The Law Society's Law Management Section

Financial Benchmarking Survey 2022

The Law Society

In association with Hazlewoods LLP

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Foreword

This year, 206 firms participated, making the LMS Survey one of the largest of its kind in England and Wales. The COVID-19 pandemic has brought to bear new challenges, ways of working and of course opportunities, which we expect you will spot reflected here and in the next few years. I am delighted to write the introduction for the 2022 Law Management Section Financial Benchmarking Survey, because it gives the LMS the chance to help firms improve profitability year on year.

The combined turnover of firms involved amounts to £1.1billion. We can confidently say that the LMS Financial Benchmarking Survey continues to increase in importance as a valuable tool for all law firm managers, enabling them to benchmark results against a wide range of other law firms. It enables firms to objectively test their internal perceptions against their peers.

I would strongly encourage firms who are not members of LMS to look at our website and consider joining the section; and for those LMS member firms who have not yet joined in the survey, hopefully next year you will be encouraged enough to do so, making the results stronger than ever. Our objective is to support you with training, our magazine and our conferences to make a day-to-day positive impact through excellence of management.

The survey is a labour of love for those who deliver it, and I know the profession is always keen to see the trends. A huge thank you to 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 support through the year, and we welcome Andrew Allen as the sub-committee chair.

More thanks also go to Lloyds Bank Commercial Banking for their sponsorship of the survey.

Final thanks go to all who have taken the time to participate in the survey, which makes the report possible. Please contribute again next year and encourage your peers to do so at every opportunity – it will help us to support more firms.

I hope that you find this year's survey useful in improving the profitability of your firm. Please keep a look out for the survey later in the year, so that you can include your statistics in next year's report, and do join one of our conferences to get ideas arising from this year's trends.

Paul Bennett
Chair, Law Management Section Executive Committee
April 2022

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, secure payment facility and suggested links;
- national and regional CPD-accredited events programme covering all management disciplines;
- the *LMS Financial Benchmarking Survey*;
- the *LMS Quarterly Pulse Survey* – real-time insights on key metrics four times a year;
- 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 why not take advantage of even greater savings with our new corporate membership deal? For only £399 your firm can nominate up to six staff members (and £60 for additional people), who can all enjoy the individual benefits of being a Law Management Section member.

For more information, visit

www.lawsociety.org.uk/lawmanagement
email: MSadmin@lawsociety.org.uk
telephone: 0207 320 5804

Megan MacGarry
Membership Engagement Manager
at the Law Society

Megan works with the excellent Law Society's Law Management Section Committee to plan and deliver the Section offering, identifying key areas of concern for the membership and providing practical guidance and know-how through events, webinars, editorial content and a quarterly magazine.

For any feedback in relation to the Section offering and for any ideas around future content or speakers, please contact Megan at MSadmin@lawsociety.org.uk

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. We have worked with law firms since 1992 and we have a dedicated team of 35 individuals who focus only on this.

We are retained by over 200 law firms countrywide on a recurring basis and advise at least 30 others each year on projects such as practice strategy, new practice start-ups, mergers and acquisitions, structure advice and implementation, external equity investment, breaking away from larger firms and dealings with the SRA. 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**

This is the 13th year that we have compiled the LMS Financial Benchmarking Survey. Over this period, our experience and understanding of the sector have enabled us to develop and constantly refine the questionnaires and interpret the results.

Should you have questions about anything at all in it, we would be delighted to hear from you (**legal@hazlewoods.co.uk**)

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

About Lloyds Bank Commercial Banking

Lloyds Bank Commercial Banking is delighted to again sponsor the annual LMS Financial Benchmarking Survey which provides vital benchmarking data for law firms. As the most in depth of its kind it is an invaluable tool for law firm owners and managers to understand best practice and to make the right business decisions.

At Lloyds Bank Commercial we work closely with solicitors to provide funding and support that meets the specific needs of your business. Our specialist Relationship Managers are Lexcel-trained; understand practice management standards and 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 have a range of support available to the legal profession, from funding professional indemnity insurance to providing card payment solutions. We also support firms to bring in new partners through partner capital loans, and to manage client money through a range of secure accounts.

During 2021, businesses demonstrated their resilience through further lockdowns and restrictions, as well as through their innovation to find new opportunities. Our role was to be by the side of our business customers as they navigated another challenging year and to provide them with the financial support to manage through challenges and to seize opportunities for growth.

We continued to be an active supporter of the government schemes to help businesses through any interruptions they faced, and since the pandemic began, we have given **support to over 350,000 businesses** affected by coronavirus interruption.

At the beginning of 2021 we launched the Business Recovery Hub which provides support to businesses if they want to improve cash flow, obtain guidance on delaying their payments or if they want to make changes to their business.

In 2022, continuing challenges face businesses but there are more opportunities for growth than perhaps during the last two years, and we remain by the side of our business customers to support them through this year and beyond.

Becci Wicks
UK Head of Legal, SME & Mid Corporate
Lloyds Bank Commercial Banking
www.lloydsbank.com/solicitors

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Introduction

Members of the Law Society's Law Management Section (LMS) are represented in law firms across England and Wales. For over 20 years, the LMS has produced the annual LMS Financial Benchmarking Survey with the active participation of that membership, and the recent growth in support from the wider legal practice community. The survey is widely regarded as one of the leading annual health check reports for smaller and mid-sized practices.

This report is unique in providing detailed accounting and business metrics collected directly from solicitor firms across England and Wales, allowing those firms and others – particularly from the mid-market – to benchmark their performance against peers and, to an extent, over time.

The 2022 survey was carried out between July and October 2021, at a time when society as a whole was continuing to battle with the COVID-19 pandemic. As detailed in the following section, the majority of participants have either a 31 March or 30 April accounting date, and therefore the entirety of their 2021 results will have been impacted by COVID-19.

206 law firms from across England and Wales, concentrated in the mid-market, with a combined turnover of almost £1.1billion have taken part in this year's survey. We anticipate that most of the participants' income relates to domestic work. For reference, in 2019-20, total domestic turnover for all firms in England and Wales was £27.2billion, although over half of this amount was earned by the 100 largest firms, which are not the subject of this survey.

As in previous years, all participants provided two years' data, i.e. the most recent accounting period and the previous one, which 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 include three figures for each turnover band; the lower quartile, median and upper quartile. The results for 2021 are shown as columns and numbers, and the like-for-like results for 2020 are shown as a dash, i.e. - .

Participants are analysed in more detail in the following section.

We consider that the response rates that we have seen for this voluntary survey are very good compared to other financial surveys of professional firms. The response is particularly pleasing, given that it was carried out during the COVID-19 pandemic.

In order to allow the findings to be statistically valid, we have only provided full results for categories where at least 30 firms participated in the survey. Although we have a particularly strong representation from mid-sized firms this year, as detailed in the following section, fewer than 30 participants were in the £10million to £35million turnover band, and therefore the charts and statistics quoted throughout this report only reflect the median figures for those firms.

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

Participants

206 law firms from across England and Wales, comprising almost 12,500 partners and employees, took part in this year's survey. The fee income of all participants totals £1.1billion - an average of £5.3million per practice - and combined net profits of £300million.

As in previous years, we have categorised firms based on turnover. The turnover bands and the number of participants in each band are shown in the table below.

The total number of firms in England and Wales in each band is also shown.

Turnover band	Total number of practices	Number of participating practices	%
Up to £2million	9,099	73	0.8%
£2million to under £5million	721	66	9.2%
£5million to under £10million	259	43	16.6%
£10million to under £35million	186	22	11.8%
£35million+	128	2	1.6%
Total	**10,393**	**206**	**2.0%**

There was a good participation amongst firms with a turnover greater than £5million, but a lower proportionate participation from firms with turnover below £2million.

As shown in the chart on page 7, the majority of participants had either a 31 March, 5 April or 30 April accounting date. In July 2021, the Government proposed changes to the way that profits are taxed for sole practitioners, partnerships and LLPs that do not prepare their accounts to 31 March or 5 April (limited companies are not affected). Under the proposals, self-employed individuals and partners will, in future, be taxed on a tax year basis, rather than an accounting year basis, i.e. individuals will pay tax on profits arising in each tax year, regardless of their firm's accounting date.

To make the preparation of personal tax returns easier, we anticipate that many firms will move their accounting dates to 31 March or 5 April, to tie in with the tax year. Firms will need to be careful that they do this at the correct time in order to avoid missing out on the ability to spread any accelerated tax bills resulting from the proposed changes over up to five years.

The locations of the participants are as follows:

Region	Number of participating practices
Eastern	18
Greater London	42
Midlands	33
North East	6
North West	14
South East	30
South West	46
Wales	8
Yorkshire	9
Total	**206**

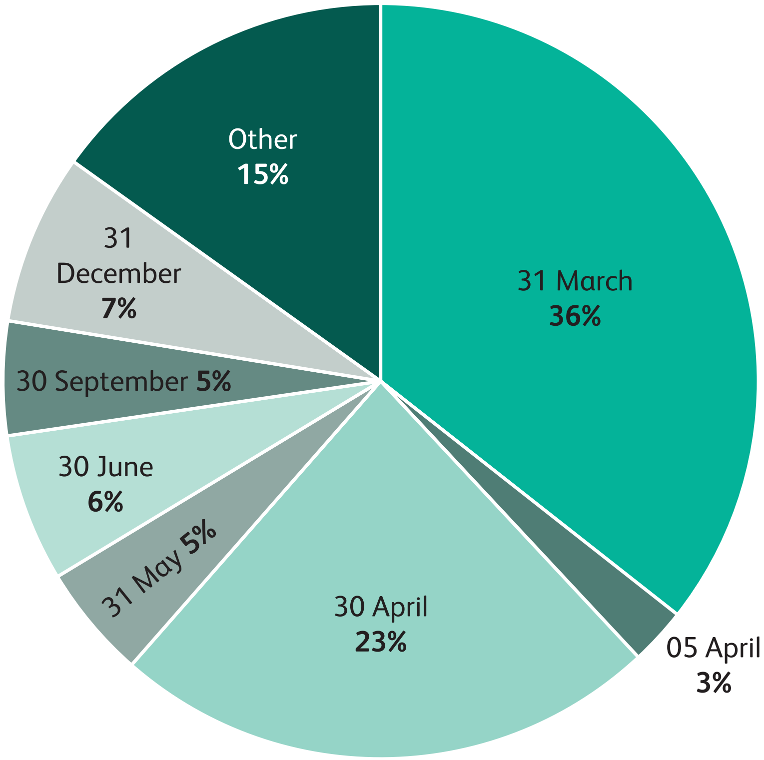
86% of participants traded as either a Limited Liability Partnership (LLP) or limited company. The remaining participants were unincorporated partnerships or sole practitioners. This is significantly higher than, and in different proportions to, the percentages for the legal sector as a whole. According to SRA statistics, 52% of law firms were operating as a limited company, and 15% were operating as an LLP at 31 January 2022. These statistics, and more, can be viewed here:
www.sra.org.uk/sra/how-we-work/reports/statistics/regulated-community-statistics/

This difference between the survey participants and the sector as a whole reflects the fact that a greater proportion of mid-sized firms have taken part again this year, as the majority of the Top 200 law firms are either an LLP or limited company.

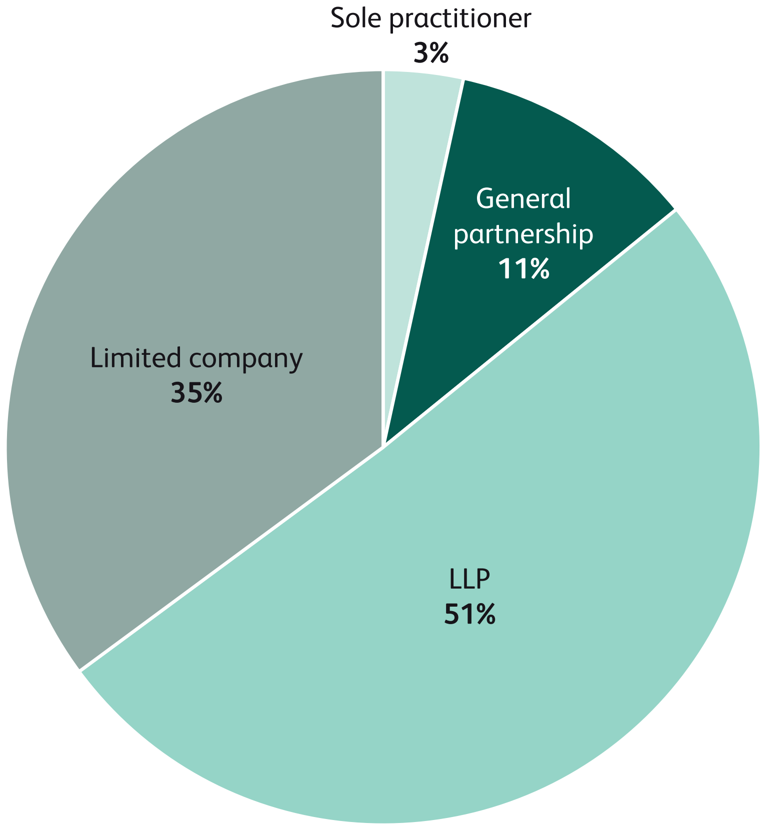
The SRA's statistics show that the number of limited companies has increased by 158 in the last two years, whilst the total number of firms of all types has fallen by 441 over the same period.

From April 2023, the rate of corporation tax is set to increase to 25% from the current rate of 19% for companies with annual profits over £250,000. In addition, the marginal rate of tax on personal dividend income increased by 1.25% with effect from 6 April 2022. Both of these are likely to make limited company status less attractive to some law firm owners, and it will be interesting to see if these changes impact on the number of firms operating as a limited company in the coming years.

Financial year end of participating practices



Structure of participating practices



1. Impact of COVID-19 on law firm finances

Overview

The first COVID-19 lockdown commenced on Monday 23 March 2020, and by the end of that week the majority of law firms' offices lay fairly empty.

It was completely natural for law firm owners to worry about how work could be completed, at least to a satisfactory standard/timescale, and in our experience the majority of law firms set about producing what turned out to be fairly pessimistic financial budgets for the next 12 months, with some firms forecasting a loss.

In last year's survey, we asked participants for details of the impact of COVID-19 on their projections for the 2020/21 financial year. The median drop in forecast income for participants was 15%, resulting in a median reduction in forecast profits of 24%.

We also asked last year's participants for their views on staff redundancies, and at the time of completing the survey, a third of participants anticipated making redundancies amongst their fee earning staff, and 44% anticipated redundancies for support staff.

Most participants in last year's survey also put a stop on partner profit distributions or, at the very least, restricted partner drawings to some extent to bolster cash flow.

In England, the first national lockdown ran from March 2020 to June 2020, and with this came the new concept of furlough. Firms that furloughed staff were able to claim the Coronavirus Job Retention Scheme grant, also known as furlough grant, and it is fair to say that furlough grants and better than expected workflow helped many firms to avoid making widespread redundancies. In fact, as explained later in this report, total fee earner and support staff numbers for participating firms changed very little between 2020 and 2021.

Around the same time, the Government introduced the Bounce Back Loan Scheme (BBLS) and Coronavirus Business Interruption Loan Scheme (CBILS), to provide financial support for SMEs across the UK through a Government lending guarantee.

During the early summer months of 2020, workflows for most firms were better than expected. There were exceptions though and some work areas suffered, including residential property work, business sales and purchases, and anything reliant on the court system.

Following the end of lockdown in June 2020, workflow in the sector increased quite quickly, particularly residential conveyancing which, after a very challenging few months, saw huge upturns in activity, fuelled by the stamp duty land tax (SDLT) incentives, which commenced on 8 July 2020 and ran until 30 June 2021.

The gradual unfurloughing of staff by law firms started from around July 2020, and many had very few (or even no) staff left on furlough by the Autumn of 2020. During Autumn and Winter 2020, the majority of mainstream law firms were operating at or near to pre-COVID-19 levels, or in some cases better, despite a second lockdown in November 2020 and the reintroduction of a tiered system in December 2020. As a result, many of the salary reviews and promotions that were originally deferred from early 2020 were later implemented.

The third national lockdown ran from January to March 2021, after which we began a phased exit from lockdown. The 2021 calendar year was generally a stronger year for most law firms throughout England and Wales, and across all work types, and the findings from each of the LMS Quarterly Pulse Surveys carried out throughout 2021 have shown increasing confidence across the firms that took part in those surveys, with steadily improving workflows, income and cashflow.

Financial performance

Participants in this year's survey were asked whether they had taken advantage of the assistance provided by the Government and HMRC to help manage cashflow through the pandemic.

- 83% of participants reported that they had furloughed at least some of their staff at some point during the 2020 and 2021 calendar years. Where staff members were furloughed, a median one in six fee earners were placed on furlough. The proportion of support staff placed on furlough was considerably higher than the proportion of fee earners, at a median of just over one in three.
- Amongst participants in this year's survey, the total amount of furlough grant money claimed in their 2021 financial years was over £19million – an average of £123,000 per firm. This money will have reimbursed firms for the bulk of the cost of continuing to employ staff that might otherwise have been made redundant.

- Whilst firms are under no obligation whatsoever to repay the furlough grants, in recent months we have seen a number of (mainly larger) firms announcing in the legal press that they had repaid the amounts claimed. 11% of participating firms that had claimed furlough grants told us that they had either repaid, or intended to repay, furlough monies received.
- Depending on their size and location, some law firms have been able to claim local authority grants throughout the pandemic. 13% of firms in the survey had received grants, with an average amount received of £27,000.
- 79% of firms deferred the payment of their VAT liability from March to June 2020 until 2021. This is fairly unsurprising, given that the deferral was automatic. The majority of firms have now either paid the deferred VAT or are paying it in instalments.
- 12% of firms had been able to agree a time to pay arrangement with HMRC to defer or spread the payment of the PAYE/NIC due on monthly salaries.
- 12% of the limited company firms that took part in the survey were able to negotiate time to pay on their corporation tax bills.
- 44% of self-employed sole practitioners or partners in partnership/LLP participant firms deferred their July 2020 tax payments until January 2021. Again, this was automatic, and individuals did not need to apply for the payments to be deferred.
- Finally, 74% of participants borrowed monies through either of the BBILS or CBILS. The median amounts borrowed by participants under the two schemes were £50,000 and £350,000 respectively, and in our experience, many firms have still not used the money, preferring to hold onto it 'just in case'. Some firms used the money to fund their PII premiums, as interest rates on the BBILS and CBILS are generally lower than more traditional funding options.

Turning to firms' financial results, as we will see throughout this report, the overall picture is that many of the firms that took part in this year's survey have seen stronger than expected levels of performance in 2021, particularly in comparison to 2020. 75% of participants reported increased profitability between 2021 and 2020.

Overall profitability is up for the majority of firms, driven by a combination of the following:

- Fee income has increased by a median of 6.2% between 2020 and 2021 – the strongest growth that we have seen for seven years. Firms across all regions of England and Wales have seen fee growth, and fees are up in most work types too. Firms specialising in residential conveyancing and employment have fared particularly well compared to 2020.
- Salary costs as a percentage of fee income have fallen this year. It is likely that this is due to a number of factors, including staff being furloughed for a greater proportion of the period, delays in awarding pay reviews and promotions, and fees per fee earner rising by more than the increase in salaries. A small proportion of firms also reduced salaries for staff members who were not furloughed.
- Non-salary overheads as a proportion of fee income have also fallen. In particular, we have seen reductions in marketing, accommodation and other premises costs (light, heat, repairs, etc), and with staff working from home, our experience is that other overheads such as printing, stationery and postage have fallen for many firms too.

