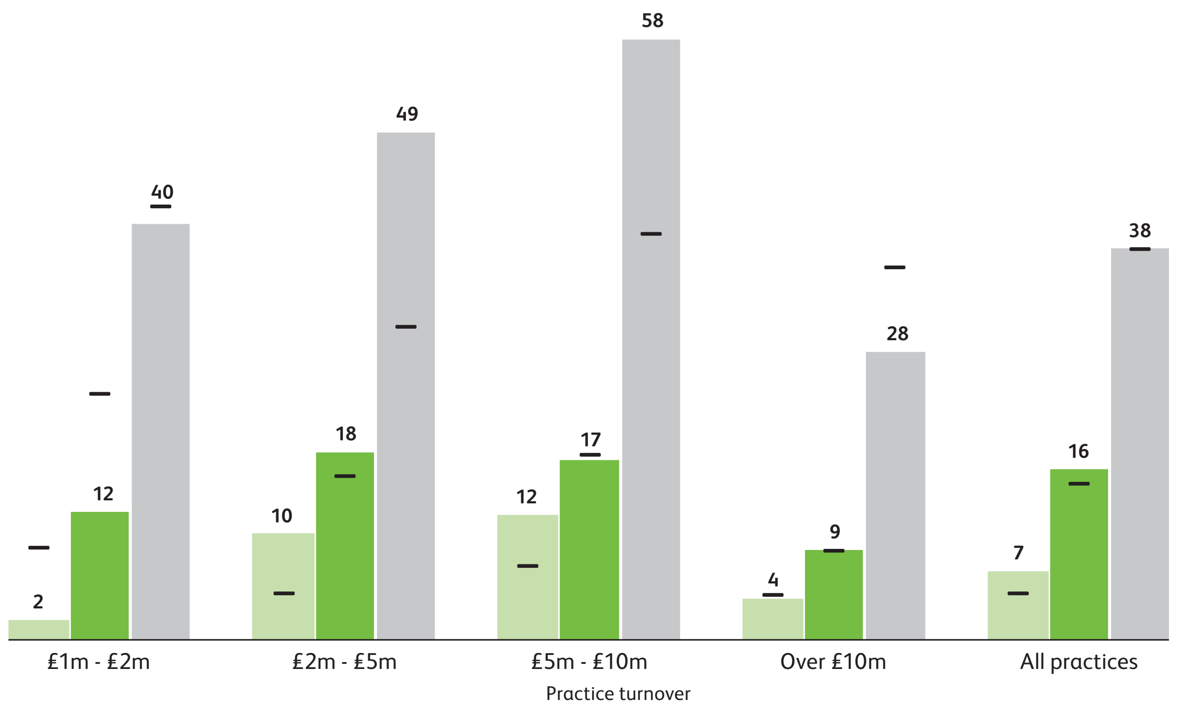
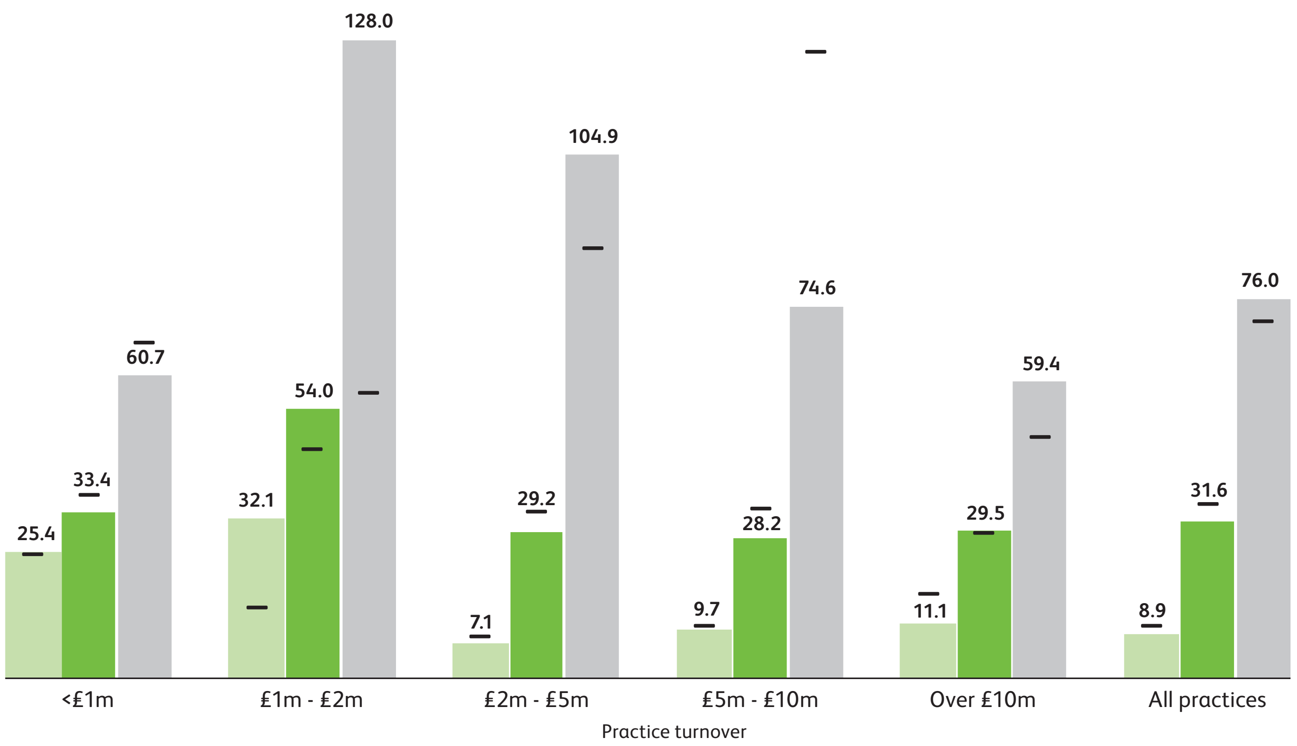