Looking forward

Our experience is that many firms have continued to see strong financial performance into 2022, as workflow remains strong in most areas. However, the challenge is going to be maintaining the increased levels of profitability over the coming months and years. Firms are facing increasing pressure to raise staff salaries in order to retain and attract good quality staff, and many have seen large increases in their professional indemnity insurance premiums. Alongside this, employer national insurance rates increased by 1.25% from 6 April 2022, which will add more pressure on firms looking to control costs.

Key to all of this is getting the most from your staff, providing the best possible client service efficiently, and charging for it accordingly, whilst always making sure that your working capital is being managed efficiently. This is where benchmarking can help.

As we noted last year, firms have already turned their attention to some very significant emerging opportunities for themselves, including:

- Genuine belief that the new efficiencies that remote working can bring are real.
- Noticing that the wellbeing and motivation of many staff is higher where they are offered more flexible working arrangements. These can also help to overcome the challenges around staff recruitment and retention currently being faced by the majority of firms.
- Expectations of many clients have altered away from what can be long face-to-face meetings every time, and more towards swifter overall service levels.
- The upskilling in the use of technology by so many people has paved the way for greatly improved ways of both sharing and executing legal documents electronically.
- Communication methods have become more auditable, with improved electronic working, thereby improving service levels and reducing risk.
- There is a new willingness within those working in law firms to try new approaches, and as a result, belief has accelerated that they can give rise to efficiency gains, better service and a generally improved working life.
- The natural caution of law firm owners towards different ways of working has noticeably changed too, and therefore those running law firms are far more open to new ideas and ways of thinking as to how legal services can be delivered.

As a result of all of this, many firms are now starting to focus on designing client experiences to actually suit the client, and not just to suit themselves, and in doing this are finding that delivering services that suit the client better are actually more efficient anyway.

Fee earner breakeven point

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

	2021 £	2020 £
Median fee earner cost, including notional salaries for equity partners (Figure 5.5)	59,438	57,894
Median support staff cost per fee earner (Figure 5.10)	23,957	24,406
	83,395	82,300
Median non-salary overheads per fee earner (Figure 6.9)	38,293	37,495
Breakeven point per fee earner	**£121,688**	**£119,795**

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:

	2021 £	2020 £
Cost per hour	£110.63	£108.90
Cost per day	£553.13	£544.52

In Figure 4.6 we see that the median fee income per fee earner in 2021 was £134,788. This means that just over 90% of fees earned by a fee earner are used to cover their costs. Looking at it another way, if a firm has a 31 March year end, on average it takes until 24 February for a fee earner to earn sufficient fees to cover his or her total costs for the year, and for the practice to start earning 'super-profits' for the partners.

These figures assume an average of five chargeable hours per day, but in reality, fee earners in many firms do not record anywhere near 1,100 chargeable hours per annum, while others may find they exceed that.

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 – five years ago the breakeven point was £104,866. Despite the impact of COVID-19, salary expectations remain robust and so salary costs are generally going one way. Furthermore, overheads in many firms have already been cut back as far as possible, particularly over the last two years, and so further cuts may not be possible without having implications for efficiency.

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

Fee earner performance

Fee income is driven by a combination of fee earner numbers per partner (fee earner gearing), chargeable hours recorded (productivity) and the amount billed and received for each of those hours recorded (recovery rate).

While fee earner gearing is an important metric when the industry is growing, COVID- 19 has meant that firms have had to look much more closely at fee earners' capacity for chargeable work and the availability of that work. Put simply however, the greater the productivity and recovery of fee earners, the higher the income.

For example, let's assume a firm 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 the fee earners are able to increase the recovery rate by just 1%, annual fee income and profitability will increase by £38,500.

A 1% improvement in productivity represents just one additional (and chargeable) 6- minute unit per fee earner per day.

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

Time recording

In our experience, fee earners in many firms do not fully time record. This is often the case where the work is fixed fee, for example in residential conveyancing.

We frequently see firms adopting a policy whereby fee earners are only required to record chargeable time and/or there is no minimum on the number of hours that must be recorded each day which can result in a lack of accountability for non-chargeable time, and this can also have a negative impact on overall time recording.

Where fee earners do fully time record, it is fairly common to see fee earners recording somewhere around four or five chargeable hours per day, and sometimes lower than this.

This raises an important question: if you do not know how long it takes to do a job, because your fee earners do not record their time, how will you be able to tell if it is profitable and therefore worth doing at all or whether individual fee earners are working efficiently? 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" and, while this will make an individual fee earner's recoverability statistics look good, it will damage underlying profitability.

Furthermore, without a full time recording policy that is monitored and enforced, it is difficult to properly establish what 'capacity' looks like, and so working towards an appropriate level for fee earner gearing becomes difficult too.

In these situations, firms need to consider why time is not being fully recorded. Is it because work is being pushed down too much and fee earners feel out of their depth, or is there a deeper cultural point that needs to be addressed, with staff members feeling under pressure to charge less time to a particular matter?

Capturing all time spent on a client matter, for all work types, is essential, as too is capturing non chargeable time. 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. Where fee earners are seen as 'rain makers', their use of business development time should also form part of the monitoring process.

Coming up with a suitable productivity/chargeable hours 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 productivity target, whereas more junior people with no other responsibilities at all should be looking at an above average target of upwards of, say, 1,200 or 1,300 hours. In some cases, where matter volumes are high, and the nature of work is more routine/transactional, this could go even higher. This may sound like a lot, but even after allowing for holidays, sickness and other absences, it amounts to under 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, as well as for the firm as a whole, and compare them to our findings in section 4. 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).

Management information

Monitoring the performance of individual fee earners and the firm as a whole is only possible if you have accurate and reliable management information (MI). In our experience, many firms struggle to extract useful data from their practice management software, either because they do not know how or because their software has poor functionality and reporting.

Firms should use good quality MI to measure, and track, a small number of meaningful key performance indicators (KPIs). While there is no 'one size fits all' approach to measuring success in a business, and KPIs will commonly measure both financial and non-financial factors, there are common themes that will allow firms to benchmark themselves against their peers, and that is what this report explores.

If you already have good MI, consider sharing it with all fee earners. In our experience, the potential upsides from doing this usually outweigh any potential drawbacks. Individuals who understand how they can have a positive impact on a firm's performance will often adapt their behaviours accordingly, and may feel that they have a greater personal investment in the business.

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

6.2%
median practice fee income

median fee income per equity partner
£825,331

median cost of employed fee earner
£59,438
£57,894 2020

5.5:1
fee earners to partners

13.2%
increase in partner capital

135
-7 days
year end lock up

median cost per hour
£110.63

median fees per hour
£122.54

median 'super profit'
2020
£52,775
2021
£102,097

5% of practices
2020 & 2021
drawings exceeded profits

- Median practice fee income increased by 6.2% - the largest increase for seven years.
- Median fee income per equity partner of £825,331 (2020: £761,981).
- The median cost of a fee earner, including fixed share partners and notional salaries for equity partners, was £59,438 per fee earner, compared to £57,894 in 2020.
- The ratio of fee earners to equity partners dropped to 5.5 : 1 – a reduction of 4.0%.
- The median spend on support staff, including secretaries, reception, HR, finance and other back office functions, was £23,957 per fee earner, compared to £24,406 in 2020.
- The median spend on non-salary overheads per fee earner was £38,293 compared with £37,495 in 2020, and as a proportion of fee income, non-salary overheads reduced to 27.8% from 30.0% in 2020.
- Total year end lock-up days (WIP and debtors combined) dropped from 142 days to 135 days.
- Median equity partner capital (combined total of capital account, current account and tax reserves in a partnership, or retained profits in a limited company) rose by 13.2% to £225,250 per partner.
- The median hourly cost of a fee earner (based on 1,100 chargeable hours per year) was £110.63, compared to median hourly fees per fee earner of £122.54

Median net profit per equity partner (before deducting notional salaries for partners) firms rose from £146,417 in 2020 to £203,199 this year – a jump of 39%.

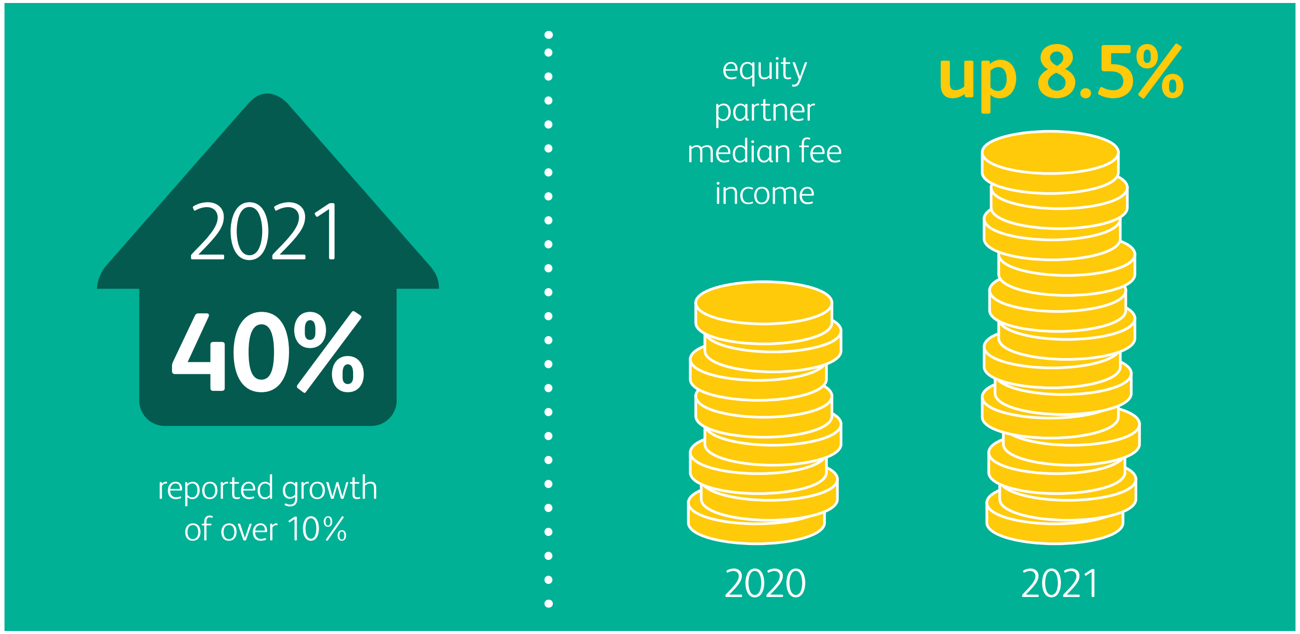
When we adjust the net profit figure to include a notional salary cost for equity partners, and also notional interest on partner capital, the median 'super-profit' for the year was £102,097 compared to £52,775 in 2020.

Just 11% of participants reported a 'super-loss' for the year – the lowest we have seen for many years.

We start our detailed analysis by reviewing income growth. We have measured income performance by equity partner and by individual fee earner. We reveal the effects on revenue from changing the gearing in a practice; that is the ratio of fee earners to equity partners.

Most of the charts throughout this and later sections include the results for two accounting years, and the results are analysed into turnover bands. Most charts include three figures for each turnover band; the lower quartile, median and upper quartile. The results for 2021 are shown as columns and numbers, and the results for 2020 are shown as a dash, i.e. - . The dashes show the like-for-like 2020 results for the participants in this year's survey, so may not correlate exactly with the findings from last year's survey.

As there were fewer than 30 participants in the greater than £10million turnover band, we have only included the median results for those firms in all of the charts in this report.



Key points are:

- 69% of the participants in the survey reported year-on-year fee growth in 2021, with 40% seeing growth of over 10%. Smaller practices in the survey saw a wider range of fee change than other turnover groups, as shown in Figure 4.1, possibly due to the fact that a modest increase in £ terms can represent a large proportion of overall fees for those practices.
- This is the 12th consecutive year that we have reported a median fee increase, although it should be noted that the composition of the sample across those 12 years will have varied. The last time we saw a general reduction in fees was in 2009, when firms were struggling with the impact of the global recession of the time.
- Participants reported a median fee income per equity partner of £829,487 compared to £764,319 in 2020 – an increase of 8.5% - although smaller firms in the survey generally saw lower results.
- Firms across all regions of England and Wales reported a median increase in fee income, and most work specialisms did too, particularly residential conveyancing, which saw a median rise of 15%. In our experience, most conveyancing firms increased their fee rates several times during 2021 and have not reduced them since.

Figure 4.1: Change in fee income compared to previous year's fee income (%)

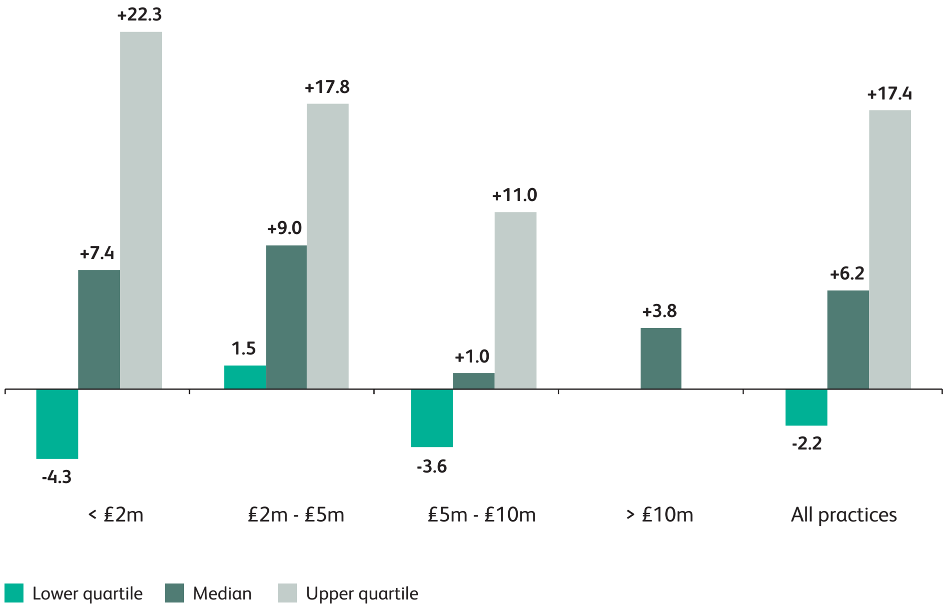


Figure 4.2: Median changes in fee income over the last 13 years (%)

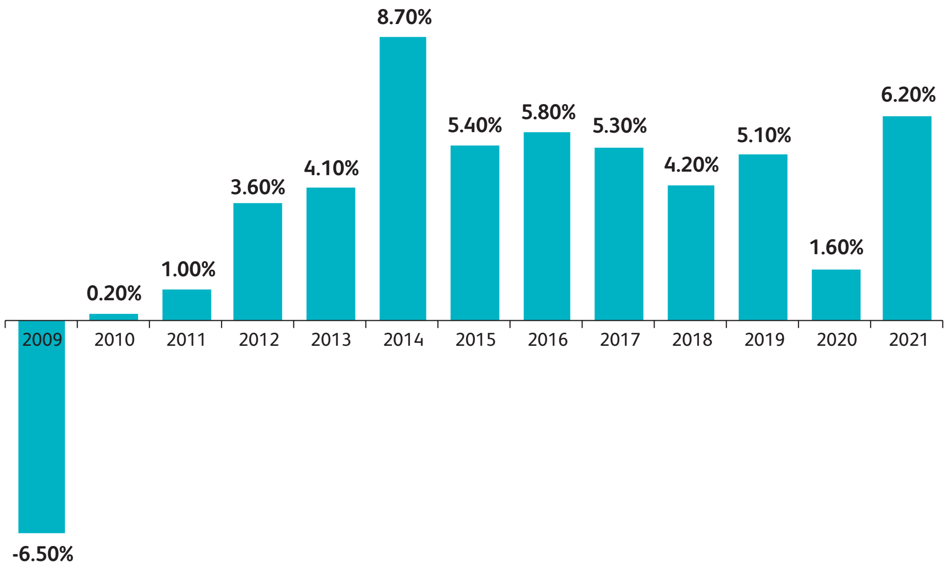
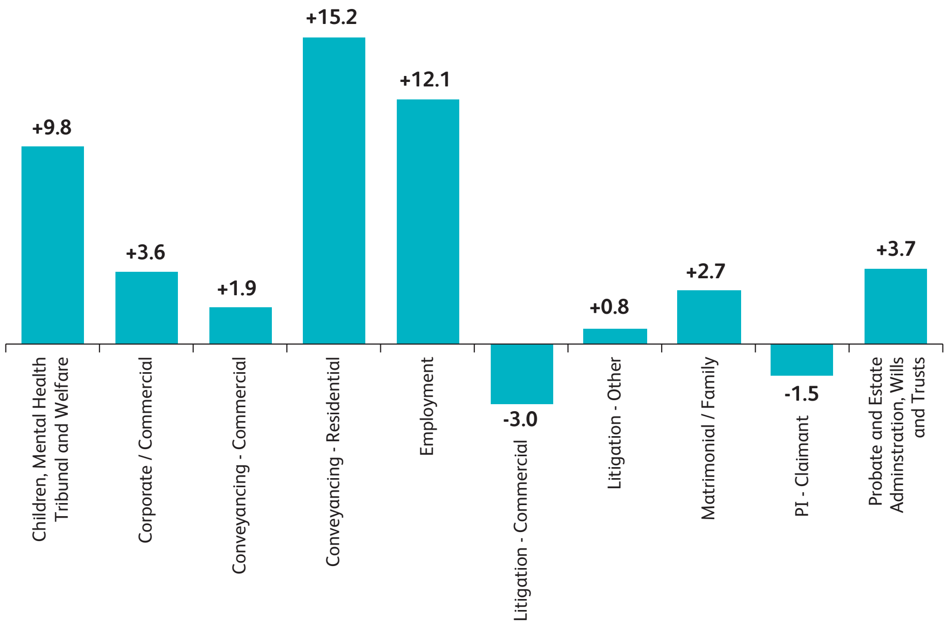


Figure 4.3: Change in fee income compared to previous year's fee income by specialism (%)(median figure only)



Equity partner performance

The majority of participants in the survey reported minimal change to the number of partners between 2020 and 2021.

For most firms, the growth shown in Figure 4.1 has resulted from increased fee income per equity partner, rather than a reduction in partner numbers, which is an encouraging trend. All turnover groups saw a rise in fee income per equity partner, with a median growth of 8.3%.

Figure 4.4: Fee income per equity partner (£'000)

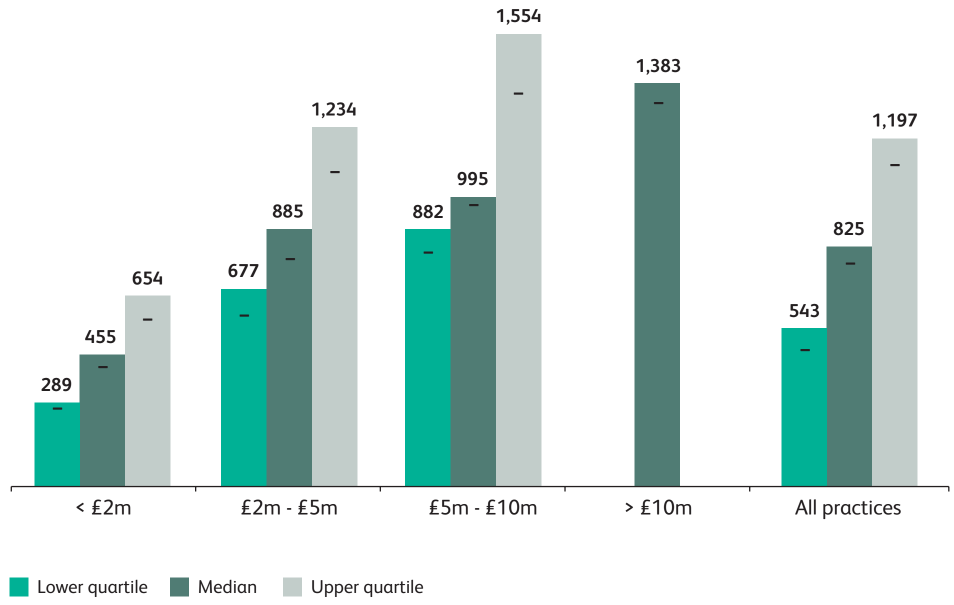
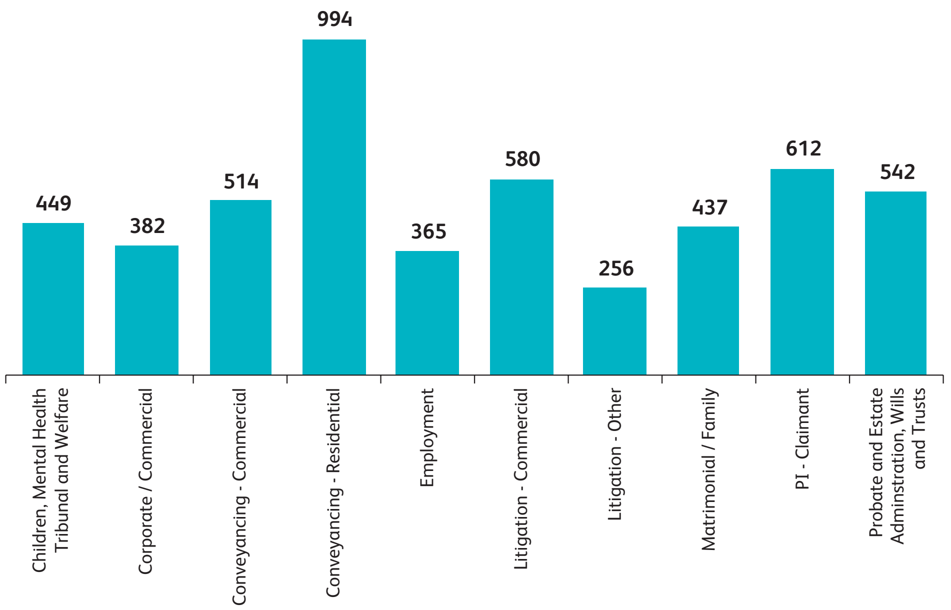


Figure 4.5: Fee income per equity partner by specialism (£'000)(median figure only)



Income by individual fee earner

Key points here are as follows:

- The total number of fee earners for participating firms was 7,125 compared to 7,100 in those same firms in 2020.
- Average fees per fee earner were £134,788, compared to £126,184 in 2020 - an increase of 6.8%. Firms across all turnover bands saw an increase, which is very positive.
- Despite the positive picture, fees per fee earner is a key issue for all firms to focus on, and alongside this there needs to be close monitoring of productivity and recovery rates as discussed previously. Our view is that, if fee earners are not fully time recording both chargeable and non-chargeable time, then it is very difficult to know whether work is being carried out efficiently and profitably, or what real fee earning capacity looks like.
- Increasing numbers of firms are giving their fee earners training on issues such as pricing and lock-up management, and we have seen some very positive results from this, both from an income generation and cash management perspective.

Figure 4.6: Fee income per fee earner (£'000)

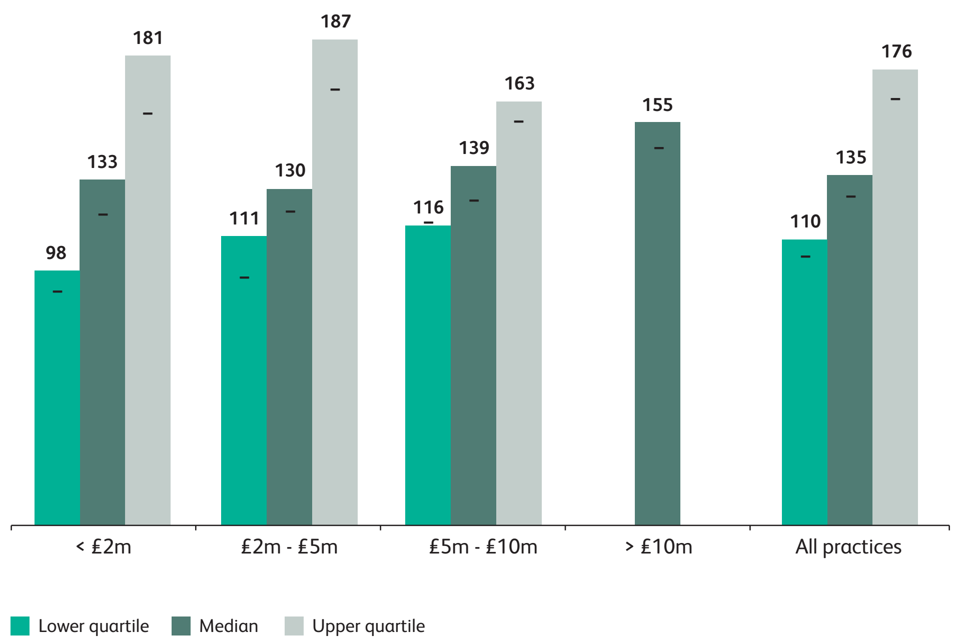
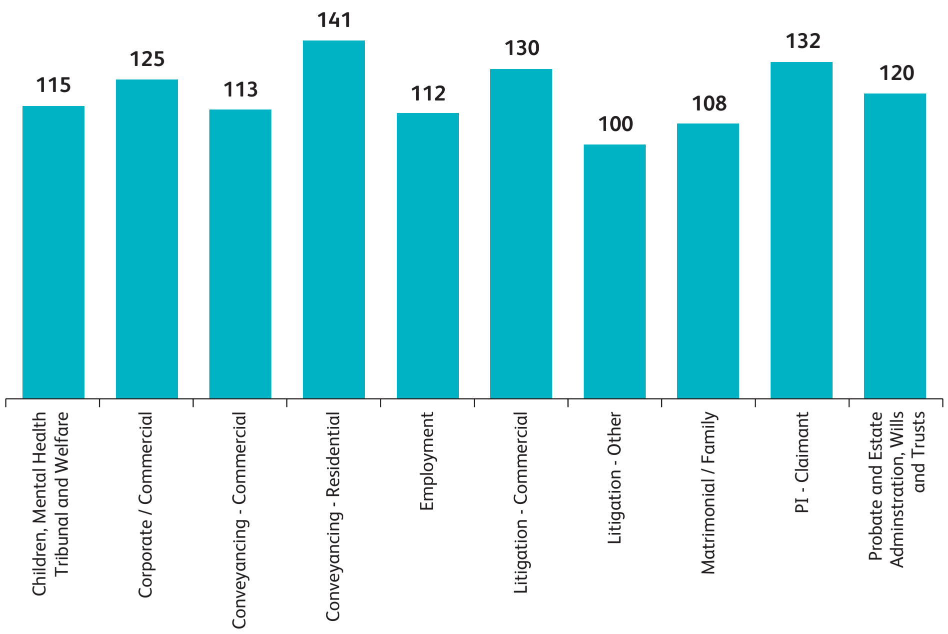


Figure 4.7: Fee income per fee earner by specialism (£'000)(median figure only)



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

In improving economic conditions, the ratio of fee earners to equity partners tends to increase as firms grow, with the opposite happening in times of recession.

This is certainly true in our surveys. Back in 2009, when Hazlewoods first carried out the LMS survey, the median ratio was 4:1, and the general economic climate then was challenging. Since then, we have seen a steady rise in fee income, and the gearing ratio gradually crept up to 6.0:1 immediately prior to the pandemic. This year, there has been a small fall in gearing to an overall median of 5.5:1, and this is the first drop that we have seen for several years.

Another factor to be aware of is that fee earner gearing can vary between different departments in the same firm, and we tend to see higher gearing in teams such as residential conveyancing and high volume personal injury work, and lower gearing in more specialised technical teams, such as complex litigation and corporate work, which generally require a larger amount of senior fee earner involvement.

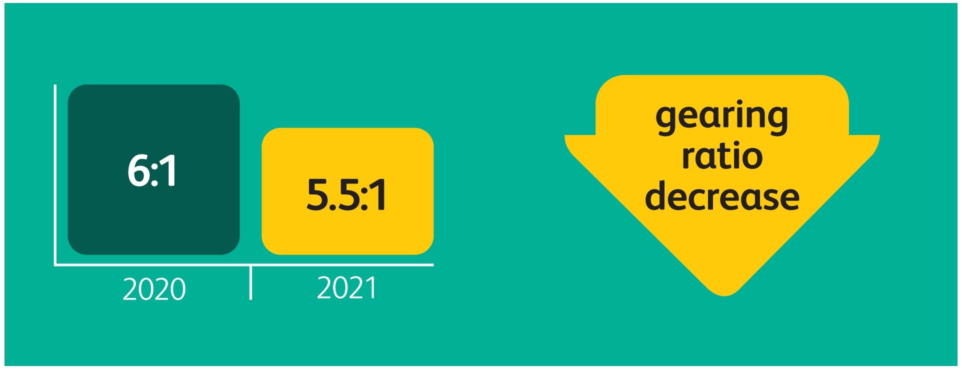


Figure 4.8: Number of fee earners per equity partner

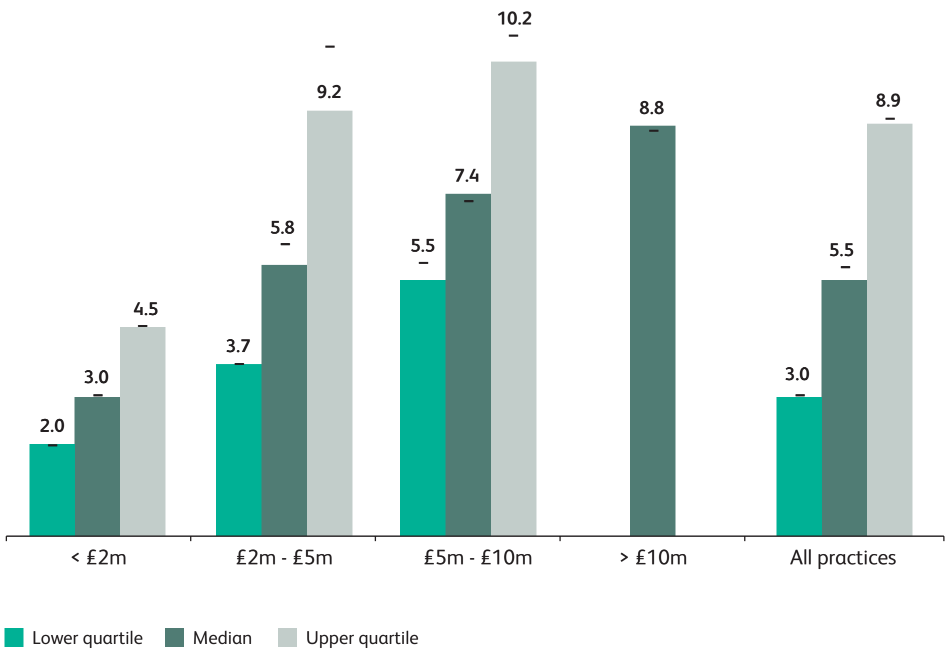
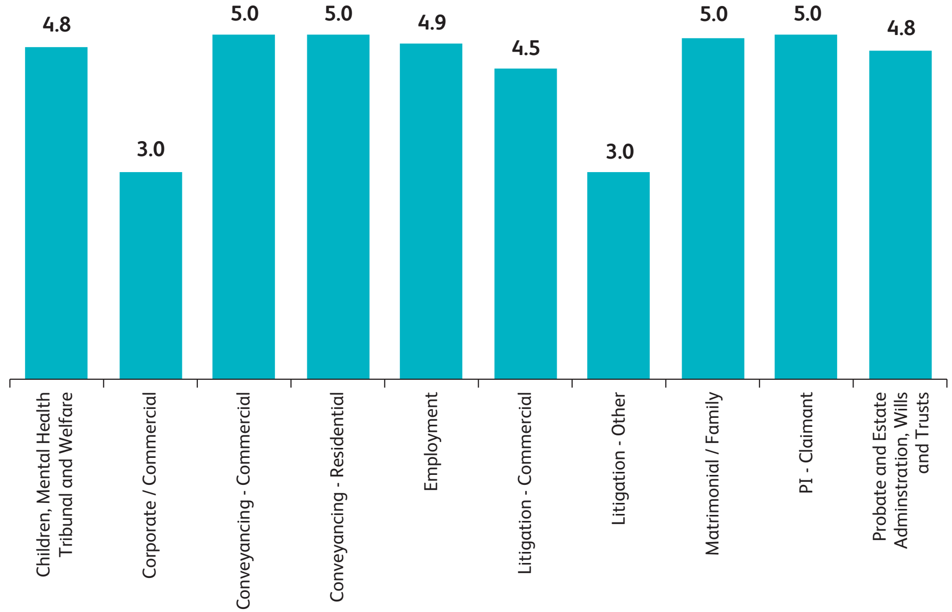


Figure 4.9: Number of fee earners per equity partner by specialism (median figure only)



5. Employment costs

People represent not just the greatest asset for law firms, but also the primary cost. The total costs are broken down into three principal categories:

- Equity partners
- Fee earners
- Support staff

Figure 5.1 compares the total cost of all of these people against fee income. This includes notional salaries for equity partners, which we have once again set at the same level of the median highest employed fee earner's salary for the size of practice, plus 15%, to reflect Employer's NIC and employer pension contributions.

The median 2021 total is 59.1%, compared to 62.8% in 2020, giving a median gross margin/contribution of 40.9% (2020: 37.2%). This increase in margin indicates that fee earner costs have risen by less than the growth in fee income that we saw in the previous section.

The issue does not appear to have been restricted to a particular size of firm, with all turnover bands seeing a reduction in proportionate salary costs.

Aside from increased fee income, there are a number of reasons for the reduction in employment costs relative to fee income, and these are as follows:

- Concerned about their future during the pandemic, many firms deferred or cancelled salary increases.
- 84% of participants reported that they had furloughed members of staff for a time, and as result, claimed grants under the Coronavirus Job Retention Scheme (furlough money). Whilst we have excluded furlough money receipts from the analysis at Figure 5.1, our experience is that many firms that placed staff on furlough also temporarily reduced the salaries that were paid to those individuals.
- In the early months of the pandemic, some firms felt the need to cut pay for staff who were working. By the third quarter of 2020, most firms had reinstated normal levels of pay.
- Some firms found that staff working from home were more productive and efficient than when they were working in the office.

Figure 5.2 shows the same information as in Figure 5.1, except that we have deducted furlough grant income from the total staff costs when comparing staff costs to fee income. The total furlough money claimed by participants was £19million during their 2021 financial year and £4.3million during their 2020 financial year.

The average amount claimed by participating firms in 2021 was £123,000. As shown in Figure 5.2, this reduced the median total employment cost in 2021 to 57% of income (2020: 62.3%).

As noted in previous years, a key challenge facing all law firms is the need to attract and retain high quality staff, and firms have felt pressure to increase salaries by higher than inflationary amounts. Many firms are also revisiting their remuneration packages, and considering options such as staff bonuses, increased levels of employer pension contributions, improved holiday entitlements and the introduction of other benefits such as health cover.

The increase in Employer's National Insurance with effect from 6 April 2022 will also add to employment costs in a way that cannot be easily managed by firms.

Unless firms are able to increase their hourly chargeout rates and fees to clients in line with rising staff costs, we expect employment costs as a percentage of fee income to increase in next year's survey.

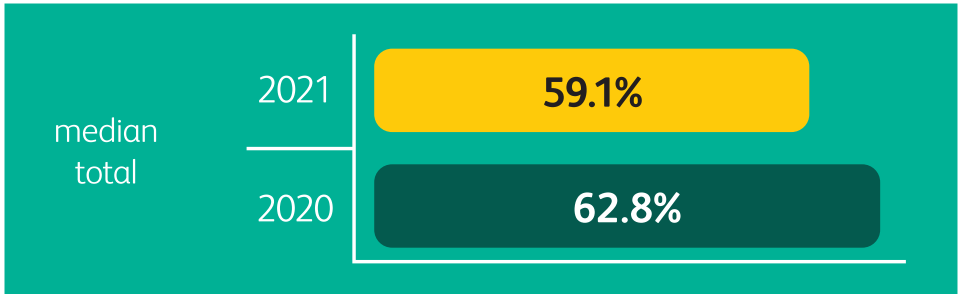


Figure 5.1: Total salary costs, including notional salaries, as a percentage of fee income (%)

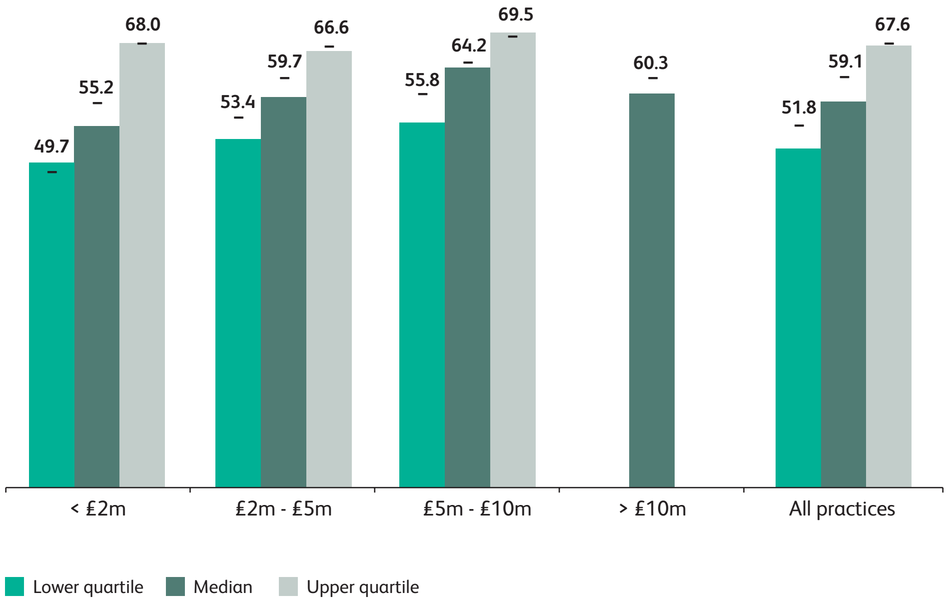
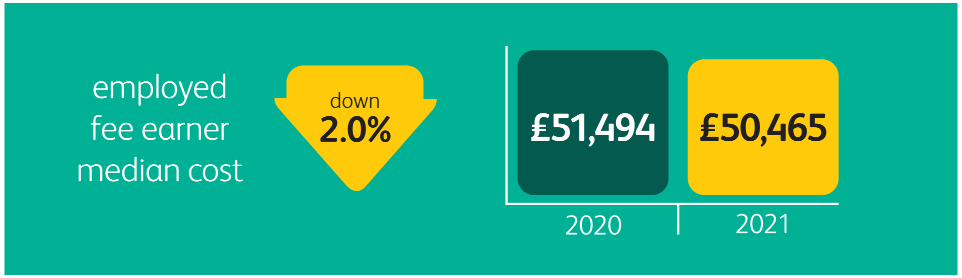


Figure 5.2: Total salary costs, including notional salaries, less furlough grants received, as a percentage of fee income (%)

Employment costs – employed fee earners

Having established the contribution margin, we can now look in more detail at how much firms are actually spending on their employees. In Figure 5.3 we include salaries, fixed share partners, consultants, temporary staff and all usual payroll and pension costs for fee earning staff. However, no redundancy or recruitment costs are included here, or any notional salaries for equity partners. We have also not taken account of any furlough monies received.