Table 8.9: Total borrowings per equity partner as a percentage of partners' capital balances per equity partner (%)



Banks' attitude to lending

Banks are presently viewing the legal sector positively overall, although personal injury practices can be an exception.

We have seen considerable levels of new lending, secured by a debenture over the practice only, where practice performance and debt to equity ratios support it.

Many banks pay close attention to the ratio of borrowings to fee income, and it is pleasing to see a median of 8.7% for the practices in the survey.

Table 8.10: Bank borrowings as a percentage of fee income

In March 2015, the SRA announced that it wanted to do more to help ensure the financial viability of law firms, and began risk-assessing practices based on three warning indicators:

- Drawings in excess of profits.
- Borrowings in excess of net assets, i.e. net liabilities.
- Borrowings over a certain (undefined) level.

Based on these indicators, practices were assessed as red, amber or green. Red rated firms received intensive supervision from the SRA, were required to provide the SRA with regular management information and contingency plans, and were told to obtain professional insolvency advice.

Amber rated firms received regular contact from the SRA, and many were also required to provide the SRA with regular financial information.

Green-rated firms were largely left alone.

In addition, the SRA published a list of what they believed were good behaviours to aim for and poor behaviours to avoid from their experiences with firms that had suffered severe financial difficulties. Good behaviours included the following:

- Drawings not exceeding profits.
- Capital element retained from profit, and a capital reserve account built up.

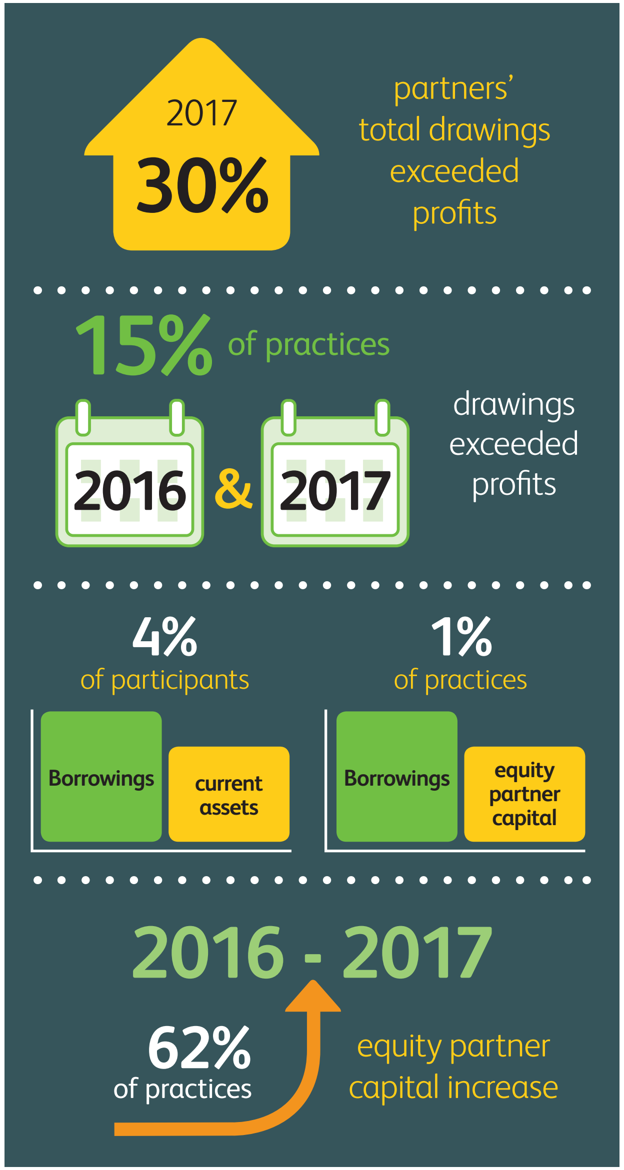
Poor behaviours included the following:

- Drawings exceeding profits.
- High borrowing to net assets ratios.
- Heavy dependence on high overdraft borrowings.

From discussions with the SRA, it seems that they are now focusing their attention on other matters In our experience, the majority of the practices that were initially assessed as red and amber are no longer required to provide the SRA with any financial information, and have little contact with them.

We have analysed the information provided by participants in this year's survey and found the following:

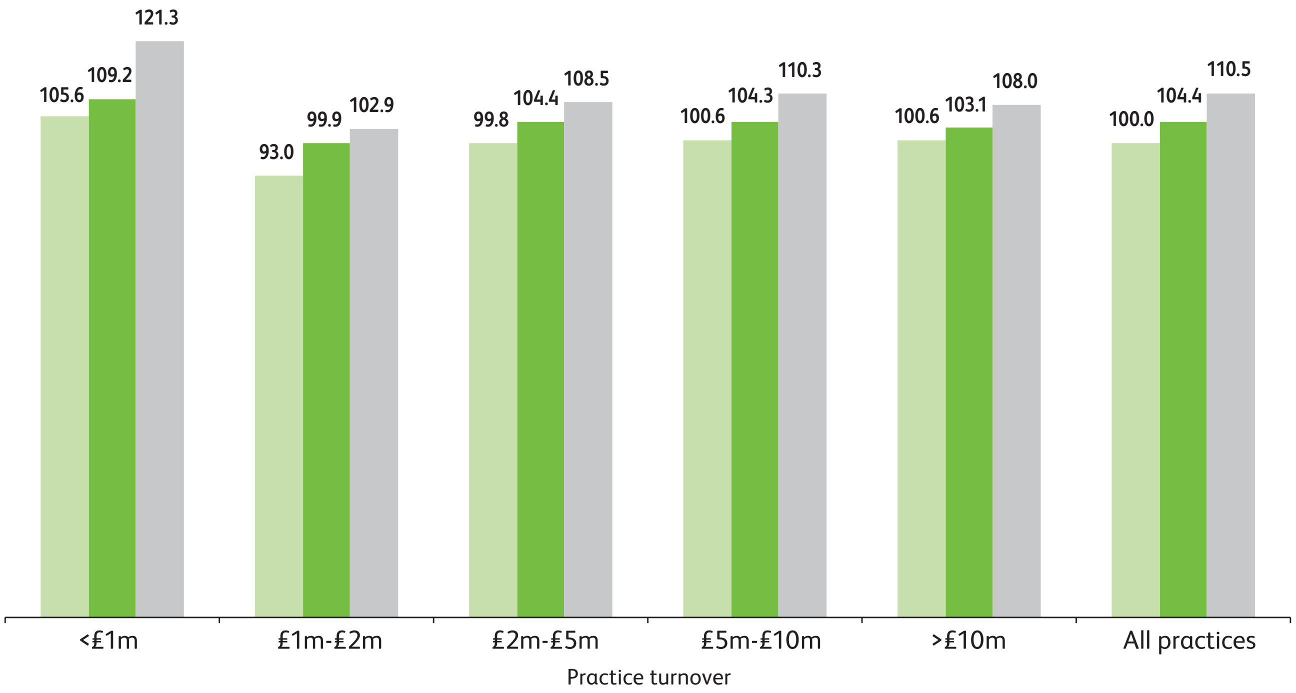
- In 2015 partners' total drawings (including income tax) exceeded profits for a quarter of participants, with a similar proportion in 2016. This increased to 30% in 2017. As we noted last year, we need to remember that sometimes this is no more than a timing difference, i.e. when practices decide to withdraw profits.
- In 15% of practices, partners' total drawings exceeded profits in both 2016 and 2017. Whilst this is a big improvement on our findings from a few years ago, when partners in 21% of practices had taken total drawings in excess of profits for two consecutive years, the figure is higher than the 9% than we reported last year.
- Borrowings exceeded current assets (WIP and debtors combined) for just 4% of participants. Borrowings exceeded equity partner capital for only 1% of practices this year. Both of these findings are in line with last year's findings.
- Finally, total equity partner capital increased between 2016 and 2017 for 62% of practices.