In terms of actual head count on a full-time equivalent basis, the total number of people employed in a fee earning capacity across all participants in our survey, excluding equity partners, was 6,089 in 2021, compared to 6,058 in 2020 – an increase of just 31 people (0.5%).



Key findings are:

- Expenditure on fee earners as a percentage of fee income is consistent for most firms, across all turnover bands.
- The median cost of an employed fee earner fell by 2.0%, from £51,494 in 2020 to £50,465. This is likely to have resulted from a reduction in salaries paid to staff placed on furlough, and also some firms temporarily reduced salaries for staff that were working.
- The average fee earner cost is not consistent across all turnover bands, and as you might expect, rises in line with firm size. Firms with the highest fee income are generally employing more expensive staff, as shown by the notional salaries detailed in section 6.

Figure 5.3: Expenditure on employed fee earners as a percentage of fee income (%)

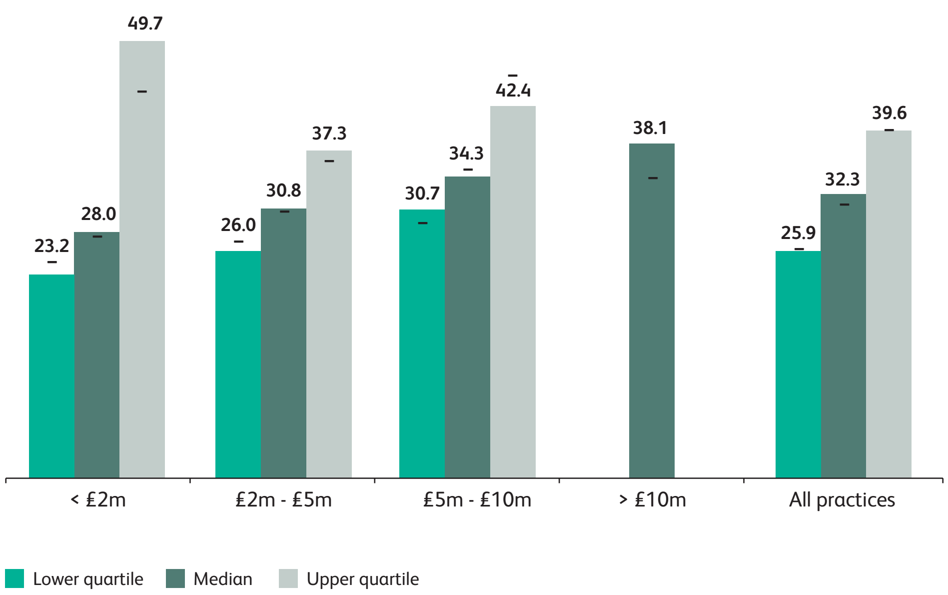
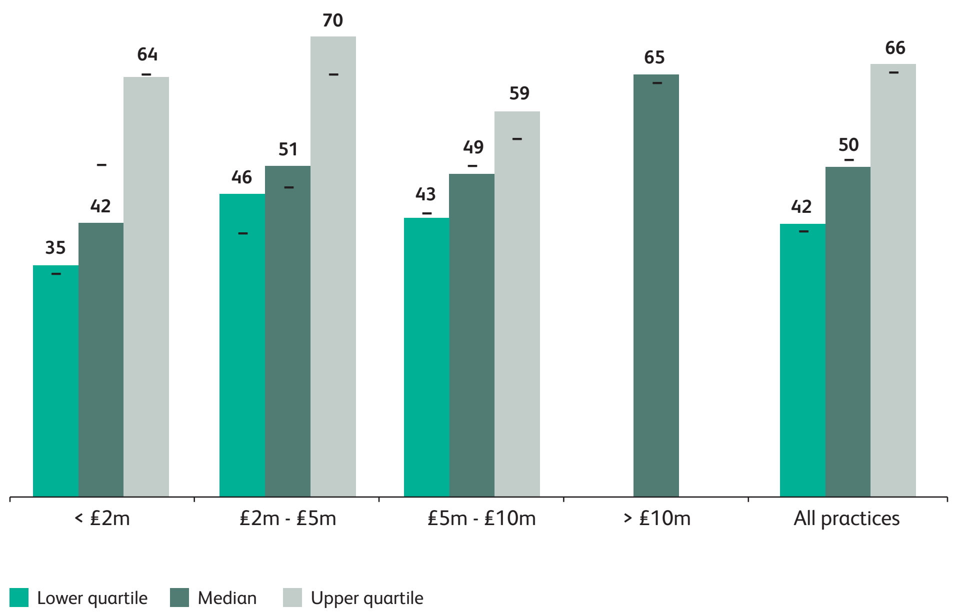


Figure 5.4: Cost per employed fee earner (excluding notional salaries for equity partners) (£'000)



Employment costs – all fee earners, including equity partners

Building on the results in Figure 5.4, 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, combining employee salaries, fixed share partners' profit shares, 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 15%, to reflect the additional costs that would have been incurred if the equity partners had been employed, such as employer's NIC and pension contributions.

When equity partners are included, the median 'true' cost of a fee earner increases to £59,438, up 2.7% from £57,894 in 2020.

Notional salary rates are shown on Figure 6.4. The median notional salary across all turnover bands is £81,000, although as with other staff costs, notional salaries vary depending on the size of the firm.

The median notional salary increased by 2.2% in 2021, with very similar increases across all turnover bands, suggesting that salaries of more senior fee earners within firms have been increased during the pandemic.

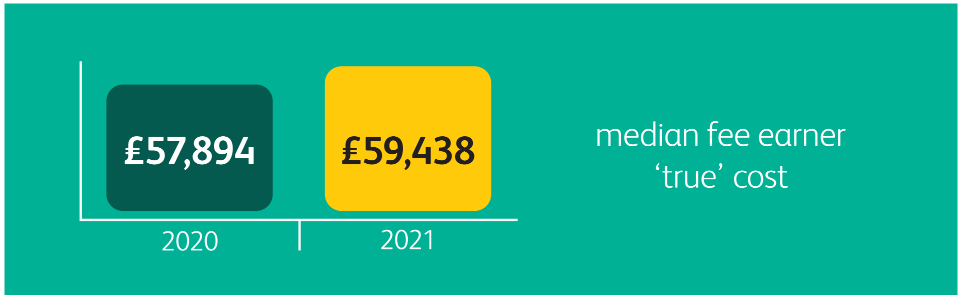
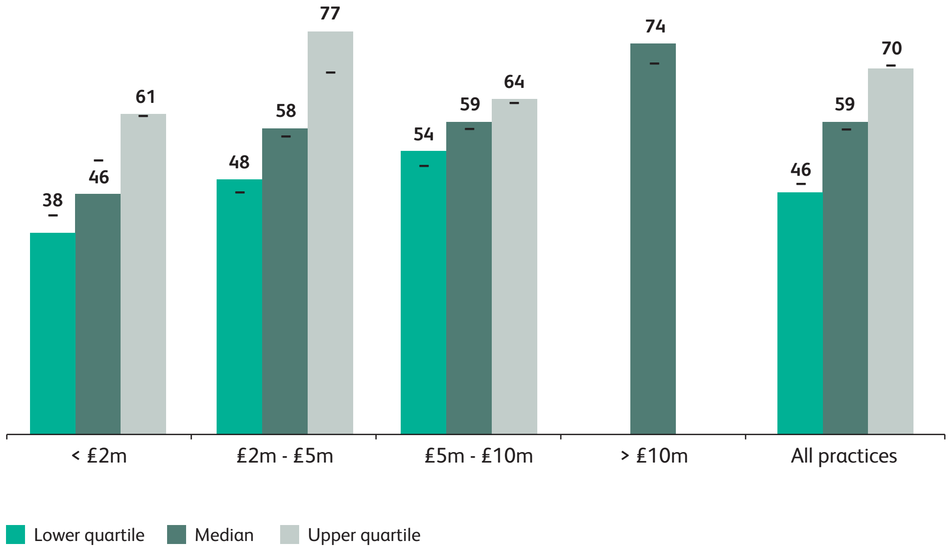
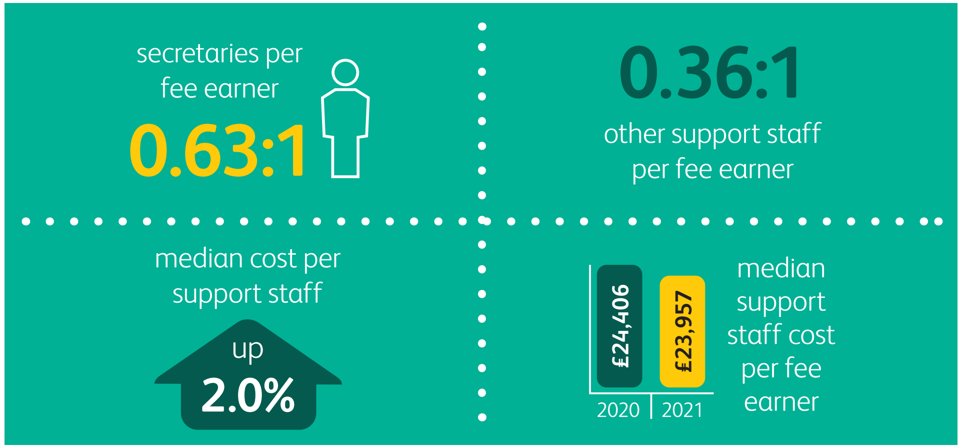


Figure 5.5: Cost per fee earner (including notional salaries for equity partners) (£'000)



Employment costs - support staff

In terms of actual head count on a full-time equivalent basis, the total number of people employed in a non-fee earning capacity across all participants in our survey was 5,755 in 2021, compared to 5,900 in 2020 – a reduction of 145 people (2.5%).



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

- The number of secretaries per fee earner remained static, at 0.63 : 1
- The number of other support staff per fee earner (accounts, administration, marketing, receptionists, IT, etc.) remained fairly static at 0.36 : 1.
- The median cost per member of support staff (including secretaries) rose from £25,706 in 2020 to £26,235. However, the median support staff cost per fee earner, including secretarial support, was £23,957 in 2021, compared to £24,406 in 2020, reflecting a reduction in reliance on secretarial support. In addition, as we noted in section 1, many firms placed some of their support staff on furlough at some point during 2020 and 2021, and this reduced their salary costs for a time.
- These two combined have reduced the median spend on support staff slightly, from 18.6% to 18.1% of fee income.

Figure 5.6: Expenditure on support staff as a percentage of fee income (%)

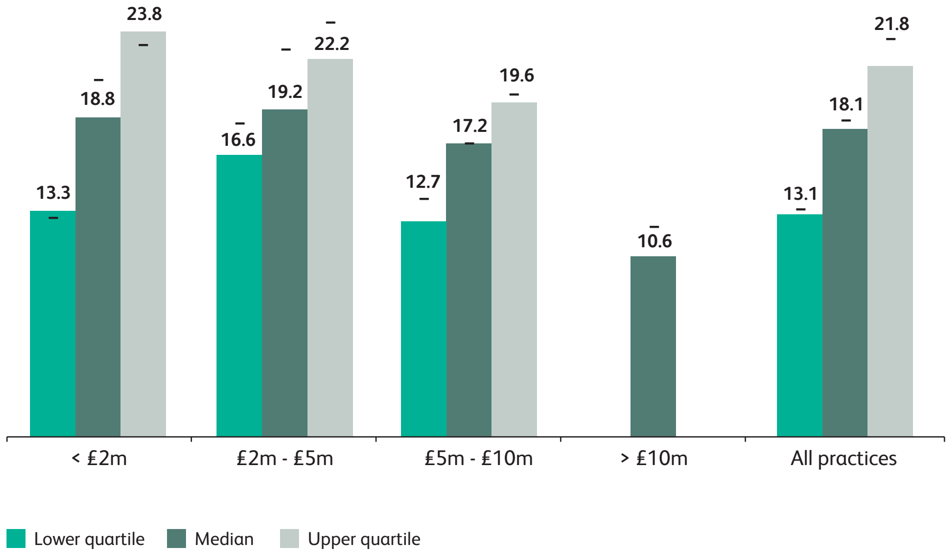


Figure 5.7: Cost per support staff member (£'000)

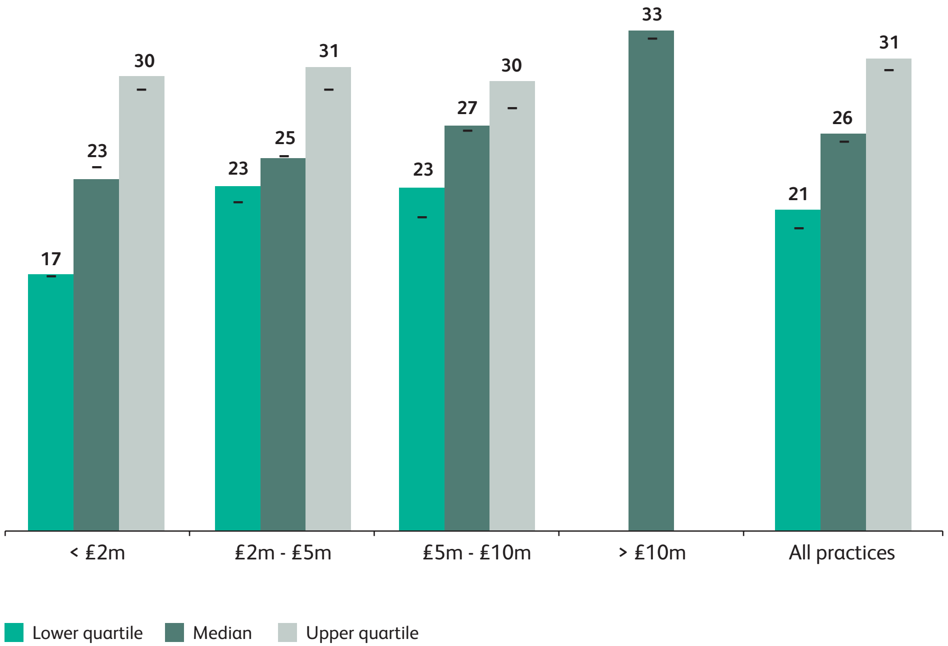


Figure 5.8: Number of secretaries per fee earner

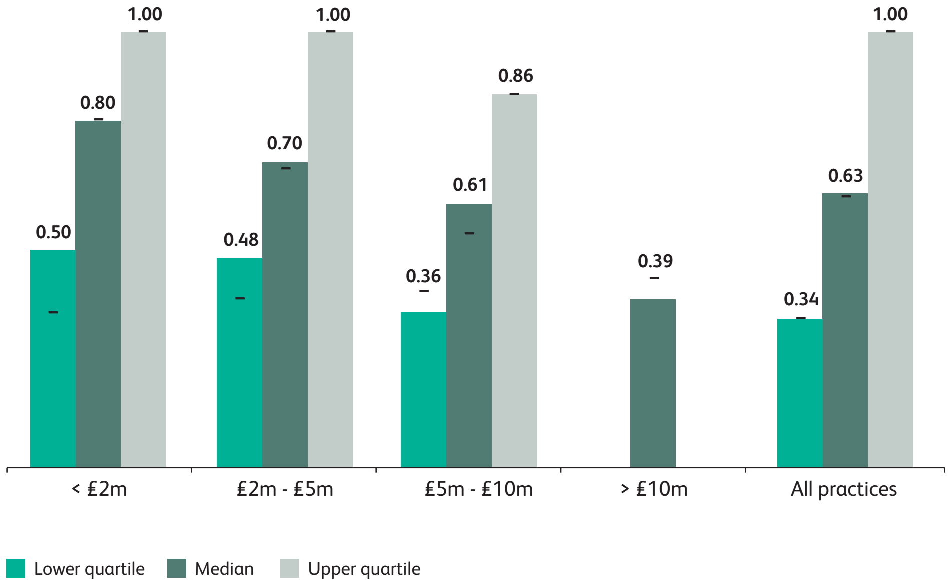


Figure 5.9: Number of other support staff per fee earner

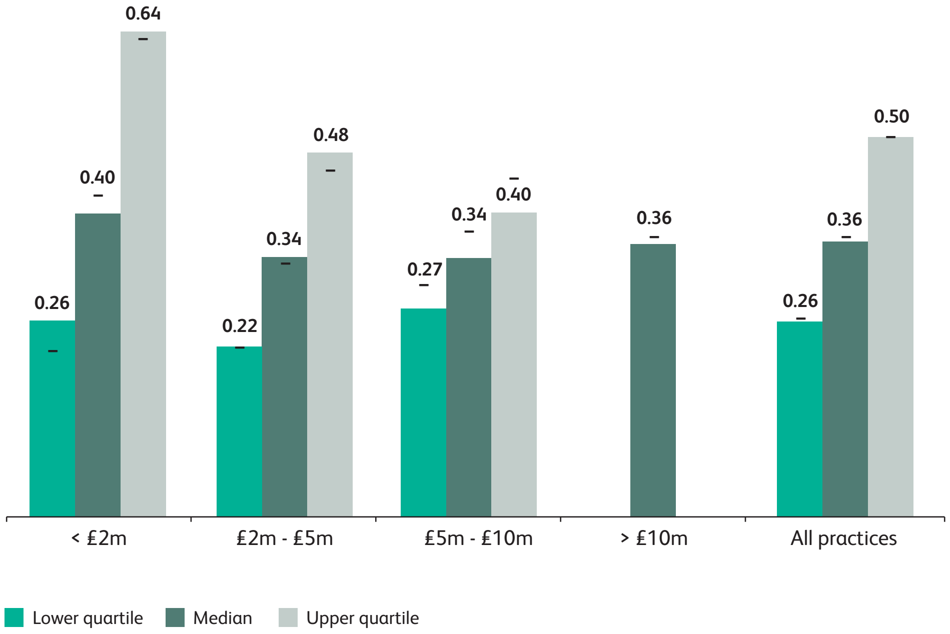
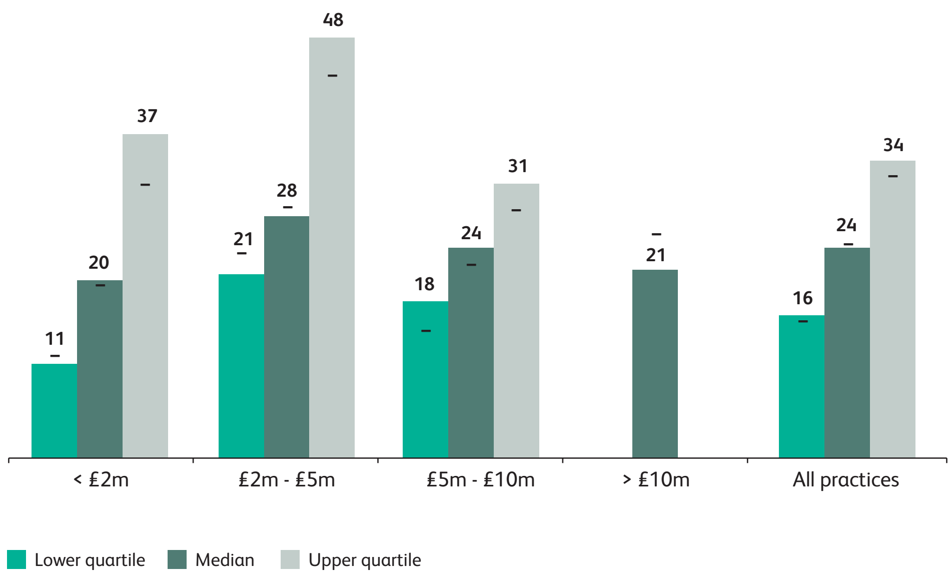


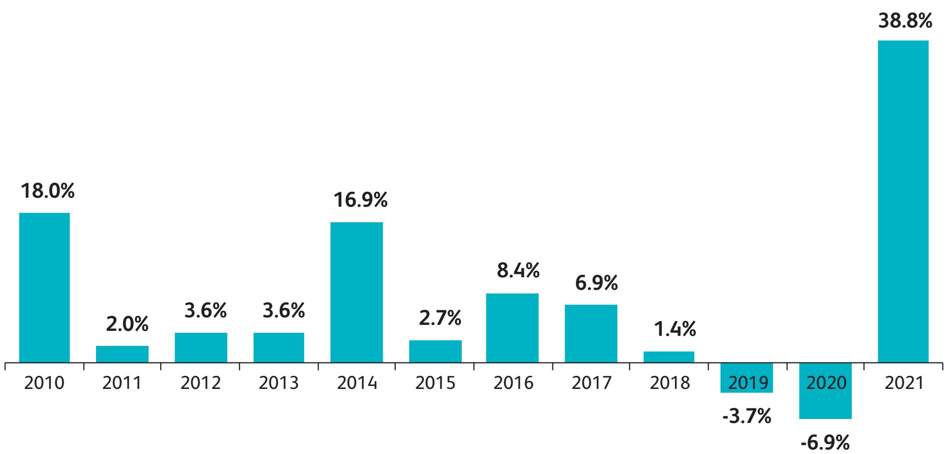
Figure 5.10: Cost of support staff per fee earner (£'000)



6. Profitability

As explained in section 1, the combination of increased income and reduction in staff and other overhead costs resulted in increased profitability for three quarters of survey participants. In last year's survey, we reported that median profit per equity partner (PEP) for participating firms had fallen for the second year in a row, but this year's findings show the largest jump in profitability that we have seen in the 13 years that we have written the LMS survey. Median profit per equity partner increased to £203,199 from £146,417 in 2020 – a rise of almost 40%. It should be noted that the composition of the sample across the 12 years shown in the chart below will have varied.

Median changes in PEP (%)



As you might expect, the net profit margin has also increased, from a median of 18.9% to 23.8% of total income. All turnover bands saw an increase, but the increased margin was particularly pronounced in the larger firms in the survey.

Just over a quarter of fee income was spent on non-salary overheads, with a median cost per fee earner, ignoring the impact of furlough income, of £38,293, compared to £37,495 in 2020. We have looked in further detail at the breakdown of this expenditure, and in particular specific costs such as professional indemnity insurance cover, marketing, accommodation costs, and staff recruitment.

For many years, the general rule of thumb for staff costs, non-salary overheads and profit compared to income was 33%:33%:33%, but this ratio is no longer appropriate for the majority of firms, mainly due to increasing staff costs. It is likely that we will see this balance shift even further in the future as some changes to firms' working practices during the earlier stages of COVID-19 become permanent.

If we combine the findings in sections 4, 5 and 6 of this survey, we arrive at the proportions shown on the following pie chart.

What this demonstrates is that law firms have, over a number of years now, adapted how they work and where they derive value from their investments. Firms are increasingly more willing to invest in human capital to drive growth, while controlling other costs more tightly to maintain profitability.

Overheads and profitability as a proportion of fee income (median results only)

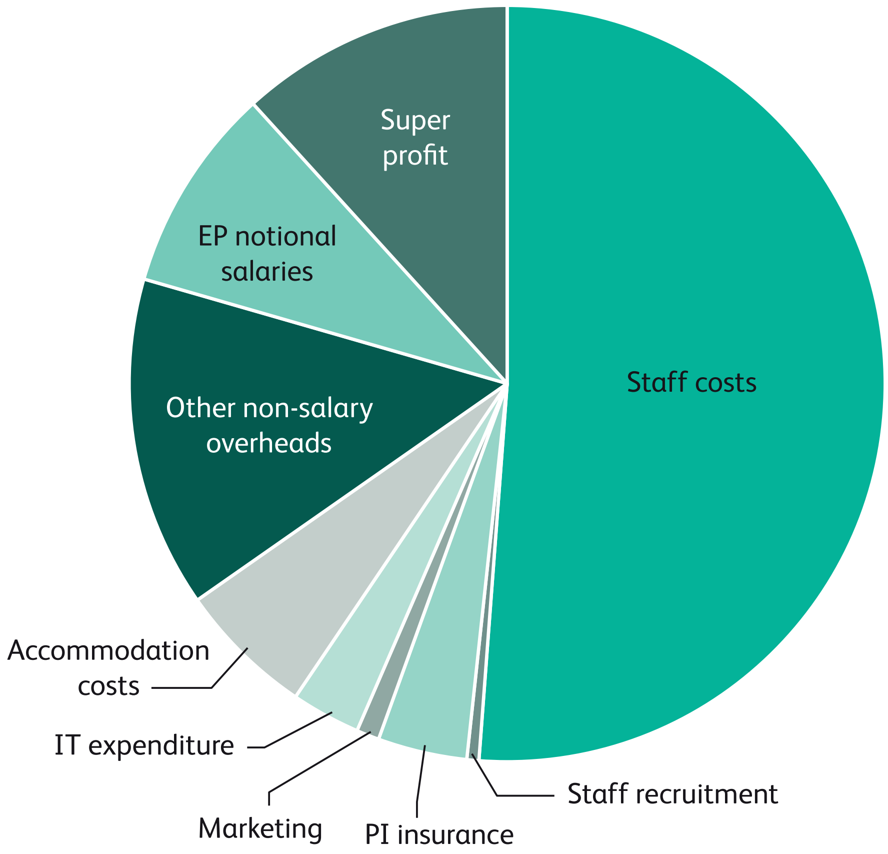


Figure 6.1: Profit per equity partner (£'000)

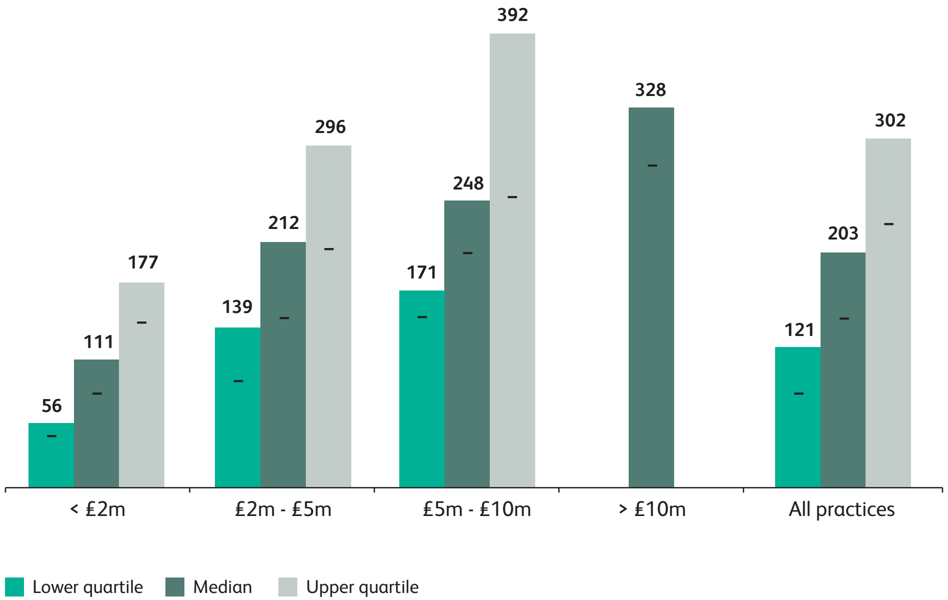


Figure 6.2: Profit per fee earner (£'000)

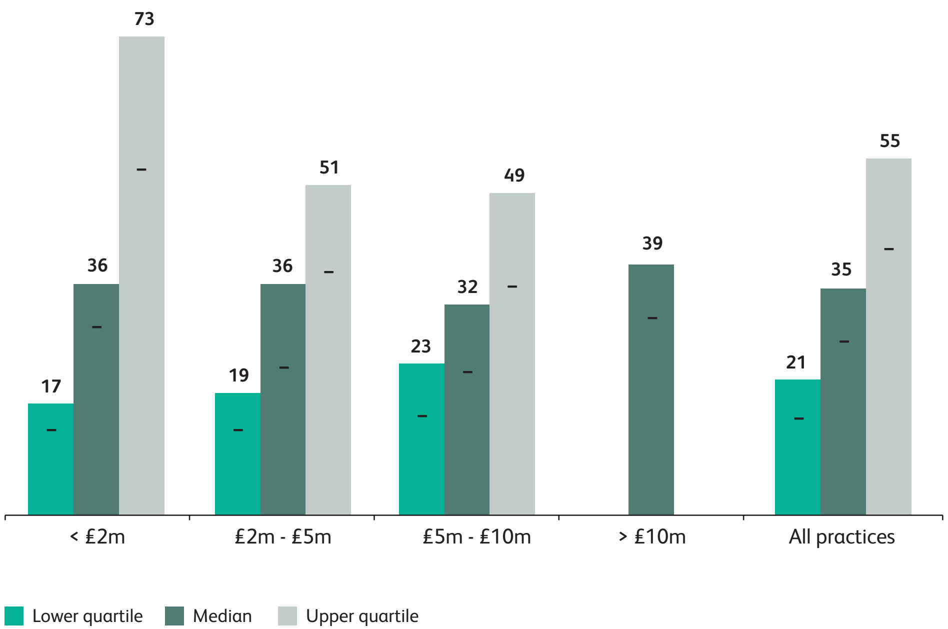
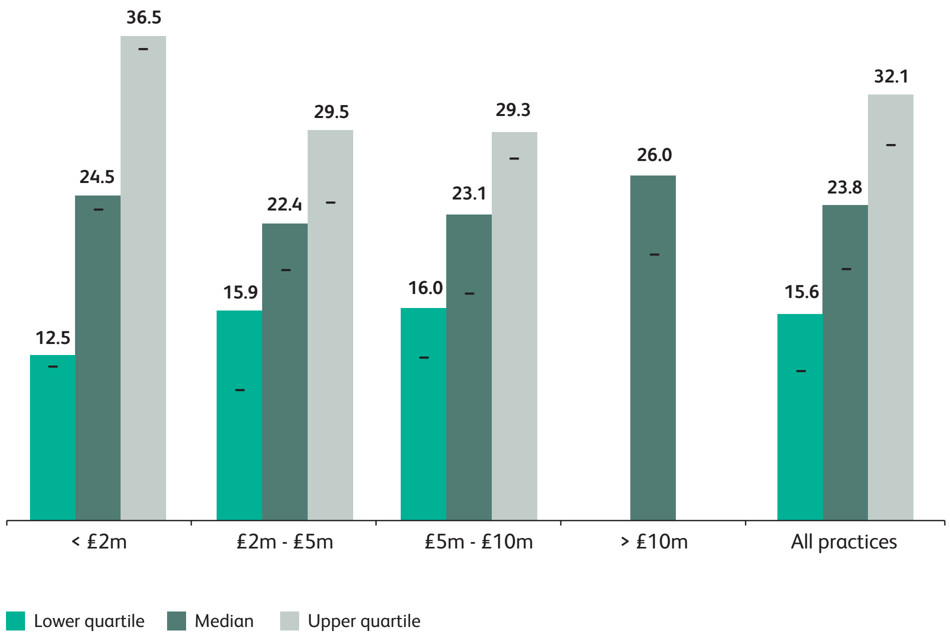


Figure 6.3: Profit as a percentage of total income (%)



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

As law firm owners, equity partners expect to be rewarded with a 'salary' equivalent for the work that they do. They also expect a return for their capital invested in the practice and an additional 'super-profit' for the additional risk that they face through being business owners rather than employees. We refer to these three layers of remuneration as notional salary, notional interest and super-profit.

As noted in section 5, equity partner notional salaries have been calculated based on firms' highest fee earner salary plus an extra 15% to reflect the incidental costs of employment such as employer's NIC and pension contributions.

Notional interest is set at 3% of partner capital/company reserves.

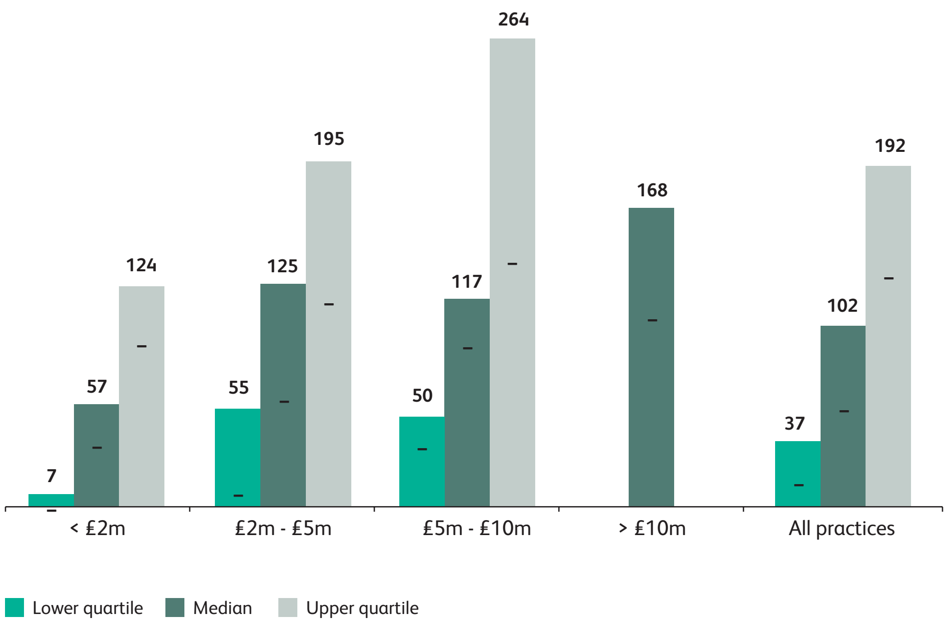
Total super-profits are simply the net profit less notional salaries and notional interest.

In Figure 6.4 we show the 'super-profit' per equity partner. In 2021, the median 'super profit' was £102,097, compared to £52,775 in 2020, which is to be expected given the jump in PEP that we saw in Figure 6.1. Firms in all turnover bands have seen an increase in super-profit, although the median for firms in the £5m-£10m turnover band is lower than the median in the £2k-£5m turnover band. This is largely due to the increased notional salary level for firms in the higher turnover bands, as shown below Figure 6.4. 75% of participants reported a higher super-profit in 2021 than in 2020.

We also noted that super-profits per fee earner have increased, from a median of £9,811 in 2020 to £18,262 in 2021.

The picture is not positive for all firms though. 11% of firms in our survey reported a super loss, suggesting that partners in those firms could (in theory) have earned more by being employed somewhere else.

Figure 6.4: Super-profit per equity partner (£'000)



Notional salaries (£'000)

	< £2m	£2m - £5m	£5m - £10m	> £10m	All practices
2021	52	78	107	152	81
2020	51	76	103	148	80

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

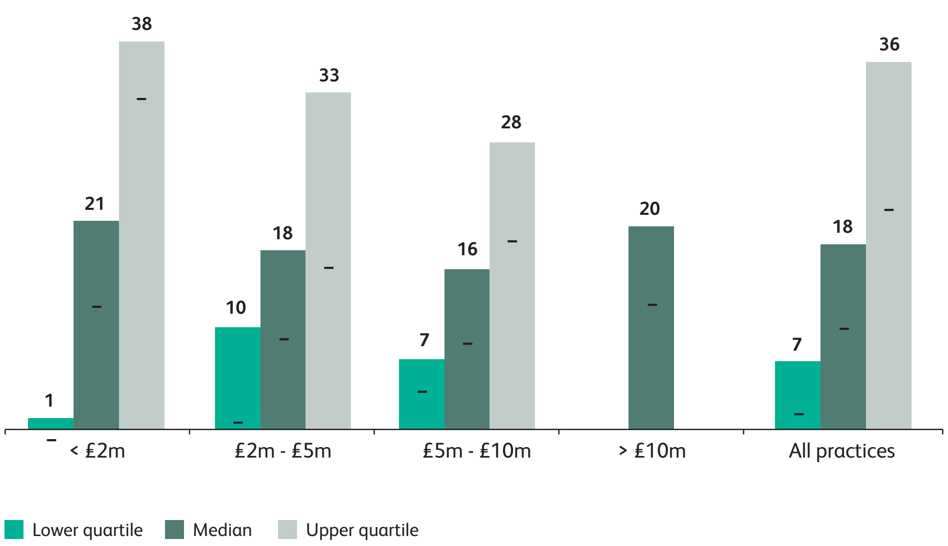
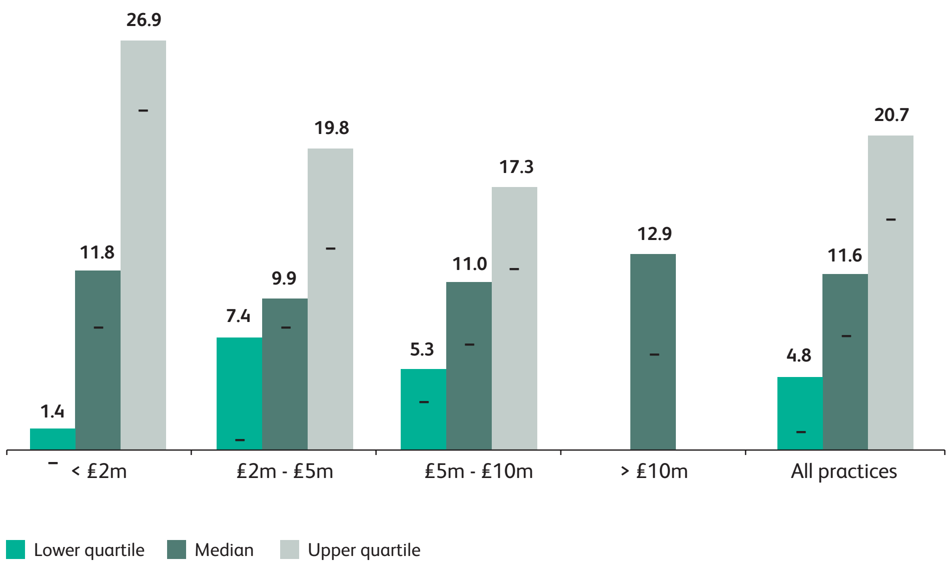


Figure 6.6: Super-profit as a percentage of total income (%)



Return on capital employed (ROCE)

ROCE is a measure of the returns made by a firm on the resources available to it. For a law firm, ROCE is measured in terms of super-profits as a percentage of partner capital in a partnership or LLP, or retained profits and share capital in a limited company.