The short term future – fee predictions

Last year practices predicted a median growth in fee income for 2016/17 of 4.2%. Confidence is higher amongst this year's participants, with a median growth prediction for 2017/18 of 4.4%. The upper quartile are predicting growth up to approximately 10.5%, and the lower quartile are predicting no change.

Table 10.1: Predicted fees for the 2017/18 year as a percentage of this year's fees (%)



Fee earner breakeven point

By combining some of our findings throughout this report we are able to calculate the expected breakeven point for a fee earner. This is the fees a practice must generate per fee earner before any profit contribution is earned. As illustrated below, this is substantially more than simply the median cost of a fee earner.

	2017 £	2016 £
Median fee earner cost, including notional salaries for equity partners (Table 5.4)	48,787	47,744
Median support staff cost per fee earner (Table 5.9)	20,775	20,830
	69,562	68,574
Median non-salary overheads per fee earner (Table 6.9)	35,304	35,816
Breakeven point per fee earner	**£104,866**	**£104,390**

Working on an average of say 1,100 chargeable hours per annum per fee earner, or 220 chargeable days per annum, this equates to the following:

	2017 £	2016 £
Cost per hour	£95.33	£94.90
Cost per day	£476.66	£474.50

In Table 4.5 we saw that the median fee income per fee earner was £118,637. This means that, on average, over 88% of fees earned by a fee earner are used to cover their costs. Looking at it another way, if a practice has a 31 December year end, on average it takes until 19 November for a fee earner to earn sufficient fees to cover his or her total costs for the year, and for the practice to reach ‘super-profits’.

Areas to focus on

Sections 5 (Employment costs) and 6 (Profitability) include some pointers on key overheads, such as fee earner costs support staff costs and accommodation costs, and these may help to identify areas for potential savings.

However, we expect the breakeven point to continue to increase. Salary costs are generally only going one way, and overheads in many practices have already been cut back as far as possible.

Section 4 (Fee income) is therefore the key section to focus on for practices looking to increase profitability.

Fee earner performance

Fee income is driven by a combination of chargeable hours recorded (productivity) multiplied by a recovery rate. The greater the productivity and recovery, the higher the income. For example, let’s assume a practice with 20 fee earners, all with an hourly chargeout rate of £175. Fee earners record an average of 1,100 chargeable hours each per year, and recover (i.e. bill) 80% of the recorded WIP value, resulting in total fee income of:

20 x £175 x 1,100 x 80% = £3.08million

If fee earners are able to increase recovery rate by just 1%, annual fee income and profitability will increase by £38,500.