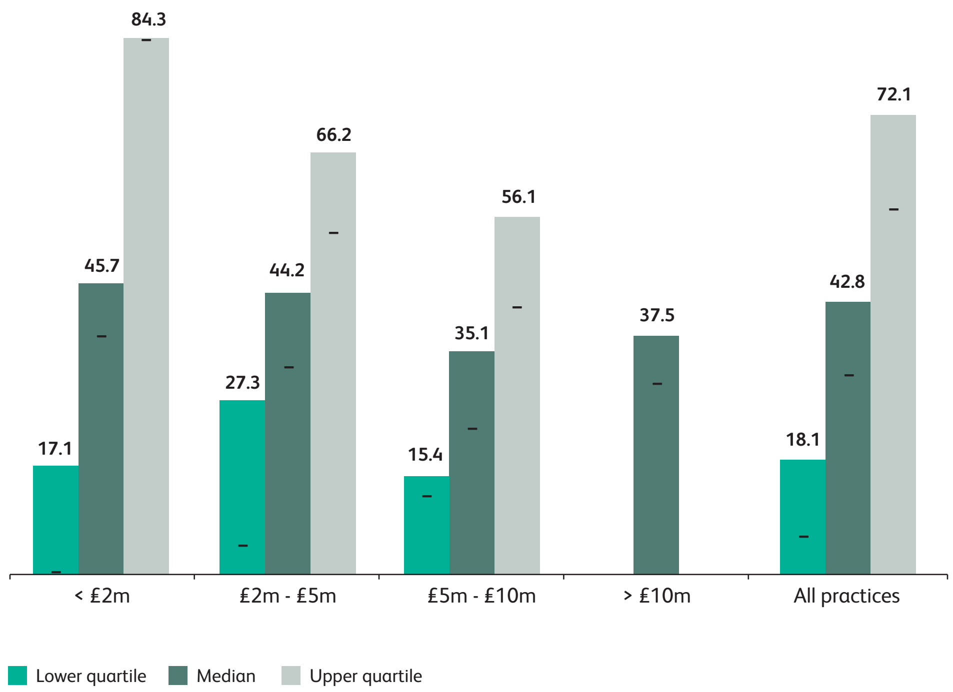
In the context of the returns made to the owners of a law firm, we use super-profit, as this takes account of notional salaries for partners, and also notional interest on partners' capital and so is representative of the reward to the partners for the risk they take in being owners of the business.

The results show a median ROCE of 42.8% for 2021, compared to 31.1% in 2020. Naturally, firms looking to attract new partners will be more successful with higher levels of ROCE and the range of returns between the lower performers and the higher performing firms is apparent.

In an industry climate where M&A activity is on the increase, ROCE is a key measure, as 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 the smaller firms in the survey saw a slightly higher ROCE than the larger firms in the survey, reflecting the fact that partner capital balances tend to increase in line with the size of the firm, in order to fund increasing working capital requirements.

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



Non-salary overheads

In section 1 we explained that total non-salary overheads in firms across all turnover bands fell during the pandemic, and this is reflected in the charts over the next few pages. As shown below, it is interesting to note a steady reduction in the amounts spent on marketing, perhaps reflecting a move towards often less expensive online and social-media based activities. Marketing will also have been fairly low on the list of priorities for some firms, particularly early on in the pandemic.

There have been some exceptions though, particularly in professional indemnity insurance costs, where we saw significantly increased premiums for many firms. Rises of between 10% and 30% for primary cover were commonplace, with even higher increases for top-up cover. Premiums are expected to continue to rise in the short term at least.

We have also seen an increase in IT spend, as firms had to quickly take action in the first half 2020 to enable their staff to work from home during the national lockdowns. The view from many firms that we have spoken with is that this action was more an acceleration of longer term IT plans and, while the short term financial impact of these measures have been felt in the 2021 results, firms expect to see longer term financial benefits across other traditional overhead costs making their way into the 2022 results and beyond. In the case of property related costs, we expect these changes to be enduring.

Median spend on non-salary overheads (as a % of fee income)

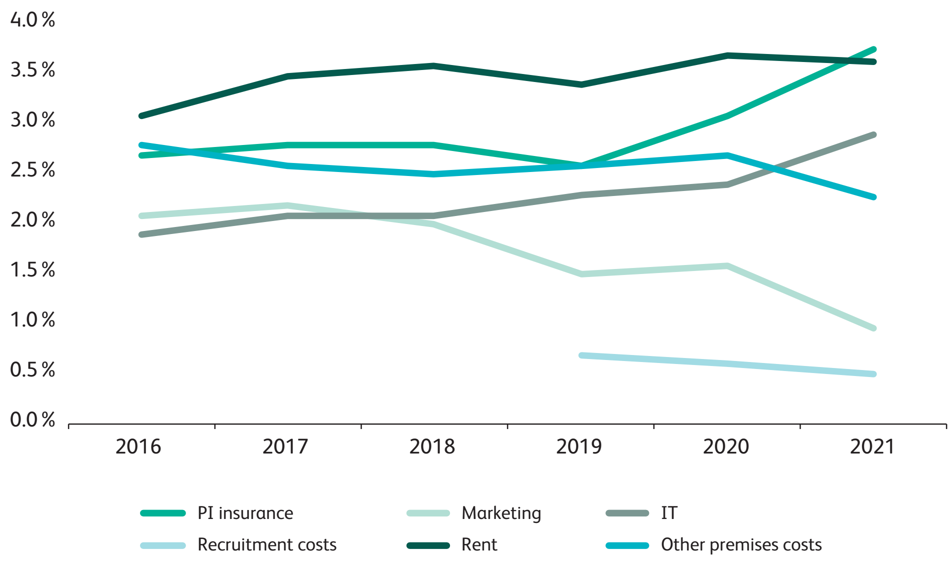


Figure 6.8: Non-salary overheads as a percentage of fee income (%)

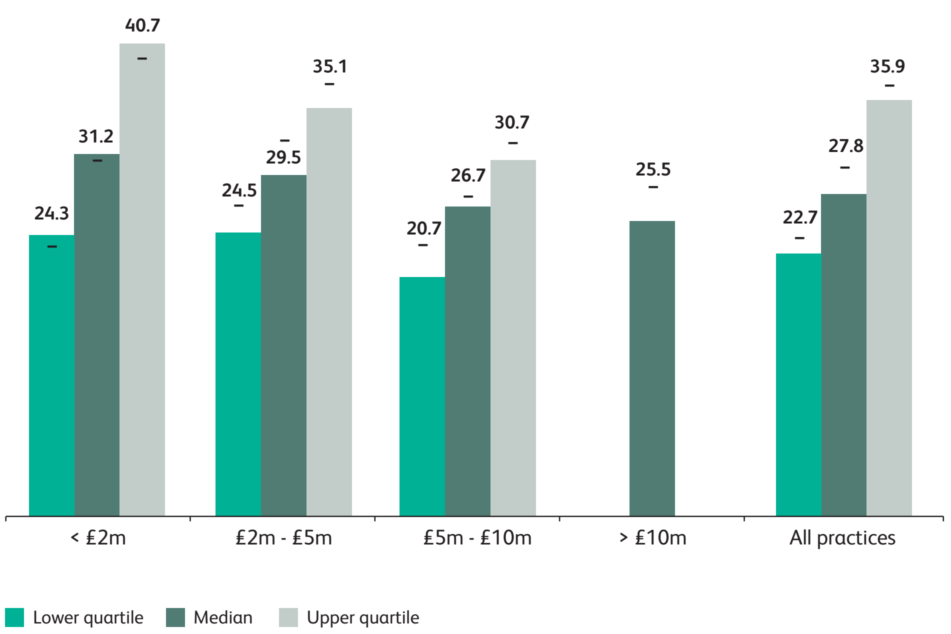


Figure 6.9: Non-salary overheads per fee earner (£'000)

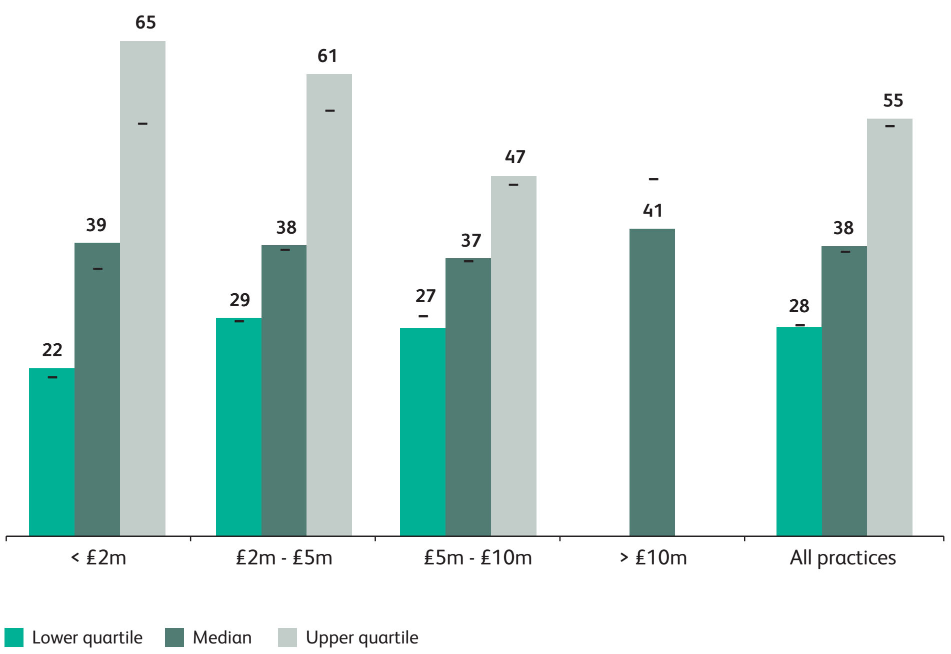


Figure 6.10: PI insurance premium expenditure as a percentage of fee income (%)

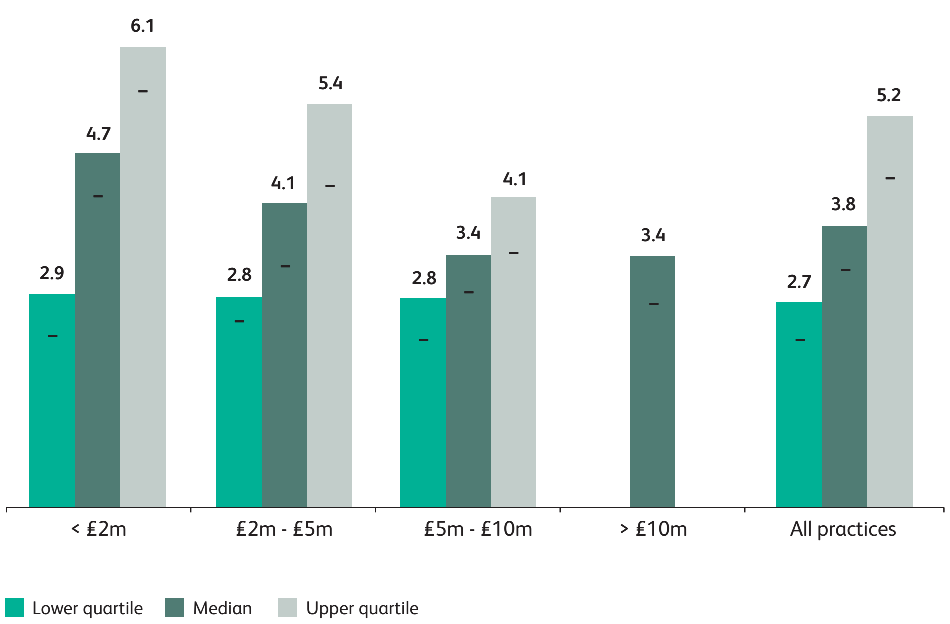


Figure 6.11: Marketing expenditure (including staff costs) as a percentage of fee income (%)

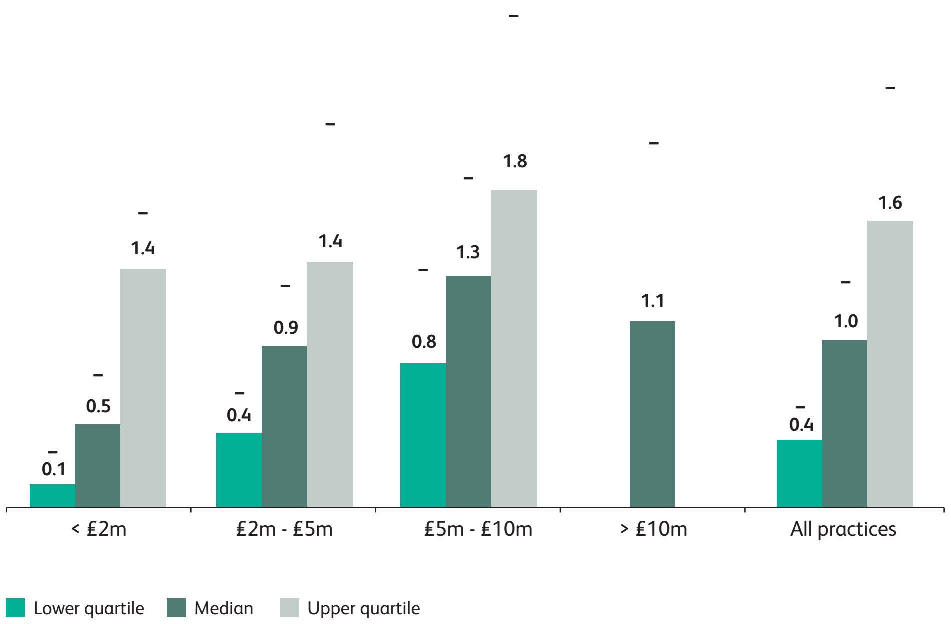


Figure 6.12: IT expenditure (including IT support, IT consultants and cloud-based storage) as a percentage of fee income (%)

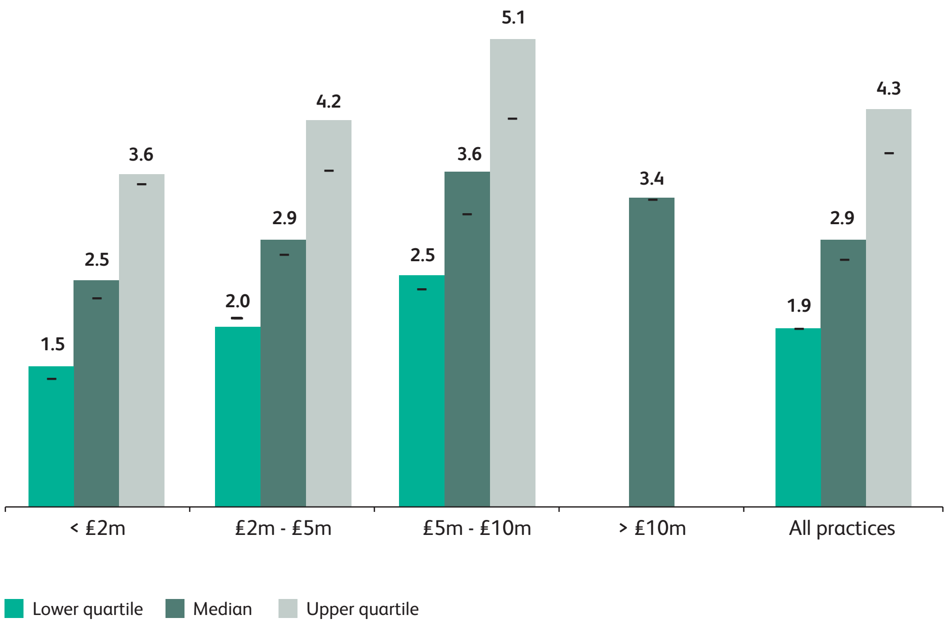
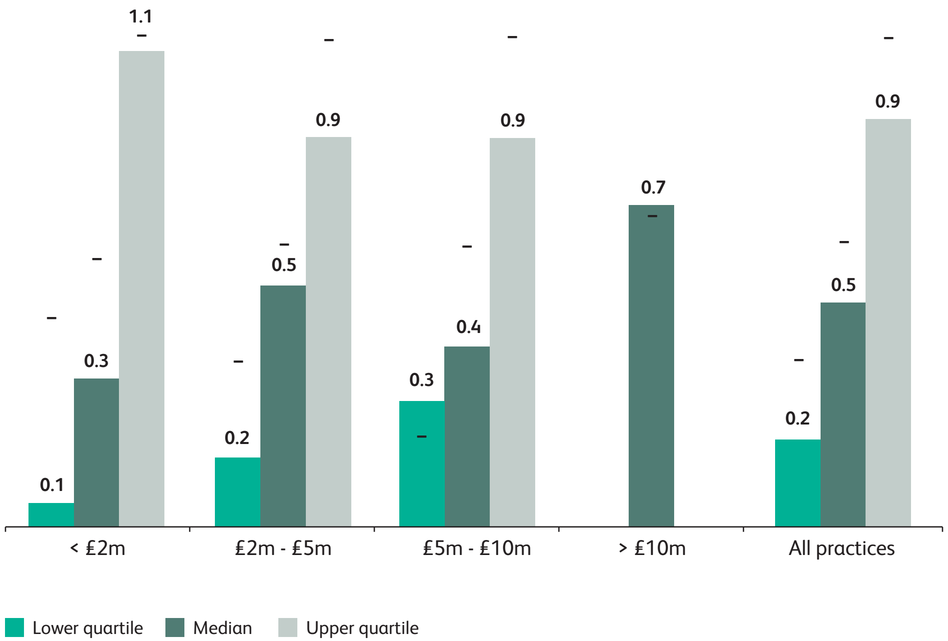


Figure 6.13: Staff recruitment costs (external or in-house) as a percentage of fee income (%)



Accommodation costs

After staff-related costs, accommodation costs are usually the next largest expense for any law firm. Accommodation costs typically consist of rent, rates, office insurances and office running costs such as day to day utilities.

The results here show a median spend on accommodation costs of 5.7% of fee income, down from 6.4% in 2020. In some cases, this resulted from agreed rent reductions during the pandemic.

Many firms are paying considerably more than this though, and in many cases, this is due to offices being in prime locations such as those in city centres or brand new offices. We have also seen firms operating with surplus office space, which exacerbates the problem for many.

A few firms in the survey pay a reduced rent on their premises, either because the property is owned by the principals or former principals of the firm, or because they have managed to negotiate reduced rent with their landlords. Where this is the case, those firms have provided us with a current market rental value, so that the results shown are comparable across the board.

As considered previously, the pandemic forced all firms to take urgent action to enable staff to work effectively from home, with many investing in IT equipment and in some cases furniture too. Our experience is that most firms have adopted a hybrid approach to working practices, with a combination of some time in the office and some time working from home.

There are mixed views on how this has impacted on firms' use of existing office space, with some firms wishing to scale back as much as possible, whilst others are looking to use their offices in different ways.

In any case, for now, many firms will find that they are tied into lease agreements that extend beyond the pandemic, and so the true cost savings of remote working may not be fully unlocked for a number of years.

As you might expect, with fewer staff working in offices, other premises costs such as light, heat and maintenance fell for the majority of firms in the survey, as shown in Figure 6.16.

Figure 6.14: Accommodation costs as a percentage of fee income (%)

Figure 6.15: Premises rental payments as a percentage of fee income (%)

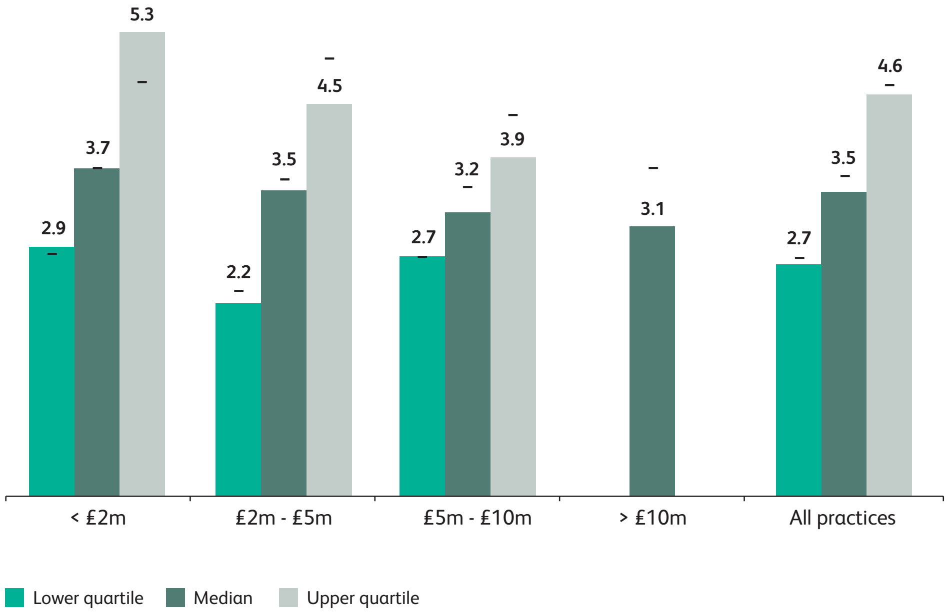
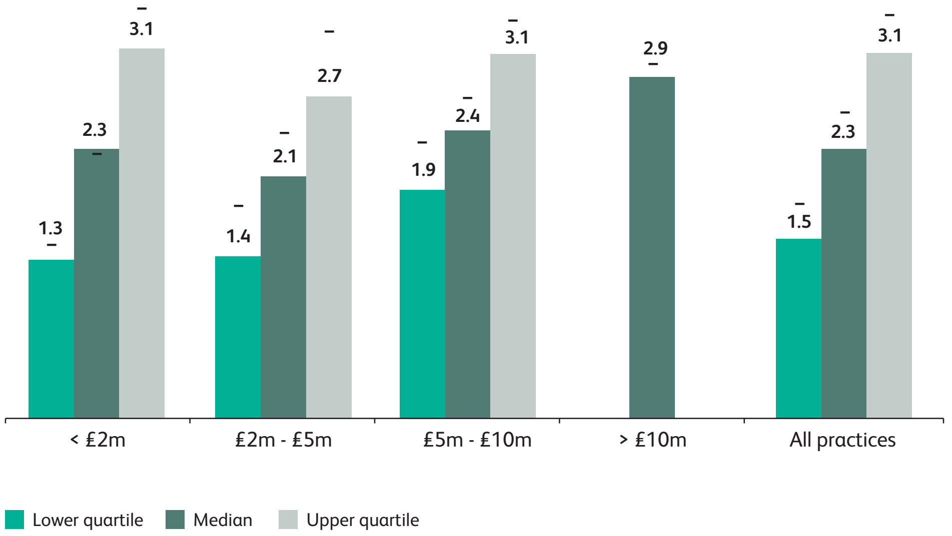


Figure 6.16: Other premises costs (rates, light and heat and maintenance) as a percentage of fee income (%)



7. Characteristics of profitable firms

In this section we examine the characteristics of the firms that achieved above-average levels of profitability in this year's survey and compare them against the same characteristics of the firms that achieved lower than average levels of profitability. We have focused 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 separating all participants into two groups: those with net profit per partner above the median shown in Figure 6.1, and those with net profit per partner below the median, in each turnover band. We then reanalysed these two groups, to calculate new median figures, so that we can more easily represent what a well performing firm looks like relative to a firm that is underperforming.

The four Figures in this section show two bars for each turnover band. The bars on the left are the figures for the firms with above-average levels of profitability, and the bars on the right are for the firms with lower than average levels of profitability.

A common theme across all firms is the correlation between higher salary costs and lower profitability, with the smallest and the largest firms having the most pronounced gap between the good and the not so good

Figure 7.1: Fee earner gearing (median figure only)

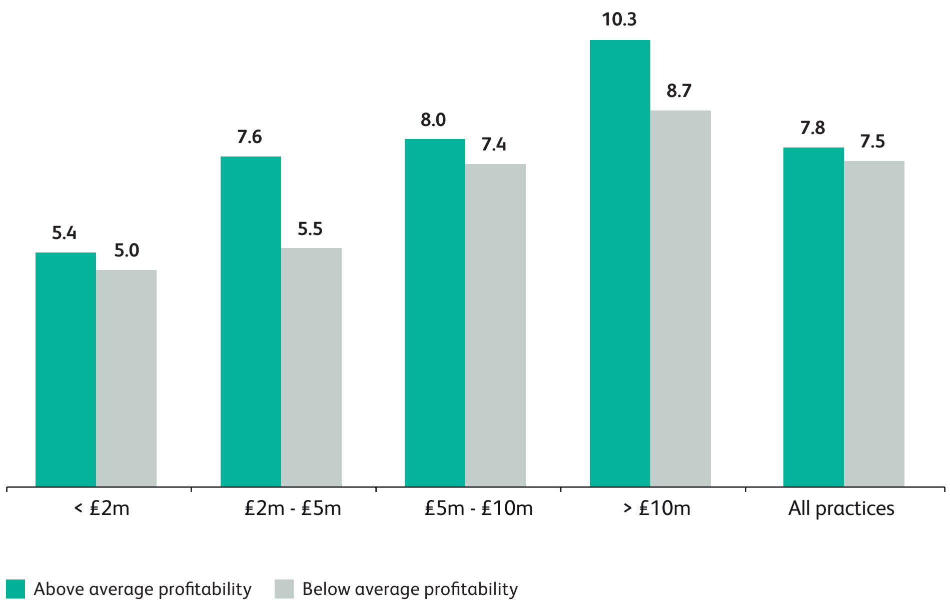


Figure 7.2: Fee income per equity partner (£'000) (median figure only)

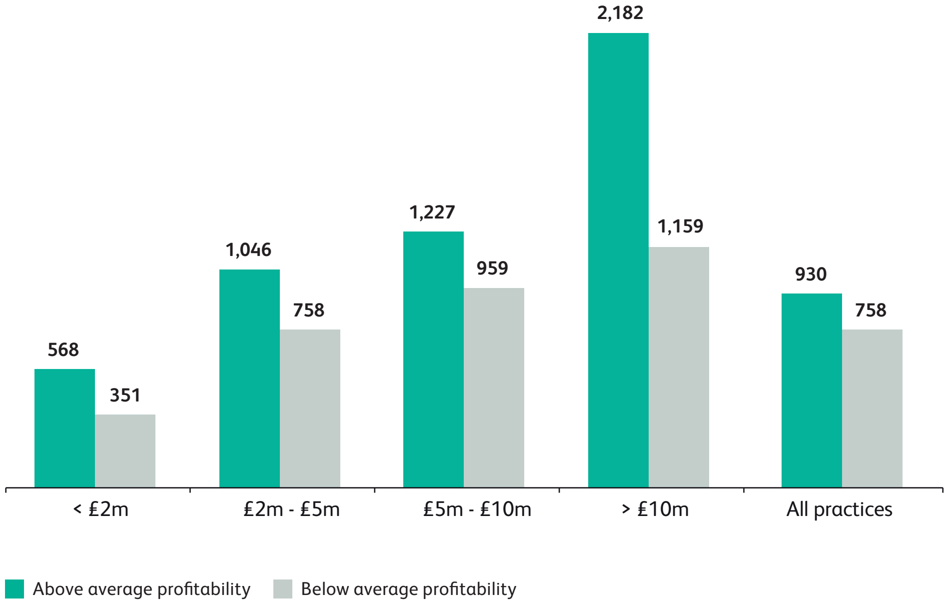


Figure 7.3: Total salary costs, including notional salaries, as a percentage of fee income (median figure only)

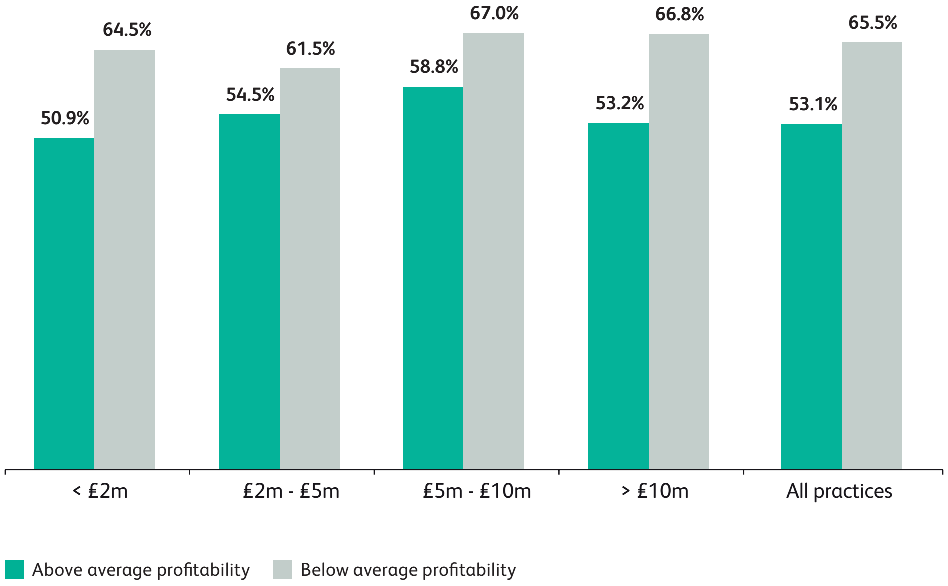
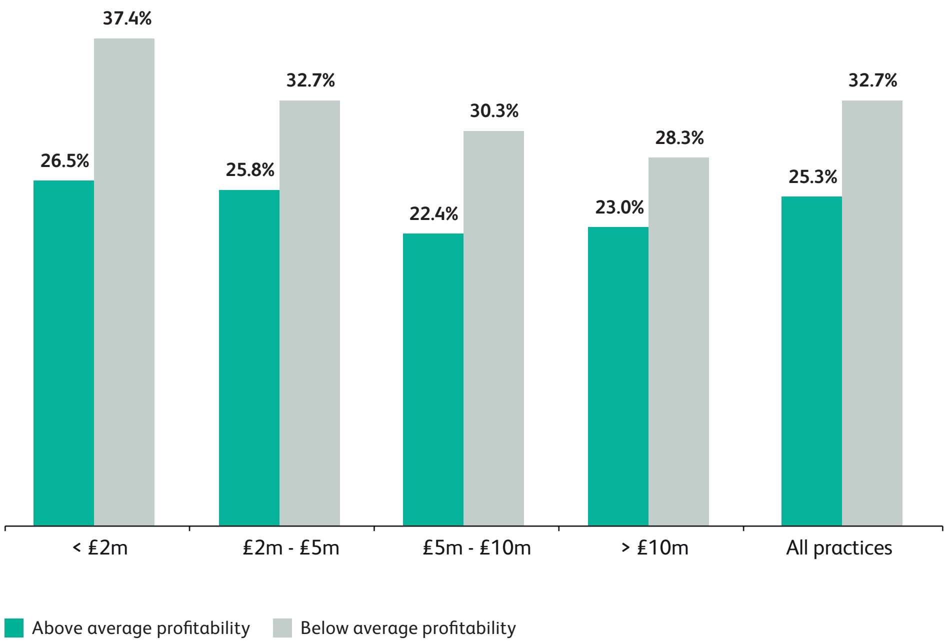


Figure 7.4: Non-salary overheads as a percentage of fee income (median figure only)



It is challenging to conclude on trends in working capital management in a survey of law firms, as lock up (work in progress and debtors combined) varies so dramatically in differing areas of law.

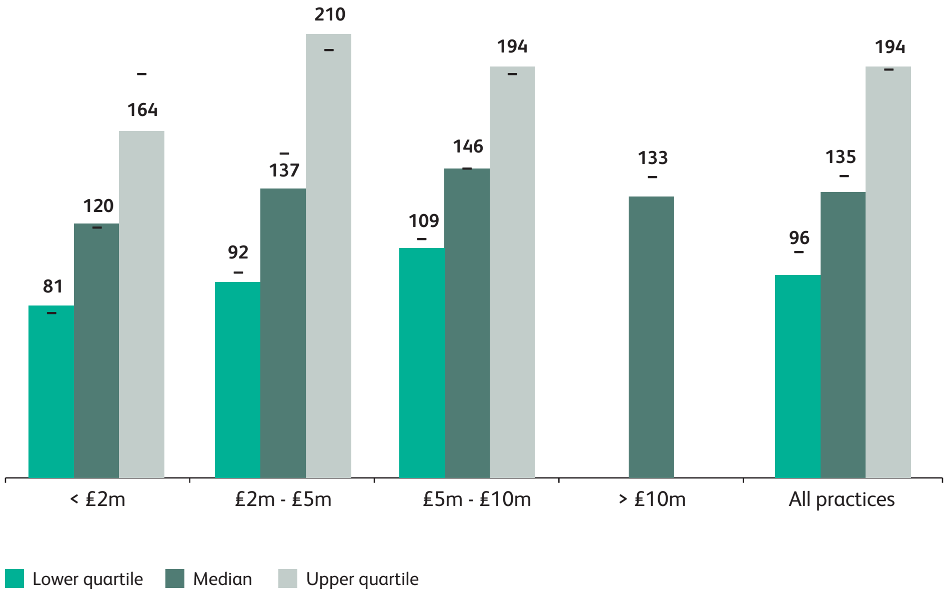
This is particularly true this year, where some firms in the survey will have had their financial year ends during one of the COVID-19 lockdowns, and others will not. The early stages of lockdown were characterised by firms and clients alike pushing particularly hard to progress matters in the pipeline and convert time worked into bills as quickly as possible. This had an early impact on lockup as firms struggled to keep pace with their WIP management processes and it became a challenge for individuals to find the balance between billing quickly and correctly, while also still generating good quality billable time. In some cases, this initial flurry of activity stalled as quickly as it started, and so a firm's year end date had a more pronounced impact on reported financial performance than ever before.

That said, the median number of days combined lock up has remained fairly steady between 2020 and 2021, falling from 142 days to 135 days, and both WIP days and debtor days have changed only slightly.

This seven day reduction in lock up may not sound like much, but for a firm with turnover of £5million, a one-week permanent reduction in lock up will free up £100,000 of cash. For many firms, that can make the difference between operating close to their overdraft limit and operating with no overdraft at all.

Regardless of the ongoing challenges facing firms, and as a matter of general good procedure, firms 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.

Figure 8.1: Total lock up (days)



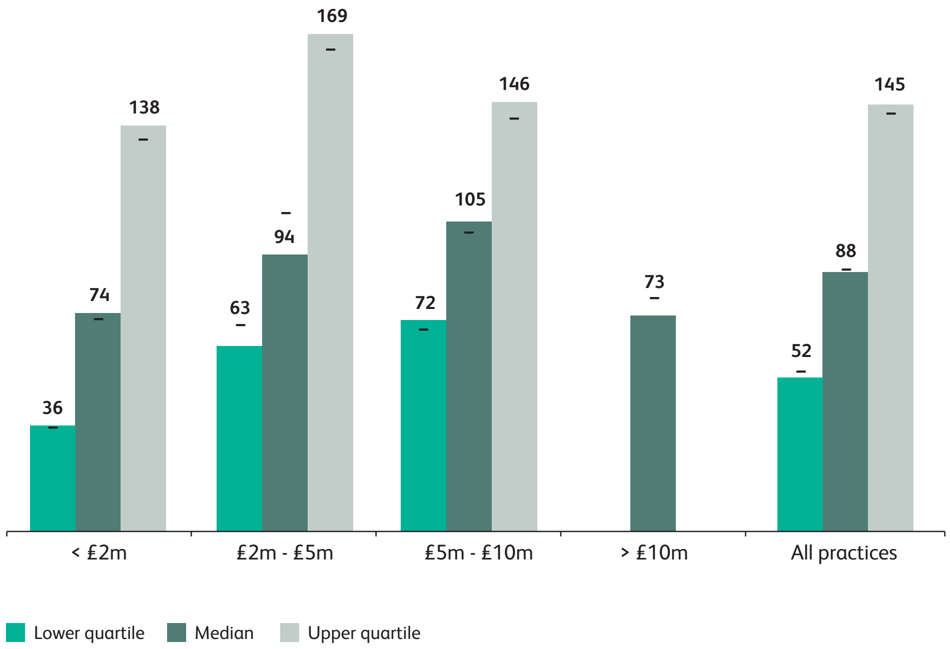
WIP days

Work in progress (WIP) days have been calculated based on total WIP per participants' time records, as opposed to the figure included in their year end accounts, as, for many firms, the figure in these accounts does not include large amounts of contingent WIP.

We typically see firms that operate conditional fee agreements carrying large amounts of contingent WIP that is not reflected in their year-end accounts, and it is just as important for those firms to be able to monitor that WIP as it is for firms that raise interim bills as matters progress.

While firms tend to focus on credit control as the primary tool to manage lock up, good financial hygiene starts at an earlier stage than chasing debts, and the best performing firms have robust polices that ensure that all time is captured properly, in a timely manner, and that time is billed as soon as the work is complete (and the client is still happy), rather than waiting until the month or quarter end.

Figure 8.2: WIP days



Debtor days

Consistent with last year, the survey shows a small change in debtor days between 2020 and 2021, with an increase from 36 to 37 days.

Many clients will be struggling with cash flow at the moment, and so it is essential that firms keep a close eye on debtor days to keep exposure to potential bad debts to a minimum. As we have noted in previous years:

- Fee earner training on managing lock-up can make a huge difference.
- Small changes to standard practice, such as raising bills as soon as the work is complete, or raising more frequent interim bills where the work type allows, can make a big difference to how soon you get paid. Moving away from billing at month-end to billing across the month can also result in clients paying a full month earlier. A client who is happy with the outcome of a case may well pay more quickly if they receive the bill promptly. For those clients that are not as happy, prompt billing gives everybody the opportunity to resolve the matter while knowledge is still fresh.
- Many firms continue to carry large amounts of unbilled disbursements, and often do not ask for money on account of them, even in areas where it should be straightforward for them to do so (e.g. property work). Too many firms continue to extend unnecessary free credit to clients by funding disbursements from the office account rather than using the client's own money.
- It can often be helpful to remove fee earners from the credit control function entirely. Fee earners generally do not like having difficult conversations with clients, and appointing a dedicated credit controller can allow balances to be chased sooner and more effectively, as well as taking a lot of the emotion out of the process, and will allow fee earners to focus on fee earning. However, any policy should allow some degree of flexibility, and in some cases, it is the fee earner who is better positioned to negotiate a favourable outcome.
- Finally, the SRA introduced the current version of the Accounts Rules in November 2019, which permits some firms to hold money received on account of fees and disbursements in their office account, even before the work is carried out. These changes have been in place for over two years now, but our experience is that very few firms have been able to take advantage of this, and therefore there has been minimal impact on cash flow and debtor days.