If fee earners improve productivity by 1% then the increase in turnover and profitability is £30,800. A 1% improvement in productivity represents just one additional 6 minute unit per fee earner per day.

A 1% improvement in both productivity and recovery increases income and profits by almost £70,000.

In our experience, fee earners in many practices do not fully time record. This is often the case where the work is fixed fee, for example in residential conveyancing. Even where fee earners do time record, it is rare to see fee earners recording more than four chargeable hours per day.

If you do not know how long it takes a job to do, how will you be able to tell if it is profitable and therefore worth doing at all? If fee earners are making the decision to not record all of the time they have taken on a matter, you also risk a further reduction being made at the point of billing, or "double discounting". The fact that it is felt not all time can be recorded suggests that work might not be being performed at the right level, further training is required, or there are undue pressures from management.

Capturing all time spent on a client matter, for all work types, is essential, not only to allow you to charge your clients a commercial fee, but also to ensure that work is being carried out efficiently and at the right level. Fee earners should be provided with targets for both productivity and recovery, which can then be monitored, and the process of recording time and billing should be made as simple as possible.

Deciding on a suitable productivity target for each grade of fee earner can be difficult. Generally speaking, we would expect more senior people, with non-fee earning responsibilities, to have a reduced target, whereas more junior people with no other responsibilities at all could be looking at upwards of 1,200 or 1,300 hours. This may sound like a lot, but after allowing for holidays, sickness and other absences, it amounts to less than six chargeable hours per day.

Once you arrive at a target level of productivity and recovery, this should allow you to calculate target fees per fee earner, and for the practice as a whole, and compare them to our findings in section 4. Ideally, you should be aiming to be in the upper quartile for your turnover band, which will hopefully move you into the upper quartile in section 6 (Profitability).

Fee earner gearing

As we explained in section 4, fee earner gearing also impacts on fee income. Generally speaking, the higher the ratio of fee earners to equity partners, the greater the fee income. However, high gearing ratios are not suitable for all work types, particularly those requiring greater levels of supervision and experience.

As a reminder, and as indicated on chart 4.7, even the very largest practices in the country average ratios of between 6 and 7 fee earners per equity partner. The largest practices produce most of their higher profit numbers by individual fee earner chargeable hours, charging rates, and therefore billing figures being (often significantly) higher than the numbers in this survey.

As in previous years, we thought it might be helpful to include a brief list of these, to help practices make allowances in their 2018/19 budgeting process.

Interest income. For the first time in many years we recently saw an increase in bank Base Rates, and the Bank of England has hinted at more increases in the near future. The days of practices earning substantial amounts of interest on client monies are a distant memory, but that doesn't mean that you should ignore interest receivable. Nowadays, many practices have begun holding the top slice of client money in SRA-compliant term deposit accounts in a bid to earn more interest, and we would recommend that you review your interest policy, as lots of practices have moved away from a £20 de minimis limit.

New SRA Accounts Rules on the way. Ordinarily, changes to the Accounts Rules have little impact on finances. However, the SRA's proposed new Accounts Rules will allow some practices to hold monies received in advance for fees and disbursements in office account in future, if they wish. This will clearly be beneficial to cash-flow.

Staff costs will remain under pressure, not only due to market salary levels and rising pension costs, but also higher expenditure on both recruitment and training. Fee earner retention continues to cause practices headaches, adding to the pressure to increase salaries.

Increasing numbers of practices have introduced small but frequent treats for staff, to help minimise leavers. Little things like providing free fruit once a week, or buying everyone an Easter Egg can make a surprising difference.

Incorporation is becoming popular again. As we mentioned in this report, 44% of practices operate as limited companies, compared to 37% two years ago. Larger practices in particular are considering incorporation, as a means of both managing tax exposure and creating additional working capital more tax efficiently. With corporation tax rates set to reduce to 17% from April 2020, the trend is likely to continue.