Figure 8.3: Debtor days

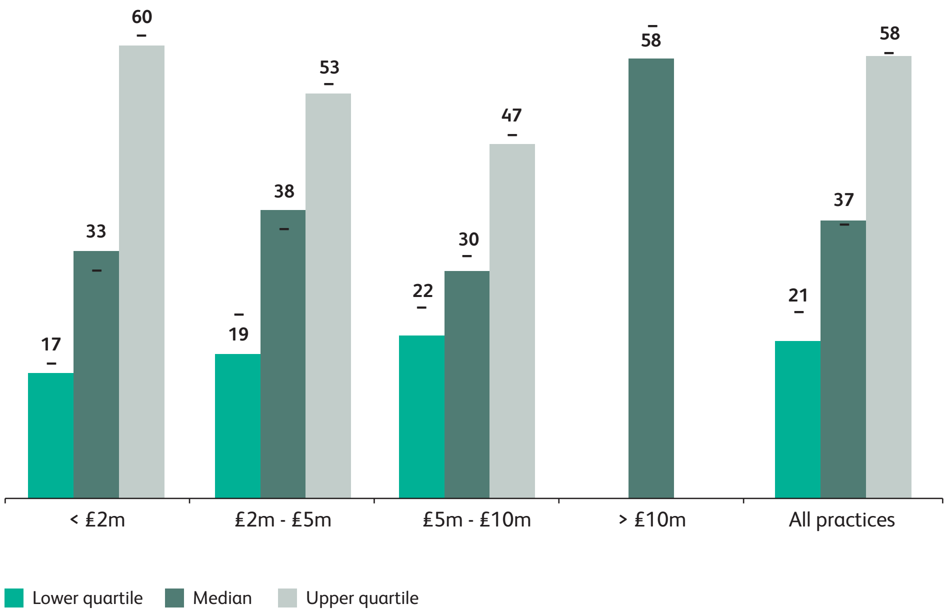
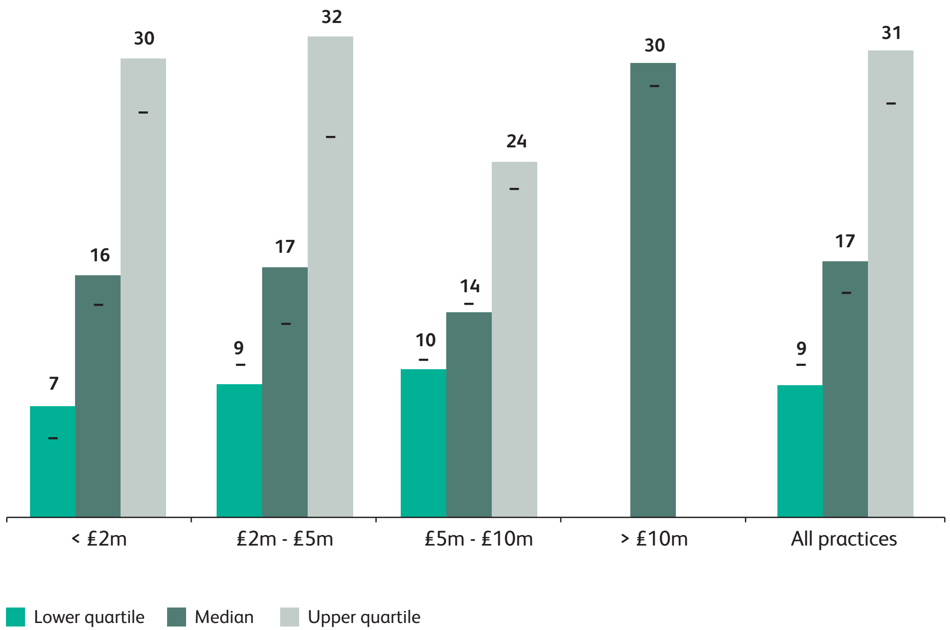


Figure 8.4: Debtors per fee earner (£'000)



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.

The participants in this year's survey reported a median 13.2% increase in individual partner capital in 2021, with a median of £225,250. As you might expect, partner capital increases in line with the size of firm.

One of the first actions that many firms took when the pandemic began in March 2020 was to put a stop on partner profit distributions or, at the very least, restrict the drawings to some degree. Whilst this helped with cashflow, it also meant that partners' account balances at their financial year end increased, although our experience is that partners have since been looking to access those balances.

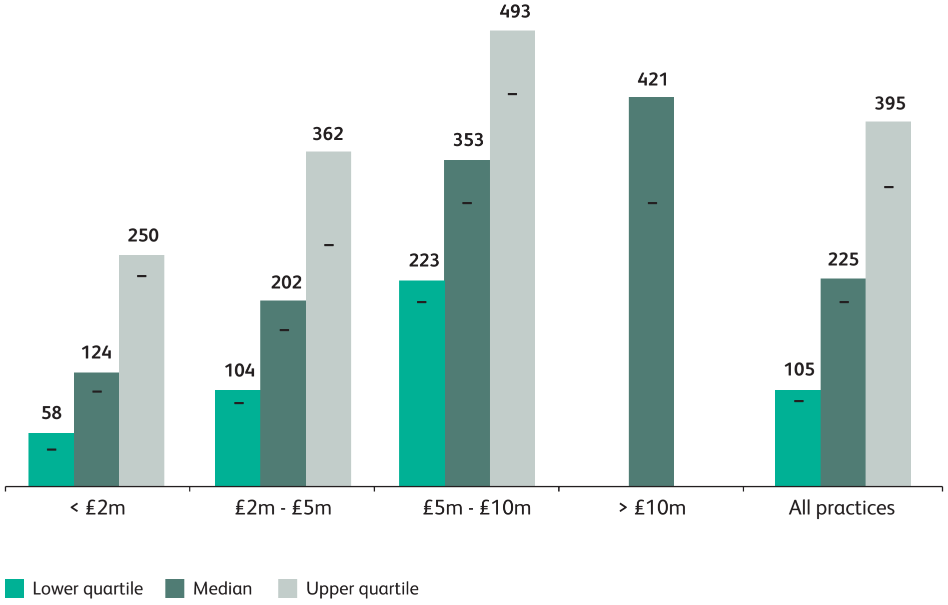
As noted earlier in this report, last summer the Government issued a consultation and draft legislation for a proposed change in the way profits are taxed for sole practitioners, partnerships and LLPs that do not prepare their accounts to 31 March or 5 April. Under the proposals, all self-employed individuals and partners will in future be taxed on a tax year basis, rather than an accounting year basis, i.e. individuals will pay tax on profits arising in each tax year, regardless of the firm's accounting date.

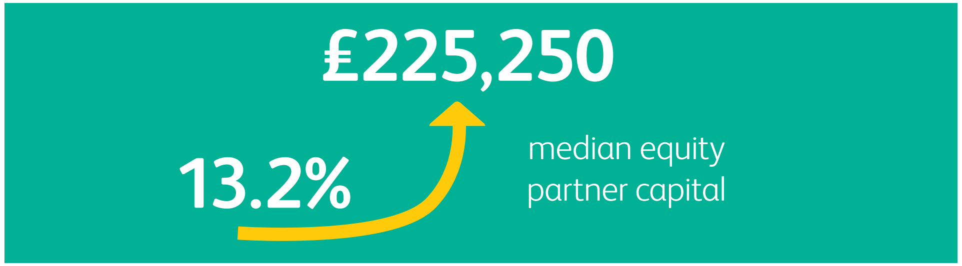
The changes are set to come into effect from April 2023, with a transitional period in the 2023/24 tax year. Limited companies are unaffected.

For most firms, the changes will not involve ultimately paying more tax – rather it is an acceleration of tax payments, and therefore firms will need to manage cashflow to prepare for the changes. Managing lock-up is key to this, and the tips listed earlier in this section can help.

We would also recommend that firms consider introducing partner tax reserves into their accounts if they do not already have them, as this can help ensure that partners do not overdraw profits, leaving themselves short.

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





Bank and other borrowings

88% of participants reported a positive office account balance at their most recent accounting date. This was an improvement on the previous year, when three quarters of the same firms had a positive office account balance. The median office account balance across all participants was £357,000, with all turnover bands reporting a positive median balance.

The median year end balances were significantly higher than in the previous year across all turnover bands, and many firms that we speak to tell us that cashflow is better than it has been for many years. Reasons for this include:

- The arrival of the pandemic in March 2020 forced firms to take a close look at working capital management. At the same time, many firms stopped making profit distributions, and some stopped paying partner drawings too, although this has since returned to a more normal position for most firms. This was largely in anticipation of future challenges rather than immediate cash shortages, and so some firms reported very strong balance sheet positions in their 2020 and 2021 year end accounts.
- As noted earlier in this report, almost three quarters of participating firms had borrowed through either BBILS or CBILS, with median amounts borrowed of £50,000 and £350,000 respectively, and many firms were still holding on to the money at their year end 'just in case'.

Almost two fifths of participants reported that they operated with no overdraft or bank debts at all. For those firms that had bank borrowings and/or a bank overdraft, the median amount per equity partner was £83,771.

Finally, 21% of firms told us that they used secondary funding to finance payments such as the firm's VAT, partners' tax bills and annual practicing certificate renewals.

Figure 8.6: Year-end office account bank balance (£'000)

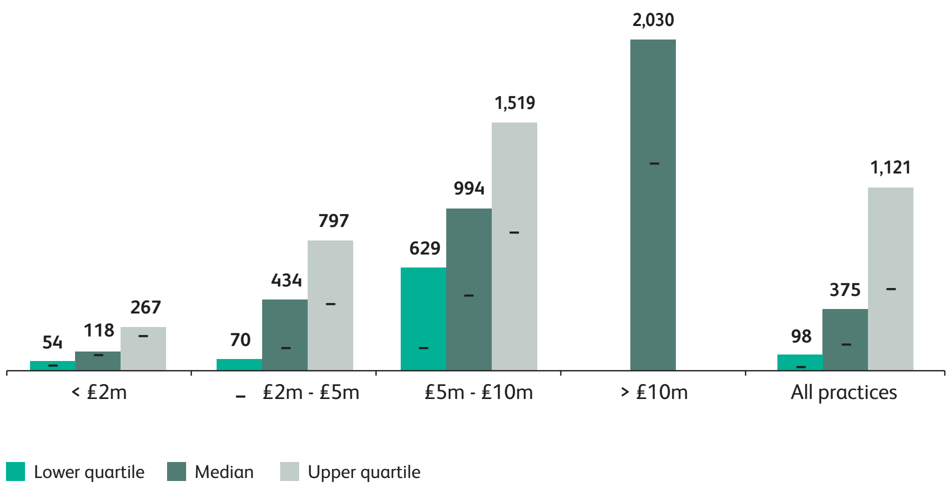


Figure 8.7: Bank borrowings per equity partner (£'000)

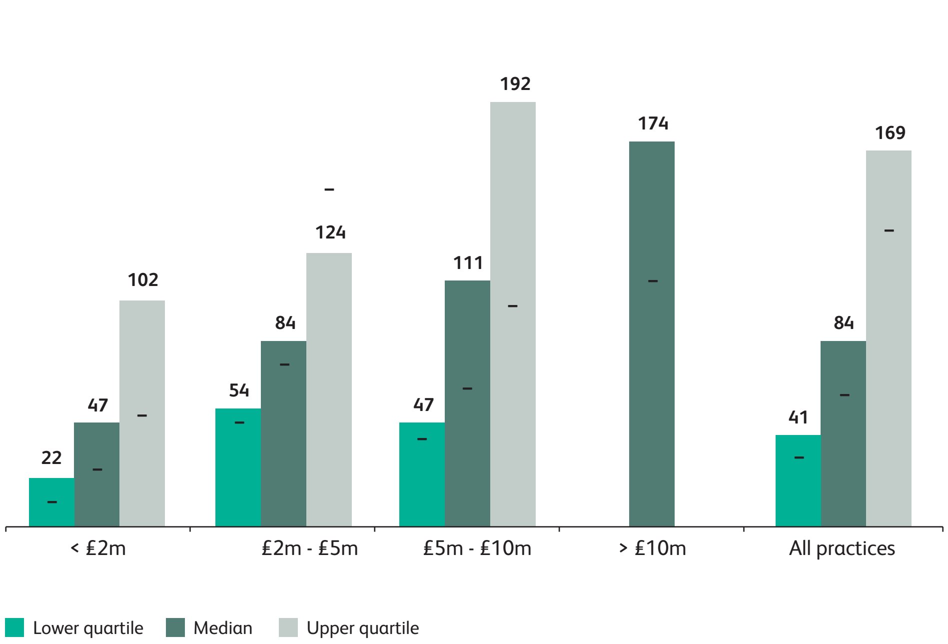
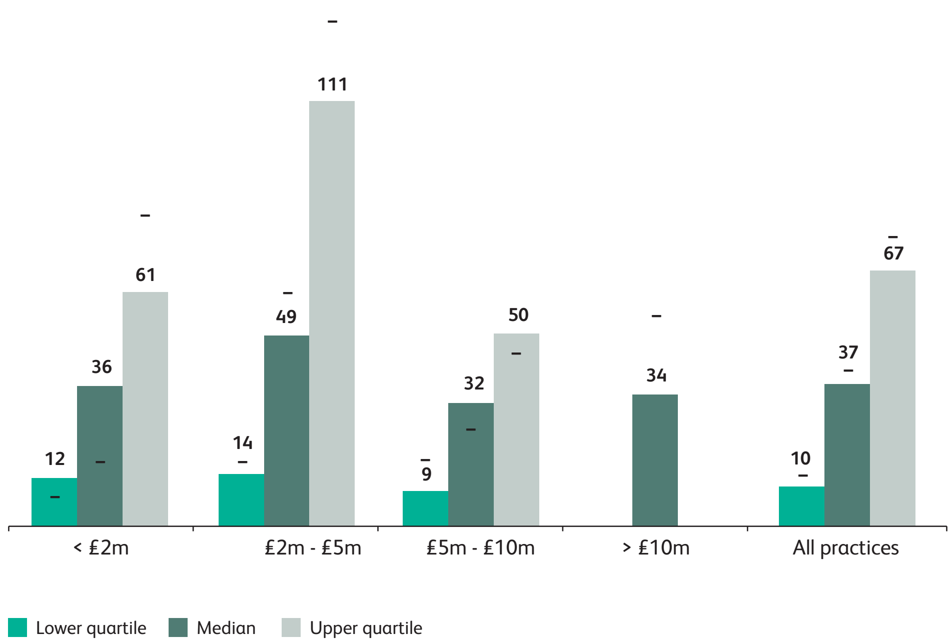


Figure 8.8: Other borrowings per equity partner (£'000)



Banks' attitude to lending

Banks continue to view the legal sector positively overall, although there is an increasing reluctance to lend to firms specialising in areas such as personal injury or clinical negligence work, where very high levels of WIP and disbursements often result in corresponding high levels of external working capital funding.

Whilst most banks have lending options for incoming partners in a partnership or LLP, there are currently very few options for people wishing to buy into a limited company.

Some banks have been hit quite badly by high profile firm collapses in recent years, and those experiences have had a lasting impact on some banks' appetite to lend, especially where a large proportion of borrowings are secured against contingent WIP.

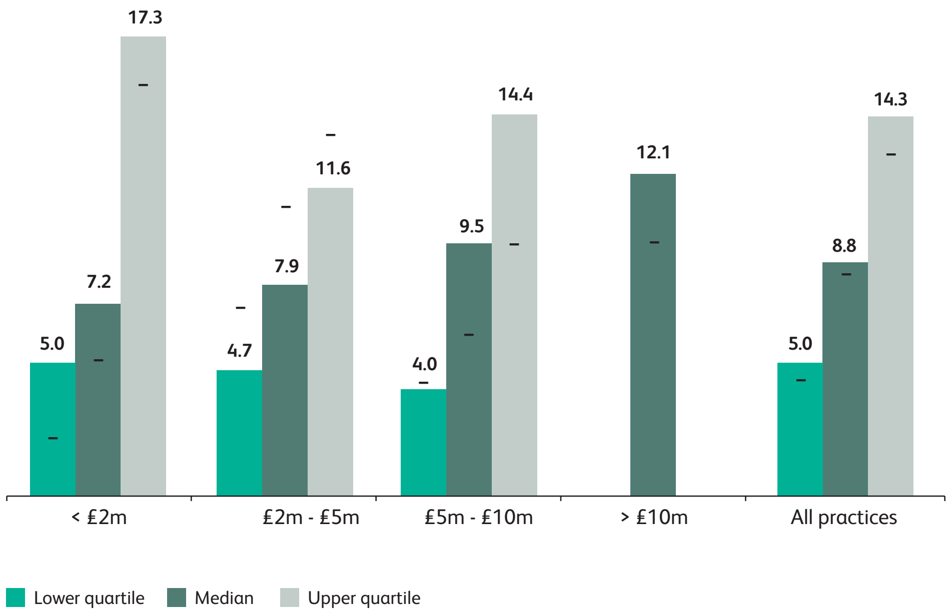
There have been other recent developments that are likely to impact on banks' attitudes to lending:

- From 1 December 2020, HMRC's status as a preferential creditor was restored, which means that when a company goes into liquidation owing money to HMRC, HMRC takes priority over other creditors for certain outstanding taxes. These taxes are those which have been 'paid' by employees and customers through the business, such as PAYE, VAT and employee NIC. The age of these tax debts does not matter, and all outstanding arrears will be given preferential status. Given the number of firms that have taken up HMRC's recent VAT payment deferral scheme, this will be a more acute consideration, at least in the short term.
- As noted earlier, many law firms have borrowed through BBILS or CBILS, either from their main bank or a secondary lender. As a result, the ratio of borrowings to partner capital in those firms will have risen sharply.

Both of these factors could mean that lenders will become more reluctant to lend on an unsecured or floating charge basis, as the chances of recovering funds on a liquidation will be reduced.

Many banks pay close attention to the ratio of borrowings to fee income when assessing a firm's ability to make repayments, and will be concerned to see an increase for the firms in the survey, with a median of 8.8% compared to 8.3% in 2020.

Figure 8.9: Bank borrowings as a percentage of fee income (%)



Financial stability 9.

In 2015, the SRA began risk-assessing law firms based on selected figures from their annual accounts. The three warning indicators identified by the SRA were:

- 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, firms were assessed as red, amber or green, resulting in differing levels of supervision from the SRA. For example, 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.

In recent years, the SRA have moved their attention to other matters, and the majority of the firms 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.

Every year since 2015, we have analysed the information provided by participants to see how they fared against the SRA's original warning indicators. This year's findings are as follows:

- Between 2017 and 2020, we found that partners' total drawings (including income tax) exceeded profits in between 30% and 36% of participants each year. This year, the jump in profitability and growth in partner capital have had a positive impact on this, with partners in just 11% of firms taking drawings in excess of profits. As we have noted in previous years, sometimes this is no more than a timing difference driven by when partners decide to withdraw profits and is more pronounced in firms that carry a large amount of contingent WIP.
- The good news continues. In each of the last six years, we have found that partners in about 15% of firms had taken drawings in excess of profits for two consecutive years, but this year's statistic has dropped to just 5%. Given this is seen over more than one year, it is less likely to have arisen from timing differences.
- Borrowings exceeded current assets (WIP and debtors combined) for 7% of participants, compared to 3% last year, mainly as a result of new BBILS and CBILS debt. Borrowings exceeded equity partner capital for just 1% of firms this year, which is slightly better than last year.